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DIRECT DEMOCRACY AS A DISCIPLINARY DEVICE ON EXCESSIVE PUBLIC SPENDING

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Introduction

The current debt crisis in Europe and North America raises the question of how to impose greater spending discipline on governments and politicians. In Germany, for example, a debt break at both the federal and the state level has now been incorporated into constitutional law. After 2016, net borrowing by the federal government cannot exceed 0.35 percent of GDP. After 2020, a balanced budget is also required by all German states (except in rare circumstances such as natural disasters or an exceptionally deep recession).

Do such rules or similar provisions constrain public spending? The evidence is not clear-cut (see, for example, Poterba 1997; Bohn and Inman 1996 for evidence from the United States). Past experience, most recently with the Stability Pact in the European Union, has certainly demonstrated that governments can be quite creative in circumventing such budget rules.

To increase budget discipline, a promising alternative could be direct democracy, which gives citizens more direct influence over public spending. Direct democracy has experienced a remarkable renaissance over the past few decades. The recent referendums on the new European constitution in France, the Netherlands and Ireland are a few prominent examples of this upsurge in direct voter participation, which has also become increasingly popular at the local level in Germany. Moreover, its introduction is currently being debated

in such diverse contexts as in the Netherlands, South Africa and even in the European Union.

The rising popularity of direct democracy is fuelled by the belief that direct voter control may not only improve the legitimacy of political decisions, but could also slow down or even reverse the rapid growth in government spending and debt observed over the past decades. In recent work (Funk and Gathmann 2011, 2013), we evaluate the merit of these policy proposals using the exemplary case of Switzerland. Switzerland is a country with historically low government spending, which many argue is related to its intensive use of direct democracy.

More specifically, we ask whether direct democracy reduces government spending and whether direct democratic institutions at one level of government shift spending to lower levels of governments – resulting in more decentralization. Our evidence suggests that direct democracy constrains spending but its effect is more modest than previously suggested (for example Feld and Matsusaka 2003; Matsusaka 2004). We also find little evidence that direct democracy at the state level results in higher local spending or decentralization. This result suggests that state politicians cannot easily avoid the disciplining effect of direct democracy by simply shifting responsibilities to local levels of government. Overall, direct democracy seems to be a promising institutional alternative to reduce public spending when citizens are more fiscally conservative than representatives.

Direct democracy in Switzerland

Switzerland has a strong federalist system in which its cantons play an important role. In fact, all political responsibilities remain with the canton unless they were granted to the federal government in a national referendum. In 2010, 42 percent of all government spending was undertaken by the cantons, 34 percent by the federal and 24 percent by local governments. Cantons have a lot of autonomy in the provision of public goods, as well as the authority to tax labor and capital income. As a result, there is a great deal of heterogeneity in taxes, public spending, and – most importantly – political institutions across cantons. The study focuses on the di-

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rect democratic institutions most relevant for fiscal policy: the mandatory budget referendum and the voter initiative.

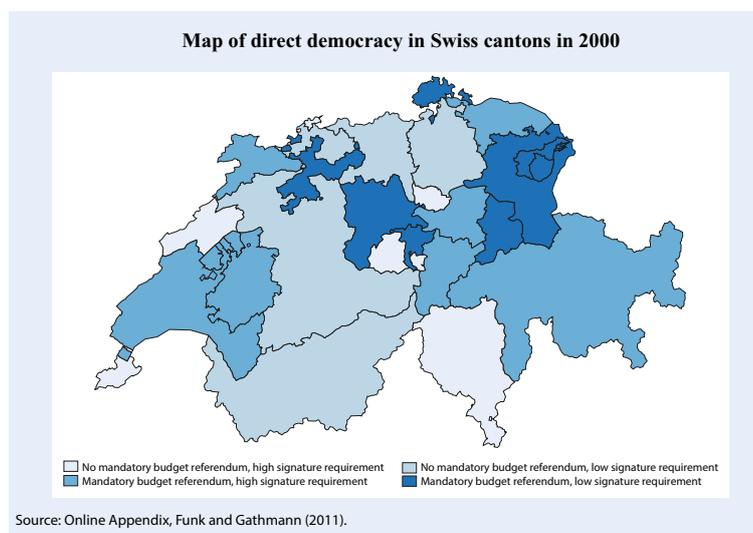
Direct democracy has always played an important role in Switzerland (Curti 1900; Trechsel and Serdült 1999; Vatter 2002). The referendum and voter initiative for a revision of the federal constitution have been in place since the Swiss Confederation was founded in 1848 (Kölz 1992). Direct democracy has an even longer political tradition at the canton level. In cantons such as Appenzell, Glarus or Uri, the direct participation of citizens in town meetings goes back to the 13th and 14th century. The right to propose new laws through initiatives, for example, was already in place in Glarus, Vaud and Nidwalden in 1850 (Kölz 2004).

The mandatory budget referendum (currently in place in about 60 percent of the cantons) gives citizens the power to approve or reject government projects when their (one-time or recurring) expenditures exceed a certain monetary threshold (the exact threshold is set in the canton constitution). The construction of a new canton hospital is one example of a project falling under the mandatory budget referendum. Between 1980 and 1999 alone, citizens voted on 461 expenditure referendums and approved 86 percent of the projects proposed (Trechsel and Serdült 1999).

By contrast, referendums in the remaining Swiss cantons as well as at the local level in Germany, for example, are optional. Here, citizens have to collect a certain number of signatures before a political project or decision is taken to the ballot box. Yet control over the budget is stronger with a mandatory budget referendum because voter approval is mandated by law.

The voter initiative in turn allows citizens to propose entirely new laws, for example, limits on spending growth. While all cantons in Switzerland allow for voter initiatives, there is substantial variation in the number of signatures required to get an initiative on the ballot. A lower signature requirement (measured in terms of eligible voters) imposes fewer costs on citizens to propose a decision and therefore facilitates the use of direct

Figure 1



democracy. Hence, low signature requirements for the voter initiative strengthen voter control over political decisions. Figure 1 shows the geographic distribution of the mandatory budget referendum and signature requirement for the voter initiative in the Swiss cantons in 2000.

Political representation with direct democracy

But how exactly do the referendum and the voter initiative affect public policies? If representatives simply implemented the preferences of voters (according to the median voter theorem), direct democracy would have little impact on political decisions. With imperfect electoral competition, however, the preferences of legislators and voters may diverge and actual policies need not necessarily reflect the preferences of the median voter. This divergence could arise, for example, as a result of career concerns by politicians, lobbying by special interest groups or bargaining (log-rolling) in the legislature. Referendums and initiatives then give citizens tools to influence the policies above and beyond general elections – which tend to bring actual policies closer to those preferred by the median voter.

In a referendum, politicians propose the project and hence the amount of additional spending citizens can approve or not (Romer and Rosenthal 1979). If voters agree with the project and the proposed spending, the project is implemented. If voters decline the project in the referendum, the status quo budget (without the particular project) is implemented instead. Referendums thus constrain public spending when politicians prefer

to spend more than voters (and the costs of going to the ballot are not too high).

The effect of the voter initiative on public spending also depends on the spending preferences of politicians compared to voters. When legislators spend more than desired by the median voter, the mere threat of an initiative can force legislators to implement policies closer to the preferences of the median voter (Gerber 1996). Otherwise, voters can always launch an initiative to force a reduction in public spending (as they did with Proposition 13 in California, for example). A second argument why initiatives might affect spending directly is that they allow citizens to select their preferred choice for individual policy proposals. In a purely representative democracy, citizens can only select candidates representing a whole bundle of policy proposals. Legislators' choices on non-salient issues may therefore differ from the actual preferences of the median voter (Weingast, Shepsie and Johnson 1981; Besley and Coate 2002). By launching an initiative, citizens can effectively "unbundle" a policy issue from other decisions taken.

Two insights emerge from this discussion: both a referendum and a voter initiative may constrain public spending when the costs of direct democratic participation are not too high and voters actually prefer less spending than representatives. If voters were to prefer more public spending than politicians, direct democracy could, in fact, increase government spending.

Direct democracy at the canton level may also affect spending behavior at the local level: fewer canton resources might constrain local fiscal budgets, or might affect citizens' willingness to delegate responsibilities to the canton (rather than local) level. Direct democracy could also increase local spending if canton politicians

constrained by voter control at the canton level were to delegate responsibilities to the local level. In that case, higher spending at the local level would partly offset the constraining effect of direct democracy at the canton level (Feld, Schaltegger and Schnellenbach 2008; Galleta and Jametti 2012).

Fiscal effects of direct democratic participation in Switzerland

To isolate the actual effect of direct democracy on public spending, we need to ensure that cantons are comparable along other dimensions. Most importantly, voters in cantons with stronger direct democracy might prefer less public spending than voters in other cantons. In that case, the public spending observed should also be lower in those cantons with strong direct democracy, even if direct democracy had no effect on spending whatsoever. To explore the role of voter preferences on spending, we use the fact that Switzerland also has direct democracy at the federal level. Specifically, we assembled data on all federal ballots held in Switzerland since 1890. Based on supplementary official documents, we select ballots in which voters had to decide on a measure that would increase (decrease) public expenditure, subsidies or taxes (see Funk and Gathmann 2013 for details). As citizens in all cantons decide on the same ballot, we can compare the voting preferences of cantons in which voters have more control over political decisions to those of cantons with weaker direct democracy.

Table 1 shows cantonal voter support for increases in public spending relative to the Swiss average. The table demonstrates that voters in cantons with strong direct democracy are more fiscally conservative than voters in other cantons. Hence, voter preferences seem to shape

Table 1

Voter preferences vary by institutional regime					
	Mandatory budget referendum		No mandatory budget referendum		T Statistic Mean Differences
	Mean	Std. Dev	Mean	Std. Dev	
% Support for more government	1,35	7,42	1,93	9,42	5,9
% Support for higher spending	-2,45	8,21	3,47	9,99	8,4
Notes: The table reports the weighted mean and standard deviation of voter support for more government (higher spending, taxes or subsidies) and higher public spending. The summary statistics are shown separately for cantons with and without a mandatory budget referendum and weighted by the size of a canton's electorate. Voter support in federal propositions is calculated as the support (in percent) in each canton's electorate for a proposition with higher implied spending or taxes and as a deviation from the Swiss average. Hence, cantons with negative numbers show less than average support for the proposition while positive numbers indicate a higher voter support than the average canton.					

Source: Funk and Gathmann (2013).

institutions which, in turn, affect the size and composition of public spending.

We further collected a rich new data set with detailed information on direct democratic institutions in all Swiss cantons, which we coded from past and current canton constitutions. The long horizon of the analysis from 1890 to 2000 has the advantage that almost all cantons reformed their direct democratic institutions at least once, and often multiple times, over this period. To evaluate the public spending effects of direct democracy, our study then compares how much public spending adjusts if a canton adopted (or abolished) the mandatory budget referendum, or facilitated (impeded) voter initiatives by reducing (increasing) signature requirements, relative to public spending changes in a similar canton without a reform.

We start out with canton fixed effects to control for any permanent unobservable canton differences (like cultural differences, for example) that may also influence public spending. We further control for other observable canton characteristics such as population composition, or its economic structure, as well as our measure of voter

preferences. Our fixed effect estimates suggest that the mandatory budget referendum reduces canton spending by 8.4 percent (see Table 2). An increase in the signature requirement for the voter initiative by one percent (of the eligible population) raises expenditure by 0.4 percent. In all specifications, the canton fixed effects are highly statistically significant, suggesting that cantons also differ along time-invariant unobservable dimensions.

Table 2, however, does not suggest that direct democracy at the canton level shifts spending to the local level. If anything, the voter initiative seems to be associated with more centralized spending, not less. Hence, the reduction of state expenditure through direct democracy is not offset by higher expenditure at the local level.

Figure 2 also suggests that periods of high spending (that is, overspending in the eye of the voter) increase the likelihood of adopting stronger direct democratic institutions in a canton. Thus, direct democracy is not only stronger in cantons where voters are fiscally more conservative, but periods of high spending also seem to trigger reforms to increase voter control over public resources.

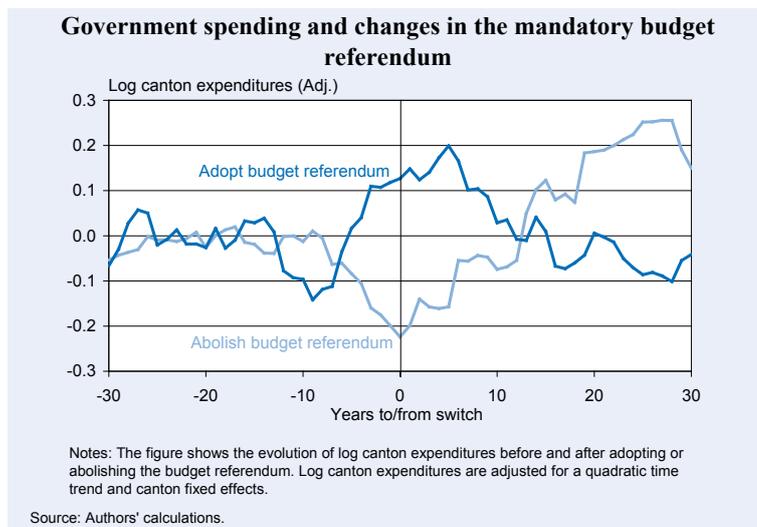
Table 2

	Direct democracy and government spending					
	Canton expenditure			Local expenditure		
	OLS (1)	OLS (IV sample) (2)	IV (3)	OLS (4)	OLS (IV sample) (5)	IV (6)
Budget referendum	-0.084** (0.041)	-0.097** (0.042)	-0.107** (0.043)	-0.065 (0.042)	-0.007 (0.058)	0.151 (0.095)
Signature requirement initiative	0.004*** (0.001)	0.004*** (0.001)	0.014** (0.006)	0.004*** (0.001)	0.009*** (0.002)	0.023*** (0.007)
Other canton characteristics	Yes	Yes	Yes	Yes	Yes	Yes
Age structure of canton	Yes	Yes	Yes	Yes	Yes	Yes
Size legislature and executive	Yes	Yes	Yes	Yes	Yes	Yes
Canton fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Year fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Observations	2,395	2,355	2,355	2,310	2,310	2,310
R-squared	0.98	0.98		0.95	0.95	

Notes: The dependent variable is log annual canton per capita expenditures in columns (1)-(3) and log annual local per capita revenues in columns (4)-(6) over the period 1890-2000. The mandatory budget referendum is a binary variable equal to one if a referendum for large projects is mandated by law. The signature requirement for the voter initiative is measured as share of eligible voters. All specifications include log population, the percentage of the population in different age groups (20-39, 40-64, 65 and above, age 0-19 being the omitted category), the percentage of the population living in cities with more than 10,000 inhabitants, the percentage of workers employed in agriculture and industry, the log per capita federal subsidies to a canton, labor force participation rate, infant mortality rate, the per capita ownership of cars, the number of doctors per 1,000 inhabitants, the percentage of Protestants, the size of the canton parliament and the size of the canton executive as well as canton and year fixed effects. Columns (1) and (4) show OLS results; columns (2) and (5) restrict the sample to those with valid observations of the instruments. Columns (3) and (6) show instrumental variable estimates where we use the provisions for the constitutional initiative and for the mandatory budget referendum in neighboring cantons as instruments for the current direct democratic institutions in a canton. Statistical significance: ***, p<0.01, **, p<0.05 and *, p<0.1.

Source: Funk and Gathmann (2011).

Figure 2



To address this concern of reverse causality, that is the possibility that public spending results in institutional reforms rather than the reverse, we use an instrumental variable approach. Since all direct democratic participation rights are set down in the constitution, institutional reform necessarily requires a change in the canton's constitution. Our first instrument measures how difficult it is for voters to amend the canton's constitution. As a second instrument, we use changes in direct democracy in the neighboring cantons. Both instruments affect the provision of direct democracy in a canton, but are plausibly unrelated to a canton's public spending. Empirical identification of the causal effect of direct democracy on public spending is then achieved by instrumental variables combined with canton fixed effects.

The instrumental variable estimates show that the budget referendum decreases canton spending by 12 percent. In addition, a one percent lower signature requirement for the initiative decreases canton spending by 0.4–1.4 percent. Overall, these results suggest that direct democracy works as a constraining tool even after we account for voter preferences, other institutional differences and the endogeneity of direct democratic institutions.

Conclusion

Our recent work clearly supports the view that direct democracy might not only increase the legitimacy of political decisions, but also act as an effective tool to reduce public spending. In the Swiss context, voters in cantons with stronger direct democracy do indeed prefer less spending than voters in cantons with weaker participatory institutions. Direct democracy improves the representation of these fiscally more conservative voter preferences in actual political decisions. Both the mandatory budget referendum and the voter initiative are

effective tools for reducing public spending, even after accounting for differences in voter preferences and the fact that direct democracy is itself a product of voters preferring more political influence.

We also show that direct democratic institutions at the canton level play a limited role in the vertical structure of government. Neither the budget referendum nor the voter initiative decentralizes spending to the local level. Hence, we find little evidence for the concern that representatives can circumvent the tighter voter control over public spending by shifting spending to lower levels of government.

As such, direct democracy seems a promising institution for countering overspending and excessive debt. There are, however, a few caveats to this conclusion: first, not all political decisions lend themselves to a ballot vote as the issue needs to be framed as a simple yes/no vote (which is not always possible). Further, citizens need to be able to make an informed decision which is difficult when the issue is very complex. Finally, voters also need to be well-informed through supporting material that is accessible to all eligible voters. Yet, the example of Switzerland and other countries with direct democracy shows that these caveats can not only be overcome but that citizens deciding directly at the ballot actually contribute to a vibrant democratic culture.

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