ABSTRACT OF THE DISSERTATION

Limited Government, Fiscal Centralization, and Public Finances:
From Game Theory to Economic History

by

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This dissertation combines game theory, econometrics, and economic history to study how political arrangements affect public finances. In particular, I examine two institutional transformations. Limited government enables rulers to make credible commitments to sound fiscal policies. Fiscal centralization allows central governments to exercise control over taxation within states.

Chapter 1 uses game theory to study how private information about national security affects the ruler’s choice of fiscal arrangements. The results of the model indicate that limited government does not always emerge as the institution that the ruler most prefers to collect tax revenues. When the threat of foreign invasion is great, the ruler foregoes limited government, opting instead to exploit the subject’s fear of attack to secure tax funds. When the threat is low, the ruler concludes that limited government is
simply not worth the amount of resources that it costs to implement. Indeed, I find that political change occurs only at intermediate threat levels.

Chapter 2 uses economic history to examine the impact of limited government and fiscal centralization on sovereign credit risk in European states over the 18th and 19th centuries. The results indicate that limited government led to significant improvements in financial property rights to public debt. At the same time, I find that fiscal centralization was also necessary to significantly reduce sovereign credit risk.

Chapter 3 analyzes the possible effects of limited government and fiscal centralization on state revenues and expenditures in Europe from 1650 to 1914. The results indicate that each political transformation led to significant increases in per-capita revenues and expenditures, suggesting that both institutional changes were necessary to improve public finances.

For the past two decades, researchers have touted the economic virtues of limited government. In my dissertation, I use theoretical and empirical means to refine this conventional wisdom, discovering important instances where it falls short. First, limited government may be difficult to establish, regardless of its fiscal benefits. Second, limited government by itself is not sufficient. Structural characteristics like fiscal centralization also matter to the efficient workings of public finances.