

Lobbying and Endogenous (De)Centralization*

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Abstract

This paper takes a novel look at the political economy of fiscal federalism. I present a positive theory of (de)centralization of policy decisions in an international union. My central claim is that lobbies play a role in determining the assignment of competencies to the union because their power of influence can increase or decrease under centralization. I provide a simple model where decentralization emerges as a political equilibrium with lobbying. Three extensions show that this result depends on the voting rule at the constitutional stage; the details of the institutional decision mechanism under centralization; and the ability of national lobbies to coordinate under centralization (i.e. to form an international lobby).

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JEL Classifications: *F02, D72, H77.*

1 Introduction

Political economists define an international union as a group of countries that take common decisions on certain policies. A widely debated “constitutional” issue is the proper allocation of competencies between national governments and the international union. In other words, a key normative question concerns the identification of policy domains that should be decentralized (i.e. remain at the national level) and of policy domains that should be centralized (i.e. delegated to the international union authority). Well-known examples are the ongoing debates over the com-

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petencies of the European Union (EU) and the proper scope of the World Trade Organization (WTO).¹

The literature on fiscal federalism deals with the economic efficiency of the attribution of prerogatives to different levels of government, thus providing the ideal benchmark for a normative analysis.² Oates' famous Decentralization Theorem (Oates, 1972) states that policies characterized by high cross border spillovers and low heterogeneity of preferences for different districts should be centralized, while the provision of all other services should be decentralized.³ Alesina, Angeloni and Schuknecht (2005) contrast this normative benchmark with a set of indicators that measure the role of the EU in different policy areas. They find that there is a partial inconsistency between the resulting allocation of competencies to the EU and the Oates' (1972) normative criteria. In particular, their data suggest that the EU is active in areas where cross border spillovers are low and that its intervention is too limited in policy domains characterized by large spillovers and low heterogeneity of preferences.

This paper departs from this inconsistency between theory and evidence and provides a positive theory of (de)centralization of political decisions in an international union.⁴ More precisely, the aim of this work is to show that a misallocation of competencies between the international union and national governments can arise as a result of a political equilibrium with lobbying. The key idea that I want to put forward is that organized interest groups play a role in determining the assignment of prerogatives to an international union.⁵ My central claim is that the influence that special interests can exert on policy outcomes (loosely speaking, the "power" of lobbies) depends on which political authorities - national or supranational - decide the policy. This idea is only partly new. Olson (1982) first observed that there exists a link between jurisdictional integration - "*the shift to a new institution of the right to take at least some important decisions in economic policy*" - and the power of organized interest groups. However, he argued that the assignment of competencies to the international union authorities always reduces the influence of lobbies. A similar argument is in Buchanan (1991).

In this paper I build a model to study the allocation of a competency between an international union and national governments in a setting in which lobbies affect policies as well as the constitutional stage (i.e. the centralization/decentralization decision). The economic framework employed

¹From an economic perspective, a useful reference for the ongoing debate on the EU is Tabellini (2002), while for the WTO see Bagwell and Staiger (2002).

²A recent survey of fiscal federalism is in Oates (1999).

³Recent articles by Alesina, Angeloni and Etro (2005), Besley and Coate (2003) and Lockwood (2002 and 2007) qualify this result in a political economy analysis that explicitly formalizes how decisions are taken at the local and the central level. In addition, a growing political economy literature on federalism studies conditions under which countries integrate politically or break up into smaller jurisdictions. For a survey see Ruta (2005).

⁴Therefore, in contrast to most of the literature on the assignment of prerogatives to different levels of government, this paper adopts a positive rather than a normative approach. A similar approach is in Cremer and Palfrey (1996).

⁵This idea finds support in historical records for the EU (see Moravcsik (1998)).

excludes from consideration efficiency issues related to centralization. International spillovers and differences in national preferences, key elements of a normative approach, are not modeled because they would confound the pure effects of lobbying on the equilibrium allocation of the competency.

I analyze two levels of government: national (i.e. decentralized) and union (i.e. centralized) -see figure 1. At the constitutional stage, member governments of the international union vote to maintain the exclusive competence over a certain policy or to delegate it to the union. Special interests lobby to induce centralization (decentralization) if their power increases (decreases) when the policy is assigned to the international union. If the policy is decentralized, the interaction of national special interests and national governments determines equilibrium policies. If the policy is centralized, national lobbies influence the union authorities. The interaction of national special interests and the international union authorities determines equilibrium policies in the centralized policy areas.

Section 2 introduces the general structure of the model. I employ a framework widely used to explain special interest politics in modern democracies that was first developed by Bernheim and Whinston (1986) and Grossman and Helpman (1994)⁶. In section 3, I provide a model based on three key assumptions: national lobbies are symmetric, the policy under centralization is decided by a union government, and national lobbies compete for influence. I show that in this case the equilibrium with lobbying always implies decentralization. Centralization of a competency has two contrasting effects on lobbies' welfare. On the one hand, it creates competition in otherwise monopolistic national political markets. On the other hand, centralization makes it possible for national lobbies to influence a union-wide (instead of only national) policy, -e.g. a larger union budget rather than the national budget. However, in an equilibrium with symmetric lobbies (and countries), competing special interests fully offset each other: the policy does not change under centralization, but the cost of political influence is higher. National special interests lobby for decentralization at the constitutional stage because their welfare decreases when the policy is assigned to the union authority.

The paper then provides three extensions of this basic framework in section 4. In the first extension, I remove the assumption of symmetric lobbies. In this case, more "powerful" (e.g. larger) special interests are better able to distort the policy to their advantage under centralization and to the disadvantage of the less powerful national groups. If the voting rule at the constitutional stage is sufficiently strict (e.g. unanimity), the equilibrium with lobbying always implies decentralization. The second extension assumes that the policy under centralization is decided by a union council with an external agenda setter that is subject to lobbying. In this case, national lobbies can benefit or lose from centralization depending on their ability to influence the agenda setter. As in the previous case, unanimity at the constitutional stage is sufficient to have endogenous decentralization. Finally,

⁶See Grossman and Helpman (2001) for a recent survey of the literature.

in the last extension, I study the case in which transnational lobbies can be formed. If national lobbies can easily coordinate, then both centralization and decentralization are possible outcomes of the constitutional stage; if the costs of forming an international lobby are high, decentralization results in equilibrium.

Several recent papers discuss the effects of lobbying under centralization and decentralization (or political integration and separation). Among these, Bardhan and Mookherjee (2000), Bordignon, Colombo and Galmarini (2003), Redoano (2004), Brou and Ruta (2006) and Lockwood (2007). Differently from these papers, the focus of the present work is on how national lobbies affect the (de)centralization decision (i.e. the constitutional stage of the game) in addition to the policy choice.

2 The model

We model a society where the government uses a common pool of tax revenues to provide public spending, the benefits of which are concentrated to well defined groups of citizens.⁷ Other policy instruments, such as tariffs, environmental standards, regulations, etc., can be modeled in a similar way.

There are two levels of government: public spending and taxes can be decided at the national level or at an international union level. The union is defined as a supranational jurisdiction, formed by I countries (indexed by $i = 1, \dots, I$), that takes decisions on centralized policies through common authorities.

In each country i there is a small subset of the population that is organized to lobby. Lobby members are denoted with l , while n stands for non-organized. Each group $j = \{l, n\}$ has mass N^j with $\sum_j N^j = N$. A lobby is defined as an organized interest group that can take political actions to influence the government to its advantage.⁸ We abstract from international differences, assuming that all member countries have same size N and same per capita income y .

All individuals in group j are identical and have the same preferences, given by the quasi-linear utility function:

$$w_i^j = x_i^j + H(g_i^j), \quad (1)$$

where x_i^j is consumption of the private good in country i and g_i^j is per capita public spending that benefits each individual belonging to group j in country i in the same way. The function $H(\cdot)$ is increasing and concave, therefore $H_g > 0$ and $H_{gg} < 0$, with $H(0) = 0$.⁹ Underlying this utility

⁷The framework for this application of special interest politics to public spending is due to Persson (1998).

⁸We assume that the lobby was able to overcome the free-riding problem implicit in collective action highlighted by Olson (1965).

⁹Moreover $\lim_{g \rightarrow 0} H_g(g) = \infty$.

function is the assumption that public spending in one country has no spillover effects on other countries' government spending.

Countries in the union can choose to centralize public spending. Centralization implies that the governments cede to the union authority the right to choose public spending, but does not imply that it should be harmonized.¹⁰ Under decentralization, this power remains in the hands of national governments. In both cases public spending is financed by proportional taxation.

Before describing the implications of lobbying activity, it is worth thinking for a moment about optimality. The question is: should the union authority decide over this policy or not? The answer depends on the effect of centralization on the union social welfare.

2.1 Social optimum

In a decentralized (centralized) setting, a social planner chooses public spending in order to maximize national (union) social welfare. The optimal policy under centralization and decentralization is implicitly determined by the condition

$$H_g \left(g_i^{j*} \right) = 1, \tag{2}$$

where a “ * ” indicates optimal public spending. In condition 2, the marginal benefit of the representative agent in each group equals the marginal cost of unity. The members of each group receive an “amount” of public spending that gives them the same marginal benefit as the members of any other group.

Without cross border spillovers, there is no argument in favor of (or against) centralization. In a world of benevolent policy makers (or where there are no lobbies that try to affect policies) all outcomes are Pareto optimal. The economic model excludes from consideration efficiency issues related to centralization. The reason for this formalization is to isolate the pure effects of lobbying on the equilibrium allocation of a competency in an international union.

We now specify how interest groups enter the political process.

2.2 The political game

Special interest groups take political actions to influence policy outcomes to their advantage. Generally, incumbent governments care about social welfare, but are willing to pay some attention to what interest groups want because the political support of lobbies can increase their chance of being reelected. As a result, there is a tension between the politicians' interest in social welfare and political support from lobbies. This tension causes a distortion in equilibrium policy outcomes.

¹⁰The assumption that local public spending is not necessarily uniform is justified on empirical grounds (see, for instance, the discussion in Besley and Coate, 2003). It does not, however, affect in any way the results of this paper.

The situation represented in this paper is an extreme one, where governments only care about the political support of organized groups. This is to amplify the role of lobbies in the political process.¹¹ The political game has two main stages (see figure 1). At a constitutional stage, the governments of member countries meet to vote on centralization. In a second stage, if centralization is accepted, the union authority decides the policy for the entire international union. If centralization is rejected, national governments independently choose public spending.

National lobbies enter both stages of the political game. Before each decision is taken, special interest groups lobby their own government by offering political support. Political support consists of “actions” that special interests promise to take contingent on governments’ decisions. Actions span from the effort to influence voters’ opinion through the media to direct contributions to the campaign of the incumbent government, as emphasized by Grossman and Helpman (1994). Consistently with the literature, we will generally refer to these actions by organized groups as political contributions.

Information is perfect and complete. The game is solved by backward induction and, therefore, the solution needs to be subgame perfect.

3 Lobbying and equilibrium decentralization

This section provides a simple model of endogenous decentralization based on three main assumptions:

- A1. National lobbies are symmetric
- A2. Policy under centralization is decided by a union government
- A3. National lobbies compete for political influence.

Section 4 discusses several extensions where each of these assumptions is removed.

3.1 Decentralization

When the policy is decentralized each national government independently chooses public spending for the two groups: the lobby and the non-organized citizens. The basic framework has the structure of a principal-agent problem, in which the principal (the lobby) offers an incentive scheme (the political contribution function) to the agent (the government).

The objective function of a representative member of the organized interest group is

$$u_i^l = w_i^l(g) - c_i(g), \tag{3}$$

¹¹The model in the case of governments that care about social welfare and lobbies’ support provides qualitatively similar results.

where $w_i^l(g)$ is given by equation 1 and $c_i(g)$ is the contribution function that gives for every vector of public spending g the effort in support of the government of each member of the lobby. Note that under decentralization the objective function of the national special interest is defined only over the national policy vector (i.e. $g \equiv g_D$), while under centralization preferences are defined over the union policy vector (i.e. $g \equiv g_C$).

The lobby's problem is to design an optimal incentive scheme $c_i(\cdot)$, taking into account that the national government sets g_i so as to maximize overall political contributions:

$$w_i^{GOV}(g_i, c_i) = N^l c_i(g_i) \quad (4)$$

Following Grossman and Helpman (1994) and Bernheim and Whinston (1986), we focus on a particular type of political contribution functions (defined as truthful) that have the following form

$$c_i(g_i, b_i) = \max \left[0, w_i^l(g) - b_i \right], \quad (5)$$

where b_i is a constant that is set optimally by the lobby.¹² Truthful political support functions allow the problem to be formulated as follows

$$\max_{g_i} N^l w_i^l(g_i)$$

subject to the budget constraint

$$t_i y N = \sum_j N_i^j g_i^j, \quad (6)$$

where public spending is financed by proportional taxation and the national tax rate $t_i \in (0, 1)$ is residually determined.

Maximizing, we get the first-order conditions that define equilibrium public spending in a decentralized setting:

$$H_g(\tilde{g}_{iD}^l) = N^l/N \quad (7)$$

$$H_g(\tilde{g}_{iD}^n) = \infty, \quad (8)$$

where a “ \sim ” indicates equilibrium public spending.¹³ As it is well understood, conditions 7 and 8 show that lobbying activity distorts policy in favor of the special interest group and against the non-organized citizens ($\tilde{g}_{iD}^l > g_i^* > \tilde{g}_{iD}^n$).¹⁴

¹²Truthful contribution functions imply that the political support from the lobby reflects for every policy level the true preferences of the interest group ($\frac{\partial c_i(g_i, b_i)}{\partial g_i^j} = \frac{\partial w_i^l(g_i)}{\partial g_i^j}$ everywhere). For a more detailed discussion of the properties of truthful functions, see Bernheim and Whinston (1986) and Grossman and Helpman (2001).

¹³We will use a similar notation to denote equilibrium contributions and utility in the rest of the paper.

¹⁴See for a discussion, Persson and Tabellini (2000).

The last step to fully characterize the equilibrium under decentralization is to calculate the political contribution for each member of the lobby. Equilibrium contributions under decentralization are given by

$$\tilde{c}_i^D(g) = 0. \tag{9}$$

This is not surprising under our assumptions. In the Grossman and Helpman (1994) approach, where the government cares about contributions and social welfare, when a single lobby confronts the government, equilibrium political contributions need to compensate the policymaker for (a fraction of) the loss in social welfare created by lobbying activity. However, if the policymaker has no concern for public welfare - as in this case -, he or she requires nothing by way of influence payment.

3.2 Centralization

When a policy is centralized, the right to choose it is ceded by national governments to the political authority of the international union. In this section we assume this authority to be a supranational government independent of national governments.

Centralization has some relevant consequences for lobbies. First, centralization opens new opportunities for special interests: a lobby in a country could receive public spending from a larger pool of resources (i.e. the union budget). On the other hand, as noted by Olson (1982), under centralization lobbies that were monopolists at home have to compete with organized special interests coming from other countries to get favorable policies. This might change equilibrium public spending and the cost of political influence.

A union government cares about overall political contributions of organized groups. Its objective function is similar to the one assumed for national governments (equation 4):

$$w_U^{GOV}(g_C, c_i) = \sum_i N^l c_i(g_C). \tag{10}$$

Under centralization political contributions are contingent on the union policy vector g_C . The reason is that each group is indirectly affected - i.e. through taxation - by the public spending that other groups in the union receive.

The framework now has the structure of a common agency problem in which several principals (the national lobbies) non-cooperatively offer an incentive scheme (the political contribution function) to a common agent (the union government). As before, assuming truthful political support functions, there is an equivalent maximization problem in which the union government chooses public spending to

$$\max_{g_C} \sum_i N^l w_i^l(g_C) \quad (11)$$

subject to

$$t_C y I N = \sum_i \sum_j N^j g_i^j, \quad (12)$$

where t_C is the union tax rate.

The first-order conditions that define equilibrium public spending in a centralized setting are the following:

$$H_g(\tilde{g}_{iC}^l) = N^l/N \quad (13)$$

$$H_g(\tilde{g}_{iC}^n) = \infty \quad (14)$$

Conditions 13 and 14 and the first-order conditions under decentralization are the same, implying that the equilibrium policy under centralization does not change. In this symmetric model, competing national lobbies offset each other under centralization. None of them is able to take advantage of the larger pool of resources created by the union budget.

This result is at odds with the argument of several economists, such as Buchanan (1990) and Olson (1982), who have suggested that the assignment of a competency to an international union can reduce distortions due to lobbying activity.¹⁵ Their argument is based on the increased competition in the international union political market (from the monopoly of the national arena, to the oligopoly of the international one). The difference here is that centralization not only creates competition among pressure groups, but also increases the size of the tax base -and therefore the possibilities for organized groups to distort public spending- in the exact same proportion. The two effects -increased competition and increased resources- fully offset each other.

The last step is again to find the political contributions that members of national special interests have to provide to the union government. From equation 10, government welfare in equilibrium is given by

$$w_U^{GOV}(\tilde{g}_C, c_i(\tilde{g}_C)) = N^l \sum_i c_i(\tilde{g}_C) \quad (15)$$

Assume that group i deviates and chooses not to provide any political contribution. The government's welfare becomes

¹⁵Related to this is Becker's (1983) argument on the efficiency of competition between interest groups. See also Dixit, Grossman and Helpman (1997).

$$w_U^{GOV}(\tilde{g}_C^{-i}, c_j(\tilde{g}_C^{-i})) = N^l \sum_{j \neq i} c_j(\tilde{g}_C^{-i}), \quad (16)$$

where \tilde{g}_C^{-i} is the equilibrium vector of public spending when the national lobby of country i chooses not to influence the union government. In equilibrium the welfare of the union government is not affected by lobby i 's deviation. The intuition is that when there is more than one organized special interest, if a lobby deviates, the government can always “work a deal” with the other lobbies (that is, change the equilibrium policy vector) and get the same welfare level.¹⁶ Using equations 15 and 16 and considering truthful political support functions (equation 5), we get

$$N^l c_i(\tilde{g}_C) + N^l \sum_{j \neq i} [w_j^l(\tilde{g}_C) - \tilde{b}_j] = N^l \sum_{j \neq i} [w_j^l(\tilde{g}_C^{-i}) - \tilde{b}_j].$$

Therefore, under centralization equilibrium contributions for each member of a national lobby are:¹⁷

$$\tilde{c}_i^C(g) = \sum_{j \neq i} [w_j^l(\tilde{g}_C^{-i}) - w_j^l(\tilde{g}_C)]. \quad (17)$$

In equilibrium lobby i needs to compensate the union government for the loss in welfare of the other special interests in order to influence policy in its favor. Clearly this contribution is equal to zero only in the special case where there is only one lobby; otherwise it is always strictly positive.

Summing up, centralization does not change equilibrium policy: special interest groups simply offset each other. In this model where spillovers are absent the only effect of centralization is to drive up costly political support.

3.3 Voting on centralization

We now move to the first - i.e. the constitutional - stage of the game. Governments meet to decide whether to maintain the prerogative at the national level or to delegate it to the union authority¹⁸. National lobbies exert political pressures on national governments to influence this constitutional

¹⁶A formal proof of this result can be found in Dixit, Grossman and Helpman (1997).

¹⁷Note that $\tilde{b}_j \forall j$ does not change when lobby i deviates. The intuition is that \tilde{b}_j is the equilibrium welfare of lobby j net of contributions. Clearly each special interest wants b_j to be as large as possible; however if it increases b_j above \tilde{b}_j the government can always change the policy vector to favor some other lobby that is willing to request a lower b_j and therefore provide larger political support to the government. The only way lobbies can obtain a larger net of contributions welfare when there are at least two organized groups competing for influence is if all special interests choose to reduce their political support. But this is clearly not a Nash equilibrium.

¹⁸From a normative perspective, one could argue that constitutional decisions should be taken directly by voters through referendum. However, most constitutional decisions in international environments (including the European Union) take the form of international treaties negotiated by national governments and are only seldom ratified by referenda. I will come back to this point at the end of the section.

choice. The question we address is the following: how does lobbying affect the (de)centralization decision in an international union?

Government i votes in favor of decentralization whenever

$$\tilde{w}_i^{GOV}(C) < \tilde{w}_i^{GOV}(D), \quad (18)$$

where $\tilde{w}_i^{GOV}(C)$ and $\tilde{w}_i^{GOV}(D)$ are respectively the utility of government i if it votes in favor of centralization or against it. Using equation 4, this condition can be expressed as follows

$$c_i(C) < c_i(D), \quad (19)$$

where $c_i(C)$ and $c_i(D)$ are respectively the (per capita) political contributions to government i if it casts its vote in favor or against centralization.¹⁹

The game at the constitutional stage does not differ from the policy choice stage. Lobbies present a binding promise to provide political support to the government, contingent on the decision that the government takes. The difference is that here the decision is binary. Accordingly, the political support function consists of two numbers. Clearly the lobby pays contributions only if the government casts its vote for the option that the lobby prefers.

We proved that equilibrium policy is the same under centralization and decentralization. On the other hand, competition for influence under centralization drives up equilibrium political contributions, thus decreasing the welfare of organized groups. For this reason lobbies set $c_i(C) = 0$ and $c_i(D) \geq 0$ so that condition 19 always holds and national governments are induced to vote against centralization. This proves the following

Result 1. *Under A1, A2 and A3, (i) national lobbies lose from centralization; (ii) decentralization is the equilibrium outcome of the constitutional stage.*

This result comes about because of the opposition of national special interests that (correctly) perceive the costs of losing their monopolistic power on national governments, but does not depend on the specific assumption on the governments' objective function. Assume that governments are semi-benevolent, that is policymakers care both about social welfare and political contributions. It can be easily shown that equilibrium policy under centralization and decentralization would be the same, but that in a centralized regime competition between national interest groups drives up equilibrium contributions; hence, lobbies are still better off under decentralization. At the

¹⁹Recall that we are assuming that (representatives of) national governments are not part of the union authority and, therefore, do not receive any contribution when the policy is centralized. Results would not change if we assume that national governments receive some fraction of these contributions: national lobbies would find it convenient to offer a little more at the constitutional stage. However, how national governments could enter the union decision mechanism is a key issue. We expand on this in section 4.

constitutional stage, governments vote in favor of decentralization if condition 18 holds, but now governments also take into account the change in social welfare. Being equilibrium policy the same under both regimes, so is social welfare. Therefore, the constitutional decision is still easily tilted in favor of decentralization by national lobbies²⁰.

The decentralization outcome clearly depends on the assumption that national governments are responsible to decide whether to maintain a policy prerogative or not. Assume instead that the (de)centralization decision is taken by all voters through a referendum. Members of organized groups have strict preferences for decentralization, but represent only a fraction of the total population. The outcome of the constitutional stage would depend on the voting behavior of the unorganized that, in this case, are indifferent between the two regimes.²¹

4 Extensions

This section presents three extensions. We first allow national interest groups to differ across countries (i.e. remove assumption A1). We then study a different institutional setting at the union level (i.e. remove A2) and, last, consider cooperation -rather than competition- between national lobbies under centralization (i.e. remove A3). We discuss sufficient conditions under which result 1 holds.

4.1 Asymmetric lobbies

Special interest groups of different countries are seldom identical and might have diverse size, organizational ability, connections to politicians, etc. because of different history, economic structure, population, etc. In this section, we focus on differences in size of national interest groups and ask how this asymmetry affects previous results²².

The union government maximization problem now delivers the following first-order conditions:

$$H_g \left(\tilde{g}_{iC}^l \right) = \sum_i N_i^l / IN \quad (20)$$

$$H_g \left(\tilde{g}_{iC}^n \right) = \infty. \quad (21)$$

Simple inspection of equations 7, 8, 20 and 21 shows that larger lobbies (i.e. those with $N_i^l > \sum_i N_i^l / IN$) receive more public spending (overall and per capita) under centralization. Smaller

²⁰Introducing cross border spillovers implies that social welfare is superior under centralization (see Oates, 1972). National lobbies would have to pay contributions at the constitutional stage to ‘compensate’ the government for not casting its vote in favor of the socially superior regime.

²¹Redoano and Scharf (2004) study how direct (i.e. referenda) or representative democracy influence the centralization decision in an international union. Differently from this paper, the focus of their work is on heterogeneity in policy preferences across countries and not on lobbying by national interest groups.

²²Other differences could be modeled in a similar way.

national special interests (for which $N_i^l < \sum_i N_i^l / IN$) instead receive more favorable policies under decentralization. When lobbies are asymmetric, it is the size of a group relative to the other national special interest groups that determines the pattern of public spending within the union under centralization.

Following the same steps as in section 3, it is easy to show that the cost of political influence in the case of lobbies with different size is:

$$\tilde{c}_i^C(g) = \frac{1}{N_i^l} \left\{ \sum_{j \neq i} N_j^l [w_j^l(\tilde{g}_C^{-i}) - w_j^l(\tilde{g}_C)] \right\}. \quad (22)$$

Equation 22 suggests that the larger the lobby size N_i^l , the lower the equilibrium contribution that the special interest pays to the union government.

As a simple example, consider three countries ($I = 3$) and assume $N_1^l > 0$, $N_2^l = N_3^l = 0$ (i.e. only country 1 has an organized special interest). From the above conditions, it is immediate to see that the lobby in country 1 benefits from centralization: it receives higher public spending under centralization $H_g(\tilde{g}_{1C}^l) = N_1^l / IN < H_g(\tilde{g}_{1D}^l) = N_1^l / N$, which implies $\tilde{g}_{1C}^l > \tilde{g}_{1D}^l$, and pays the same amount of political contributions ($\tilde{c}_1^C = \tilde{c}_1^D = 0$). In this case, the government of country 1 will be induced by its national lobby to cast its vote in favor of centralization at the constitutional stage, while the governments of the other two countries will be exactly indifferent (recall that we are considering politically motivated governments only).

The previous example is suggestive, but probably quite extreme. More in general, under centralization smaller national special interest groups receive less public spending and end up paying higher contributions. For sufficiently strict voting rules at the constitutional stage -for example, unanimity- result 1 clearly still holds.²³ The reason being that governments of countries where lobbies are small -and therefore less powerful- are induced by national special interests to veto centralization at the constitutional stage.

These findings are summarized in the following:

Result 2. *Under A2 and A3, (i) national lobbies can benefit from centralization if they are sufficiently large compared to other national groups; (ii) if the voting rule at the constitutional stage is sufficiently strict (e.g. unanimity), policy decentralization results in equilibrium.*

4.2 Union council

The actual working of an international union can, in fact, be quite different from the one depicted in the previous sections. In particular, national governments are hardly left out of the policy

²³The unanimity rule represents a good example: constitutional decisions in the EU are taken according to this rule. However, unanimity is a sufficient, but not necessary, condition for the decentralization result of this model.

determination process, as we have assumed until now. This section considers an extension of the model where member governments meet in an ad hoc body - the union council - and vote on a policy proposed by an (external) agenda setter. This is a very simplified version of how decisions are taken in the European Union, where an agenda setter (the European Commission) makes a proposal that is voted on by the representatives of national governments (the Council of Ministers).²⁴

The timing of the game is the following. First, each national lobby provides the agenda setter with a contribution function contingent on the proposal. At a second stage, and after observing the contribution schedules, the agenda setter makes a take-it-or-leave-it proposal. Third, each interest group provides its own government with contributions contingent on the vote that the government casts in the union council. Last, the council votes on the proposal. The proposal is adopted if it receives a majority of votes in favor. Otherwise, a default policy with a minimal amount of public spending is implemented.²⁵

We start from the agenda setter's proposal and then show that no government has an incentive to deviate from the proposed policy. If the agenda setter only maximizes special interests' political contributions, at the first stage, each national lobby faces the same problem we studied in section 3. Therefore the proposal that the agenda setter formulates is not different from the policy implemented by a union government (\tilde{g}_C). The difference is now that a national government can vote against such a proposal in the union council; that is, the agenda setter faces the additional constraint

$$w_M^{GOV}(g_C, c_M(g_C)) \geq w_M^{GOV}(\bar{g}_C, c_M(\bar{g}_C)). \quad (23)$$

Condition 23 is a participation constraint for a majority of governments (e.g. under simple majority $M = \frac{I-1}{2}$) and \bar{g}_C is the vector of default public spending that is undertaken when the proposal of the agenda setter is rejected by the council.

Consider now the voting problem of national governments. Each government wants to maximize overall political contributions (equation 4). National lobbies are clearly better off under the agenda setter's proposal, which they influenced, rather than the default policy, which they had no chance to influence. Therefore, organized groups will be willing to pay a positive (but infinitesimal) contribution to induce national governments to approve the proposal. In equilibrium the agenda setter's proposal (\tilde{g}_C) is accepted with unanimity and the policy implemented.

At the constitutional stage national lobbies still find it convenient to induce their government to reject centralization. Therefore, in this example the result of section 3 carries over. This, however, would not necessarily be true in a different institutional setting, because equilibrium

²⁴On certain policy domains the EU has adopted the so-called "community method", which involves in the decision-making process the European Parliament as well as the European Council of Ministers and the Commission. However, the role of the Parliament in the EU is, on most issues, marginal compared to the Council of Ministers. For a detailed description of the EU institutions and their procedures, see Nugent (1999).

²⁵This is a variation of a framework originally created by Helpman and Persson (2001) where the agenda setter is an external body rather than a member of the council randomly chosen.

policies and lobbying expenditures depend on the assumptions on the rules of the game.²⁶ In general, whether national lobbies favor centralization in the hands of a union council depends on the council's decision mechanism. A careful study of how different institutional rules affect these findings is left for future research, here I briefly provide a simple counter-example.

Assume that only a subset of countries $P \subset I$ is able to influence the agenda setter. One can easily check that the agenda setter's proposal will make lobbies in all other countries indifferent between accepting the proposal or rejecting it (i.e. $u_{i \notin P}^l(\tilde{g}_C) = u_{i \notin P}^l(\bar{g}_C)$) and equilibrium payoffs for all countries $i \in P$ will be given by $H_g(\tilde{g}_{iC}^l) = \sum_{i \in P} N_i^l / IN = PN^l / IN$ and $H_g(\tilde{g}_{iC}^n) = \infty$. In this case, the agenda setter's proposal is always approved with unanimity. Notice that lobbies in countries that cannot influence the agenda setter are clearly worse off under centralization; while, special interests in countries that have access to the agenda setter face a trade off between the increasing costs of political contributions ($\tilde{c}_i^C(g) = \frac{1}{N_i} \left\{ \sum_{j \in P, j \neq i} N_j^l \left[w_j^l(\tilde{g}_C^{-i}) - w_j^l(\tilde{g}_C) \right] \right\} > 0$) and the benefits of receiving more public spending ($H_g(\tilde{g}_{iC}^l) = PN^l / IN < H_g(\tilde{g}_{iD}^l) = N^l / N$).²⁷ While the negative effect on contributions derives from the increase of competition between special interests under centralization (as in section 3), the positive effect on public spending comes from the (asymmetric) ability of some countries to influence the agenda setter and, therefore, to distort funds from the union budget to their exclusive advantage. Provided that this second effect dominates, governments of countries that belong to the "influential" subset P will be induced at the constitutional stage to approve centralization; special interests in countries that do not belong to the "influential" subset will always lobby against centralization. As in the previous subsection, result 1 continues holding only for a sufficiently strict voting rule.

Summarizing:

Result 3. *Under A1 and A3, (i) national lobbies can benefit from centralization if they are able to influence the agenda setter, while other groups are not; (ii) if the voting rule at the constitutional stage is sufficiently strict (e.g. unanimity), policy decentralization results in equilibrium.*

4.3 International lobbies

Underlying this model there is a strong assumption on special interests' behavior: national lobbies always choose to compete for influence in the international arena. However, many national interest groups have managed to coordinate their lobbying activity by forming international lobbies. Greenwood (2003) finds that in the EU there are 1,450 interest groups that associate special interests of

²⁶For example, if the agenda setter is one of the governments, as in Helpman and Persson (2001), lobbying costs do not increase under centralization. Only the lobby in the agenda-setting country is able to affect policy to its advantage and is better off under centralization.

²⁷There is a third effect on the tax rate. However, the sign of this effect is ambiguous, as it depends (among other things) on the default policy \bar{g}_C .

different nationalities.²⁸

We now endogenize the choice of international lobby formation. Consider a new stage of the game in which, when a policy is centralized, national interest groups can choose to form an international lobby or remain unorganized at the international level. An international lobby is defined as an organization of national special interests with the following objective function:

$$u_{INT}^l = \sum_i u_i^l, \quad (24)$$

where u_i^l is given by equation 3.

When the union government interacts with an international lobby, the game looks like the one under decentralization: the international lobby is the only principal in the agency relation with the union government. Therefore the equilibrium policy and political contributions are the same as under decentralization. From the perspective of international lobby members (as well as non-organized citizens) centralization does not affect welfare. Whenever a policy is centralized, national lobbies find it convenient to coordinate.

This example sheds some light on the reason international lobbies form: if a policy is centralized, national interest groups have an incentive to coordinate in order to reduce the cost of political influence. In the case of the EU, as reported by Greenwood (2003), many European interest groups were formed following the implementation of the Single Market project.²⁹ An important open question, however, is why some national groups coordinate while others do not. To put it differently, under what conditions are international lobbies formed?

A simple way to study this problem is to assume that there exists an exogenous fixed cost of lobby formation ($F > 0$) that is specific to different sectors/groups³⁰. National interest groups will be willing to merge if the utility that they can get when they coordinate their lobbying activities is larger than the utility they get when competing plus the fixed cost. That is, an international lobby is formed if and only if

$$\frac{\tilde{u}_{INT}^l}{I} \geq \tilde{u}_i^l + F.$$

Define \bar{F} as the threshold level of the fixed cost of organization in the above condition. In this model, groups that face a low cost of organization ($F \leq \bar{F}$) form an international lobby and are indifferent between centralization and decentralization; while groups that face a high cost

²⁸A second interesting source is the European Commission's website dedicated to civil society organizations (http://europa.eu.int/comm/civil_society/coneccs). On this website there is a list of 975 special interests, most of which have an international dimension. Needless to say these numbers are purely indicative.

²⁹There are some relevant exceptions. Moravcsik (1998) reports that cooperation between the main German and French organizations of farmers (respectively the DBW and the FNSEA) had already begun in the 1950s and intensified during the Rome Treaty negotiations.

³⁰This formulation follows the same logic of the endogenous group formation model of Mitra (1999).

($F > \bar{F}$) do not coordinate and are better off under decentralization. This implies that opposition to centralization in an international union will be stronger in those sectors where coordination between national special interests is perceived to be more difficult and costly.

This approach provides a novel explanation of why it is harder to centralize social policy than enterprise or industrial policy in the EU. A related issue is why it is politically difficult to pass agreements on labor standards in the WTO. In this view the reason is that business lobbies find it easier than labor unions to coordinate internationally their lobbying activity -i.e. have a lower fixed cost of organization F . This argument is complementary to the more traditional explanation of decentralization based on the greater differences in preferences across countries over social policy.³¹

The main findings are summarized as follows:

Result 4. *Under A1 and A2, (i) national lobbies are indifferent between centralization and decentralization if the costs of coordination are low ($F \leq \bar{F}$), while they lose from centralization for high costs of coordination ($F > \bar{F}$); (ii) if ($F \leq \bar{F}$) both centralization and decentralization are possible outcomes of the constitutional stage, while for ($F > \bar{F}$) policy decentralization results in equilibrium for any voting rule.*

5 Conclusions

This paper presents a positive theory of (de)centralization of political decisions in an international union in a setting in which national special interests influence governments' policy and constitutional decisions. The central claim is that special interests can affect the allocation of competencies between different levels of government

The model provides an example where the assignment of prerogatives to a union authority creates competition in otherwise monopolistic political markets and thus increases the cost of lobbying. National special interests correctly perceive the loss of influence associated with centralization and lobby for decentralization at the constitutional stage. In the absence of cross border spillovers, politically motivated governments reject centralization. Three extensions show that this result depends on the voting mechanism at the constitutional stage, the institutional decision mechanism under centralization and the ability of national special interests to coordinate under centralization.

³¹The two arguments might be related in the sense that differences in preferences can help to explain why national interest groups do not coordinate under centralization.

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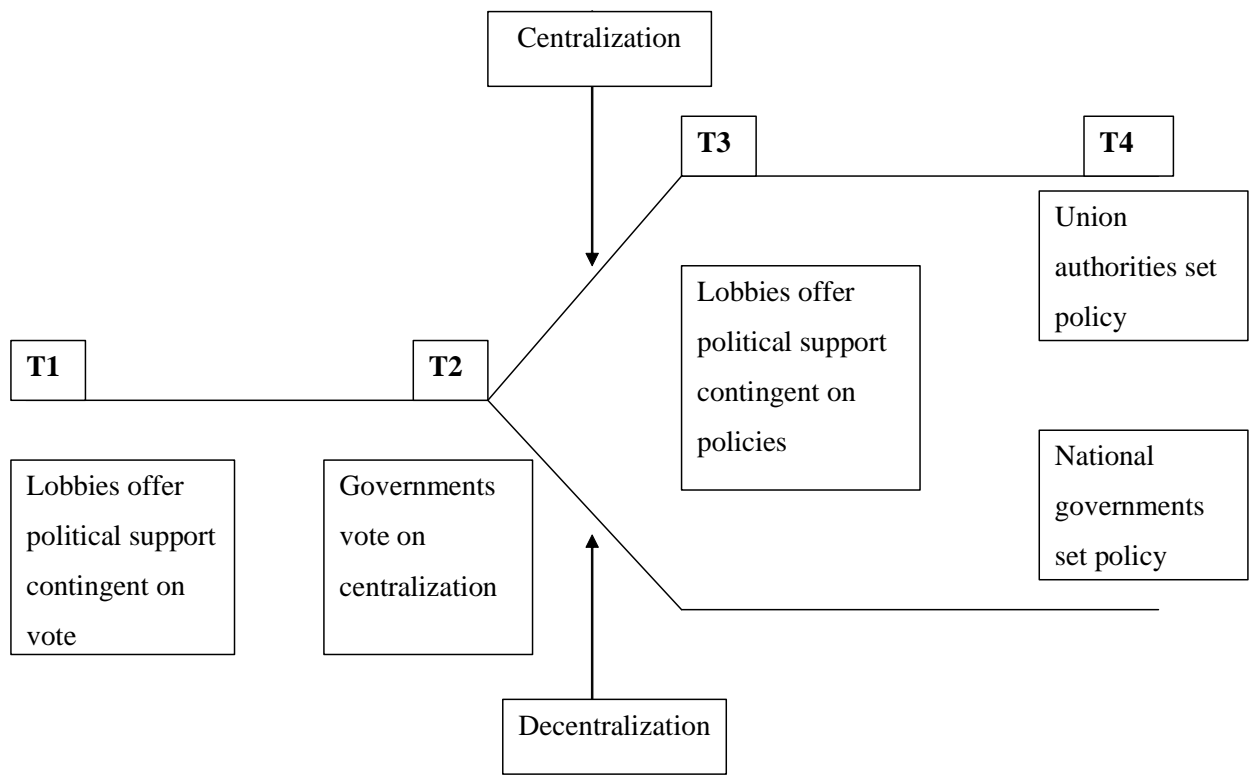


Figure 1: **Timing of the political game**