C.D. Howe Institute
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A Tragedy of the House of Commons:

Political Institutions and Fiscal Policy Outcomes from a Canadian Perspective

Kenneth J. McKenzie

Professor of Economics,
University of Calgary,
and
Research Fellow,
C.D. Howe Institute

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Foreword

Canadians, like the citizens of many other democracies, have in recent years become more discontented with the way their political institutions function. A general dissatisfaction with the performance of governments and the apparent lack of responsiveness of policymakers to public concerns have prompted a number of suggestions for reform — modifying the existing first-past-the-post electoral system in the direction of models with more proportional representation, for example, or changing the workings of Parliament and the cabinet to reduce the power of the Prime Minister's Office.

While much dissatisfaction with the way Canadian government operates springs from specific economic complaints, ranging from the National Energy Program two decades ago to the chronic deficits and mounting debt of more recent memory, there has been little attention to the possible effects of changes in governance for economic policy more generally. But the links between governing institutions and economic outcomes is a subject on which both theoretical and empirical research has recently yielded important insights. Accordingly, we asked Kenneth J. McKenzie, Professor of Economics at the University of Calgary and one of Canada's foremost contributors to academic economics and policy research, to bring those insights to bear on Canada's debates over political reform.

As the following pages reveal, Dr. McKenzie has responded impressively. He is both rigorous and accessible as he takes us through public choice theory and its predictions about how policymakers will respond in different political environments, as well as the results of recent empirical research into fiscal policy outcomes under various systems of governance.

His conclusions are at the same time sobering and encouraging. They are sobering in revealing that some high-profile suggestions for reform — in particular, proportional representation in Parliament and a more decentralized budget-making process — might make Canada more susceptible to higher government spending on transfer payments and deficits than under the current system. But while this result will disappoint many who hope that such reforms might improve Canadian competitiveness, it has an encouraging side. It suggests that there is nothing in Canada's current system of governance that biases it toward high spending and deficits — in other words, the adverse fiscal outcomes of the recent past are the result of specific policy choices that could have been made differently, rather than some deep-seated systemic failure. Put simply, it is policy, not the system, that needs reform for a better fiscal future.

The Institute's aim in presenting the Benefactors Lecture series is to raise the level of public debate on issues of national interest by presenting diverse points of view. In doing so, the Institute hopes to give Canadians much to think about, including information they need to exercise their responsibilities as citizens.

I wish to thank our benefactor for this year's lecture, Fairmont Hotels and Resorts and, in particular, William R. Fatt, Chairman and Chief Executive Officer, whose support also enabled us to make copies of the lecture available free of charge.

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Jack M. Mintz
President and Chief Executive Officer
C.D. Howe Institute

Many Canadians perceive that their country suffers from a sizable and growing "democracy deficit." When asked "How much do you trust government to do the right thing?" 59 percent of Canadians responded "just about always" or "most of the time" in 1969. But by 2000, only 30 percent of Canadians felt this way. Currently, only 22 percent of Canadians believe that government policy reflects the interests of the general public; the remainder feel that government policy primarily reflects the interests of big business, politicians and their friends, or special interest groups.[1]

This apparent lack of confidence in government naturally leads commentators to reflect on the nature of our political institutions and to contemplate potential improvements to them. Suggested measures include changes to electoral rules, the reform of cabinet institutions, parliamentary reform, Senate reform, and on and on. Much of the debate is, not surprisingly, concentrated on what one can think of as the "political" aspects of potential reforms: How would they change the nature of representation for different regions and groups in Parliament? What are the implications for party structure in Canada? for the stability and turnover of governments? And so on.

Sometimes lacking in this debate is discussion of the implications that these reforms would have for specific policy outcomes. Yet if we think that outcomes are important and that policy is the outcome produced by the political process, then we must also try to understand how institutional reforms may affect policy choices. The contribution of this lecture is to focus explicitly on the link between political institutions and policy outcomes.

Many aspects of government policy could be examined in this regard. My focus is on fiscal policy, which affects the lives of Canadians every day in important ways. If we are going to have a serious debate about changes to our political institutions, then it is important for us to understand, as best we can, how those changes might affect matters such as the overall size of government, the composition of government spending, the configuration of taxes, debt accumulation, and so on.

I thank, in no particular order, Jack Mintz, Bill Robson, Finn Poschmann, Shay Aba, John Richards, Paul Boothe, Richard Bird, Bob Young, and Ron Kneebone for extremely useful comments on an earlier, much longer draft. So as not to implicate them, I claim sole ownership of their insightful and perceptive comments, while disavowing knowledge of the observations that my own limitations precluded my dealing with adequately.

1 Apparently, Americans are even more disillusioned: only 11 percent feel that government policy reflects the overall public interest. All these polling results were presented by EKOS Research Associates at a public lecture, Exploring North American Economic Linkages, Industry Canada, Calgary, Alberta, June 20–22, 2001.

Several institutional aspects of the political system also need examination. I focus on two dimensions of the politico-institutional landscape in Canada that seem to be particularly relevant to the current debate. The first is the electoral system. A good deal of the dialogue about institutional reform in Canada concentrates on the perceived shortcomings of our majoritarian, first-past-the-post electoral system. A common refrain is that introducing elements of proportional representation would help to alleviate the "democracy deficit" Canadians perceive. Yet few commentators consider how this change might affect the policy landscape in general or fiscal policy in particular. Thus, I discuss here recent research that sheds some light on the implications for fiscal policy of moving from our existing system to one based on proportional representation.

Another argument heard in many quarters is that the policymaking process in Canada is so highly centralized as to be nearly authoritarian, adding to the "democracy deficit." Suggested reforms involve moving away from the existing hierarchical process to a more collegial, decentralized one. Again, few people discuss how such a change might affect the specifics of government policy. Therefore, the second institutional dimension I investigate is the budgetary process itself. In particular, how might changes in the power to propose, veto, amend, or approve of budgetary policy affect the configuration of fiscal policy?

Political reforms along both these dimensions are particularly relevant to the current dialogue in Canada. Moreover, they are linked in some important and not always obvious ways. A recent series of studies published by the Institute for Research on Public Policy examines various aspects of governance and the political process in Canada. Howe and Northrup (2000) conclude, much as mentioned above, that Canadians feel they do not have much to say over what government does, and that elected representatives are not in touch with the people; the authors suggest that many Canadians believe that both the electoral system and the degree of centralization in the policy process are at least partly to blame for this. Articles in the July 2001 issue of *Policy Options* are particularly critical of the first-past-the-post system. Although proposals vary, the most prominent suggestion for reform is the adoption of some sort of proportional representation.

Obviously, this lecture could examine many other types of government policy and other institutional dimensions. Fortunately for the audience, the need for parsimony dictates that I leave those to the consideration of others. In particular, I do not consider institutional aspects related to Canadians' perennially favorite topic of fiscal federalism (see Boothe 1998). I also ignore the impact that government officials and outside experts may have on fiscal policy. The reason is not that these issues are unworthy of consideration, only that I have neither the time nor space to address them here.

Economic Analysis and Political Institutions

I emphasize from the outset that I am an economist! Some of my audience may be skeptical about the role that economics can play in the analysis of political institutions. At least in the eyes of the general public, such analysis is viewed as the domain of political scientists, while economists are seen as being more concerned with policy outcomes.

Indeed, the tendency in much of the formal, mainstream economic analysis has been to treat governments (and their behavior) as given, abstracting from the interactions between economics and politics.[2] For many policy questions this traditional approach, typical of most of the research in welfare economics, has proven quite adequate and generated important insights, but for other questions it has been less satisfactory. The burgeoning field of political economics (the economic theory of politics)[3] lies on the boundary between economics and political science and provides a framework for analyzing the implications of political institutions for fiscal policy outcomes.

The foundation of economic analysis is rationality. Economists assume that rational, self-interested agents (firms, consumers) populate markets and make choices that maximize their sense of well-being. This assumption underpins the vast bulk of theoretical and empirical research in economics. The economic theory of politics applies the same idea to the analysis of political decisions. Thus, rational citizens vote in a way that maximizes their well-being, and rational politicians choose policies that maximize their well-being.

A key question then concerns the motivation behind political decisions. As Anthony Downs put it more than 40 years ago, do political parties "formulate policies in order to win elections, rather than win elections in order to formulate policies" (1957, 29), or does the causality run in the opposite direction? Most of the research considered in this essay reflects, at least implicitly, the view that Downsian opportunism is an important factor in political deci-

2 I refer here to the mainstream. There has always been a strong undercurrent of political economics, going back to Adam Smith, David Ricardo, John Stuart Mill, and Karl Marx. The genesis of the modern treatment can be found in Black (1948); Bowen (1943); Buchanan (1949); and Downs (1957).

3 Although I sheepishly hide the comment in a footnote, the phrases *political economics* and *economic theory of politics* are, in the grand tradition of economics, somewhat imperialistic. Many political scientists follow a similar approach under the heading *rational choice theory*.

sions. Quite simply, politicians benefit from being in office and in power, and they make policy decisions designed to put and keep them there. Similarly, voters choose parties that offer and implement policies that make citizens better off.

This sketch is admittedly oversimplistic. Policy decisions are influenced by partisan, ideological, and altruistic considerations. Similarly, individual voters may have ideological or partisan biases toward particular parties or policies. Nonetheless, I think that we can glean a great deal of insight into the role that political institutions play in affecting policy outcomes if we take the assumption of Downsian rationality seriously and pursue it to its logical conclusions.

The approach serves to highlight the presence of various conflicts within the political process.[4] One conflict exists among voters, who differ in their preferences for the distribution of government spending and the way that those expenditures are financed by various taxes. Another source of conflict arises among politicians, who contend for power. This struggle takes place most obviously at elections but continues afterward within government when policymaking takes place. Political institutions dictate the "rules" under which these conflicts are resolved. The idea is to examine how different institutional frameworks or rules affect fiscal policy choices.

This situation lends itself naturally to economic analysis. Another word for *conflict* is *competition.* In the markets that economists traditionally analyze, there are conflicts between consumers and producers regarding the price and quality of products and among producers over the profits from production. The framework within which this conflict is resolved determines the outcome, which in this case is prices, quantities, product quality, and profits. That framework encompasses both the economic environment — the nature and intensity of competition, preferences, technologies, and so on — and the institutional environment, which includes regulations regarding competition, the design of the tax system, and laws dealing with contracts and property rights. The structure of these institutions establishes the rules under which competition (or conflict) takes place and helps determine the outcome. So it is with the economic analysis of political conflicts.

Fiscal Policy Outcomes and Political Institutions

One of my objectives in this lecture is to speculate on the implications that reforms to Canada's electoral and budgetary institutions might have for its

4 This paragraph and the following one borrow from Persson (2001) and Hallerberg and von Hagen (1999).

fiscal policy. This exercise is a difficult one because each country's political institutions are unique. Thus, although attributing differences in fiscal policy outcomes to differences in political institutions may be suggestive, it cannot mean that importing institutional characteristics from one jurisdiction to another would generate the same outcomes.[5] And outcomes do vary substantially across countries. For illustrations, consider two aspects of fiscal policy: the size of government and the tax mix. Figure 1 depicts total government spending as a share of gross domestic product (GDP) in countries of the Organisation for Economic Co-operation and Development (OECD), while Table 1 shows the tax mix. The variations are substantial. Government spending as a share of GDP ranges from a high of 66 percent to a low of 35 percent. In the case of the tax mix, the share of tax revenues accounted for by the personal income tax ranges from 43 percent to 12 percent, while the share of general consumption taxes ranges from 33 percent to 5 percent.

One explanation for this variation is that it reflects differences in countries' economic structures. That point is no doubt true, but note that the data here are restricted to OECD countries, which are relatively homogeneous from an economic point of view. Another explanation is that the variation reflects the heterogeneity of policy preferences across countries. This too is no doubt true. But in democratic societies, those preferences are reflected in the choices made by the politicians citizens elect to represent their interests. While these choices are influenced and constrained by the economic, social, cultural, and even geographic environment, they are also mediated by the political environment, within whose institutional framework voters transmit their preferences and policy decisions are subsequently made.

A Peek Ahead

It is traditional in lectures such as this to anticipate the conclusions in the introductory section. It is also customary to be provocative in this anticipation so as to give the audience a reason to stay. In this tradition, I claim that the research presented here provides grist for the following argument. Reforms to our electoral system and budgetary process motivated by a desire to address the "democracy deficit" in Canada could generate pressures that

5 The most common criticism of the exercise is that it involves comparing apples to oranges. And indeed, apples and oranges are quite different. But they also have a lot in common — they are both fruit — and they are more like each other than they are like, say, computers. This commonality provides information. So, while ignoring the differences between apples and oranges admittedly ignores important information, so too does ignoring their similarities. In other words, while generalizing from one country to another entails costs, not generalizing entails costs too. (I borrow this analogy from Laver and Shepsle 1996, 287.)

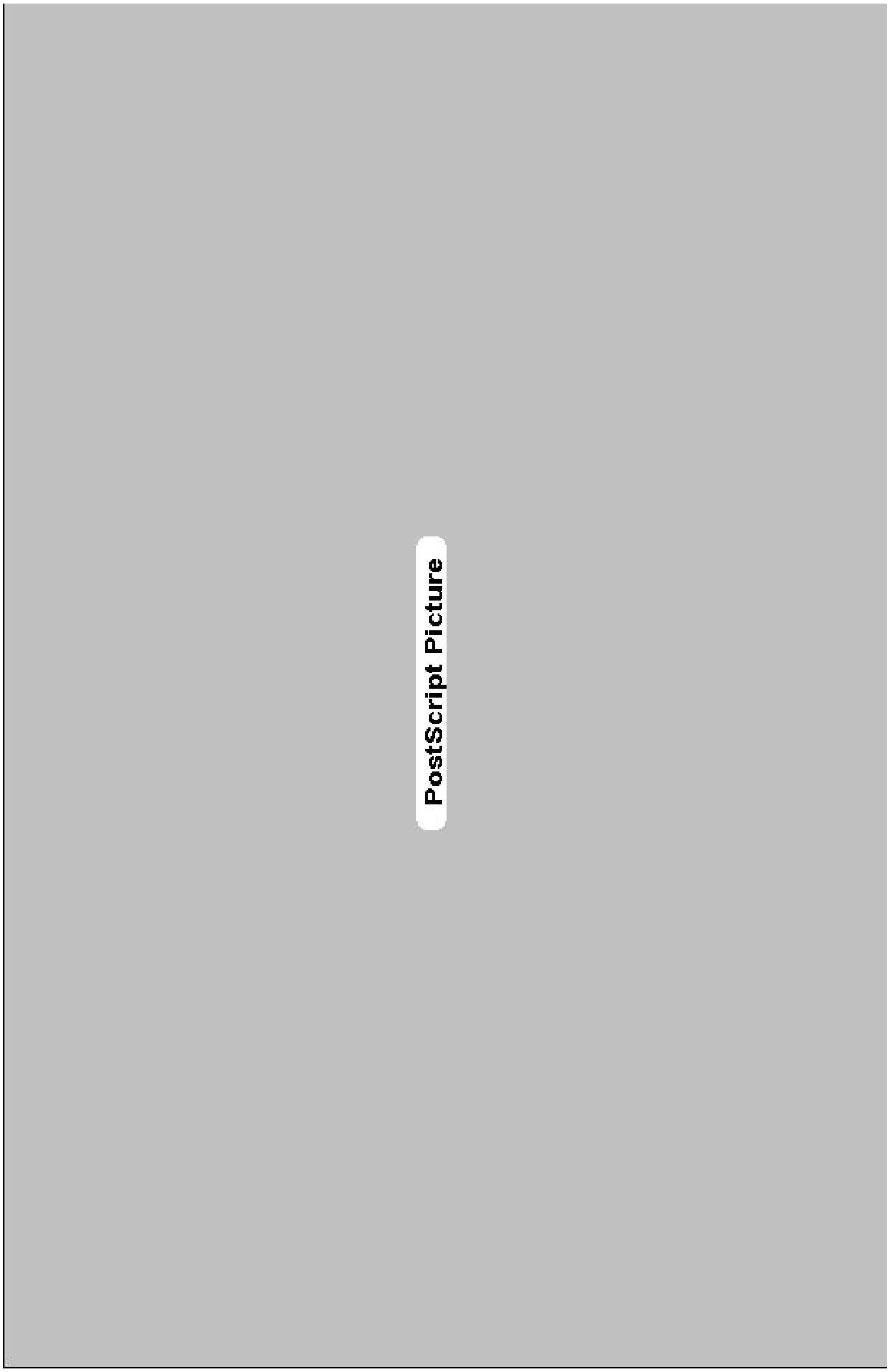
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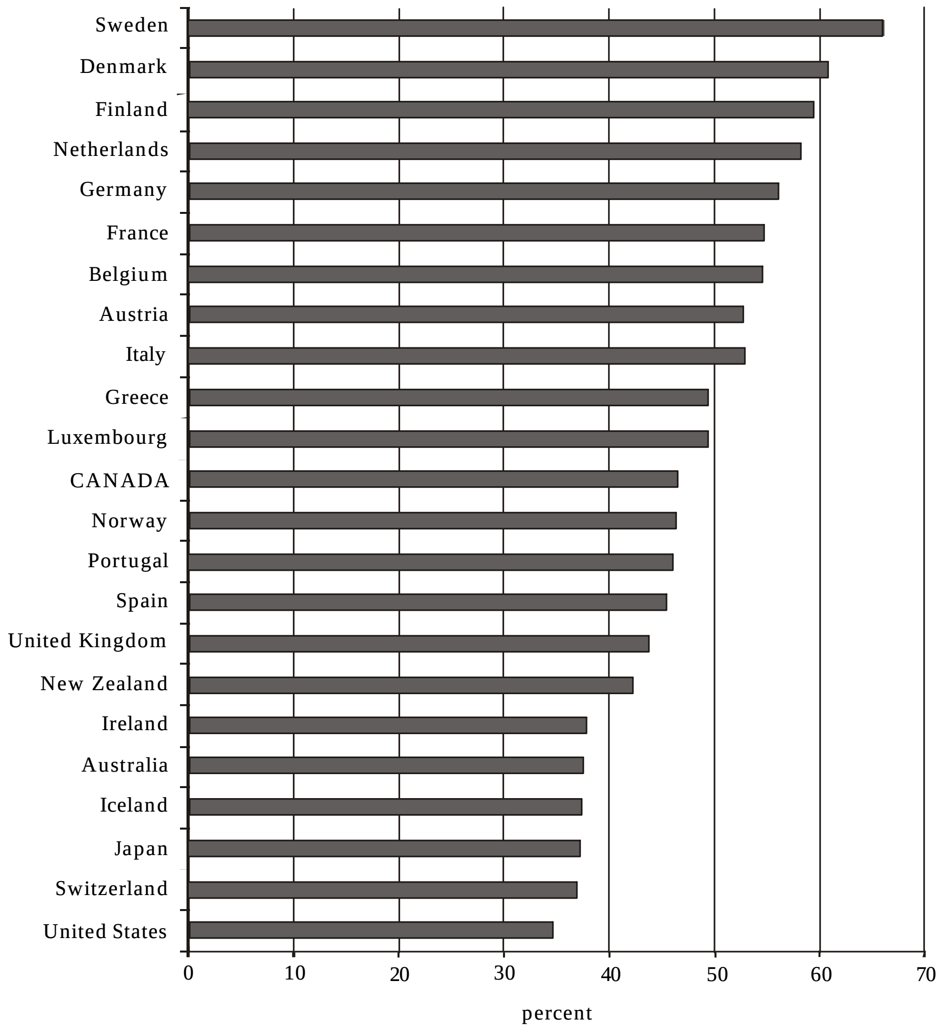
Figure 1: ***Total Government Spending as a Percentage of GDP, Selected OECD Countries, 1999***



Source: Data from OECD 2001.

might lead to the re-emergence of another, more traditional, type of deficit — a fiscal deficit. Governments elected under our existing first-past-the-post system and operating with a hierarchical, centralized budgetary process have been reasonably successful at implementing prudent, sustainable fiscal policy in Canada over the past several years. Reforming our electoral system to make it more proportional, or moving to a less-centralized budgetary process, would create pressures that might jeopardize this success. Much as unfettered access to a common property resource such as a fishery can give rise to overfishing and a Tragedy of the Commons, the types of institutional reforms prescribed above as a remedy to the "democracy deficit" in Canada could create an incentive for government to overfish the pockets of Canadian taxpayers, both current and future, giving rise to a "Tragedy of the *House of* Commons." (People don't call economics the dismal science without reason.)

I recognize, of course, that the persistent deficits and unsustainable fiscal policy that have been addressed over the past several years were generated under the existing system and budget process. But my reference here is to "pressure," and the perspective is a relative one. Although the Latin phrase *ceteris peribus* may bring painful memories to those who suffered through a first-year class in economics, the concept it represents is important. The phrase means "all else being equal" or "holding all else constant." More precisely, my claim is that, *ceteris peribus* and relative to the existing institutional configuration, the types of institutional reforms alluded to above would increase the likelihood of government's deviating from the existing course of fiscal prudence in Canada. However, many other factors affect the fiscal stance of government; political institutions are just one of them.

The remainder of the lecture is organized as follows. In the next section, I present a discussion of political institutions and fiscal policy from a theoretical perspective. I then move on to a discussion of some empirical results. The penultimate section contemplates institutional reforms in a Canadian context. The final section offers some concluding thoughts.

Institutions and Outcomes: Theory

In this section, I discuss some of the theoretical insights and predictions generated by the economic approach to political institutions. I start with the electoral system and then turn to the budgetary process. Important linkages between the two need to be taken into account when contemplating the implications of institutional reforms.

The theoretical discussion is based on stylized economic models that seek to simplify and highlight the key aspects of the political institutions being considered. Aside from being useful in its own right, the economic theory generates some testable predictions about how economic policies may differ in various institutional settings and informs the interpretation of stylized facts that emerge from the empirical investigations I consider later in the lecture.

The Electoral System

For the most part, the debate regarding electoral institutions in Canada has concentrated on our use of a first-past-the-post electoral formula and alternatives to it. Electoral systems come in several types — in their minutiae there are almost as many as there are democratic countries — but all systems fall into one of four broad categories:

- simple plurality (first-past-the-post) systems, in which the candidate with the largest share of the vote wins the seat;
- majority systems in which election requires more than 50 percent of the popular vote, that share typically being achieved via multi-tier or alternative voting;
- proportional representation systems in which the distribution of seats in the legislature coincides with the distribution of the popular vote; and
- mixed systems that combine the features of the other three in some way.

For simple plurality systems, the most glaring problem emphasized by most commentators is the possibility of substantial incongruence between the popular vote and the share of seats in the legislature. Theoretically, with two parties under a simple plurality system, a party can control a majority of seats in the legislature with as little as 25 percent of the popular vote (50 percent of the vote in 50 percent of the electoral districts).[6] And if the election involves more than two parties, one of them could win a majority with an even smaller share of the popular vote.

Despite the variety of alternatives, most of the discussion regarding electoral reform in Canada has focused on moving toward a "more proportional" system. The proposed details of this system differ, but the idea is to implement reforms that would achieve a configuration of seats in the House of Commons that more closely reflects the popular vote. As mentioned earlier, much of the discussion regarding the move to a more proportional system centers on the implications for various "political" phenomena: the fragmentation of representation along regional and linguistic lines, over- or under-representation of groups and regions in the House of Commons and the government, the number of parties, the frequency of elections, government turnover, voter turnout, and so on (see Massicotte 2001; Simpson 2001; Szostak 2001; Rebick 2000). But my concern here is how such a move might affect fiscal policy.

Economists and political scientists have long recognized that there is no unambiguously superior way to aggregate the preferences of individual voters into a collective voice.[7] However, as Tom Flanagan puts it, "[a]lthough no

6 The assumption is, of course, that the districts have equal numbers of voters and equal numbers of seats. If the total number of seats in the legislature happens to be an even number, permitting a tie vote, control of the government requires winning one seat more than 50 percent.

7 Arrow's (1951) "impossibility theorem" is, of course, the seminal reference in this regard.

electoral system is demonstrably the best as a general proposition, it is quite possible that a certain electoral system will be better suited than others to the needs of a particular country at a particular stage in its history" (2001, 38). In order for us to decide which electoral system best suits Canadian needs, we must try to understand the implications of changing the current system, in terms of both the "political" phenomena identified above and economic policy. Several recent studies shed some light on this question. Although much of the research is quite new, some regularities do seem to be emerging.

The political science literature emphasizes two dimensions along which electoral systems differ: district size and the electoral formula. *District size* refers to the number of representatives chosen from each voting district. There are two limiting cases: a district size of one, in which voters elect a single representative to the legislature, and a district size equal to the total number of representatives in the legislature — for example, a countrywide district from which all representatives are chosen.

The *electoral formula* is the rule that determines how votes are translated into seats. The two types of formulas considered here are a simple plurality rule, whereby individuals who receive the highest proportion of votes win the seats in a given district, and proportional representation, whereby seats are allocated in accordance with the popular vote.

Although district size and the electoral rule are conceptually distinct, they tend to be highly correlated in real world electoral systems. We often observe small districts (a low number of representatives per district) in conjunction with a simple plurality or majority rule, and large districts (many representatives per district) in conjunction with proportional representation. This correlation gives rise to a rough dichotomy that can be used to characterize electoral systems:

- majoritarian systems: small districts with plurality rules;
- proportional systems: large districts with proportional representation.

Canada, the United States, and the United Kingdom, with one representative per district and a first-past-the-post electoral formula, are prototypical majoritarian systems, while the Netherlands and Israel, with one countrywide district for all representatives and a proportional representation electoral rule, are prototypical proportional systems. Although degrees of majoritarianism and proportionalism differ across jurisdictions, analysts find it useful to think in terms of this simple dichotomy.

How can the form of the electoral system affect a country's fiscal policy? I focus for now on three basic dimensions of that policy: the overall size of government (as measured by total spending or total revenue as a percentage of GDP), the *spending mix* (the composition of that spending) and the *tax mix* (the composition of the tax system).

The Spending Mix

Researchers identify several ways in which the electoral system can affect the mix of government spending.[8] Many of their results can be conveyed with the help of a simple example. Say a country's legislature comprises 30 elected representatives. For simplicity, assume the existence of only two parties, the Reds and the Blues, a situation that rules out minority or coalition governments. Thus, in order to form a government, a party must win 16 or more seats. The country has three regions — call them Weston, Easton, and Middleton — and to focus the discussion, assume they have the same populations and the same number of voters.

Consider two alternative ways of electing representatives to the legislature. The first is a majoritarian approach with the following features. Each of the three regions is divided into ten electoral districts, with one seat per district. In each district, the party that receives the most votes wins the seat — a standard first-past-the-post system.[9] The second electoral system is proportional on a regional basis. Each region forms a district that is assigned ten seats, which are allocated between the two parties in proportion to the popular vote in that region.

Fiscal policy is characterized by two different types of government spending: expenditures on general public goods that benefit all three regions, and targeted expenditures that benefit only a particular region. Finally, say that, on average, Weston voters are ideologically biased in favor of the Blue party, Middleton voters prefer the Red party, and voters in Easton are ideologically neutral. Thus, Weston can be considered relatively safe for the Blues, Middleton relatively safe for the Reds, while Easton is up for grabs.

With this description in hand, consider the fiscal policy platforms the parties present under the two alternative electoral systems. Presume that each party is purely opportunistic and chooses a fiscal policy platform that maximizes its chance of being elected. Start with a majoritarian system, and take the perspective of the Red party. Given that Middleton is a sure thing while Weston is a lost cause, the best interest of the Reds is to present a fiscal platform favoring expenditures that benefit Easton — with relatively less

8 Key research in this regard includes Persson and Tabillini (2000, chap. 8; 1999); Lizzeri and Perisico (2000); and Milesi-Ferretti, Perotti, and Rostagno (2001).

9 With two parties, simple plurality is akin to majority rule.

expenditure on general public goods that benefit all three regions, and less targeted spending in Weston and Middleton. Such a policy's political cost, in terms of lost seats and a reduction in the party's probability of being elected, is relatively low. Although the strategy will doubtless cost the Reds some *votes* in Middleton, that loss is unlikely to translate into lost *seats* under the majoritarian electoral rule. (Remember, Middleton is ideologically biased in favor of the Red party, and under the majoritarian rule all it needs is more than 50 percent of the votes in each district in order to get all ten seats.) The Reds will also lose some votes in Weston, but since it is effectively a lost cause, they lose no seats.

Clearly, in terms of lost *seats* from Weston and Middleton, the political cost of targeting expenditures toward Eason is relatively low under a majoritarian system. How low obviously depends on the strength of the ideological bias in the two regions. At the same time, the political benefit, in terms of increasing the possibility of winning the seats from the ideologically neutral swing region, may be quite high because, under a majoritarian system, just a small change in the vote in Easton could win the Reds all of its seats.

Of course the Blue party's strategy is entirely symmetrical. It too will offer a fiscal platform skewed in favor of Easton.

A Canadian Example. None of the above is surprising, and any political strategist worth her salt would arrive at exactly the same conclusion. An example can illustrate the point. In 1996, the Canadian federal government introduced various reforms to the employment insurance (EI) system. One of the changes was to reduce EI benefits for frequent users via the introduction of an "intensity rule." Although the rule was criticized in Atlantic Canada — where many seasonal workers realized it would affect them adversely — many economists lauded it, at the time and subsequently, as moving the EI system closer to a true insurance regime (see, for example, Nakamura 1996; 2000).

Political commentators widely accept that the EI reforms cost the Liberal Party a number of seats in Atlantic Canada in the 1997 federal election. But with none of the opposition parties at that time exhibiting anything more than regional strength, the Liberals nonetheless formed a majority government. Complaints from Atlantic Canada continued,[10] however, and during the run-up to the 2000 election, the Liberals seem to have seen reason to change tactics. Just before the dissolution of Parliament, the government

10 See "Ottawa needs to act quickly on its promise: seasonal workers were unfairly attacked in the EI changes a couple of years ago and it's now time to change the legislation," *The Guardian* (Charlottetown), February 5, 2001, final edition, p. A6.

announced its intention of eliminating the intensity rule. The promised policy change was targeted explicitly at Atlantic Canada. At the time, the Canadian Alliance Party was attempting to establish itself as a national party, and although it may be difficult to believe in retrospect (given the outcome of the election and subsequent events), the Liberal camp had some concern that its majority government might be in jeopardy. Heritage minister Shelia Copps provided an indication of this fear in a speech on the eve of the election: "There is a likelihood that if Atlantic Canadians split the vote by voting for the New Democrats or the Conservatives, they will be handing the keys to the kingdom over to the Alliance." Minister Copps went on to promise, "[w]e will fix the intensity clause if we can get a Liberal majority government" (Sharratt 2000, A3).

This example is provided merely to clarify the point, not as confirmation of the theory. But it appears that the Liberals viewed Atlantic Canada as an important swing region in the 2000 election. With much of Ontario and some of Quebec considered relatively safe and most of Western Canada a lost cause, targeting spending to the Atlantic region was perfectly consistent with rational, opportunistic political behavior in the presence of a majoritarian voting rule. At the time, the Canadian Alliance naturally protested that the move was nothing more than "vote-buying" (Mofina 2000, B7). Of course it was. The economic approach to politics assumes that virtually *all* fiscal policy is motivated by vote buying, at least to a degree. This motivation is not inherently good or bad, it just exists, and it must be taken into account in trying to understand political choices. For our purposes, insight comes from distinguishing among the *patterns* of vote buying that may occur under different electoral systems.

Proportional Representation. Consider the fiscal policy choices of the parties under a proportional electoral system. In the example we have set up, opportunistic parties under a proportional system also present fiscal policies that target spending toward the region of Easton, for much the same reason — swing voters are important regardless of the electoral system. But are the incentives to skew the spending mix in favor of Easton of the same magnitude as under a majoritarian system? Is the pattern of vote buying the same? Some reflection suggests that the answer is no because the change in the electoral system alters the nature of the political costs and benefits of spending in each region. Unlike the case under a majoritarian rule, where a loss or gain in popular vote does not necessarily translate into a loss or gain in seats, under a proportional system a loss or gain in votes is reflected directly in the seat count. Thus, while each party benefits from directing expenditures toward Easton, the cost of doing so, in terms of lost seats in Weston and Middleton, is greater under a proportional system than under a majoritarian system. Whereas a small diversion of spending away from Weston and Middleton and a resulting loss in *votes* may have no impact on a party's *seats* in those regions under a majoritarian rule, it probably will under a proportional rule where seats shares correspond to the popular vote. Moreover, the benefits of increasing spending in Easton are also smaller under a proportional system; rather than potentially gaining all the seats by tipping the popular vote, the party can gain seats only in proportion to the increase in its share of the vote.

Overall. Using reasoning such as this, the economic approach to politics predicts that opportunistic political parties will allocate spending across regions and between general and targeted spending so as to equate the political benefit of spending one more dollar in each region (the expected increase in seats in that region) to the political cost (the expected decrease in seats in other regions). When the net marginal political benefits are equal across all the regions, opportunistic parties cannot alter the spending mix so as to increase their probability of being elected.[11] Under a majoritarian system, the marginal benefit of targeting spending toward the swing region (Easton) is higher and the marginal cost is lower than under a proportional system. In other words, electoral competition under a majoritarian system is more intense in swing regions. One result is more targeted spending and less spending on general public goods than under a proportional voting system.[12]

Our simple example illustrates how the electoral system may influence the mix of government spending by changing the nature of the political cost-benefit tradeoff and the intensity of competition over swing voters. We can introduce various subtleties and complexities into the analysis without changing the basic conclusions. For example, one implication of the analysis is that, under proportional systems, governments will tend to favor broad demographically and socially based spending, while under majoritarian sys-

11 To see this point, consider a situation in which the expected gain in seats from spending one more dollar in Easton is greater than the expected loss in seats from spending one dollar less in Weston. Clearly, the party can increase its expected seats by increasing spending in Easton by one dollar and reducing spending in Weston by one dollar. When the expected gain in seats from diverting a dollar from one region to another is equal to the expected loss in seats, the party has maximized its chances of winning the election.

12 In some ways, the difference in the equilibrium outcome under majoritarian and proportional systems is reminiscent of the difference in the equilibrium outcome under Bertrand and Cournot competition in industrial organization. By changing the way that firms compete, the rules of the game in a Bertrand model result in more intense competition in the sense that firms can get the entire market by undercutting their rivals.

tems, governments prefer regionally or geographically targeted spending. We may, therefore, expect to observe proportionally more spending on general transfers, such as health care, education, social security, and welfare programs, in proportional systems than in majoritarian systems. Similarly, majoritarian systems are likely to spend relatively more on regional transfers and on government goods and services, expenditures that can be more easily targeted to swing districts (see Lizzeri and Perisico 2000; Milesi-Ferretti, Perotti, and Rostagno 2001; Scartascini and Crain 2000).

Another implication follows from recognizing that the distribution of swing voters need not be a geographic one. For example, middle-income earners may be more likely to be ideologically neutral than lower- or upper-income earners. If that difference exists, a majoritarian system is likely to target more spending to middle-income earners than one elected under a proportional system.

The Size of Government

To this point, the analysis has focused on the spending mix, suggesting that proportional electoral systems generate more spending on broadly distributed pubic goods and less on targeted spending than majoritarian systems do. What about the overall size of government spending?

In the standard welfare economics approach, which ignores political and institutional considerations, a factor that limits the overall size of government is the presence of distortions arising from the taxes used to finance government spending. By changing relative prices in the economy, taxes distort all sorts of economic decisions, including those related to labor supply, savings, and investment. These distortions lead to an additional loss in income in the private economy, over and above the tax revenue collected.[13] This additional loss in income is called the *excess burden* of the tax. And the excess burden associated with a particular tax rises with the tax rate at an increasing rate — a doubling of the rate more than doubles the excess burden of the tax. The increase in the excess burden associated with raising more tax revenue eventually exceeds the additional benefit of the expenditure financed with the tax revenue. Thus, the loss in income associated with distortionary taxes limits the size of the public sector.

13 For pedagogical reasons, I am being somewhat imprecise here. In fact, excess burden can arise even if there is no change in economic behavior due to the imposition of a tax. What is important is the presence of a substitution effect whereby behavior changes after the individual is (hypothetically) compensated for the loss in welfare due to the income effect arising from the imposition of the tax.

What happens if we introduce political considerations into this cost-benefit analysis? The key question for our purposes is whether the type of electoral system might influence how government internalizes the tax distortions and the economic costs associated with them. One strand of research suggests that, just as politicians in majoritarian systems do not fully internalize the loss of income associated with lower spending in “non-swing” districts, they also do not fully internalize the reduction in income associated with levying distortionary taxes in those districts. The implication is that overall government spending (and taxes) in majoritarian systems is higher than in proportional systems (see Persson and Tabellini 1999; 2000, chap. 8).

This conclusion may, however, be too simplistic. Other research suggests that the impact of the electoral system on the overall size of government depends on the size of the public sector to begin with — in particular, on the size of broad social transfers relative to targeted expenditures. For example, regardless of the type of electoral system, developed countries tend to have public sectors that are much larger (as a proportion of GDP) than those of less-developed countries. Moreover, spending on social transfers relative to more targeted expenditures on goods and services tends to be higher in developed countries. Some research suggests that an increase in the degree of proportionality in the electoral system is associated with an increase in the size of the government sector in developed economies but with a decrease in the size of the government sector in less-developed economies (see Milesi-Ferretti, Perotti, and Rostagno 2001).

A third strand of research emphasizes the interaction of the electoral system with the budgetary process. The prediction here is that the overall size of the public sector may be higher in proportional systems than in majoritarian systems because of their respective impacts on the budgetary process (see Scartascini and Crain 2000; Hallerberg and von Hagen 1999; and von Hagen and Harden 1995). I have more to say about this below.

All of this suggests that, despite some theoretical ambiguity regarding the impact of electoral systems on the size of government, we have some reason to expect that spending may be higher under proportional systems than majoritarian ones, at least in developed countries.

The Tax Mix

Governments can finance expenditures by levying taxes on personal income, corporate income, total consumption, wealth, sales of particular goods and services, exports, imports, and so on. They also can modify these bases by using special provisions, such as deductions, credits, and exemptions. Does the electoral process affect government's choice of the tax mix?

As stated above, all taxes distort economic decisions by imposing an excess burden of taxation. A related concept is the *marginal excess burden* of taxation, which is the increase in the excess burden associated with raising one more dollar of tax revenue from a particular source. All else being equal, the more responsive individuals are to changes in the tax rate, the higher the marginal excess burden of a tax. The reason is obvious: the more responsive individuals are, the greater the distortion the tax causes.[14]

The standard welfare economics approach to the tax mix presumes that government seeks to minimize the total excess burden associated with raising a given amount of revenue. The suggestion is that the tax mix should be chosen so as to equate the marginal excess burden across all revenue sources.[15] The resulting configuration of tax rates is such that higher taxes are levied on activities that are less responsive (less sensitive) to the tax rate.

The standard welfare economics approach to taxation can be modified to take distributional considerations into account. For example, the objective of minimizing the excess burden of the system may result in high tax rates on some items, such as food and housing, that poorer individuals consume in greater proportion to income than their better-off compatriots. But the voting population may deem that outcome socially unacceptable. The tax system can take this preference into account by attaching social welfare weights to different groups of individuals (see Dahlby 1998). This approach generates what is called a *social marginal excess burden* associated with each revenue source. The optimal tax mix then exists when the social marginal excess burden is equated across the various revenue sources. The problem with this theoretical approach is that it says nothing about what the social welfare weights should be or where they come from. The reason is that any ethical criteria used to determine the social welfare weights are, by their nature, subjective and arbitrary.

14 This statement, like my earlier assertion about the excess burden, is somewhat imprecise; the key is the size of the substitution effect (see note 13).

15 The argument should now be familiar. Consider two revenue sources: a tax on ice cream and a tax on chocolate. If the marginal excess burden of the ice cream tax is greater than that of the chocolate tax, then the tax on chocolate could be reduced by one dollar and the tax on ice cream increased by one dollar, raising the same revenue but at lower economic cost (excess burden). When the tax rates on the two goods are chosen so as to equate the marginal excess burden associated with each tax base, it is no longer possible to lower the economic cost associated with raising the required tax revenue by altering the tax mix. In other words, the tax mix now minimizes the economic cost of raising a given amount of tax revenue.

The political economic approach to tax policy is more pragmatic. Rather than looking at the issue from a normative (prescriptive) perspective and asking what the social welfare weights *should be*, it takes a positive (descriptive) perspective and asks what they *are*. Or rather, for our purposes, what determines what they are? It recognizes that politicians may have objectives that differ from minimizing the social excess burden of the tax system, but they are the people who make tax policy decisions. The political economic approach to tax policy presumes that politicians undertake a similar type of cost-benefit analysis to that suggested by the welfare economics approach but with an important difference — they focus on the political cost rather than on just the economic cost associated with raising an additional dollar of revenue from each source. The marginal political cost of a particular tax is the decrease in the probability of being elected associated with raising one more dollar of tax revenue from that revenue source. The politically optimal tax mix is then one where each revenue source is utilized up to the point where the *marginal political cost* of raising an additional dollar of tax revenue is equalized across all sources (see Hettich and Winer 1988; 1999).

The implication is that the politically optimal tax system is characterized by tax rates and tax incentives targeted at different groups and that the relative tax burden imposed on each group is determined not only by its members' sensitivity to the taxes imposed (which determines the excess burden imposed on them) but also by their political influence (weight) in the political cost-benefit analysis.

So far, all this discussion of the tax mix is reminiscent of my discussion of the spending mix — with one important exception: there has been no mention of the role that the electoral process may play in the formulation of the tax mix. The reason is that current research in the political economics of tax policy tends to abstract from the institutional context of the political decisions and instead focus on the role of things such as administrative costs and the sensitivity of various taxpayers to different taxes in the determination of a politically optimal tax mix. As already indicated, this research suggests that the configuration of the tax system is determined by the sensitivity of different groups of taxpayers to the taxes imposed on them, the desire to economize on administration costs, and the political weight of each group. But, as is the case with the normative welfare economics approach, where the political weights come from is not specified.[16] What is missing is an understand-

16 Strictly speaking, this statement is not true. There is a good deal of research relating to the role of interest groups in this regard (see, for example, Hettich and Winer 1988; 1999). For the sake of parsimony, I forgo a discussion of interest groups in this lecture.

ing of how the institutional context of political decisions in general and the electoral system in particular may help determine these political weights.[17]

In some recent unpublished work (McKenzie 2001), I try to address this issue by explicitly incorporating electoral rules into a political economic model of the tax system. I show that the electoral process helps to determine the political weight the parties attach to each group of taxpayers. By altering the intensity of political competition over swing taxpayers' groups, the electoral process determines the weight attached to each in the political cost-benefit analysis. Under a majoritarian system, swing groups of taxpayers have more weight than they do under a proportional system, for much the same reasons discussed above.

The implication is that, as with the spending mix, majoritarian electoral systems tend to generate a tax mix that involves preferences targeted more intensely to swing voters than proportional systems do. Unfortunately, this insight falls short of painting a precise picture of what the tax mix is likely to look like under the alternative electoral systems. The actual tax system depends on the distribution of swing voters across groups and the characteristics of these voters. With respect to the latter, what matters is the correlation between political ideology and variables such as income, consumption, and wealth, which represent the tax bases. For example, if we think that ideologically neutral voters tend to occupy the middle of the income distribution, we might expect to observe more features that favor middle-income earners in the tax mix of majoritarian systems than in the tax mix of proportional systems. We may also expect to observe more complex tax systems in majoritarian than in proportional systems, as targeting swing groups may naturally be associated with more complexity. The extent to which tax provisions can be targeted to swing voters, groups, or regions may thus be limited by the costs associated with administering such provisions (Hettich and Winer 1999).

Measuring the degree of targeting and the complexity of different tax systems is difficult, especially when many diverse jurisdictions are involved. One conjecture is that it may be easier to tailor tax provisions to individual or group characteristics in the case of a direct tax such as an income tax than in the case of an indirect tax such as a value-added tax. Thus, all else being equal, we might expect to observe majoritarian systems relying more on income taxes, relative to value-added taxes, than proportional systems do. This prediction is, however, very rough given the wide range of variations in the features of income and sales tax regimes.

17 An exception is Chen (2000).

The Budgetary Process

To begin our discussion of the implications of the institutional structure of the budgetary process for fiscal policy, consider the following thumbnail sketch of how budgetary policy is formulated in Canada.[18] In conjunction with her senior officials and with guidance on the general budgetary stance from the prime minister and his officials, the minister of finance prepares a draft budget to present to cabinet. It is, in principle, next discussed and modified within cabinet and then introduced by the minister of finance to the House of Commons, where it receives first reading and is voted on without debate. Debate on the budget begins with second reading, although no amendments are allowed at this stage. Having received approval at this stage, the bill is referred to the Standing Finance Committee, which then reports back to the House. In the subsequent report stage, amendments emerging from the committee are discussed and voted on, as are amendments offered from the floor. The bill then goes to third reading, in which it is voted on without debate. Afterward, the bill is sent to the Senate, where it goes through a similar process. The culmination is the presentation to the governor general for Royal Assent.

This description of the budgetary process is technically accurate, if somewhat abridged, but it is also misleading. In practice, the process in Canada is very hierarchical and extremely centralized. It is almost the exclusive domain of the minister of finance and her bureaucracy in the Department of Finance, as well as the Prime Minister's Office. Most of the "real work" on the budget takes place within the Department of Finance before it even goes to cabinet, and other cabinet ministers typically have little to say on budgetary matters. So long as the budget has received the stamp of approval from the prime minister, it is likely to pass through cabinet unscathed. Moreover, although the procedure provides scope for amendments at both the committee and the report stage, in practice as the budget travels through the legislature, it is extremely unlikely to undergo substantive changes because of the very high degree of party discipline characteristic of the Canadian parliamentary system. Although the budget bill undergoes nominal scrutiny in the Senate, in practice this step is irrelevant, as the Senate typically rubber-stamps financial bills that have passed the House of Commons. Normally, the budget that the minister of finance takes into cabinet and the budget that ends up on the desk of the governor general for Royal Assent are virtually indistinguishable from each other.

18 The description is based on Archer et al. (1999).

Of course, it does not have to be this way. In principle, the budgetary process has a good deal of scope for involvement by numerous participants at virtually every stage. What might we expect to happen if Canada followed a more collegial, less centralized approach to the formulation of budgetary policy? In this section, I discuss some research that sheds light on this question. The discussion is divided into three parts: in the first, I focus on the budgetary process within cabinet; in the second, I deal with the legislature; and in the third, I turn to legislative committees.

The Cabinet

Consider a common property resource, such as a fishery, characterized by free, unfettered access. When deciding whether to put the effort into catching an additional fish, an individual fisherman cares only about the benefit he receives from the private cost he incurs for catching that fish; he has no incentive to take account of the costs his catch imposes on other fishermen. Those costs arise because each fish he catches reduces the stock of fish for all fishermen, lowering the probability that others will catch another fish. With each fisherman ignoring the cost he imposes on others, focusing only on his individual benefit (and cost), the result is overfishing — an example of the *common pool* or Tragedy of the Commons problem.

What do fishermen and politicians have in common? The political benefits cabinet ministers receive are derived, in part, from their ability to deliver economic benefits to their constituents. This phenomenon need not be geographic; other sorts of constituencies also benefit from government policies that a cabinet minister promotes. For example, the idea of *regulatory capture* suggests that cabinet ministers may be captured by (become advocates for) the clientele served by their ministry.[19] A quintessentially Canadian manifestation of this involves the dual role of ministers in Canadian cabinets — as advocates both for their ministries and for the region that they represent. The resulting narrowness of focus generates a *decision externality*[20] whereby cabinet ministers do not take full account of the social costs or benefits associated with their decisions. Individual ministers thus have an incentive to promote policies that benefit certain groups or regions, while not fully accounting for the costs borne by others. For example, a minister may promote a spending program that benefits his particular region or ministry. That pro-

19 For early work on regulatory capture, see Stigler (1971) and Peltzman (1976).

20 The term *decision externality* comes from Hettich and Winer (1993; 1995); von Hagen and Harden (1995) use *fiscal illusion*. The two phrases allude to the same basic idea.

gram must be financed by taxes paid by all taxpayers, many of whom do not benefit from the spending program.

What fishermen and politicians have in common, therefore, is that they both exploit a common property resource. Whether that resource is fish or the pockets of taxpayers, the implication can be the same: overexploitation. For the same reason that fishermen fish too much, governments may spend too much.[21] Similar considerations also suggest the presence of a deficit bias. The reasoning here is that individual ministers may not take full account of the costs future taxpayers must pay because of deficit financing. The presence of decision externalities therefore suggest governments have both a spending and a deficit bias.

Or do they? The discussion so far has been devoid of an institutional context within which decisions are made. The key to solving a common property resource problem is somehow to internalize the externality, forcing individuals to face the true, full costs of their actions and decisions, including the costs imposed on others. Several institutional responses to the Tragedy of the Commons attempt to do so. One approach often advocated for situations such as a fishery is to impose a Pigovian *corrective tax* on each fish caught. If that tax is set equal to the cost that a fisherman imposes on the other fishermen by catching an additional fish, he tends to internalize the cost of his actions on others and the socially optimal amount of fishing takes place — overfishing is eliminated.

Although the idea of imposing corrective taxes on politicians is intriguing, if not tempting, two other institutional responses to the common pool problem may be more relevant for our purposes. One is to invest *monopoly control* over the common property resource with a particular fisherman. He will then internalize all the costs and benefits associated with catching an additional fish and exploit the resource at the socially optimal rate.[22] The other such response is to establish an institutional structure that facilitates bargaining and negotiation among fishermen. They can then collectively negotiate a system of side payments or quotas that internalize all of the costs and benefits of fishing. This negotiated approach to the common property resource problem is due to the insight of Ronald Coase and is thus referred to as *Coasian bargaining*. The capacity of such bargaining to achieve an opti-

21 The analogy between budgets and a common property resource has been pointed out by several authors, including von Hagen (1991; 1992); von Hagen and Harden (1995); Hallerberg and von Hagen (1999); Velasco (1999); Feld and Kirchgassner (1999); and Hettich and Winer (1993; 1995).

22 Of course, I presume here that the assignment of monopoly control does not give rise to other distortions associated with monopoly, such as distortions in the price of fish.

mal outcome depends on the costs of negotiation and on the ability to monitor and enforce the subsequent agreement.

Some Research. What does all of this have to do with the institutional structure of decisionmaking within cabinets? The two approaches I described to force the internalization of externalities that arise from a common property resource suggest two alternative institutional approaches to cabinet decision-making that may be used to encourage internalization of decision externalities and thus to moderate the spending and deficit bias of governments. An emerging research program examines the implications of different budget processes from this perspective (see Breton 1991; von Hagen 1991; 1992; von Hagen and Harden 1995; Hallerberg and von Hagen 1999; Alesina et al. 1999).

Consider, for example, a budget process in which each minister merely submits to cabinet a budget for his own ministry, treating all other ministry budgets as given, with a simple vote taken on the result. This process generates an outcome similar to that described above — a budget in excess of the social optimum because of the presence of decision externalities.

Now consider two alternative budget processes.[23] Under the first, strategic budgetary authority is invested with a single individual — call her the finance minister. She sets the agenda in budgetary matters, makes the initial budgetary proposal, and has the power to constrain amendments offered by other ministers. She also has control over the information flow to the other ministers and has the backing of the prime minister. The finance minister thus plays the role of the “fiscal entrepreneur” or “kingfisher” in the budget process. This role is an important one, as the finance minister does not suffer from a decision externality to the same extent as the other, “spending” ministers. She does not answer to a narrow constituency or coalition of interests but rather to the broader interests of all taxpayers. Moreover, the finance minister is often judged more on the overall size of the budget or of the deficit (or surplus) than on the distribution of the budget across various groups and constituencies. Thus, she can internalize the decision externalities discussed above. Investing strategic budgetary control with the finance minister is therefore akin to providing monopoly control over certain aspects of the budget to a single minister, an approach that serves to internalize the decision externality. This sort of process is sometimes referred to as *hierarchical* or *centralized* cabinet process.[24]

23 Much of what follows is based on von Hagen and Harden (1995) and Hallerberg and von Hagen (1999).

24 This terminology follows that of Alesina et al. (1999). Hallerberg and von Hagen (1999) use *delegation.*

Under the second budget process, the government commits itself to an overall budgetary target, which is established not by the finance minister but by the cabinet collectively via negotiation. Once the overall budget target is set, ministers bargain over its allocation. Because the overall size of the budget is set in the first stage, subsequent negotiations over allocation must satisfy this constraint. (Previously legislated tax, spending, or borrowing limits can accomplish the same thing.) One result is to internalize the fiscal externalities. Any negotiated outcome requires monitoring and enforcement. The finance minister plays this role in the process, which is referred to as a *collegial* or *decentralized* cabinet process.[25]

Hierarchal versus Collegial Processes. In referring to the conflict between the finance minister and the spending ministers in the budgetary process, Aaron Wildavsky (1984) employs the terms "guardians" and "advocates." Canadian political scientist Donald Savoie uses this idea to describe how "spending departments act as advocates for their programs and for increased spending while central agencies, such as the Department of Finance and the Treasury Board secretariat try as best they can to exert control on spending as the guardian of the Treasury" (1990, 6). The two types of budget processes discussed above determine how the guardians and the advocates interact with each other. Both approaches involve bargaining among ministers. It is really a matter of degree, the distinction lying in the relative strength of the bargaining positions. However, the rough dichotomy of centralized versus decentralized (hierarchical versus collegial) serves a useful expository purpose.

The idea that the institutional framework that governs bargaining within cabinet has important implications for fiscal policy is prominent in the work of Canadian political economist Albert Breton (1998) and Canadian political scientist Douglas Hartle (1982; 1998). Breton, for example, emphasizes the role of budget secrecy. In Canada, even other cabinet members are not privy to the details of the revenue budget until a couple of days before the minister of finance tables the budget. Most analysts view secrecy as necessary to maintain the external integrity of the budget process, but Breton focuses on its internal consequences for budgetary policy. By controlling the information flow within the government, budget secrecy weakens the bargaining position of the spending ministers, who are unable to revise their own bargaining strategies in light of possible concessions the finance minis-

25 Once again the terminology follows Alesina et al. (1999). Hallerberg and von Hagen (1999) use *negotiated commitment*.

ter makes to others. This situation strengthens the position of the finance minister as fiscal entrepreneur (Breton 1998, chap. 4).

Just as monopoly control or Coasian bargaining over a common property resource can lead to a reduction in overexploitation, hierarchical and collegial budget processes can moderate the spending and deficit bias of the executive. Two important questions now come to mind. Under what conditions may we expect one or the other of the two budgetary procedures to be employed? And can we expect one of these approaches to be more effective than the other at moderating decision externalities?

The response to the first question is partially rooted in the structure of the electoral system, which can strongly influence both the number of political parties in the legislature and the likelihood that a single party wins a majority of parliamentary seats (see Lijphart 1999). Majoritarian systems are typically associated with fewer parties and are more likely to produce single-party governments. Proportional systems are associated with more parties and are more likely to produce multiparty (coalition) governments.

A hierarchical cabinet process is more likely to emerge in the single-party governments typical of majoritarian electoral systems. Indeed, it is difficult even to imagine a hierarchical cabinet structure in a coalition cabinet. Members of the same party share ideological views, and the primary source of conflict among cabinet ministers is likely to be the common pool problem discussed above. In coalition governments, on the other hand, conflicts are likely to emerge on a number of additional dimensions. Moreover, in the single-party governments typical of majoritarian systems, the prime minister is particularly strong (as manifested in his ability to appoint and dismiss cabinet ministers) and is therefore able to support a finance minister who is playing the role of fiscal entrepreneur. In the coalition governments typical of proportional systems, however, the prime minister is usually more concerned with holding the coalition together than with supporting the finance minister. For these reasons, the expectation is that we would observe collegial cabinet processes in countries with proportional electoral systems and hierarchical cabinet processes in countries with majoritarian systems. Casual observation suggests that this is indeed the case.[26]

This brings us to the second question: Can we expect the spending and deficit bias due to the common pool problem to be moderated more in hierarchical (majoritarian) systems than in collegial (proportional) systems? The bias may be higher in collegial systems than in hierarchical systems, for two reasons. The first is that, in the environment of a collegial cabinet, Coasian

26 Hallerberg and von Hagen (1999) show that cabinet processes in European Union countries are almost perfectly explained by the features of the electoral systems.

bargaining's capacity to internalize the decision externality depends in part on the associated costs. As the number of parties increases, so do those bargaining costs, and the moderation of the spending bias thus decreases.

A related explanation is based on the notion of universalism. As the number of parties represented in the legislature increases, the number of party combinations that can form a minimum winning coalition (MWC) — the minimum number of seats required to form a majority — rises. Thus, as the number of parties increases, the government coalition becomes less stable, as more alternative coalitions can defeat it. Moderating this instability, coalition governments have an incentive to negotiate budgets that do more than merely satisfy the requirements to maintain the existing MWC. Rather, cabinets may seek virtual unanimity by passing budgets that include the favorite expenditure programs of several parties in the coalition, not just those that form the MWC.

For both these reasons, the collegial cabinet processes that are typical of proportional systems may be less successful than the hierarchal processes typical of majoritarian systems in moderating the spending and deficit bias resulting from the presence of decision externalities (see Scartascini and Crain 2000).

An Illustration. I can usefully conclude this discussion with Albert Breton's illustration of the role the bargaining process within cabinet can play in the determination of fiscal policy (1998, chap. 4). In 1979, the federal government implemented the Policy Expenditure and Management System (PEMS) or envelope system for the expenditure budget. One of the implications of PEMS was to change the nature of bargaining between the finance minister and the spending ministers. Rather than the finance minister's bargaining with individual ministers over the allocation of funds, PEMS created superministers to do the bargaining for entire groups (envelopes) of ministries. Breton argues that, by changing the nature of competition among the ministers, PEMS "produced (exactly) what was expected of it — a reduction in the growth of government expenditures" (ibid., 109). In terms of the framework we established above, PEMS can be viewed as having increased the degree of centralization in the budget process. Each superminister bargained on behalf of a broad cross-section of interests and was therefore better able to internalize the fiscal externalities; the result was a reduction in the exploitation of the common budgetary resource.

Breton's example raises another interesting issue — that of institutional endogeneity. The implementation of the envelope system was motivated in part by the desire to curb government spending. Thus, not only may budgetary institutions affect fiscal policy outcomes, but fiscal policy outcomes may affect budgetary institutions. In this regard, Ron Kneebone and I argue that Alberta's institutional changes of the mid-1990s — which included massive government downsizing, changes in the budgetmaking process and committee structure, and the introduction of balanced budget legislation — were precipitated by a sense of fiscal crisis that arose precisely because of shortcomings in the previous institutional structure (Kneebone and McKenzie 2000).

Political institutions seem to display a good deal of status quo bias; indeed, political scientists refer to the "iron law" of institutional inertia. One reason is doubtless that institutional change is a costly and complex process. Nonetheless, change does occur, if only sporadically, when existing institutions are perceived to be producing policy outcomes that are unsatisfactory enough to make it worth bearing the cost of changing them.

The Legislature

As discussed above, the Canadian Parliament plays a very small role in the initiation and formulation of budgetary policy. Yet the process does not have to work that way, and indeed in many countries it does not. In general, the budgetary process offers much scope for legislative participation. Here I analyze the fiscal policy implications of some of those possibilities.

An important aspect of the budgetary process is the extent to which the legislature may introduce amendments to the budget the executive proposes. The possibilities are several, the two extreme cases being a process in which no amendments can be introduced, and a process that sets no limits on amendments. The former is indicative of a highly centralized process, and the latter of a more decentralized process. Intermediate cases include (in descending order of centralization) the possibility of minor, nonsubstantive amendments; restriction to amendments that do not increase overall spending or taxes (in other words, raising spending in one area requires lowering spending in another); and amendments that do not change the overall size of the deficit (legislators can introduce new spending initiatives introduced, but they must be financed by raising taxes).

What implications for fiscal policy come with these varying degrees of legislative amendment power? In general, the more restrictive are the regulations governing amendments to budget proposals, the less room for individual members of the legislature to increase spending for their constituents at the expense of taxpayers in general. We saw in the discussion of the cabinet process that individual line (spending) ministers can suffer from decision externalities in exploiting a common budgetary resource, and the result is overspending. This problem is likely to be more acute at the level of individual members of the legislature because they represent smaller districts than cabinet ministers and therefore internalize even fewer of the costs associated with increased spending. Thus, the absence of limits on the ability of the legislature to amend budgetary legislation, and the resulting "Tragedy of the House of Commons," could lead to excessive government spending and reliance on deficit financing. A centralized budgetary process that limits the scope of amendments is one way to prevent this situation.

A related issue is the implications of any vote against the budget proposal by members of the governing party. An important factor in this regard is the degree of *legislative cohesion*, which refers to the discipline of the members of the governing party or coalition.[27] Legislative cohesion is high when members tend to vote in a disciplined manner. If the governing party requires the confidence of the legislature to maintain agenda control at the executive level, parties tend to vote in a disciplined manner, and the degree of legislative cohesion is high. This situation is typical of most parliamentary regimes, including Canada's. If the governing party does not require the confidence of the legislature in order to maintain control, then voting tends to be less disciplined, and legislative cohesion is lower. This situation is typical of US-style regimes, in which the president is elected separately from the legislature.

If the defeat of a budget can lead to the downfall of the government, then the cost of voting against it is very high for members of the governing coalition; they risk losing control of the policy-setting agenda. If the defeat of the budget proposal is not an issue of confidence, then these costs are low. Raising the political cost of rejecting the budget at the parliamentary stage strengthens the position of the executive and reduces the ability of members of the legislature both to trade favors among themselves and to exploit the common budgetary resource. Legislative cohesion (and the associated party discipline it entails) is thus another way to encourage internalization of the decision externalities associated with budgetary decisions.

Another related issue involves the bicameral nature of many legislative regimes: a lower house (in Canada, the House of Commons) and an upper house (in Canada, the Senate). The upper house may play several roles. From the budgetary perspective we have been using, the strength of the government's position varies inversely with the budgetary powers of the upper house.

An important issue here is the way in which the members of the upper house are chosen. If they are selected by an electoral process different from that of the lower house — for example, on the basis of regional representation as opposed to representation by population — then the government

27 The concept of legislative cohesion comes from Diermeier and Fedderson (1998).

must account for the interests of both the houses in the formulation of the budget. In general, the more interests that need to be accommodated (or appeased) in the budgetary process, the higher spending is likely to be.

All of this suggests that countries that employ decentralized budgetary processes, a strong amendment power for the legislature, low legislative cohesion and party discipline, and a strong upper house are likely to have higher spending and deficits than countries with centralized budgetary processes, weak legislative amendment power, high legislative cohesion and party discipline, and a weak upper house.

Legislative Committees

Although the research suggests that jurisdictions in which the legislature plays a subsidiary role in a centralized budgetary process are more likely to be associated with low spending and deficits, the legislature can still act as an important monitoring, evaluation, and review mechanism for government policies. The institutional mechanism through which it plays this role is the legislative committee.

Distributive and Informative Committees. The research distinguishes between two competing models of legislative committees: *distributive* and *informative*.[28] The distributive model of committees is motivated by the US congressional system. The idea is that committees exist to facilitate the making of deals among legislators to distribute spending across various policy areas.

Proponents of the informative model, while not denying the importance of distributional considerations, take the view that the primary role of committees is to provide information. This perspective is motivated by the idea that, although the consequences of policy decisions cannot be known with certainty at the outset, a better idea of those consequences can be obtained if committee members invest effort in policy analysis and information acquisition. This specialized knowledge can feed into the policy process in several ways. One is to inform the government about the implications of various decisions; another is to increase the transparency of the policy process, both for other legislators and for the public at large, enhancing the legislature's role as watchdog on the government.

The implications of these two types of committees for the size of government depend on many factors. In the United States, for example, con-

28 For an example of a model emphasizing the distributive role of committees, see Shepsle and Weingast (1994); for an example of the informative role, see Gilligan and Krehbiel (1989). Much of the following discussion draws heavily from Hallerberg (2000).

gressional committees are blatantly distributive and have a great deal of budgetary power independent of the executive (the president and his cabinet). In the context of the current discussion, this situation is suggestive of a highly decentralized budgetary process. Yet presidential regimes are typically associated with lower spending and smaller governments than are parliamentary regimes (see Persson, Rolland, and Tabellini 2000; Persson and Tabellini 2001; and Scartascini and Crain 2000). Thus, the suggestion appears to contradict the conclusion that a decentralized budgetary process leads to inflated spending.

Separation of Powers. To resolve the apparent contradiction just described, we must recognize that one of the things that distinguishes presidential regimes from parliamentary regimes is the degree of *separation of powers*, by which I mean differentiation of the power to propose various aspects of government policy among different legislative bodies or among what Albert Breton refers to more generally as "centers of power" (1998, chap. 3). Virtually all democratic countries are characterized by a separation of powers between legislative bodies, at least to some extent. What distinguishes one regime from another is the degree and nature of that separation. And it can take many forms. For example, US-style regimes separate the powers of the executive (the president) and the legislature (Congress) and then again the powers of various congressional committees. Parliamentary regimes may also separate the executive and legislative powers; however, that separation is typically less prominent and less formal. It depends on factors such as the ability of Parliament (through its committees) to propose and amend government policy, on parliamentary convention, and so on. A separation of powers can, in principle, also exist between the upper and lower houses of a legislature, depending on their relative powers to propose, amend, and veto government policy.

Presidential regimes are typified by a high degree of separation of powers between legislative bodies and a low degree of legislative cohesion due to the lack of a confidence requirement. Parliamentary regimes typically invest a great deal of power in the executive and much less in the legislature, specify little formal separation of powers, and have a high degree of legislative cohesion due to the confidence requirement.

The separation of powers and legislative cohesion can both play important roles in the determination of fiscal policy. The explicit separation of powers and distributive nature of US-style congressional committees gives several committees agenda-setting power over different aspects of fiscal policy. The legislators who sit on these committees often have opposing interests that reflect the conflicting desires of their constituents. In simple terms, each committee member wants more spending for her constituents to be financed by taxes paid by the constituents of legislators who sit on other committees. In the absence of contravening factors, the common pool problem discussed above suggests that this situation can generate overspending.

Yet such contravening factors do exist in the United States, through a system of checks and balances that prevents distributive committees from overspending the common budgetary resource. These checks and balances take several forms, including the requirement that both houses of the US Congress agree, via voting, to committee proposals at various stages of the budgetary process; the culmination is the veto power of the president. Without these checks and balances, the separation of powers would allow opposing interests to exert independent and unchecked influence over the common budgetary resource, leading to overspending.

Decentralized distributive committees may not generate the same result in parliamentary regimes without a stronger system of checks and balances. Although it is possible that these committees may reinforce the role of the fiscal entrepreneurs at the cabinet level, this strengthening is unlikely to occur in practice, at least for sustained periods of time. The nature of competition for committee chairs and memberships differs between distributive committees and informative committees. In the case of distributive committees, legislators with the most to gain from being on a particular committee lobby for membership, including the coveted job as chair. One implication is that distributive committees are more likely to be composed of “high demanders” for government spending, which implies a greater proclivity to spend than the fiscal entrepreneurs in the cabinet. This means that decentralized parliamentary systems in which the distributive characteristic of committees is strong are likely to exhibit higher spending as they exploit the common budgetary resource. Without the imposition of countervailing checks and balances, the only way to limit the spending proclivities of parliamentary committees is to restrict their ability to amend and initiate legislation with budgetary implications.

Informative Committees. What about informative committees? Their implications for fiscal policy are less straightforward. Although lacking powers of policy amendment and initiation, these committees can still affect budgetary outcomes by influencing the flow of information to both the legislature and the cabinet. Recall that one of the strategic powers invested with fiscal entrepreneurs in hierarchical cabinet structures is control over the flow of information. Powerful informative committees may act to undermine the authority of the fiscal entrepreneurs in this regard. This possibility is related to the problem of budget secrecy (discussed above). Greater committee involvement in the flow of information may compromise budget secrecy, which could impinge on the finance minister's role as fiscal entrepreneur (Breton 1998, chap. 4). One implication is a need to limit the power of informative committees.

I argued above that the electoral system helps to determine whether a hierarchical or collegial budgetary process is more likely to emerge at the cabinet level. Similar influences exist in the case of legislative committees. Majoritarian electoral systems that tend to generate single-party governments also tend to give rise to hierarchical budget processes within cabinet (see Hallerberg 2000). Anything at the committee level that usurps the fiscal entrepreneurs' strategic control over the budget has the potential to introduce a deficit bias into the budget process. To restrain this proclivity, budget-related legislative committees must have only a limited ability to rewrite and amend government budgetary legislation in majoritarian systems as well as only a limited capacity to collect and distribute information. Hierarchical systems can achieve these restrictions in a number of ways. Examples include limiting the tenure of committee chairs and having committees responsible for broad areas that do not line up with ministerial divisions. Both of these characteristics make it difficult for committees to specialize and control the information flow in particular areas.

In proportional electoral systems, which tend to produce multiparty or coalition governments, the informative role of legislative committees differs somewhat. As discussed above, the cabinet is likely to use a less hierarchical, more collegial budgetary process, with more bargaining and negotiation over budget targets and the allocation of spending. Here, informative parliamentary committees can serve as monitors, helping to guarantee the implementation of agreements struck by the coalition partners at the executive level. It is important to enhance the informative role of such committees by appointing chairs and members to fairly long terms, to line up committee and ministerial responsibilities, and possibly even to appoint a committee chair from a different party than the relevant minister.

Limits. Although parliamentary committees can play a useful role in the government policy process, the research suggests that the imperative of internalizing decision externalities may require imposing limits on the ability of those committees — and on the legislature as a whole — to formulate, initiate, amend, and possibly even inform budgetary policy. Walter Hettich and Stanley Winer caution that, "to the extent that they actually influence legislation, the 'you scratch my back and I'll scratch yours' atmosphere in such committees will tend to produce over expansion of government budgets" (1993, 19). In order to prevent this situation, the institutional regimen must be such that there is "government in parliament, not by parliament" (ibid. 1995, 25, quoting Franks 1987, 260).

Some Loose Ends and a Summary

The discussion up to this point has focused on various static elements of fiscal policy: the size and mix of government expenditures, the size of the deficit, and the mix of taxes. But fiscal policy has important dynamic elements as well. Before moving to a summary of the theoretical analysis, I tie up some loose ends by considering the implications of electoral and budgetary institutions for some dynamic elements of fiscal policy.

Fiscal Shocks. One such aspect relates to the responsiveness of fiscal policy to external *fiscal shocks* (unanticipated changes in the economic environment that have budgetary implications). As economies become more and more linked globally, the ability of economies and governments to react to these shocks becomes increasingly important. Fiscal policy may react to shocks in two ways. One is the automatic reaction of tax collection and spending to unanticipated changes in income — the "automatic stabilizer" aspect of fiscal policy.[29] The other is discretionary reactions — deliberate decisions to alter fiscal policy in light of changes in the economic environment.

How might political institutions affect the response to these external shocks? The previous analysis suggests some answers to this question. To the extent that the institutional configuration leads to higher spending (and taxes), overall and particularly in the area of broadly based social programs, we can expect a higher degree of automatic stabilization. As we have seen, not only may countries with proportional electoral systems spend more than countries with majoritarian systems, but they may also devote a greater fraction of that spending to broadly based social programs, such as employment insurance, that tend to be sensitive to economic fluctuations. Thus, the degree of automatic stabilization is probably greater in proportional systems than in majoritarian systems, although this may be offset to some extent by the possible tendency of majoritarian systems to rely more heavily on income taxes than on more broadly based consumption taxes.

The extent of automatic stabilization is a product of the basic structure of fiscal policy and does not reflect short-run policy choices in the face of external shocks. The latter are the domain of discretionary stabilization poli-

29 For a discussion of automatic stabilization in a Canadian context, see Kneebone and McKenzie (1998).

cy. The ability to react in a discretionary manner to fiscal shocks depends on the extent to which the institutional framework allows for fast government action.[30]

Here the budgetary process and its relationship with the electoral system may be important. Hierarchical cabinets and a centralized budgetary process, typically produced by majoritarian electoral systems, are able to respond to external shocks quickly. Collegial cabinets and decentralized budgetary processes, typically associated with coalition governments produced by proportional electoral systems, are likely to move less quickly as the bargaining and negotiation that characterizes a decentralized process results in delays in the formulation and implementation of a policy response to fiscal shocks. This institutional lag may also delay the implementation of a policy response to a building fiscal crisis (see Roubini and Sachs 1989; Alesina and Drazen 1991).

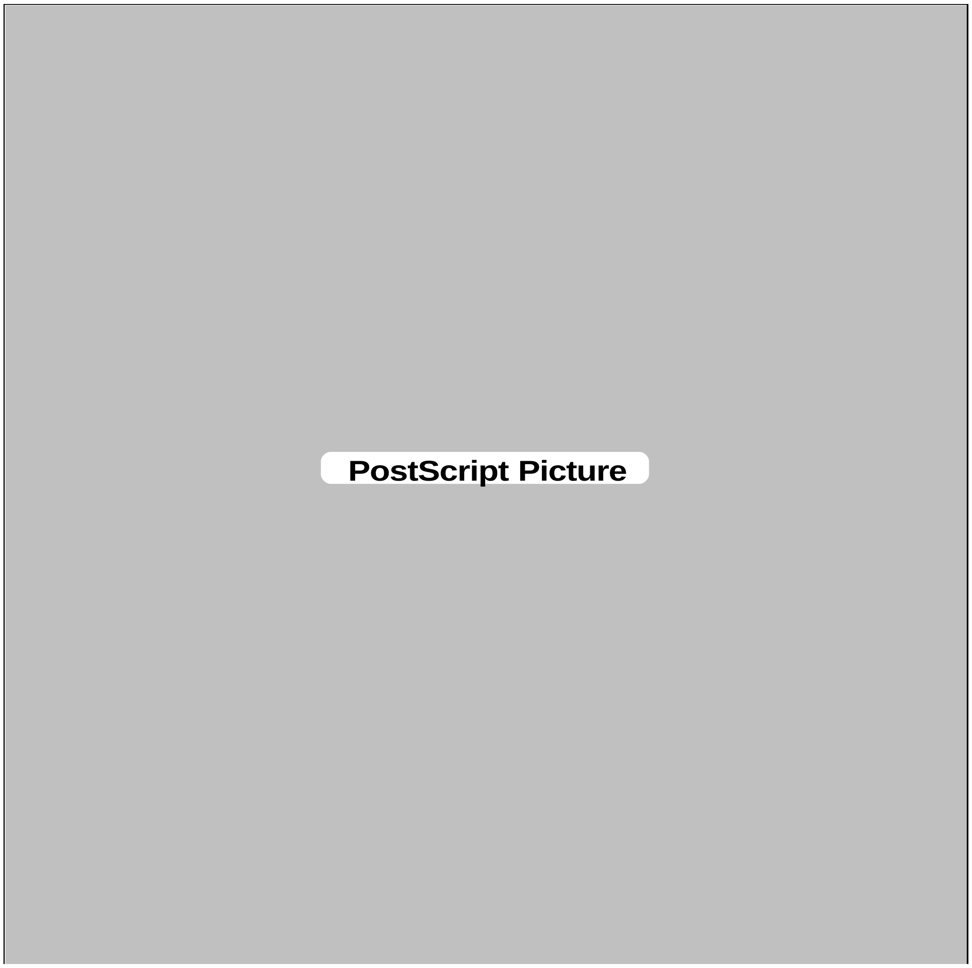
Overall, the suggestion is that countries characterized by a majoritarian electoral system and hierarchical budgetary process may tend to have less automatic stabilization and more discretionary stabilization than countries that have a proportional electoral system and a collegial budgetary process.

Theory. The discussion of the theory behind the impact of political institutions on fiscal policy has been lengthy. A summary is therefore warranted before I move on to some of the empirical research. Table 2 provides a summary of the theoretical impact of political institutions on several aspects of fiscal policy. The table shows the dual dichotomies that I have used to characterize the institutional environment — majoritarian versus proportional electoral systems, and centralized versus decentralized budgetary processes — and in each case it indicates the predicted impact on various aspects of fiscal policy. (For now, ignore checkmarks and question marks in the cells. Their meaning will become clear shortly in the discussion of some empirical research.)

Institutions and Outcomes: Empirical Results

I now turn to some of the empirical research. Before I do so, a couple of cautionary notes are in order. The first involves the nature of empirical research and its relationship to anecdotal evidence. The empirical methodology followed in the studies discussed here involves quantifying the characteristics

30 Note that I said nothing about that action's being appropriate; only that it be fast.



of the political institutions in some way and then determining the relationship between those institutions and various aspects of fiscal policy across jurisdictions. This procedure requires going beyond the mere measurement of correlations between policy and institutions as the researcher must control for other economic, demographic, and geographic variables that can affect fiscal policy. The research discussed here employs statistical econometric techniques of varying degrees of sophistication in an attempt to isolate the impact of the variables describing the political institutions on fiscal policy. The objective is to uncover systematic regularities and tendencies that hold on average and after controlling for other influences.

The phrases *on average* and *controlling for other influences* are important. People have a natural temptation to draw general conclusions on the basis of specific, particularly familiar, comparisons. For example, Canadians tend to compare their country with the United States and, on the basis of that comparison, to draw inferences about the role of political institutions in affecting policy. It is similarly natural to refer to specific events in our own fiscal history when considering the role that political institutions play in determining policy outcomes. Yet we must recognize that, although experience informs intuition and sets the frame within which we analyze and interpret what we perceive, these sorts of comparisons provide only a limited number of data points and must be interpreted in that light.

My second caution is merely that empirical research in political economics is difficult. Researchers must confront challenges associated with quantifying institutional variables, measurement and data difficulties, econometric problems, and so on. Moreover, much of the work in this area is quite new and, in many cases, scanty. Thus, the results must be interpreted with care. In particular, although I obviously think that the research has something useful to say, we must recognize that the jury is still out on many of the empirical questions addressed here.

Considering Some Empirical Research

Using a panel of 61 democracies and 1960–98 data, Torsten Persson and Guido Tabellini (2001) study the impact of several political-institutional variables on government spending, including the electoral system. They divide countries into a rough dichotomy of majoritarian and proportional electoral systems, as we did above, and find that countries with majoritarian systems have smaller governments. After controlling for other factors that can influence the size of government (several economic, geographic, demographic, and other institutional variables), they produce point estimates suggesting that governments elected under majoritarian systems spend, on average, about 3 to 5 percentage points of GDP less than governments elected under proportional systems.

Gian Maria Milesi-Ferretti, Roberto Perotti, and Massimo Rostagno (2001) also investigate the impact of electoral systems on public spending, but they use much finer representations of the electoral system and the degree of proportionality. When they examine spending in 20 OECD and 20 Latin American countries over the 1960–94 period (again controlling for several economic and demographic variables), their results generally support the theory. For example, they find that total spending as a percentage of GDP increases significantly with the measures of proportionality in OECD countries, while it declines with proportionality in Latin American countries. This finding is consistent with the idea, mentioned previously, that proportionality tends to lead to increases in expenditures in developed countries and to decreases in less-developed countries because the former spend relatively more on general social transfers than do the latter.

Carlos Scartascini and Mark Crain (2000) follow a slightly different approach in their investigation of political institutions and the size of government. Recall that the theory suggests the electoral system plays an important role in determining the number of parties in the legislature; multiparty legislatures and therefore multiparty governments are more likely to arise in proportional electoral systems than in majoritarian systems. Scartascini and Crain therefore study the relationship between the effective number of parties in the legislature and the size of government spending. Depending on the statistical specification, they find that an increase in the number of effective parties by one raises central government spending as a share of GDP between 0.38 and 0.6 of a percentage point.

What about the spending mix? Again, some empirical evidence is generally consistent with the theory presented above. For example, Milesi-Ferretti, Perotti, and Rostagno (2001) find that more proportional systems do indeed spend relatively more on broader, socially based transfers while more majoritarian systems spend relatively more on the purchase of goods and services that can be regionally targeted. Scartascini and Crain's results (2000) are consistent with this, as they find that an increase of one effective party (which can be associated with an increase in proportionality) reduces expenditures on goods and services by 0.4 of a percentage point of GDP and increases social transfers by more than 0.5 of a percentage point.

Substantial empirical research investigates political influences on tax policy. Hettich and Winer survey some of this work in their book on the political economics of taxation (1999, chap. 8), and conclude that a sizable body of empirical research is consistent with the general economic approach to politics. I am unaware, however, of any empirical research that explicitly addresses the issues that are my focus: How do different political institutions, in particular the electoral system and the budgetary process, affect tax policy?

What about the dynamic aspects of fiscal policy, such as automatic and discretionary stabilization? Persson and Tabellini (2001) investigate some of these issues in their empirical research. They find evidence that the sensitivity of both spending and taxes to income shocks is higher in proportional and parliamentary countries than in majoritarian and presidential countries. For example, an unexpected drop in real income of 10 percent leads to an increase in the spending ratio of about 2 percentage points in proportional and parliamentary countries, while the spending in majoritarian and presidential countries is not affected by the income shock.

As for the budgetary process, several researchers investigate the relationship between centralization and the size of government and the tendency to deficit finance. The typical approach is to develop an index of the hierarchy and centralization of the budget process and then determine whether a systematic relationship exists between this index and government spending or the deficit. The indexes typically have subcategories that are related to the hierarchy of the cabinet process and to the budget process at the legislative level. Included in the latter group are factors such as the strength of legislative committees, the ability of the legislature to amend government proposals, and the strength of the upper house.

For the most part, these studies support the idea that more hierarchical, more centralized budget processes generate less spending and lower deficits. For example, in some recent work Jürgen von Hagen develops an index of centralization and applies it to European Union countries (von Hagen 1992; von Hagen and Harden 1995). His index consists of four subindexes. The first concerns the structure of decisions at the government (cabinet) stage and focuses on the extent to which the process is hierarchical or collegial. The second subindex involves the structure of decisions at the parliamentary stage and includes factors such as the ability of the legislature to amend government bills, the power of committees, and the implications of rejecting budget bills. The third subindex deals with the flexibility of budgetary implementation, including the scope for and implications of budget overruns, carryovers, and the ability of the finance minister to block expenditures. The final subindex concerns the informativeness of budget documents.

Von Hagen finds a strong, negative relationship between his index of centralization and the size of the debt and the deficit. For example, for the three most centralized countries, the deficit-to-GDP ratio was between 1.2 and 2.7 percent and the debt-to-GDP ratio was between 42.5 and 43.2 percent. For the three least centralized countries, the respective ratios were between 10.7 and 11.2 percent and 74.6 and 100.1 percent.

Several other studies report similar results. Alberto Alesina et al. (1999) undertook a similar investigation of 28 Latin American states. They too find that cross-country differences in spending and deficits can be explained by differences in the degree of centralization of the budget process. Leif Helland (2000) extends von Hagen's study, focusing more on committees, and again finds evidence of a significant relationship between the degree of centralization and fiscal policy. Sung Deuk Hahm, Mark Kamlet, and David Mowery (1996) also study the role that the budget process of nine industrialized parliamentary democracies, including Canada, plays in the determination of spending and deficits. They too find a strong negative relationship between the deficit and the degree of centralization. All of these findings are consistent with the theory presented earlier.

Putting Theory and Empirical Evidence Together

Returning to Table 2, we can summarize the results of the empirical research discussed above. A checkmark indicates that, on balance and in my opinion, the weight of the empirical evidence is consistent with the theoretical predictions; a question mark indicates ambiguity or a lack of empirical research.

Although my review of the empirical literature is not intended to be exhaustive, the discussion summarized in the table suggests that many of the theoretical predictions of the economic approach to political institutions receive at least some empirical support. Recall, however, my cautionary notes from above. In many cases, the empirical analysis is rudimentary, and the data are not always well suited to the questions under investigation. Moreover, although the body of empirical research is growing, it is still relatively small. More work needs to be done.

Institutions and Outcomes: Contemporary Reforms for Canada

One of the objectives of this lecture is to use the insights generated by this research to speculate on the implications of various reforms in a Canadian context. To this task, I now turn. Although I do not detail again the associated difficulties, I reiterate that the exercise is very much a speculative one. Having said this, I think most of the implications are self-evident in light of the previous analysis.

Canadian political institutions tend to occupy a position solidly at the limits of the two dichotomies that form the basis for the preceding discussion. Canada has a highly majoritarian electoral system and a very hierarchical and centralized budget process. The types of reforms considered below would therefore involve moving our political institutions away from these dichotomous limits.

The Electoral System

In this spirit, recent discussions of electoral reform in Canada have focused on moving our electoral system away from the existing plurality, first-past-the-post system, and toward some form of proportional representation. Most critics of Canada's present system emphasize the large discrepancies that can emerge between the popular vote and the share of seats in the House of Commons. Currently, the governing Liberals control 57 percent of the Commons seats on the basis of only 41 percent of the popular vote in the 2000 election.

This situation is not unusual. In only three of the sixteen majority federal governments since 1921[31] has the party that formed the government received more than 50 percent of the popular vote; the remaining thirteen governments were all artificial majorities, formed with the support of less than 50 percent of those who voted.

Although figures such as these are often used to illustrate the extent to which the Canadian electoral system departs from proportionality, they are not useful for comparisons either over time or with other jurisdictions. Researchers have developed several indexes of the proportionality of electoral systems. A simple one that is commonly used by political scientists is the Gallagher index of disproportionality.[32]

Figure 2 graphs the Gallagher index for Canada's federal government after every election from 1926 to 2000. The higher the index, the more disproportional is the representation. Notice the wide variation in the index, with a low of under 3 and a high of 21. The average over the entire period is 12.4. To put this number into perspective, the average Gallagher index in 36 democracies (including Canada) studied by Arend Lijphart ranges from a low of 1.3 (the Netherlands) to a high of 21.08 (France). The average over the 36 countries is 8.26. Canada is the eleventh *least* proportional country of the 36, less proportional than Australia (9.26), New Zealand (11.11), and the United Kingdom (10.33) but more so than the United States (14.91).[33] Clearly, Canada's electoral system is quite disproportional by international standards.

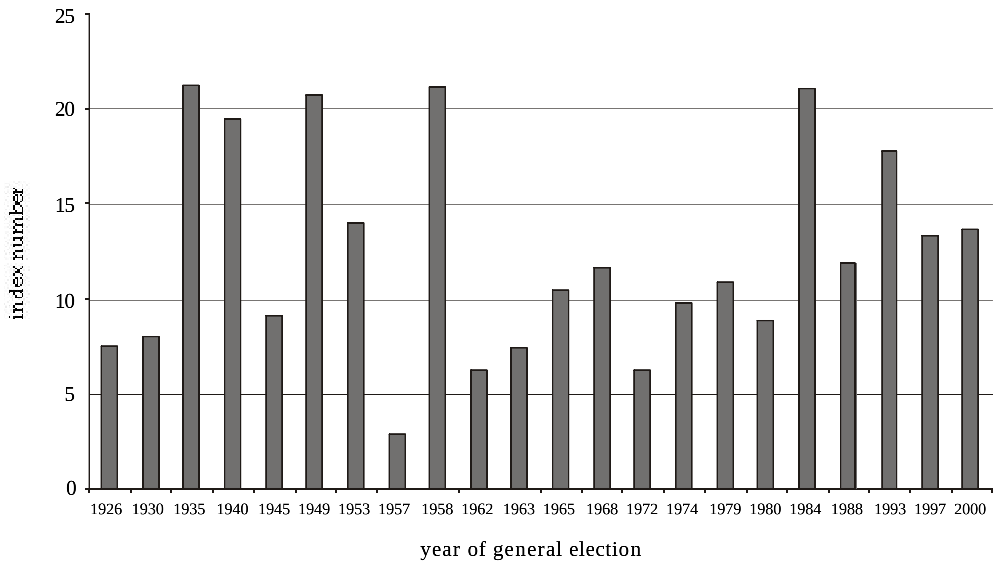
The departure from proportionality suggests that the distribution of seats in Canada's Parliament does not represent the views held by the country's citizens, at least as indicated by their choices at the ballot box. This fact is often offered as one of the reasons for the perceived "democracy deficit" in Canada (see Massicotte 2001; Simpson 2001; Szostak 2001; Rebick 2000). Critics associate our current electoral system with the creation of regional and linguistic divisions within the House of Commons, a lack of fairness in the political system, an underrepresentation of women in Parliament, low voter turnout, low government turnover, and an associated paucity of new policy initiatives. Defenders of the status quo question either these conclusions or

31 There have been eight minority governments over this period.

32 The Gallagher index is calculated as $G = \sum i[0.5(s_i - v_i)^2]^{0.5}$, where s_i is the share of seats of party i and v_i is the same party's share of the popular vote (both shares are measured in percentages). This index is, of course, subject to the same criticisms as similar indexes, such as the Hirfindahl index of economic concentration. I use it here because of the ready availability of calculations for other countries as a comparative benchmark.

33 See Lijphart 1999, table 8–2. The indexes of proportionality for each country are averaged over the 1956–96 period.

Figure 2: ***Gallagher Index of Disproportionality, Canada, 1926–2000***



Note: For an explanation of the calculation of these index numbers, see the text, especially note 32.

Source: Author's calculations.

the ability of a proportional system to alleviate them (or do not consider them problematic at all).

Without taking a position on these issues, I note that the research discussed above points to several implications for fiscal policy of introducing more proportionality into the Canadian electoral system. In what follows, I sketch what our fiscal policy might look like under a more proportional electoral system.

By changing the nature of electoral competition, a more proportional system would alter the pattern of vote buying in election campaigns. Specifically, the net political benefit of concentrating spending in swing regions would be reduced as the intensity of political competition over swing voters declined. This shift would generate a more diffuse configuration of redistributional spending across regions and groups. For similar reasons, expenditures on general public goods would increase. Thus, we could expect a reduction in regional transfer programs, such as equalization and the regional elements of employment insurance, and a concomitant increase in expenditures on broader social programs, such as health care, education, protection of persons and property, transportation, and communications. And we would see lower expenditures on government goods and services and other types of government spending that can be targeted to specific regions.

Moreover and importantly, a move to introduce more proportionality in the electoral system would, on balance, increase total government spending as a percentage of GDP. As already explained, such a change in the electoral system would reduce the probability of a single party's commanding a majority in the House of Commons and increase the possibility of more minority, coalition, and multiparty governments. The nature of cabinet deliberations would change as the current hierarchical process shifted in favor of a more collegial process based on negotiations among ministers. One result would be a tendency for spending to increase, as governments sought to avoid instability by "buying off" a range of interests within cabinet and the legislature broader than was necessary to merely maintain the coalition. This tendency could be moderated to some extent by the implementation of institutional processes, such as the establishment of budget targets, that would encourage internalization of the decision externalities arising from the common budgetary pool. Also, the committee system might be strengthened, perhaps not in its ability to initiate and amend budgetary policy, but in its informational capacity as a mechanism to monitor government agreements.

Because of the increased spending on broad social programs and the higher taxes needed to finance them, automatic stabilization would increase as the budget became more sensitive to business cycles. At the same time, policy inertia would increase and, therefore, discretionary stabilization would decrease because multiparty governments, which we would likely see more of, would find it more difficult to react quickly to changes in the economic environment. We would therefore observe greater delays in adjusting fiscal policy to changes in the economic environment, even in a fiscal crisis.

What would occur on the tax front is difficult to say. Theory suggests that the change in the nature of political competition would lead to a greater reliance on less-targeted taxes, but empirical investigations in this regard are few. The most we can conclude at present is the probability of a less complicated tax regime, because the move to a proportional electoral system would moderate the incentives for targeted redistribution through the tax system.

Although this picture is obviously a speculative caricature, the changes in fiscal policy that it presents are consistent with the conclusions of the literature discussed above. The research suggests that a move from our current majoritarian electoral system to a proportional system would give rise to pressures on fiscal policy in the general directions I discussed. The unique character of Canada would doubtless determine the magnitude of these tendencies.

The Budgetary Process

As indicated earlier, a very hierarchical, centralized budgetary process characterizes the institutional framework in Canada. Most of the reforms contemplated recently involve moving away from this configuration to one involving a more collegial, decentralized process. In this section, I speculate on some of the implications of these sorts of reforms. Of course, as with electoral reforms, the devil is very much in the details, and the research in political economics offers only broad-brush insights.

To organize the discussion, I consider reforms at the cabinet and parliamentary levels separately.

The Cabinet

Each country has a truly unique cabinet process. It reflects the nation's historical and cultural context and, of course, the personalities and propensities of the individual members of the executive, particularly the prime minister. However, the research discussed above suggests that the way that cabinet decisions are made can help to explain some features of fiscal policy. What are the relevant characteristics of Canada's cabinet system?

By virtually any metric, Canada has a very hierarchical cabinet process. Indeed, many people think the office of the prime minister, in particular, has evolved in such a way as to give the holder virtually unlimited power. The situation prompts Donald Savoie to refer to the emergence of "court government" in Canada, with the prime minister playing the role of "king" and a few select ministers and senior civil servants acting as "courtiers." In budgetary matters, he points out:

> The number of people directly involved in putting the budget together is very limited. The key players are the prime minister, one or two of his senior advisors, the minister of finance, the clerk of the Privy Council, the deputy minister of finance, and a handful of senior Finance officials. (1999, 654.)

Note that Savoie makes no mention of other cabinet ministers. He goes on to argue that the traditional budget process that pitted "guardians" (the prime minister and the minister of finance) against the "advocates" or "spenders" (ministers of line departments and regional ministers) has been abandoned in favor of a highly centralized, hierarchical system in which cabinet as a collective plays a very small role. He offers several explanations for the emergence of "court government" in Canada, including technological developments in the mass media, the development of modern polling techniques, globalization, and the evolution of Canadian federalism.

As discussed previously, the nature of the cabinet process and the electoral system are closely related. Systems that produce few parties tend to generate majority, one-party cabinets, which, in turn, tend to employ a hierarchical budget process. Systems that give rise to several parties tend to generate multiparty cabinets, which employ a more collegial process. Using this metric, casual reflection suggests that the current position of Canada is a bit of an anomaly in terms of the two institutional dichotomies set out in Table 2. The House of Commons now has five parties with official status, more than at any other time in our history, yet the Liberals hold a sizable majority and the cabinet process is (apparently) more hierarchical than ever. Moreover, the increase in the number of official parties has occurred with only a very small rise in the degree of proportionality (look back at Figure 2). Indeed, some commentators argue that the first-past-the-post system itself has led to this increase, by encouraging the emergence of regional parties with concentrated support, such as the Canadian Alliance and the Bloc Québécois (see Massicotte 2001). Clearly, what matters for the type of cabinet process that emerges is not just the number of parties in the legislature, but also their size.

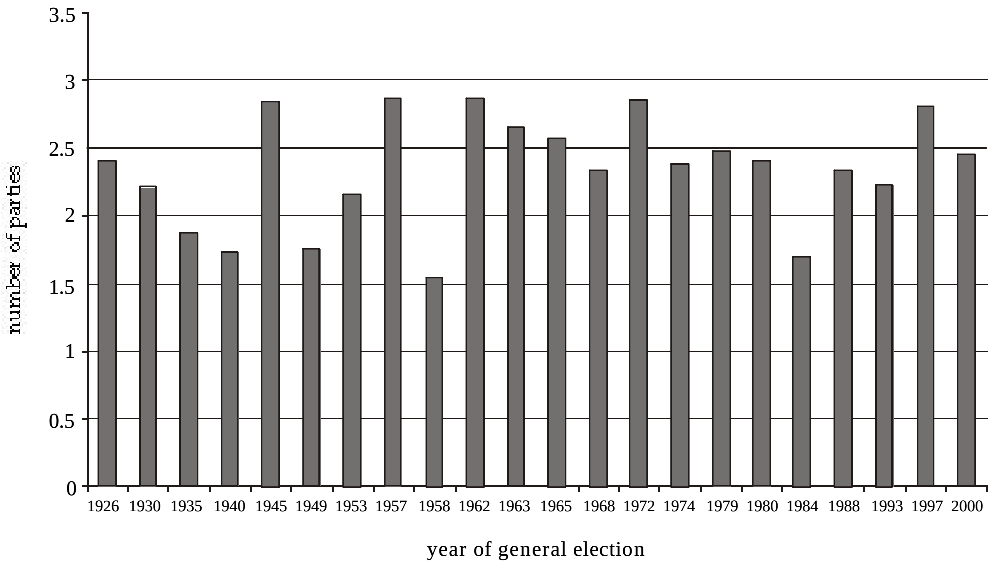
To incorporate both number and size into a metric, political scientists Markku Laakso and Rein Taagpera (1979) have developed an index of what they call the *effective number of parties*.[34] Figure 3 shows the effective number of parties in the House of Commons generated by federal elections since 1926. That number has fluctuated between 1.5 and 2.8, with an average of 2.3. For 2000, the number was 2.4, which is about average.

In brief, although the House now has five parties with official status, compared with only two or three throughout most of our history, there has been virtually no change in the *effective* number of parties. Thus, the hierarchical nature of Canada's cabinet process is quite consistent with the low number of effective parties in the House, which, in turn, is a product of our electoral system.

What does all of this imply about the reform of the cabinet process in Canada? Any likely changes would clearly involve moving toward a more collegial process. A number of observations are relevant here. First, the discussion of the spending proclivities of the government due to the common property problem suggested that decision externalities at the cabinet level can be internalized in two ways. One is to invest monopoly control over the

34 The index is $N = 1/(\sum_i s_i^2)$, where s_i is the proportion of seats of the ith party in the legislature.

Figure 3: ***The Effective Number of Parties in the House of Commons, Canada, 1926–2000***



Note: For an explanation of the calculation of these index numbers, see the text, especially note 34.

Source: Author's calculations.

budget with fiscal entrepreneurs, such as the finance minister and the prime minister — the hierarchical approach. The other is to encourage Coasian bargaining among ministers — the collegial approach. The discussion also noted that the collegial approach is the only reasonable one for multiparty governments, but they may not be entirely successful because of the need to maintain stability in the governing coalition.

Canada has opted for the hierarchical approach to internalizing decision externalities at the cabinet level, an approach consistent with our majoritarian electoral system. But this fact does not mean that the existing degree of cabinet centralization is in any sense optimal. Savoie points out that the current situation in Canada is such that "the prime minister and the courtiers are convinced that ministers are not capable of establishing priorities and that they lack the ability to look at spending proposals from the perspective broader than their respective department or region" (1999, 657).

The economic approach to politics tells us that this attitude is exactly what we should expect. The trick is to recognize it and to establish institutional processes to control it without throwing out the baby with the bathwater. The research discussed above suggests that the decision externalities that result from the narrow perspective of line ministers can be internalized by investing fiscal entrepreneurs with budgetary powers such as agenda control, veto power over amendments that increase the size of the budget, control over the information flow, and so on. In other words, the common pool problem can be dealt with by giving the guardians *strategic* control over the budget process. Line ministers would still have scope for negotiation about the allocation of the budget, which lies outside the strategic control of the fiscal entrepreneurs. Indeed, line ministers may be more effective in negotiating allocation because they have knowledge of their regions and ministries that is more specialized than that of the finance minister and the prime minister. In other words, nothing in the research suggests that the fiscal entrepreneurs require *complete* control over the budget process in order to eliminate decision externalities. Indeed, complete control is likely to do nothing more than generate a budget that reflects the preferences of the king and his courtiers, which may or may not be optimal from a social point of view.

These considerations suggest that, given our current majoritarian electoral system, cabinet reforms that reduce the strategic control of the prime minister and the finance minister over the budget process may lead to greater spending. Reforms that maintain this strategic control but allow line ministers more participation in allocating the budget need not.

What if Canada moved to a proportional electoral system? The research suggests that such a move would almost certainly require adopting a more collegial cabinet process. Although that arrangement might lead to pressures to increase spending, this tendency could be moderated by the implementation of budgetary targets and negotiation. For example, the process could be sequential. First, the entire cabinet could negotiate the establishment of overall spending, deficit, and debt targets. Then, once those targets were established, bargaining between line ministers would determine budgetary allocations. As Hallerberg and von Hagen (1999) suggest, the setting of budgetary targets in a distinct, separate first stage would be extremely important because it would force cabinet ministers in subsequent budgetary deliberations to take account of the impact of their decisions on other groups and regions and help to alleviate the common pool problem.

Parliament

Discussions of parliamentary reform in Canada have put forward a wide variety of options: the use of more free votes in the House of Commons, stronger parliamentary committees, the adoption of a triple-E (elected, equal, effective) Senate, and the elimination of the Senate altogether.

Each of these proposals is a complicated subject, deserving careful and in-depth study. Here I offer a brief, admittedly cursory discussion of some of them within the context of the research presented above. Again, I focus solely on the broad implications for fiscal policy (although there may be good political or other reasons why some of these reforms should — or should not — be contemplated).

Each of the parliamentary reforms mentioned above would involve moving Canada toward a more decentralized budgetary process. I have already discussed the hierarchical nature of the Canadian cabinet process, and this tendency continues at the legislative stage. In the House of Commons, free votes on any policy, much less one with budgetary implications, are rare. Parliamentary committees are relatively weak, and MPs have little scope for direct involvement in either the initiation or the amendment of government policy at the committee stage. The Senate is ineffective and, with few exceptions, plays little direct role in the policy process.

One issue that has garnered some political commentators' attention is strengthening the role of parliamentary committees. Suggested reforms include requiring chairs to be elected by a double majority of government and opposition MPs, reserving some committee chairs or vice-chairs for opposition MPs, remunerating committee chairs, and lengthening the tenure of committee chairs. Typically, these reforms, which have been implemented in other parliamentary regimes, are justified on the grounds that they would engage MPs more in the policy process and generate a more inclusive, cooperative environment in Ottawa (Dobell 2000). Our concern here is with how such changes might affect fiscal policy.

The research discussed above suggests that, to the extent these sorts of reforms actually increased the power of committees, they would allow those committees to impinge on the policymaking monopoly of the government (the executive), generating pressure to increase spending and deficits. Recall that, if fiscal restraint is felt to be important, even informative committees may need to be reined in if they challenge the fiscal entrepreneurs' strategic control over the flow of information. But the way to institute curbs is by implementing a committee system with precisely the characteristics that the reforms listed above would change.

Having said this, I point out that some of the reforms mentioned above would be relatively innocuous. Although changes such as increasing the tenure of committee chairs might loosen the government's control of information to a modest degree, that grip would continue to be very tight. Moreover, increasing the ability of committees to obtain specialized knowledge, therefore enhancing their informative role, would increase the analytical capability of the government.

Others of the suggested reforms are difficult to justify within the current institutional environment in Canada. For example, increasing the power of non-government MPs in committees (through the election of committee chairs or through the reservation of chairs for opposition MPs) is a practice more likely to be found in parliamentary systems with collegial budget processes, proportional representation, and multiparty governments. There, the informative role of the committees is monitoring the activities of other parties involved in the policy process, either formally or informally. This sort of monitoring role for committees is not as important in a system that tends to generate single-party majority governments with a hierarchical cabinet process. And, as discussed above, informative committees could even prove to be problematic if not held in check.

Any enhancement of the distributive role of committees — increasing their ability to initiate policy or amend government legislation — would tend to generate even more intense pressure on spending and the deficit. Though some backbench MPs may look longingly at the powerful congressional committees south of the border, any reforms that increased the ability of Parliament, through its committees, to initiate and amend legislation with significant budgetary implications but that lacked accompanying checks and balances to moderate the incentives to overexploit the common budgetary resource could precipitate a true “Tragedy of the House of Commons” (see Persson, Rolland, and Tabelli 2000b).

Similar considerations are relevant when contemplating reforms that would generate a more powerful, more effective Senate. Although the specific details of how this change might be achieved are obviously important, the general result of a more powerful upper house inevitably would be to reduce the control that the government has over Parliament. (This result is presumably exactly what Senate reformers have in mind.)

One suggested approach involves the election of an equal number of senators from each province. The reasoning here is presumably that such a body would give rise to a government that was more responsive to regional and provincial concerns. It almost certainly would. Moreover, depending on the ability of a reformed Senate to initiate, amend, or otherwise influence government policy — and I presume that an elected Senate would indeed be effective in some sense, or else the discussion is moot — such a change would alter the incentives facing the government in its determination of fiscal policy. Under the status quo, the governing coalition in Parliament is predetermined along party lines. To maintain the confidence of this coalition, the government provides public goods and targets spending to the groups and regions represented by the legislators in the coalition. In general, there is no need to take account of the Senate when making this determination. But a Senate elected by province would change the government’s incentives to allocate spending across regions. To the extent that the Senate was effective in this regard, the expectation is that it would change both the allocation of expenditures across regions and the level of spending overall as the government sought to maintain the support of two coalitions, one in each house. And, as already discussed, the broader the coalition required to maintain government stability, the more likely that aggregate spending would increase as the government seeks to buy off and grant favors to competing interests.

What about free votes? As discussed earlier, party discipline (and the legislative cohesion that it entails) is one way to internalize the externalities associated with budgetary decisions, strengthening the position of the executive *vis-à-vis* the legislature. The corollary is that the use of free votes on matters with budgetary implications could lead to a weakening of this position and an expansion of government spending. The implication is a need to limit free votes to matters without budgetary implications.

Concluding Remarks

This lecture has summarized some recent research in political economics that addresses the question of how the design of political institutions can affect fiscal policy outcomes. My summary has been selective and should not be viewed as an exhaustive survey of the sizable and growing research in this area. Based on the research I have discussed, however, I think one conclusion is inescapable: *political institutions matter*. They matter for the size and mix of government expenditures, the configuration of the tax system, and the way in which government responds to fiscal shocks.

I have drawn on this research for some tentative speculation about the implications for fiscal policy of reforming two aspects of the politico-institutional landscape in Canada. The first was moving away from our majoritarian, first-past-the-post electoral system toward one based on proportional representation. The second involved changes to the budgetary process, at both the cabinet and parliamentary levels, to make it less hierarchical and more collegial (or less centralized and more decentralized). Reforms such as these have been advocated by many as a way to reduce the "democracy deficit" in Canada.

In my view, the research presented here provides grounds for arguing that the introduction of proportional representation and a more decentralized budgetmaking process in Canada might generate pressures that would cause the emergence of another, more traditional type of deficit — a fiscal deficit. More specifically, a move to proportional representation would generate political pressure to increase the size of government and to finance that expansion by issuing debt. That pressure might well be reinforced by the changes in the budgetary process that are likely to accompany such a change in the electoral system. Indeed, changes that increased the degree of decentralization in the budgetary process, whether they were implemented in conjunction with or independently of a move to proportional representation, would tend to generate increased pressures on spending and the fiscal deficit.

All of this is, of course, speculative. But it is speculation informed both by theoretical deliberation and by a consideration of the empirical regularities that emerge from comparisons of cross-jurisdictional differences in political institutions and fiscal policy. It is possible, even likely, that other institutional processes will emerge to counteract some of these pressures. The historical, cultural, societal, and institutional context in Canada is unique. If I can make one prediction with virtual certainty, it is that implementing political reforms would generate uniquely Canadian outcomes. However, to contemplate those reforms while ignoring the growing body of research in political economics that suggests that political institutions affect fiscal policy in important and systematic ways would, to quote Michael Laver and Kenneth Shepsle, be "an act of the crassest stupidity" (1996, 287).

The research in institutional political economics is very much a work in progress. In my view, even its partial completion reveals important insights. Yet more needs to be done to deepen our understanding of the role that these institutions play in the determination of policy outcomes. By highlighting one piece of a complicated puzzle, I hope that the research presented here will assist Canadians in forming their own views regarding what democracy Canadian-style should look like.

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