

Term Limits and Electoral Accountability*

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Abstract

Periodic elections are the main instrument through which voters can hold politicians accountable. From this perspective term limits, which restrict voters' ability to reward politicians with re-election, appear counterproductive. We show that despite the disciplining effect of elections two-term limits – which is the empirically most frequent restriction on tenure – or even longer term limits can be ex ante welfare improving from the perspective of voters. By reducing the value of holding office term limits can induce politicians to implement policies that are closer to their private preferences. Such “truthful” behavior by incumbents in turn results in better screening of incumbents. We show that the combination of these two effects can strictly increase the utility of voters.

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1 Introduction

In representative democracies, periodic elections are the main instrument through which voters can hold politicians accountable. A broad lesson from the growing literature on political economy is that electoral accountability should benefit voters through two main channels. First, elections enable voters to selectively retain good incumbents. If politicians have heterogeneous preferences, for example, then politicians with preferences which are close to those of the electorate should face a higher re-election probability. Second, electoral accountability constrains opportunistic behavior by incumbents. If the payoffs from future terms in office are sufficiently large, then the threat of being replaced by a challenger should reduce politicians' willingness to implement policies which are not in the interests of the electorate.

From this perspective term limits, which limit politicians to a maximum number of terms in office, are a curious intervention into the political process. In the presence of term limits voters are unable to retain good politicians who face a binding term limit. Furthermore, term limits will reduce or, in the case of a binding term limit, eliminate the incumbent's payoffs from future periods in office, which reduces voters' ability to punish opportunistic behavior by threatening to replace the incumbent with a challenger. It would therefore not be surprising if voters were strongly opposed to term limits.

However, the opposite seems to be the case in practice. Opinion polls suggest substantial support for term limits among voters from all sides of the political spectrum. Carey et al. (2000) document that large majorities of voters supported the introduction of term limits in a series of referenda in the US states during the 1990s. Term limits are not only popular, but also widely used. In the United States several states have limited their governor to a maximum number of terms in office since the founding of the United States.¹ Currently, the office of the

¹See Grofman and Sutherland (1996) for a history of term limits in the United States.

president, most governors and many other politicians in the state executive face term limits. Recently, several states have also introduced term limits for their state legislators.

In this paper we address this apparent puzzle. We argue that term limits can in fact serve the interests of voters – even though elections do indeed have a disciplining effect on politicians. We analyze a model in which politicians can be of one of two types: some are “public-spirited,” with payoffs that coincide with those of the electorate, while others have biased preferences. The key idea behind our results is that the incentives created by electoral accountability may not only reduce opportunistic behavior by biased politicians, but may also distort the behavior of public-spirited politicians. The reason is that the payoffs from future periods in office can make even public-spirited politicians unwilling to take actions that are in the interests of voters today, if doing so reduces their re-election prospects.

In this context limiting politicians to a finite number of terms in office can be an attractive institution. Consider a restriction to at most two terms in office. This reduces the value of staying in office after the first term and it changes the political equilibrium in our model sharply. It is immediate that politicians will follow their own preferences in their second term in office, when re-election is not an option. However, the reduced payoff from re-election ensures that politicians in their first term will also be less inclined to implement policies that would enhance their re-election probability but are not in line with their own policy preferences. We refer to this as the “truthfulness effect” of term limits. Furthermore, increased truthfulness reduces the re-election probability of biased incumbents. As past policy choices become a better indicator of the true preferences of the incumbent, it is easier for voters to detect and remove biased politicians. We refer to this as the “selection effect” of term limits.

Our main contribution is to show that the combination of the truthfulness and selection effect can make a two-term or even longer limit the optimal in-

stitution from the perspective of voters. The welfare impact of truthfulness is in general ambiguous: truthfulness by public-spirited politicians must be beneficial, but truthfulness of biased politicians will not. However, the welfare implications of the selection effect induced by more truthful behavior are unambiguously positive. An increase in voters' ability to weed out politicians who do not share their preferences must increase the voters' utility. If the costs of more truthful behavior are small (they could even be negative), then the positive selection effect will ensure that two-term limits increase voter welfare.

Our finding that the political equilibrium in the absence of term limits can distort the incentives of both biased and public-spirited politicians is related to the growing literature which shows that reputational concerns can result in very inefficient equilibria. Morris (2001), for example, shows that an informed advisor who shares the preferences of the decision maker can have an incentive to lie about his information if telling the truth would induce the decision maker to think that he is a biased advisor. If the advisor cares sufficiently about his reputation, then no information is transferred to the decision maker in equilibrium. A related idea is developed in Ely and Välimäki (2003), who look at a market in which long-lived players interact with a series of short-lived players. They show that there can be a complete market failure if the long-lived players are too concerned about their future reputations.

Some recent work has applied similar ideas to political economy environments. Maskin and Tirole (2004), building on Canes-Wrone et al. (2001), compare the relative efficiency of representative democracy, direct democracy and judicial power in a simple two-period model. They find that strong re-election incentives induce politicians to "pander" to public opinion. In this case representative democracy is strictly inferior to the other two alternative institutions. In contrast, our focus is the interaction between term limits and incumbents' re-election incentives in a representative democracy. Glazer (2003) shows that both good and bad politicians may have an incentive to take decisions prematurely if good

politicians are able to respond faster to a new problem than bad politicians.

The most influential explanation for term limits for members of congress was introduced by Dick and Lott (1993) and Buchanan and Congleton (1994) and is developed further in Chari et al. (1997). They argue that politicians' ability to transfer resources to their districts increases in their tenure in office relative to the tenure of other delegates. This seniority bonus makes it costly for voters from one district to unilaterally not re-elect their incumbent, which in turn allows senior incumbents to extract rents. They show that one solution to this dilemma are term limits, which reduce the average tenure of politicians and make it less costly to punish bad behavior by incumbents.

An alternative explanation for term limits, which is not limited to a congressional setting, is introduced by Tabarrok (1996) and formalized in Glaeser (1997). In this model a right-wing and a left-wing party have an equal probability of winning the first election. However, an exogenous incumbency advantage ensures that the party which wins the first election is also re-elected for further terms in office. If voters are sufficiently risk averse then a term limit after each term, which eliminates the incumbency advantage, can increase the ex ante utility of both the left-wing and right-wing party.

Closest in spirit to our analysis is the almost entirely informal discussion in Glazer and Wattenberg (1996). They argue that in a world without term limits the spoils of future periods in office may generate excessive incentives for politicians to secure their re-election. To improve their re-election prospects politicians are assumed to divert time from important legislative work, which is viewed as a public good, to narrow services for their constituencies. They argue that term limits would reduce the value of gaining re-election and induce politicians to concentrate more on legislative work. Our model will capture the effect that term limits reduce the value of holding office and will make precise under what circumstances this mechanism can improve the welfare of voters.²

²Two further explanations for term limits are developed in Konrad and Torsvik (1997), where

There are two important differences between our approach and the existing literature on term limits. First, our approach explicitly considers the accountability effect of elections, which constrains the behavior of bad incumbents.³ Second, our approach provides a natural explanation for why term limits that take effect after an incumbent's second - or even later - term in office can be optimal for voters. In contrast, the mechanisms identified in the existing literature on term limits, only justify the use of one-term limits. To account for longer term limits they would have to be combined with a non-linear payoff from tenure, which first increases but later declines. However, the peculiar combination of a limited number of re-election possibilities followed by a certain removal from office, which is present under two-term or longer term limits, seems to be empirically very prominent. In the United States, for example, term restrictions typically allow politicians to stay in office for two or more terms, and this predominance has been growing over time.⁴

2 Model

We develop a simple infinite horizon political agency model. The political agency literature originated with Barro (1973) and recent contributions include Banks and Sundaram (1998), Coate and Morris (1995) and Besley and Burgess (2002). The next subsection introduces the economic environment and the following subsection introduces the equilibrium definition.

the optimal provision of incentives for a bureaucrat requires that the politician is removed from office after every period, and Adams and Kenny (1986), where term limits are used as a substitute for elections to implement an optimal tenure for politicians. See Lopez (2003) and Tabarrok (1994) for surveys of the term limits literature.

³Empirical evidence from gubernatorial elections that accountability does indeed influence the behavior of politicians is presented in Besley and Case (1995a, 2003) and List and Sturm (2006).

⁴List and Sturm (2006) document the movement to two-term limits for US governors in the post-war period and also the term limits in the US state legislatures analyzed in Carey et al. (2000) allow at least two terms in office.

2.1 Economic environment

We consider an infinitely repeated game between a single voter and a sequence of elected politicians. In each period, the incumbent makes a policy decision $x_t \in \{0, 1\}$. The payoff from the two possible actions on the policy issue depends on a state of nature $s_t \in \{0, 1\}$. The voter's per period payoff from the decision is

$$v(x_t, s_t) = x_t s_t + (1 - x_t)(1 - s_t), \quad (1)$$

i.e. the voter receives a payoff of one if $x_t = s_t$ and zero otherwise. The realizations of the state s_t are independent draws from a distribution with $p = \text{Prob}(s_t = 0)$ and we assume that $p > 1/2$, i.e. the voter believes *ex ante* that action $x_t = 0$ is the right choice.

Each incumbent politician may be of one of two types $\theta \in \{B, G\}$. Type G agents will be referred to as "good" and type B agents as "bad" politicians. Good politicians are public-spirited officials who derive utility from implementing the policy that is in the interest of the voter. The payoff of a good politician from choosing x_t in any period when he is in office is just

$$u_G(x_t, s_t) = v(x_t, s_t). \quad (2)$$

Bad politicians' preferences are similar, but they are biased in favor of choosing $x_t = 1$. The payoff of a bad politician from choosing x_t when he is in office depends on a state of nature $r_t \in \{0, 1\}$ and is

$$u_B(x_t, r_t) = x_t r_t + (1 - x_t)(1 - r_t). \quad (3)$$

The realizations of r_t are independent draws from a distribution with $\text{Prob}(r_t = 0) = q$. We assume that $q < p$ and $\text{Prob}(r_t = 1 | s_t = 1) = 1$. That is, when a good politician would like to choose $x_t = 1$ then a bad politician agrees. However, bad politicians prefer to choose $x_t = 1$ strictly more often than good politicians. Finally, we assume that bad politicians' preferences satisfy the restriction $p > 1 - (p - q)$. The right hand side of this inequality is the per period payoff to the

voter of a bad politician who sets $x_t = r_t$ in every period. The inequality places a lower bound on the bias in bad politicians' preferences and ensures that the agency problem is sufficiently severe.

The probability that a randomly chosen politician is good is π_0 . Let π_t be the updated belief of the voter about the probability that the incumbent is good at the beginning of period t , which will also be referred to as the politician's reputation at date t . Both types of politicians and the voter discount future payoffs relative to current payoffs with a discount factor $\beta = 1/(1 + \delta) < 1$ where δ is the discount rate. When not in office both types of politicians receive a reservation utility which is normalized to zero. Finally, we assume for simplicity that electoral defeat is an absorbing state in the sense that politicians who are voted out of office never return to holding political office.

Timing and information structure of the game are as follows. At the beginning of each period nature reveals the state s_t and r_t . The key informational assumption is that both r_t and s_t are observed by the incumbent but not by the voter.⁵ In Section 5 we return to this assumption and show that our results are unchanged as long as there is some critical level of asymmetric information between the incumbent and the voter. After observing the state of nature the politician chooses x_t which is observed by everybody. At the end of each period there is an election in which the voter decides whether to retain the incumbent ($e_t = 1$) or to choose the challenger ($e_t = 0$), who is of the good type with probability π_0 .

2.2 Equilibrium definition

We characterize Markov perfect equilibria of this game, i.e. equilibria in strategies that only condition on payoff relevant information. A strategy for good incumbents is a function

$$\lambda^G(\pi_t, s_t) = \text{Prob}(x_t = 1 | \pi_t, s_t). \quad (4)$$

⁵Allowing both types of politicians to observe both states does not a priori preclude the possibility that bad politicians implement the optimal policy for the voter in every period.

which specifies the probability with which he implements $x_t = 1$ as a function of his reputation and the state of nature. Similarly a strategy for bad incumbents is a function

$$\lambda^B(\pi_t, r_t) = \text{Prob}(x_t = 1 | \pi_t, r_t). \quad (5)$$

A strategy for the voter is a rule $\sigma(x_t, \pi_t)$ that determines whether the incumbent is retained ($\sigma = 1$) or replaced by the challenger ($\sigma = 0$). When the voter is indifferent between the incumbent and the challenger we assume that the voter re-elects the incumbent.⁶

A Markov perfect equilibrium is a strategy for each agent-type that is a best response to others' given beliefs, and a sequence of beliefs $\{\pi_t\}$ that evolves in a way consistent with Bayes' rule. At the end of period t , after the current action has been chosen, the updated beliefs of the voter about the incumbent are

$$\tilde{\pi}_t = \text{Prob}(\theta = G | x_t, \pi_t). \quad (6)$$

The reputation of the incumbent in office at the beginning of period $t + 1$ is therefore

$$\pi_{t+1} = \begin{cases} \tilde{\pi}_t & \text{if } e_t = 1 \\ \pi_0 & \text{if } e_t = 0. \end{cases} \quad (7)$$

Note that $\tilde{\pi}_t$ depends implicitly on the equilibrium strategies λ^θ through their impact on updated beliefs about the quality of retained incumbents.

The strategies are best responses if they are solutions to the value functions of incumbents and the voter. To formalize this, let $P(x_t | \theta)$ denote the probability distribution on x_t induced by the current strategy of type θ , and let $P(x_t) = \pi_t P(x_t | G) + (1 - \pi_t) P(x_t | B)$ be the unconditional distribution on x_t . The value function for a good incumbent is

$$U_G(\pi_t) = \max_{\lambda^G(\pi_t, s_t)} E \left[u_G(\lambda^G(\pi_t, s_t), s_t) \right] + \beta \sum_{x_t} P(x_t | G) \sigma(x_t, \pi_t) U(\tilde{\pi}_t). \quad (8)$$

⁶When we consider term limits, strategies will also condition on how many terms an incumbent has already served in office, as this becomes payoff relevant in the presence of term limits.

The value function for a bad incumbent is defined analogously. The value function for the voter is

$$V(\pi_t) = E \left[v(\lambda^\theta(\pi_t, s_t), s_t) \right] + \beta \sum_{x_t} P(x_t) \max_{\sigma(x_t, \pi_t)} [\sigma(x_t, \pi_t) V(\tilde{\pi}_t) + (1 - \sigma(x_t, \pi_t)) V(\pi_0)] \quad (9)$$

where now the expectation is over both s_t and θ , given the voter's current beliefs π_t .

3 Equilibrium with infinitely repeated elections

We now turn to the political equilibria of the game in the absence of term limits. To what extent can elections create incentives for incumbents to make decisions that are in the voter's interests? It turns out that the electoral incentives may be rather limited in this model. Consider first the following equilibrium strategies, which we will refer to as the "timid" equilibrium: Both types of politicians choose $x_t = 0$ if $\pi_t = \pi_0$ and play a "truthful" strategy, i.e. good politicians choose $x_t = s_t$ and bad politicians $x_t = r_t$, for any other π_t . The voter re-elects if $x_t = 0$ and fires the incumbent otherwise.

Given that both types always choose $x_t = 0$ on the equilibrium path, both the challenger and the incumbent, regardless of type, generate the same continuation payoff for the voter. It is therefore a best response for the voter to re-elect the incumbent after observing $x_t = 0$. Given the equilibrium strategies, it is also optimal for the voter to fire incumbents who have selected $x_t = 1$ if out of equilibrium beliefs are that incumbents who chose $x_t = 1$ are of the bad type. In this case our assumption that $p > 1 - (p - q)$ ensures that the voter prefers to fire the incumbent after observing $x_t = 1$.

For the strategy of the incumbent to be a best response, it must be the case that types who view $x_t = 1$ as the right decision (when $s_t = 1$ or $r_t = 1$) prefer to forgo the current payoff to their preferred action (equal to 1) in order to remain in

office. Since in this equilibrium the value of office for a good politician is $U^G = p/(1 - \beta)$ and for a bad politician is $U^B = q/(1 - \beta) < U^G$, this implies that timid behavior is a best response for incumbents whenever $1 < \beta q/(1 - \beta)$, or

$$\beta > 1/(1 + q). \quad (10)$$

Our main result in this section is that the timid equilibrium is not just one possible political equilibrium of the game without term limits, but that it is in fact the Markov perfect equilibrium with the highest possible payoff to the voter:

Proposition 1 *For sufficiently low discount rates, the Markov perfect equilibrium with the highest possible payoff to the voter in the game without term limits is the “timid” equilibrium.*

The formal proof of this proposition is relegated to the appendix. Proposition 1 implies that for sufficiently low discount rates the voter is not only unable to induce the politician to implement the first-best policy, but that the best possible outcome for the voter is one in which the politicians always ignore their private information and implement $x_t = 0$ in every period. Intuitively, low discount rates make the payoff from future periods in office sufficiently high that incumbents are unwilling to take actions that reduce their re-election probability, regardless of how much this would increase utility in the short run.

The upper bound on the utility of the voter, which has been established in proposition 1, is the benchmark against which we compare the impact of term limits. The next section analyzes how term limits change the political equilibrium and under what circumstances term limits can serve the interests of voters.

4 Term limits

In the last section we showed that for sufficiently low discount rates even public-spirited politicians who care about the welfare of the voter are induced to behave perversely, taking actions arbitrarily often that are known to be deleterious to

voter welfare. Evidently the problem is that the equilibrium behavior of voters makes the continuation payoff following untruthful actions too high, and thus the prospect of re-election too important to politicians, relative to the value of short-run decisions.

One way out of this problem is for the voter to announce that an incumbent's probability of re-election *in future* will be lower, which would reduce the anticipated continuation payoff to remaining in office and make truthful short-run behavior more palatable. But, since the electorate cannot easily bind its future behavior in this way, such an announcement is unlikely to be credible. In this context, therefore, a constitutional restriction on the number of terms that an incumbent can stay in office may serve as a commitment device for the electorate that can alter equilibrium behavior and might increase equilibrium welfare of the voter.

4.1 Equilibrium

Suppose first that politicians are constitutionally limited to serve at most two terms in office, which is the empirically most frequent restriction on tenure. In section 5.1 below we consider the benefits of term limits that only become binding after a third or later term. In the presence of two-term limits, there is now a unique Markov perfect equilibrium of the game, in which incumbents' strategies differ dramatically from the timid behavior considered above. Now any incumbent politician has a strictly dominant strategy which involves truthful behavior in each term he is in office, i.e. $x_t = s_t$ and $x_t = r_t$ for good and bad incumbents respectively. That truthful behavior is a dominant strategy in an incumbent's second term is immediate, since a second-term incumbent is a "lame duck" with no prospect of re-election. That behavior is also truthful in an incumbent's first term in office follows from the fact that the highest continuation payoff for a first-term incumbent is β , which is strictly lower than the payoff from implementing his preferred policy in his first term in office. To complete the equilibrium characteri-

zation, we must next solve for the equilibrium re-election rule of the voter, which we relegate to the proof in the appendix of the following proposition:

Proposition 2 *There is a unique Markov perfect equilibrium in the presence of two-term limits which involves “truthful” behavior by politicians in all periods. The voter re-elects the incumbent if the incumbent implements $x_t = 0$ during his first term in office and replaces him with the challenger otherwise.*

This equilibrium stands in sharp contrast to the timid equilibrium in the absence of term limits. In the timid equilibrium low discount rates make re-election so valuable that both types of politicians always implement the policy that ensures re-election. Under two-term limits, in contrast, both good and bad incumbents choose $x_t = 1$ with strictly positive probability in their first term in office even though this results in certain electoral defeat. The reason is that the now much smaller payoff from re-election no longer dominates politicians’ payoffs from implementing their preferred policy in their first term in office.

4.2 When can term limits help?

We now ask whether expected voter welfare could be higher with two-term limits on incumbents than in the timid equilibrium of the infinite horizon game, which Proposition 1 establishes as the equilibrium with the highest payoff for the voter when discount rates are small. In the timid equilibrium, the voter’s expected payoff in each period is just p , so that the expected present discounted value of equilibrium welfare is

$$V^\infty = p/(1 - \beta). \quad (11)$$

Equilibrium voter welfare in with two-term limits depends on the expected payoff obtained from first-term and second-term incumbents, and the probabilities with which the two occur. Since all incumbents behave truthfully in all periods, the expected payoff to the voter from an incumbent who is good with some prob-

ability π is

$$v(\pi) = 1 - (1 - \pi)(p - q). \quad (12)$$

A first-term incumbent is good with probability π_0 , while a second-term incumbent is good with probability $\pi_1 = \pi_0 p / P_0 > \pi_0$, where

$$P_0 = \pi_0 p + (1 - \pi_0)q \quad (13)$$

is the probability that a first-term incumbent chooses $x_1 = 0$ and is re-elected.

Relative to the timid equilibrium two-term limits induce both a truthfulness and a selection effect. The reduced re-election incentive induces truthful behavior by both types of incumbents in both periods in office. The truthfulness effect of the term limit increases voter welfare if $v(\pi_0) \geq p$ and decreases it otherwise. Additionally, truthful behavior induces a selection effect: Re-election rates for both good and bad incumbents fall. However, re-election rates of bad incumbents, who are more likely to choose $x_t = 1$, fall more than the re-election rate of good incumbents. This implies that the average quality of politicians in their second term in office will be higher than the average quality of first term incumbents. This must increase voter welfare since $\pi_1 > \pi_0$ and truthful behavior by a good politician yields a higher payoff to the voter than truthful behavior by a bad politician.

On balance, voter welfare might therefore rise or fall with the introduction of two-term limits. To sort out these effects, we calculate expected voter welfare with two-term limits from the value function

$$\begin{aligned} V &= 1 - (1 - \pi_0)(p - q) \\ &\quad + \beta [\pi_0 p(1 + \beta V) + (1 - \pi_0)q(1 - (p - q) + \beta V)] \\ &\quad + \beta(1 - P_0)V, \end{aligned} \quad (14)$$

which can be solved for V to obtain

$$V = \frac{1}{1 - \beta} \left[1 - (1 - \pi_0)(p - q) \frac{1 + \beta q}{1 + \beta P_0} \right]. \quad (15)$$

The second term in brackets in this expression is equal to the per-period expected loss from the action of a bad politician, equal to $p - q$, multiplied by the discounted average probability that a bad politician is in office. It is straightforward to verify that V is an increasing function of π and q and a decreasing function of p . Moreover, $V \rightarrow 1/(1 - \beta) > V^\infty$ as $\pi \rightarrow 1$ or $q \rightarrow p$. Thus we have:

Proposition 3 *For sufficiently low discount rates, expected voter welfare is higher with two-term limits than without term limits if the proportion of good politicians is sufficiently high, or the difference in preferences of good and bad politicians is sufficiently small.*

In some jurisdictions, the form of term limits is more stringent than considered here: politicians are constrained to serve no more than one term in office, with no possibility of re-election. Since, it is the prospect of re-election that induces undesirable behavior from incumbents, it may seem more natural to impose one-term limits than two-term limits. In fact, however, it is not possible in this environment for the electorate to prefer one-term limits to two-term limits. In both cases, the strategies of both types of incumbents are identical (they are truthful) and, since good politicians are strictly more likely to be re-elected to a second term than bad politicians, two-term limits induce a positive selection effect that increases the average payoff to the voter relative to one-term limits. Summarizing this discussion, we have:

Proposition 4 *In this model, two-term limits always yields a higher equilibrium payoff for the voter than one-term limits.*

5 Extensions

This section will discuss the implications of a number of extensions of the model. The next subsection considers under what circumstances three-term or even longer

limits might be optimal. The following subsection considers the incentives of different types of people to become politicians. The next subsection considers the importance of asymmetric information for our results and the final section explores the implications of adding “ego rents” from holding office to the model.

5.1 Longer term limits

Our analysis has so far concentrated on two-term limits, which seem to be the most frequently used restriction on tenure. However, there are also cases of three-term or even longer term limits. Many of the US states that have introduced term limits for their state lawmakers have, for example, limited them to three terms in office. What are the relative benefits of two-term limits versus longer term limits?

Consider first the trade-off between two-term and three-term limits. A politician who is in his second term in the presence of three-term limits faces the same incentives as a politician in his first term under two-term limits. It is therefore a dominant strategy for both types of politicians to behave truthfully in their second and third term in office under three-term limits for any non-negative discount rate. It is also a dominant strategy for a good incumbent to behave truthfully in his first term under three-term limits if $1 > \beta + \beta^2 p$, which is satisfied for sufficiently large discount rates. Similarly for bad incumbents, it is a dominant strategy to behave truthfully in their first term if $1 > \beta + \beta^2 q$, which is satisfied whenever the condition for good incumbents holds. It is straightforward to check that the voter’s optimal response to these strategies is to re-elect the incumbent as long as the updated beliefs about the incumbent are larger than π_0 .

If politicians are sufficiently impatient that both types behave truthfully in every term in office under three-term limits, then the voter’s utility must be higher under three-term limits than under two-term limits. In this case the expected payoff of the voter during the first two terms of a three-term limit is the same as under a two-term limit. However, under three-term limits the voter has the additional possibility to retain politicians who are more likely to be of the good type

than a randomly drawn challenger for an additional term which cannot reduce his welfare.

The same logic can be extended to even longer term limits. If discount rates are sufficiently high to induce truthful behavior by incumbents under even longer term limits, then such longer limits must dominate shorter restrictions on tenure. The results of this discussion are summarized in the following proposition:

Proposition 5 *Sufficiently high discount rates ensure that expected voter welfare with three-term or even longer limits is higher than with two-term limits.*

Note that this result implies that there is a critical discount rate above which an “infinite” term limit, i.e. no term limit at all, is the optimal institution. If politicians are so impatient that they behave truthfully even in the absence of term limits, then finite term limits must be unambiguously welfare reducing for the voter, as they restrict his ability to retain good incumbents.

While high discount rates call for longer term limits is also not difficult to see that low discount rates make shorter term limits a more desirable institution for the voter. Consider again the choice between two-term and three-term limits when politicians are very patient. In this case a three-term limit is incompatible with truthful behavior by politicians in all three terms in office. The equilibrium will now involve pooling on either $x_t = 0$ or $x_t = 1$ during an incumbent’s first term in office and truthful strategies for the second and third term. If the voter prefers the political equilibrium in incumbents’ second and third term under three-term limits (which is identical to the equilibrium under two-term limits) to timidity, then he must prefer two-term limits to three-term limits in this case. The same argument can be extended to the choice between even longer term limits and two-term limits and we therefore have:

Proposition 6 *For sufficiently low discount rates expected voter welfare is higher under two-term limits relative to longer term limits, whenever two-term limits yield a higher expected payoff to the voter than the timid equilibrium.*

5.2 Endogenous types

So far we have assumed that the probability that a randomly chosen politician is of the good type is exogenously given. Supporters of term limits frequently argue that term limits will encourage different people to run for political office. We can address this claim in our model by comparing the change in the value of holding office for good and bad politicians as term limits are introduced.

The equilibrium payoffs of good and bad incumbents in the timid equilibrium without term limits are $p/(1 - \beta)$ and $q/(1 - \beta)$ respectively. If two-term limits are introduced, then these payoffs change to $1 + \beta p$ and $1 + \beta q$ respectively. Since $p > q$ equilibrium payoffs of good politicians are higher than the payoffs of bad politicians both in the absence and presence of term limits. The payoff of good incumbents in the presence of term limits relative to the payoff in the timid equilibrium simplifies to $(1/p + \beta)(1 - \beta)$. The same ratio for bad incumbents is $(1/q + \beta)(1 - \beta)$ which must be larger as $p > q$. The results of this discussion are summarized in the following proposition.

Proposition 7 *Introduction of two-term limits causes the equilibrium value of office to fall proportionately more for good than bad politicians, relative to the timid equilibrium of the game without term limits.*

How this change in the relative payoff of holding office for good and bad incumbents affects the proportion of good types that seek political office clearly depends on the distribution of outside options of good and bad types. If these are sufficiently similar then the introduction of term limits would endogenously reduce the average quality of politicians. This mechanism has therefore the potential to overturn our finding that two-term limits can be beneficial if the proportion of good types in the pool of possible politicians remains constant.

5.3 More information

We have so far assumed a very simple form of asymmetric information between politicians and the voter: Politicians perfectly observe the realization of the state of nature at the beginning of each period while the voter never learns anything about the state of nature. It is easy to see that some degree of asymmetric information is crucial for our results. Suppose, for example, that the voter could also perfectly observe the realization of the state s_t . In the absence of term limits the voter would then be able to enforce first-best policy-making, i.e. both types of politicians choosing $x_t = s_t$, if politicians are sufficiently patient. This equilibrium would be sustained by a strategy for the voter to re-elect the incumbent if $x_t = s_t$ and fire otherwise. It is also immediate that there would be no role for term limits in this case. Two-term limits would still induce truthful behavior by incumbents, which must be strictly worse for the voter than first-best policy-making.

While some asymmetric information is therefore clearly crucial for our results, our results do not depend on the extreme form of asymmetric information which we have assumed so far. One way to relax this assumption is to assume that with probability $\phi < 1$ the state s_t is also revealed to the voter at the time of the election. This change in assumptions has no impact on the equilibrium under two-term limits. It is still a dominant strategy for both types of incumbents to behave truthfully in both periods and as a consequence the voter only re-elects the incumbent if the first term action was $x_t = 0$.

Now consider the equilibria of the game without term limits. It is not difficult to see that the timid equilibrium and also the other classes of equilibria characterized in the proof of proposition 1 continue to exist. For proposition 1 to continue to apply, we only need to rule out that first-best policy making, i.e. both types of politicians pool on $x_t = s_t$, is an equilibrium. This equilibrium will not exist if

$$1 > \phi \frac{\beta}{1 - \beta} (1 - (p - q)). \quad (16)$$

The left hand side of (16) is the payoff to a bad incumbent from deviating from this equilibrium strategy to choosing $x_t = 1$ when $r_t = 1$ and $s_t = 0$. The right hand side of (16) is the expected punishment for this deviation from the first-best policy. With probability ϕ the fact that $s_t = 0$ is revealed and the incumbent loses his continuation payoff of $(\beta/(1 - \beta))(1 - (p - q))$. Clearly condition (16) holds if ϕ is sufficiently small and the first-best equilibrium will therefore cease to exist if there is a sufficiently large amount of asymmetric information. If we assume that (16) is satisfied, then the upper bound on the utility of the voter established in proposition 1 continues to hold and our results on the welfare effects of term limits apply as before.

5.4 Ego rents

We have so far assumed that the only payoff from holding political office is the utility that a politician derives from implementing the policy that he prefers. An obvious extension would be to also allow that politicians receive a per period “ego rent” R from holding office which is independent of their policy choices. The presence of ego rents will reinforce the incentive of politicians to stay in office. Ego rents will therefore strengthen our finding in proposition 1 that the timid equilibrium involves the highest possible payoff to voters for sufficiently low discount rates in the absence of term limits.

Ego rents do, however, offer new possibilities in the presence of term limits. If ego rents are sufficiently high it is possible that one-term limits are the optimal institution for the voter. Suppose that $p < 1 - (1 - \pi_0)(p - q)$ and $1 < \beta(1 + R)$. It is not difficult to check that the equilibrium now either involves pooling on $x_t = 0$ or $x_t = 1$ during a politician’s first term in office and truthful behavior during the second term in office. Condition $p < 1 - (1 - \pi_0)(p - q)$ implies that the voter prefers the second term behavior to the first term behavior of incumbents in these equilibria. He must therefore prefer one-term limits which induces politicians’ second term behavior under two-term limits in every period. If politicians are

largely motivated by ego rents from holding office rather than the utility they derive from taking their preferred policy decisions there would therefore be scope for one-term limits.

6 Conclusion

At first sight, term limits seem paradoxical, as they reduce voters' ability to hold politicians accountable for their policy choices. We have developed a simple political agency model to show that a two-term or even longer limit can be in the interest of voters despite the accountability effect of elections. The mechanism that drives our results is that term limits reduce the value of holding office. This induces "truthful" behavior by incumbents, which in turn enables the voter to selectively re-elect higher quality agents to a second term in office. The combination of these two effects can increase the utility of the voter *ex ante*.

In broader terms, our analysis is a contribution to an emerging "political theory of the second best" that provides new insights into the design of electoral institutions. Agency problems in government are only partially resolved by having open elections. In this context a term limit can be welfare enhancing – even when the direct effect of term limits is unambiguously negative – because it interacts with the other distortions in the political system. In this respect, our work parallels Besley and Smart (2003), who use an agency model to study how a variety of (non-electoral) restraints on government affect political incentives. The common theme is that re-election rules chosen in equilibrium by fully rational voters will not generally be optimal from their own point of view, because voters are unable to pre-commit to use elections as an optimal incentive for their leaders. Thus, in the present context, institutions like term limits that reduce the discretion of voters may have unexpected and salutary effects on efficiency in government.

7 Appendix

Proof of Proposition 1: The proof proceeds in three steps. The first step shows that the timid equilibrium is the best pooling equilibrium from the perspective of the voter. The second step shows that all equilibria which involve a pooling strategy for the politicians at some $\hat{\pi} \neq \pi_0$ are worse than the timid equilibrium for the voter. The final step shows that for sufficiently low discount rates there is no equilibrium which involves non-pooling strategies for all π .

Step 1 Apart from the timid equilibrium there is only one other pure strategy pooling equilibrium. In this alternative equilibrium both types of incumbents always choose $x_t = 1$ and the voter re-elects if $x_t = 1$ and fires otherwise. These strategies are an equilibrium if the no deviation conditions $1 < (1 - p)\beta/(1 - \beta)$ and $1 < (1 - q)\beta/(1 - \beta)$ for good and bad incumbents respectively hold. Equilibrium payoff of the voter in this equilibrium is $(1 - p)/(1 - \beta)$, which is lower than the payoff in the timid equilibrium, which is $p/(1 - \beta)$, as we assume that $p > 1/2$.

We will now rule out that there can be any mixed strategy pooling equilibria. To simplify the notation we will use σ_1 instead of $\sigma(x_t = 1, \pi_t)$ and σ_0 instead of $\sigma(x_t = 0, \pi_t)$ if this does not cause confusion. Suppose first that the bad type randomizes between $x_t = 1$ and $x_t = 0$ if the state is $r_t = 1$. For this to be an equilibrium, it has to be the case that $1 + \sigma_1\beta U_B = \sigma_0\beta U_B$ where $U_B = q/(1 - \beta)$, which implies that

$$(\sigma_0 - \sigma_1) = \delta/q \tag{17}$$

As the timid equilibrium exists whenever $\delta < q$ equation (17) cannot be satisfied for any σ_1 and σ_0 , if the voter re-elects the incumbent if he is indifferent. The argument for the case in which the bad type randomizes in state $r_t = 0$ and the cases in which the good type randomizes in either state $s_t = 1$ or $s_t = 0$ are analogous.

Step 2 Pooling at some $\hat{\pi} \neq \pi_0$. We show that the voter's payoff in any such equilibrium can be no higher than in the timid equilibrium. From step 1 we know that the only pooling equilibria involve either both types always choosing $x_t = 0$ or $x_t = 1$. In either case this implies that on the equilibrium path $\tilde{\pi}(x_t, \hat{\pi}) = \hat{\pi}$. To support pooling at $\hat{\pi}$, it must be the case that $\sigma(\tilde{\pi}, x_t) > 0$ for at least one x_t : otherwise, both types would play the truthful (and non-pooling) strategies $\lambda^G(\hat{\pi}_t, s_t) = s_t$ and $\lambda^B(\hat{\pi}_t, r_t) = r_t$. Since re-election is a best response for the voter,

$$V(\tilde{\pi}(x, \hat{\pi})) = V(\hat{\pi}) \geq V(\pi_0) \quad (18)$$

In step 1 we have shown that the timid equilibrium has a payoff of $p/(1 - \beta)$ for the voter and that this is the highest payoff to the voter among all pooling equilibria. Hence we have

$$\frac{p}{1 - \beta} \geq V(\hat{\pi}) \geq V(\pi_0) \quad (19)$$

which completes this step.

Step 3 Non-pooling strategies for all π . First, consider strategies where $P_x^\theta > 0$, where P_x^θ is the probability that an agent of type θ chooses action x . We first show that in any such equilibrium there would exist a value of $\pi < 1$ above which the incumbent is re-elected with probability one regardless of his policy choice. If $P_x^\theta > 0$ Bayes' rule implies that updated beliefs at each action can be written as

$$\tilde{\pi}_x(\pi) = \frac{\pi}{\pi + (1 - \pi)\kappa_x(\pi)} \quad (20)$$

where $\kappa_x = P_x^B/P_x^G$ is the likelihood ratio given strategies at π . Thus

$$g(\pi) \equiv \left| \frac{1}{\tilde{\pi}_1} - \frac{1}{\tilde{\pi}_0} \right| = \frac{1 - \pi}{\pi} |\kappa_1(\pi) - \kappa_0(\pi)| \quad (21)$$

Define

$$K^* = \max_{\pi \in [0,1]} |\kappa_1(\pi) - \kappa_0(\pi)| \quad (22)$$

and let $g^*(\pi) = K^*(1 - \pi)/\pi$. By construction, (21) implies $g(\pi) \leq g^*(\pi)$ for all $\pi \in [0, 1]$. Since g^* is continuous in π and $g^*(1) = 0$, $g^*(\pi) \rightarrow 0$ as $\pi \rightarrow 1$. Since $0 \leq g(\pi) \leq g^*(\pi)$ and $g^*(\pi) \rightarrow 0$ as $\pi \rightarrow 1$, it follows that $g(\pi)$ also converges to zero. Thus $|\tilde{\pi}_1 - \tilde{\pi}_0| \rightarrow 0$ as $\pi \rightarrow 1$.

To prove the claim, suppose not, and let $\pi^* = \sup\{\pi : \sigma(\pi) = 1\}$. Further, let $\hat{\pi} = \inf\{\pi : 1 - (1 - \pi)(p - q) > (1 - \beta)V(\pi_0)\}$ define the level of reputation above which truthful behavior by the incumbent is preferred by the voter to the equilibrium behavior of the challenger. (Such a $\hat{\pi}$ exists since $E v(\lambda, \pi) < 1 - (p - q)$ for all λ and all $\pi < 1$.) Since $\tilde{\pi}_1(\pi) \rightarrow \tilde{\pi}_0(\pi)$, there exists $\pi > \max\{\pi^*, \hat{\pi}\}$ such that $\min\{\tilde{\pi}_1, \tilde{\pi}_0\} > \pi^*$; that is, the incumbent will be fired at π regardless of which action x is observed. Consequently, truthful behavior $\lambda_\theta(s) = s_\theta$ is the unique best response for the incumbent and, since $\pi > \hat{\pi}$, truthful behavior by the incumbent is preferred to the equilibrium behavior of the challenger. Hence $\sigma(\pi) = 1$, a contradiction, and it follows there exists $\bar{\pi} < 1$ such that $\sigma(\pi) = 1$ for all $\pi \geq \bar{\pi}$.

Since we assume that $P_x^\theta > 0$ it follows that $\max\{\tilde{\pi}_0(\pi), \tilde{\pi}_1(\pi)\} \geq E\tilde{\pi} = \pi$. For any $\pi \geq \bar{\pi}$, therefore, $\max\{\sigma(\tilde{\pi}_0(\pi)), \sigma(\tilde{\pi}_1(\pi))\} = 1$: the incumbent has the option to remain in office in all periods after achieving reputation π by choosing whichever action x causes reputation to rise. Thus we have, for all $\pi \geq \bar{\pi}$,

$$U_B(\pi) \geq \frac{\min\{q, 1 - q\}}{1 - \beta} \quad (23)$$

since the payoff to the action which induces re-election has expected payoff no less than $\min\{q, 1 - q\}$.

Finally, consider the choice of the bad incumbent at any critical reputation π for which one action, say $x = 0$, induces a reputation $\tilde{\pi}_0 \geq \bar{\pi}$, while the alternative action $x = 1$ induces a reputation $\tilde{\pi}_1 < \bar{\pi}$. Since for sufficiently low discount rates $\min\{q, 1 - q\}\beta/(1 - \beta) > 1$, at any such critical reputation both types of incumbents would strictly prefer the action that results in certain re-election to the action which entails $\sigma = 01$, which contradicts the hypothesis that $P_x^\theta > 0$ for all π .

Finally, consider the possibility that for some π_t one action reveals the incumbent to be of the good type with certainty and hence $\tilde{\pi}_t = 1$, which is an absorbing state. For sufficiently low discount rates bad types would deviate to this action as this would enable them to stay in office forever and earn a payoff of 1 per period. Similar arguments can be used to rule out that one action reveals the incumbent to be of the bad type with certainty. *Q.E.D.*

Proof of Proposition 2 In the main text we have already argued that it is a dominant strategy for both types of incumbents to implement the policy that maximizes their per period utility. We now need to consider the voter's optimal re-election rule. Given the strategies of the politicians, the voter's expected payoff from an incumbent who is in his first term in office is π_0 . Let π_1^x denote her updated beliefs about the type of the incumbent on observing x in the first term. These are given by Bayes' rule as:

$$\pi_1^1 = \frac{\pi_0(1-p)}{\pi_0(1-p) + (1-\pi_0)(1-q)} < \pi_0 \quad (24)$$

$$\pi_1^0 = \frac{\pi_0 p}{\pi_0 p + (1-\pi_0)q} > \pi_0 \quad (25)$$

Now let P_x denote the probability that x is observed in the first term given the equilibrium strategies and σ_x the corresponding re-election probabilities at the end of the first term. In each period, if the incumbent is good with probability π , the payoff expected in the current period by the voter is

$$v(\pi) = 1 - (1-\pi)(p-q) \quad (26)$$

In choosing re-election rules, the voter's problem is

$$V = v(\pi_0) + \beta \sum_{x=0,1} P_x \max_{\sigma_x} \{ \sigma_x (v(\pi_1^x) + \beta V) + (1-\sigma_x)V \} \quad (27)$$

Differentiation shows $v(\pi_1^x) > (1-\beta)V$ implies $\sigma_x = 1$, and $v(\pi_1^x) < (1-\beta)V$ implies $\sigma_x = 0$. By definition, $V \geq v(\pi_0)/(1-\beta)$, so $\pi_1^1 < \pi_0$ implies $v(\pi_1^1) <$

$v(\pi_0) \leq (1 - \beta)V$ and $\sigma_1 = 0$. To show $\sigma_0 = 1$, suppose instead that $\sigma_0 < 1$ were optimal for the voter. Then $V = v(\pi_0)/(1 - \beta)$, and $\pi_1^0 > \pi_0$ implies $v(\pi_1^0) > v(\pi_0) = (1 - \beta)V$ which implies $\sigma_0 = 1$, a contradiction. *Q.E.D.*

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