The Effects of Political Competition on the Feasibility of Economic Reform

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Abstract

The existing literature on the feasibility of reform focuses on the existence of special interests, informational asymmetries, distributional issues and economic rent preservation to explain reform failure. Active political competition can also reduce the possibilities of reform: In democratic regimes, successful implementation of reform generates asymmetric electoral gains, as voters reward the party most closely associated with reform. This generates a tradeoff for competitors between supporting reform for the welfare benefits and blocking reform to prevent electoral loses. This paper generates a simple unified model which incorporates the standard explanations, as well as the effect of the electoral incentives of actively competing political agents on the feasibility of reform.

1 Introduction

Why do governments fail to implement desirable economic reforms?

Several attempts to answer this question have hinged on three types of explanations: a) rent preservation b) asymmetry of information between voters and politicians and c) special interest groups.

This first set of explanations focuses on the effect that a given policy has on the income of a particular group which sees its rents affected by the policy either directly (Rajan 2007, Fernandez and Rodrik 19911), or by the redistributive effects that arise from the changes in the distribution of power that the reform generates (Jain and Mukand 2003, Besley and Coate 1996, Acemoglu

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1Rajan 2007 proposes a model where initial inequalities in endowments divides voters into constituencies with competing interests in different reforms. This can lead to reform paralysis as each constituency protects their own rents. In Fernandez and Rodrik 1991, uncertainty about the incidence of benefits and costs prevents reform from taking place.
The second set of explanations argues that informational asymmetries between voters and politicians may prevent incumbents from pursuing optimal policies. Asymmetric information may cause the public to perceive policies with uncertain outcomes as corrupt (Mukand and Rodrik 2005, Coate and Morris 1999), or may allow politicians to get away with selecting a non-optimal policy (Coate and Morris 1995, Mani, Majumdar and Mukand 2004, Rogoff and Silbert 1988), to give continuation to projects that fell short of their expected value to delay bearing the political costs (Majumdar and Mukand 2004) or to undertake inefficient policies to showcase their abilities to affect their electoral chances (Hess and Orphanides 1995, 2001, Glaeser 2006). Finally, the third set of explanations argues that small homogeneous groups are more efficient at working collectively to impose their desired policies, sometimes at the expense of society at large (Olson 1965). This issue has been studied extensively by authors such as Grossman and Helpman (1994, 1996, 2001) and Coate and Morris (1995). Lizzeri and Persico (2001, 2005) argue that democracies may generate incentives for parties to prefer targeted redistribution rather than welfare improving public good investment. Furthermore, different electoral rules can make targeted transfers more prevalent.

While many types of inefficiencies arise in many of these model due to political competition, a fundamental source of inefficiency is neglected in the lit-

2 Jain and Mukand 2003 revisit Fernandez and Rodrik 1991 and argue that even when redistribution is available as an alternative to compensate economic losers, new economic conditions change the distribution of voters making some future redistribution schemes electorally impossible. Only projects that benefit small minorities (that can be taxed) or supermajorities (in which case the chances of being both an economic and political loser are small) are successful. Besley and Coate 1998 provide a dynamic framework in which a citizen-candidate refuses to pursue projects that would change the identity of the median voter in a way that is detrimental to her. Acemoglu and Robinson 2000a, 2006a generate a framework in which the decision to introduce a new technology depends on the effect that it will have on the likelihood that the current autocrat will retain power, and thus capture the rents attached to the new technology.

3 In Mukand and Rodrik (2005), the incumbent is forced to implement proven, yet inadequate policies instead of experimenting with potentially optimal policies to avoid charges of corruption. In Coate and Morris (1999) a subsidy to a firm might be the correct industrial policy, as suggested by endogenous growth theory, but the incumbent might choose not to do so to avoid corruption accusations.

4 In Coate and Morris (1995) a politician may benefit a special interest group through a project of low value since it is less visible than a direct transfer, even when the direct transfer is less costly to taxpayers. In Mani, Majumdar and Mukand 2004, the value of a project to a politician is distorted by the fact that some projects might be more visible than others to voters. In Rogoff and Silbert (1988) political business cycles emerge as a result of opportunistic use of fiscal policy when informational asymmetries exist between the incumbent running for reelection and her constituencies.

5 Hess and Orphanides 1995, 2001 as well as Glaeser 2006 present models in which a costly and avoidable war is undertaken by the incumbent in order to showcase its military abilities and improve reelection chances.

6 Grossman and Helpman (1994) have developed a model where trade protection is achieved by bribes to politicians from special interest groups. In Grossman and Helpman (1996) bribes from special interest groups are used to buy publicity in order to capture votes from uninformed voters. Grossman and Helpman (2001) present a systematic framework for studying the effects of special interest groups on electoral outcomes and subsequently on policy choices.
reform. Reforms generate asymmetric electoral gains. When reform improves voters’ conditions, political actors associated with reform get rewarded electorally. When the reform process depends on the joint action by competing political agents the reform may get blocked by the actor that does not benefit electorally. This is a major issue in democracies, where the legislative may comprise of different parties competing over control of the executive. Even if there are economic gains for all actors from enacting reform, electoral gains are a zero sum game. Surprisingly, the effects of active political competition have rarely been studied in spite of their importance in determining reform feasibility.7

There can be several reasons for asymmetric electoral gains to arise from reform. The reform can act as a signal for the ability or level of commitment for the incumbent party, especially when the party’s electoral campaign ran on reform promises. Another possibility for asymmetric political gains which is vastly studied in the literature but not present in the model, is that asymmetric distribution of economic gains can lead to an unfavorable redistribution of constituencies (Jain and Mukand 2003, Besley and Coate 1998). Finally, reform may benefit the party that is better prepared to either efficiently implement the reform or run the government under the new regime. This is the channel through which reform generates an asymmetry in this model. There can be several reasons for one party to have greater implementation efficiency. One reason is political leadership: Jones and Olken (2005) have shown empirically that leadership plays a huge role in shaping the development of a country. This can be manifested as competence or honesty, and might also be more important in times of institutional transformation and political change. Knowledgeably about the reform, perhaps from previous experience implementing the reform at a local or state level or from technical competence, could also explain efficiency differentials. Alternatively a party may be more credibly committed to the reform because of ideology or political ties. Finally, an important source of differences in implementation efficiency could come from incumbency advantage, in which the incumbent has experience dealing with the bureaucracy that would be in charge of implementation. In that case, the value of reform may be higher when the incumbent party gets reelected.

The model is specified in the following way. Voters are separated into two social classes: a rich minority and a poor majority. Each constituency is represented by a party. Parties share control of the legislative branch. There is a status quo level of institutional development. Political consensus is necessary to implement a costless reform that improves institutions. Since most models on

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7 Some models have focused on the indirect effect of political competition. For instance incumbents choose inefficient policies to preserve powers when redistributive effects of reform leads to electoral disadvantages (e.g. Besley and Coate 1998), or when reputation and asymmetrical information can cause voters to misinterpret intentions (e.g. Mukand and Rodrik 2005, Coate and Morris 1999). Incumbents may tie their successors’ hands by the imposition of regulatory (Moe 1990) or fiscal restrictions (Alesina and Tabellini 1990, Milesi-Ferretti and Spolaore 1994). A notable exemption within the literature which actually focuses on active political competition leading to inefficient outcomes is Alesina and Drazen (1991): In their dynamic model competitive agents delay the implementation and thus compound the costs of a fiscal stabilization program, as they face a war-of-attrition over who bears the costs.
reform feasibility focus on economic rent preservation or informational issues, this model assumes that economic reforms are strictly welfare improving for all voters and that there is perfect information.

Political parties differ from one another in two ways, the constituency that they represent and their effectiveness when implementing reform. This generates two sources of political advantage: class advantage, which favors the party that represents the poor and implementation efficiency advantage which favors the party with the higher implementation efficiency when reform is enacted. For this reason there can be incentives for parties to either endorse reforms or block reforms.

The remaining of the paper proceeds as follows: the benchmark is presented and solved in the next section. A lengthy discussion and several extensions to the model are presented in section 3 and a summary of results and a conclusion are presented in section 4.

2 Model

2.1 Voters

There are \( N \gg 1 \) voters, who differ only in their productive ability. There are two types of voters, rich voters and poor voters. Rich voters have high productive ability, \( k_r \), and make up \( \beta < \frac{1}{2} \) of total population; Poor voters have low productive ability, \( k_p = \phi k_r \), and make up \( 1 - \beta \) of total population, where \( \phi \in (0,1) \). All voters are endowed with a unit of labor, which they inelastically supply. Total productive endowment of the economy is normalized to 1:

\[
N(\beta k_r + (1 - \beta)\phi k_r) = 1
\]  

Voters are risk neutral, rational and forward looking. The utility of voters depends on the consumption of a public good and a private good. Voters have the following utility function:

\[
W(g, y_i) = 4(\pi g^\sigma + (1 - \pi)y_i^\sigma)^{\frac{1}{\sigma}}
\]  

where \( g \) denotes the production of a public good and \( y_i \) determines consumption of a private good by a voter belonging to social class \( i \in \{p, r\} \). The elasticity of substitution, \( \sigma \), and the preference weight, \( \pi \), are both set equal to \( \frac{1}{2} \).

The parameters \( \sigma, \pi \) are set equal to \( \frac{1}{2} \) only to simplify exposition. The only requirements for the model to work are for \( \sigma, \pi \in (0,1) \). When \( \sigma = 0 \), the utility becomes Cobb-Douglass and class advantage dissapears as both parties choose \( \tau^* = \frac{1}{2} \). The first extension to the model shows that the main result holds in the absence of class advantage. Finally if \( \sigma = 1 \), utility becomes linear. The party of the rich choose a tax rate of 0 while the party of the poor would choose a tax rate of 1. In general terms, increasing \( \sigma \) increases class advantage ceteris paribus. Finally, \( \pi \), only affects the preference weights of private versus public goods for all agents, so as long as \( \pi \in (0,1) \), agents want both public and private goods, which justifies the existence of both public and private sectors in the model.
2.2 Private Sector Production

All voters supply labor one unit of labor inelastically. Private production by a voter of class \( i \) is:

\[
Y_i = Zk_i
\]  

(3)

where \( Z \) is the level of institutional development of the economy. Total private production in this economy is equal to \( Z \).

2.3 Institutional Development

Institutional development depends on the successful enactment and implementation of a costless economic reform. There is a legislative proposal to make a welfare improving institutional reform that improves productivity. Parties choose whether to support or effectively block reform. When both parties support reform, it gets enacted, otherwise it is blocked. If the reform is enacted, its effects on the economy depend on the implementation efficiency of the party that takes control of the executive by winning the election and implements the reform. The level of institutional development is thus:

\[
Z = 1 + \varphi_H \varphi_L (\Theta_W - 1)
\]  

(4)

where \( \varphi_j \in \{0, 1\} \) for \( j = H, L \) denotes the decision to support reform, 1, or effectively block reform, 0, by party \( j \) and \( \Theta_W \in \{\Theta_H, \Theta_L\} \) denotes the implementation efficiency level of the winner of the election for the executive branch such that \( \Theta_H > \Theta_L > 1 \).

2.4 Taxation and Public Sector Production

A proportion of private production is employed in the production of a public good. The production of the public sector good is solely financed by a linear tax on private production. Let \( \tau \) denote the tax rate faced by voters. A voter of class \( i \) pays \( \tau Y_i \) and consumes the rest. \( y_i = (1 - \tau)Y_i \). Public sector production equals total public revenue. That is,

\[
g = \tau N(\beta Y_r + (1 - \beta)Y_p) = \tau Z
\]  

(5)

2.5 Parties

Two political parties compete for office. Parties are risk neutral, rational and forward looking. Parties differ with respect to two characteristics, implementation efficiency, as discussed in the section on institutional development, and class identity. Class identity, \( i \), refers to the social class that the party represents. Class identity determines the party’s fiscal preferences. Parties care about their respective constituencies’ utilities and about capturing power. Parties have the following utility function:
\[ \Omega(g, y_i, r) = W(g, y_i) + r \]  

where \( r \) denotes exogenous political rents from capturing the executive branch. It has a value of 0 when the party loses the election and \( R > 0 \) when it wins the election.\(^9\)

### 2.6 Reexpressing Utility Functions

The voter’s utility function is reexpressed as an indirect utility function (Equation 2) in terms of \( \tau \).

\[
U(\tau, k_i, Z) = 4\left\{\frac{(Z\tau)^{\frac{1}{2}} + [(1 - \tau)Zk_i]^{\frac{1}{2}}}{2}\right\}^2 = \left\{(Z\tau)^{\frac{1}{2}} + [(1 - \tau)Zk_i]^{\frac{1}{2}}\right\}^2
\]  

Claim 1 The utility function is homogeneous of degree one on institutional development, \( Z \).

Proof. \( \frac{\partial U}{\partial Z} = \frac{U}{Z} \iff U = Z^{\frac{\partial U}{\partial Z}} \). \( \blacksquare \)

The utility can be reexpressed as:

\[
U(\tau, k_i, Z) = Z\left\{\tau^{\frac{1}{2}} + [(1 - \tau)k_i]^{\frac{1}{2}}\right\}^2
\]  

This formulation is convenient because it explicitly shows the reform is strictly welfare improving: taxation decision is independent from institutional development and \( \frac{\partial U}{\partial Z} = \frac{U}{Z} > 0 \forall k_i \).

The parties’ utility function (equation 6) is reexpressed as an indirect utility function:

\[
V(\tau, k_i, Z, r) = U(\tau, k_i, Z) + r
\]

### 2.7 Timing of Events

1. Parties identities are revealed. Parties with the high and low levels of implementation efficiency simultaneously reveal 1) their social class identities and 2) their efficiency level, \( \Theta_H \) and \( \Theta_L \), to all agents in the economy.

2. Parties simultaneously choose whether to support or block the reform: \( \varphi_H \) and \( \varphi_L \).

3. Rational forward-looking voters simultaneously vote to elect the party that maximizes their expected incomes. Voting is costless and mandatory. If both parties offer the same level of after-tax income to a given social class of voters, then voters split their vote evenly. If the poor split their vote in half then rich individuals act as tie-breakers. If both parties offer the same levels of income to both social classes, then the election is decided by a fair coin toss.

\(^9\)Note that when a party loses the election, the utility that it derives is the same as that of its constituents. This helps interpret results.
4. The winning party chooses its optimal tax policy, $\tau_j^*$ where $j$ denotes the class identity of the winning party.\footnote{There is a long discussion about the effects of changing the timing of events later in the paper. For the benchmark we just take this timing of events to derive the main solutions.}

2.8 Solving the Model

The model is a subgame perfect Nash equilibrium. It is solved backward induction. In the last stage of the game, the winning party chooses the tax rate that maximizes income to its constituents.

2.8.1 Stage 4. Selecting the Optimal Tax Policy.

The winning party solves:

$$\max_{\tau} U(\tau, y_i, Z) + r$$ (10)

Claim 2 The solution to the maximization problem is $\tau_i^* = \frac{1}{1 + k_i}$.

Proof. Necessity: The first order condition is set equal to 0: $\frac{\partial U}{\partial \tau} = Z\{\frac{1}{2} + [(1 - \tau)k_i\frac{1}{2}]\tau^\frac{3}{2} - (1 - \tau)^{-\frac{3}{2}}k_i^\frac{1}{2}\} = 0$.

The solution for $\tau$ is: $\tau^*(k_i) \equiv \tau_i^* = \frac{1}{1 + k_i}$.

Sufficiency: $\frac{\partial^2 U}{\partial \tau^2} = -Z\{k_i^2\tau^\frac{3}{2}[(1 - \tau)k_i\frac{1}{2}]^3 + 2k_i\tau^\frac{5}{2}[(1 - \tau)k_i\frac{1}{2}]^3 + \tau^\frac{1}{2}p[(1 - \tau)k_i\frac{1}{2}]\}
\{2\tau^2[k(1 - \tau)]^2\}^{-1} < 0$. ■

It is clear from this claim that tax policy is independent from the level of institutional development and from political rents, as optimal taxation only depends (and is inversely related to) productive ability, $k$.

Claim 3 The rich always prefer lower taxes than the poor.

Proof. Solution is interior since $\frac{1}{1 + k_i}$ is open and bounded between 0 and 1 $\forall k_i > 0$. The solution is decreasing in $k_i$: $\frac{\partial \tau^*(k_i)}{\partial k_i} = -\frac{1}{(1 + k_i)^2} < 0$. ■

Remark 4 Given the level of institutional development, $Z$, i) When the party of the rich is elected, the utility levels to rich and poor voters are $Z(1 + k_r)$ and $Z\left(\frac{1 + \phi \frac{3}{2} k_r}{1 + \phi k_r}\right)^2$ respectively, and ii) when the party of the poor is elected, the utility levels to rich and poor voters are $Z\left(\frac{1 + \phi \frac{3}{2} k_r}{1 + \phi k_r}\right)$ and $Z(1 + \phi k_r)$ respectively.

2.8.2 Stage 3. Electing a Candidate

At this point voters have observed: whether the reform was enacted, and the implementation efficiencies and class identities of both parties. Therefore, voters
can perfectly infer their expected payoff from electing either party. They elect the party that maximizes their expected utility.\footnote{As stated in the timing of events, since the poor are majority, the party that can offer the highest utility level to the poor wins. If they both offer the same level, then the party that maximizes the utility to the rich gets elected.}

Let $Z_j$ denote the level of institutional development that arises when a party of identity $j$ is elected. The poor compares her utility when the party of the poor and the party of the rich are elected and chooses the one that maximizes her utility. The poor only vote for the party of the rich if the expected utility from electing the rich is greater (or equal) to the expected utility they get from election the poor, that is, if

$$Z_r \frac{(1 + \phi^2 k_r)^2}{1 + k_r} \geq Z_p(1 + \phi k_r)$$  \hspace{1cm} (11)

This equation can be reexpressed as:

$$Z_r \geq \frac{(1 + \phi k_r)(1 + k_r)}{(1 + \phi^2 k_r)^2} Z_p = Z_{\text{elect}}$$  \hspace{1cm} (12)

Claim 5 \hspace{1cm} $\frac{(1 + \phi k_r)(1 + k_r)}{(1 + \phi^2 k_r)^2} > 1$.

\textbf{Proof.} \hspace{1cm} $\frac{(1 + \phi k_r)(1 + k_r)}{(1 + \phi^2 k_r)^2} > 1 \Leftrightarrow 1 + k_r(1 + \phi) + \phi k_r^2 > 1 + 2\phi k_r(1 + \phi) + \phi^2 k_r^2 \Leftrightarrow (1 + \phi) > 2\phi \Leftrightarrow (1 + \phi)^2 > 2\phi $ as long as $\phi < 1$. \quad \blacksquare

Claim 6 Poor voters only vote for the party of the rich if the reform is enacted and the party of the rich has an level of implementation efficiency sufficient to offset the differences in fiscal policies, that is if $Z_r = \Theta_H \geq Z_{\text{elect}}$.

\textbf{Proof.} It follows from comparing the utility levels under each party (i.e. equation (12)). \quad \blacksquare

To help exposition, it is important to explore the different possibilities under which equation (12) fails to hold.

Remark 7 i) $Z_r = 1$ occurs only when reform is blocked. ii) if $Z_r \in (1, Z_p]$ then reform was enacted and party of the rich is the low efficiency party and iii) when $Z_r \in (Z_p, Z_{\text{elect}})$ although the party of the rich is the high efficiency and although the reform has been enacted, the efficiency differentials are insufficient to offset the differences in fiscal policies.

Case iii) shows the situation where classadvantage dominates efficiency advantage. It is important to distinguish the different cases, as they affect the incentives parties face when choosing whether to support or block reform.
2.8.3 Stage 2. Supporting or Blocking Reform

Both parties choose whether to support or block the reform. For the high efficiency party, the decision is trivial. The reform raises the overall welfare of voters. It also increases its opportunities of getting elected, which benefits it both directly through political rents and indirectly through the effect on fiscal policy. For the low efficiency party, the decision involves a tradeoff: reform can improve welfare of its constituents but it can make constituents vote for the high efficiency party if reform gains are greater than fiscal losses. When the electoral losses are less or equal to the economic gains, parties support reform.

Claim 8 The party of the rich always supports reform (i.e. supporting is always a weakly best strategy for the party of the rich).

Proof. When \( Z_r \in (1, Z_p) \), if both parties support, the party of the poor wins the election and the payoff for the party of the rich is \( U(\tau_p^*, k_r, \Theta_H) \). When \( Z_r \in (Z_p, Z_{\text{elect}}) \), if both parties support then the party of the poor wins and the payoff to the party of the rich is \( U(\tau_p^*, k_r, \Theta_L) \). Finally, when \( Z_r \geq Z_{\text{elect}} \) if both parties support, the party of the rich wins the election and its payoff is \( U(\tau_r^*, k_r, \Theta_H) + R \). Just by plugging the respective \( Z \) and \( \tau \) it is trivial to show that \( U(\tau_p^*, k_r, 1) < U(\tau_p^*, k_r, \Theta_L) < U(\tau_p^*, k_r, \Theta_H) < U(\tau_r^*, k_r, \Theta_H) + R \) \( \iff \) if the party of the poor’s expected best response is to support reform, it is also the best response for the party of the rich. If the party of the poor’s expected best response is blocking, the party of the rich gets \( U(\tau_p^*, k_r, 1) \) regardless of its strategy and is therefore indifferent (or weakly prefers) between support and blocking reform. ■

The only case in which any party would block a strictly welfare improving reform is if reform is detrimental to the party electorally. It follows from claim 7 that reform is a necessary condition for electing the party of the rich, so it has no electoral incentives to oppose it. The interesting question then becomes: When does the party of the poor support or block reform?

If reform leads to success for the party of the rich, the party of the poor must be compensated for the loss of the election in order to support reform. For that reason, whenever equation (12) holds, the party of the poor may have an incentive to block unless:

\[
Z_r \frac{(1 + \phi^2 k_r)^2}{1 + k_r} = \Theta_H \frac{(1 + \phi^2 k_r)^2}{1 + k_r} \geq 1 + \phi k_r + R \tag{13}
\]

which can be reexpressed as:

\[
Z_r = \Theta_H \geq \frac{(1 + \phi k_r + R)(1 + k_r)}{(1 + \phi^2 k_r)^2} \equiv Z_{\text{enact}}
\]

Claim 9 The party of the poor blocks reform whenever \( Z_r \in [Z_{\text{elect}}, Z_{\text{enact}}) \) and supports reform otherwise.
Proof. Whenever $Z_r < Z^{elect}$, equation (12) fails so by claim 6 the poor vote for the party of the poor, and the party of the poor supports reform to improve efficiency (i.e. $Z_p(1 + \phi k_r) + R > (1 + \phi k_r) + R \forall Z_p > 1$). Whenever $Z_r \geq Z^{enact} \geq Z^{elect}$ or $Z_r \geq Z^{enact} > Z^{elect}$, equation (12) holds so by claim 6 the poor vote for the party of the rich and since $Z_r \geq Z^{enact}$, $U(t^*, \phi k_r, Z_r) \geq V(t_p^*, \phi k_r, Z_r, R)$. Finally, when $Z^{enact} > Z_r \geq Z^{elect}$ supporting reform would lead to the party of the poor losing the election by equation (12) but from $Z^{enact} > Z_r$, $U(t^*, \phi k_r, Z_r) \geq V(t_p^*, \phi k_r, 1, R)$ so it is optimal for the party of the poor to block reform.

Remark 10 The range $[Z^{elect}, Z^{enact})$ is empty when $(Z_p - 1)(1 + \phi k_r) \geq R$.

This remark follows from setting $Z^{enact} \geq Z^{elect}$ and solving for $R$. From this remark it becomes clear that the low efficiency party only blocks reform whenever the party of the poor has lower implementational efficiency and political rents are sufficiently high to entice opportunistic behavior by the low efficiency party. Let $R$ denote the minimum level of political rents under which there is opportunistic behavior by the party of the poor.

$$R = (Z_p - 1)(1 + \phi k_r)$$ (14)

From the previous discussion, the central proposition of the paper is constructed.

2.8.4 Equilibria of the Model

Proposition 11 There can emerge different political equilibria:

A. When the party of the poor has the higher implementation efficiency, $\Theta_H$, the party of the poor wins the election and the reform gets implemented, leading to the highest efficiency level.

Ba. When the party of the poor has the lower implementation efficiency, $\Theta_L$, if $R > \bar{R}$ there can be up to three different outcomes:

i) Whenever $\Theta_H \in (\Theta_L, Z^{elect})$, the party of the poor wins the election, as efficiency differentials are insufficient to offset fiscal policy differentials. The reform gets implemented by the low efficiency party.

ii) Whenever $\Theta_H \geq Z^{enact}$ the party of the rich wins the election as efficiency differentials are sufficient to entice the poor to vote for the party of the rich and efficiency gains are sufficient to offset political and fiscal losses for the party of the poor.

iii) Whenever $\Theta_H \in [Z^{elect}, Z^{enact})$ the party of the poor opportunistically blocks a reform that would allow the rich to get elected. Consequently, there is no reform and the party of the poor wins the election.

Bb. the party of the poor has the lower implementation efficiency, $\Theta_L$, if $R \leq \bar{R}$ there can be up to two different outcomes:

i) Whenever $\Theta_H \in (\Theta_L, Z^{elect})$, the party of the poor wins the election, as efficiency differentials are insufficient to offset fiscal policy differentials. The reform gets implemented by the low efficiency party.
ii) Whenever $\Theta_H \geq \Theta_{elect}$ the party of the rich wins the election as efficiency differentials are sufficient to entice the poor to vote for the party of the rich and efficiency gains are sufficient to offset political and fiscal losses for the party of the poor.

**Proof.** Omitted. The proof follows from direct application of claims 6, 8 and 9 and remark 10. 

It is important to understand how different parameters affect the feasibility of reform. When equation (12) fails there is no incentive to block reform, as there are no electoral costs attached to reform. This case is analogous to either a dictatorship or to a regime where there is a majoritarian or monopolistic control of electoral outcomes: in this example, the party of the poor has both an efficiency and a class identity advantage which makes it electorally invulnerable.

The interesting solutions arise when equation (12) holds. What affects the possibilities of having a party opportunistically block reform? By simple manipulation of equation (14) it can be shown that holding the high efficiency level, $\Theta_H$, and political rents, $R$, constant, a smaller differential in efficiency levels (i.e. a higher $\Theta_L$) reduces the area over which reform is blocked. The intuition is that increasing $\Theta_L$ increases the area over which the differential in abilities is insufficient to offset the differences in fiscal policies. Conversely, increases in either income, $k_r$, or reductions of inequality (increases in $k_r$) reduce the area over which reform is blocked. This happens because increasing $\phi$ or $k_r$ raises the marginal economic benefit from reform for the party of the poor.

### 3 Discussion and Extensions

The crucial assumption in the model is the existence of efficiency differentials between parties in implementing reform. It acts as the mechanism through which electoral asymmetries arise from reform.

#### 3.1 Implementation Efficiency and Political Asymmetries

There can be many reasons for implementation efficiency differences to exist. The party might have experience pushing similar reforms. Consider the case where the leader of the party comes from a background of implementing a similar policy at the local level. Alternatively we could consider an incumbency advantage. In this case, the party might have better knowledge as to how to operate the bureaucracy. Or it might have appointed some of the bureaucrats that would stay once the reform gets implemented even after its term. For example, monetary authorities may be more politically insulated than other bureaucrats if their expertise and reputation brings market reassurance and stability. Implementation efficiency advantage might also arise if a party has done extensive research concerning the expected value of the reform. Finally, the profile of the party leadership or the party ideology might be more appropriate for implementing a given reform.
There is an equally interesting explanation which focuses on reputation rather than efficiency or experience as sources of asymmetric electoral gains when reform is implemented. After that party captures executive control, voters assess its performance on whether reforms were successfully enacted and implemented. If the opposition is able to block these policies or render them either ineffective or costly, it hurts voters’ assessment of the incumbent’s performance: Successful implementation translates into high political gains for the incumbent. This generates incentives for the opposition to block reform. This behavior could explain the reform paralysis that Mexico has faced since 1997 when the party in power lost majority control of Congress. President Clinton also experienced a similar situation when failure to implement his ambitious health reform program lead the Democratic Party to lose a Congressional majority in the midterm elections during his first term.

There might also be issues about timing. Having an economic benefit for voters that materializes after the election based on the electoral outcomes forces voters to reward a party for reform. While this assumption might be debatable, it allows us to deal with a complex dynamic problem in a static framework, much akin to the often employed assumption about political parties that act in the interest of voters in the last stage of a finite-stage model. We should also ask whether it is reasonable to believe that reform proposals are pushed right before an election takes place? In reality, the timing might be more nuanced, but in competitive political regimes, there is always an election in sight, so it is not a bad assumption. Furthermore, many reforms, especially major ones (e.g. education, energy, fiscal, labor, etc.) take some time to implement and survive the administrations that first enacted and implemented them. The timing of events, however, raises interesting empirical questions about the timing of policy reforms, which lie outside of the scope of this paper: Is it harder to push for reform in countries with a more frequent electoral cycles? What are the implications for reform in the life-cycle of an administration: Is it easier to push for reform earlier in the term, during the so-called "Honeymoon period"? Does successful policy implementation lead to early election recalls by parliamentary leaders wishing to attain higher independence from coalition parties? A second important issue with respect to the timing of events concerns the assumption that fiscal policy is decided solely by the winner of the election.

3.2 Fiscal Policy
Allowing the fiscal decision to arise in the last stage allows us to study class advantage, which makes results more interesting by allowing voters to make decisions based on a tradeoff between class advantage and implementation efficiency. On the other hand, some readers might find this assumption objectionable. The first concern might be that in democracies with strong legislative branches, the taxation policies of the executive is subject to approval by the legislative. The counterargument would be that even within the restrictive set of fiscal rules that a legislative imposed on the executive there might be differences in fiscal policies. For instance, a party representing the poor might use tax proceeds for
projects that benefit the poor disproportionately, like in building elementary schools in poor neighborhoods. The party of the rich, on the other hand, might reduce social programs to finance the introduction of technological infrastructure which might increase the productivity of capital or to subsidize programs targeted towards the rich like tertiary education (e.g. Fernandez and Rogerson 1995) or export subsidy programs. Alternatively, executive from different parties might target fiscal law selectively. A party representing the rich might prosecute black markets while a party representing the poor might focus on corporate evasion. So even under the most restrictive scenario, the actual value of fiscal policies might differ across parties. A second reason why parties might deviate from a Downsian equilibrium fiscal policy is the existence of multiple policy issues (e.g. Grossman and Helpman 2001). Furthermore, the choice of off-center political or fiscal stances might be justified as strategic deterrants of new entry into the political arena (Rubinchik and Weber 2005). Even then it is interesting to see how relaxing the assumption of fiscal divergence affects the results. Fiscal convergence can be achieved if either a) the fiscal preferences of voters converge (e.g. $\sigma = 0$ or $\omega = \{0, 1\}$, b) both parties cater to the same constituency or if c) the tax rate is fixed institutionally.

### 3.2.1 Extension 1: Fixed Fiscal Policy

Without loss of generality it is assumed that the tax rate is fixed institutionally, $\tau = \tilde{\tau} \in [\tau^*_r, \tau^*_p]$.\(^{12}\) Parties only compete on implementation efficiency.

A small change in notation is used to ease exposition. Let $k_L$ and $k_H$ denote the earning ability of the social class that the low and high efficiency parties represent (e.g. if the party of the poor is the high efficiency party, then $k_L = k_r$ and $k_H = \phi k_r$).

The timing of events is as follows:

In period 1, nature determines the tax rate, $\tilde{\tau}$, as well as the implementation efficiencies and class identities of the parties. In period 2, parties simultaneously decide whether to enact or block reform. In period 3, the election takes place. In period 4 the winner implements reform if it was enacted in period 2.

**Claim 12** When no reform takes place, voters elect each party with probability $\frac{1}{2}$. When reform takes place, the high efficiency party is elected.

**Proof.** Since the tax rate is fixed, $U(\tilde{\tau}, k_i, Z) = ZU(\tilde{\tau} + (1 - \tilde{\tau})k_i)$ for $i = \{p, r\}$ regardless of the class identity of the party. Since $Z = 1$, under each party when reform is blocked which makes all voters indifferent, and equal to $\Theta_H$ and $\Theta_L$ under the high efficiency and low efficiency parties respectively. Since $\Theta_H > \Theta_L$, voters prefer, and thus vote for the party with high efficiency. \(\blacksquare\)

\(^{12}\)These are all multiple points of equilibria for taxation if changes to the tax policy require agreement from both the party of the rich and the party of the poor: Recall that voters have single peaked preferences with respect to taxation. Now suppose that the status quo rate is below (above) the range $[\tau^*_r, \tau^*_p]$. In that case, increases (decreases) in taxation to point $\tau^*_r$ (\(\tau^*_p\)) would represent Paretto improvements. If on the other hand, taxation was within the range $[\tau^*_r, \tau^*_p]$ the party of the rich (poor) would not agree to any increases (decreases).
This claim is the analogous to claim 6 in the benchmark when class advantage disappears and presents the voters’ behavior. Since class advantage has disappeared, each party can get elected with equal probabilities in the absence of reform. Reform enactment, tilts electoral outcomes in favor of the high efficiency party. The decision to support by the low efficiency party depends on whether the utility from supporting reform and losing is greater than the utility from blocking reform and winning with probability \( \frac{1}{2} \).

\[
\Theta_H U(\tilde{\tau} + (1 - \tilde{\tau})k_L) \geq U(\tilde{\tau} + (1 - \tilde{\tau})k_L) + \frac{R}{2} 
\]

(15)

This equation is analogous to claim 9 in the benchmark. The main difference between claim 9 and this equation is that now the identity of the party willing to block is no longer limited to the low ability party. Since there is no longer class advantage, any party can win the election, the low efficiency has electoral incentives to block reform regardless of its class identity.

**Claim 13** The high efficiency party always supports.

**Proof.** If the best response for the low efficiency party is to support reform, then the payoff for the high efficiency party when it supports reform is \( \Theta_H U(\tilde{\tau} + (1 - \tilde{\tau})k_H) + R > U(\tilde{\tau} + (1 - \tilde{\tau})k_H) + \frac{R}{2} \), which is the expected utility it gets when it blocks reform. When the best response for the low efficiency is to block then the high efficiency party weakly prefers (or is indifferent) between supporting and blocking. \( \blacksquare \)

This claim is analogous to claim 8. The decision for the high efficiency party is trivial, since it can only benefit from reform (both electorally and in terms of economic efficiency) it always supports reform.

From the previous claims, a central proposition can be contructed.

**Equilibria Under a Fixed Tax Rate**

**Proposition 14** When class advantage is suppressed, there can emerge the following political equilibria:

A. If the party of the poor has higher efficiency, there can be two outcomes:
   A.i) When \( R \leq 2\Theta_H(\tilde{\tau} + (1 - \tilde{\tau})k_r) \), the party of the poor gets elected and reform is implemented by the party of the poor, who has the high level of efficiency.
   A.ii) When \( R > 2\Theta_H(\tilde{\tau} + (1 - \tilde{\tau})k_r) \), each party gets elected with probability \( \frac{1}{2} \), and reform is blocked by the party of the rich.

B. If the party of the rich has higher efficiency, there can be two outcomes:
   B.i) When \( R \leq 2\Theta_H(\tilde{\tau} + (1 - \tilde{\tau})k_r) \), the party of the rich gets elected and reform is implemented by the party of the rich, who has the high level of efficiency.
   A.ii) When \( R > 2\Theta_H(\tilde{\tau} + (1 - \tilde{\tau})k_r) \), each party gets elected with probability \( \frac{1}{2} \), and reform is blocked by the party of the poor.
Proof. Omitted. It follows from direct application of claims 12 and 13, and equation (15).

There are two main differences with respect to the benchmark. 1) When the party of the poor is of low efficiency, it cannot support reform and win the election. Incentives to block are enhanced due to political competition. On the other hand, there is no longer a fiscal cost attached to reform as both parties choose the same fiscal policy. 2) the party of the rich can still win the election even if it is a low efficiency party, if it chooses to block reform. For that reason, the party of the rich may act opportunistically, in contrast to the benchmark, where only the party of the poor has incentives to opportunistically block reform. Curiously enough, if each party has the same possibilities of being high efficiency, the party of the poor is still more likely to act opportunistically, since a higher proportion of its utility depends on political rents. In general terms, closer competition between the two parties reduces reform feasibility by making implementation efficiency a major electoral determinant.

This analysis leads to an interesting question: How is political behavior affected if reform support can be negotiated in exchange for changes in tax policy?

3.2.2 Extension 2: Institutional Reform, Fiscal Reform and Logrolling

In order to keep the analysis simple, the high efficiency party proposes an institutional reform to which the low efficiency party responds by proposing a change the fiscal policy from $\hat{\tau}$ to $\tau^o$ which the high efficiency party can accept or reject.

The timing of events is as follows:

In period 1, nature decides the status quo fiscal policy, $\hat{\tau}$, the class identities and implementation efficiencies of the parties. In period 2, the high efficiency party proposes an institutional reform to the low efficiency party. In period 3, the low efficiency party can either condition approval of the institutional reform to the approval of a new fiscal policy or it can block the institutional reform. In period 4 the high efficiency party decides whether to accept the offer. In period 5 voters observe whether reform was enacted and vote. In period 6 reform gets implemented by the winner of the election if it was enacted.

The game is solved by backward induction.

Although fiscal policy can be changed, both parties are still constitutionally constrained in the fiscal choice. Consequently, claim 12 still holds: if reform is enacted, the voters elect the high efficiency party. When there is no reform, the voters are indifferent and each party has a $\frac{1}{2}$ probability of getting elected.

In period 4, the high efficiency has observed whether the low efficiency party has proposed a fiscal policy, $\tau^o$, in exchange for support for the institutional reform. If the low efficiency party has blocked reform, the election takes place and payoffs are realized. When the low efficiency party has proposed a fiscal reform, it follows from claim 12 that if the high efficiency party accepts the offer, it wins the election. For that reason, the high efficiency party compares the political and efficiency benefits of reform to the fiscal concessions it has to
make in order to ensure reform. That is, it compares its expected utility levels under each alternative and accepts the low efficiency party’s offer when

\[ V(\tau^0, k_H, \Theta_H, R) \geq U(\tau, k_H, 1) + \frac{R}{2} \]  \hspace{1cm} (16)

In period 3, the decision for the low efficiency party depends on whether it can find a fiscal policy which maximizes its utility, subject to the high efficiency party still accepting. The low efficiency party, therefore solves the following program:

\[
\max_{\tau^o} U(\tau^o, k_L, \Theta_H) \hspace{1cm} (17)
\]

subject to

\[ U(\tau^o, k_H, \Theta_H) + \frac{R}{2} \geq U(\tau, k_H, 1) \] (constraint 1)

\[ U(\tau^o, k_L, \Theta_H) \geq U(\tau, k_L, 1) + \frac{R}{2} \] (constraint 2)

and \( \tau^o \in [\tau^*_r, \tau^*_p] \) (constraint 3)

where the first constraint is a reexpression of equation (16) and states that the offer must be acceptable for the high efficiency and the second constraint states that the benefit from the fiscal benefit, along with the efficiency gains from reform must at least offset the electoral loss from supporting reform. The third constraint is redundant, as no party would ever choose a rate outside that range, but helps interpret the solution set.\(^{13}\)

In order to understand the mechanics of this program it helps to recall how changing taxation affects utility.

**Remark 15** Notice that each party represents one social class and any equilibrium fiscal policy lies between \([\tau^*_r, \tau^*_p]\). It follows from claims 1 and 2 that if \( \frac{\partial U(\tau, k_L, Z)}{\partial \tau} \geq 0 \iff \frac{\partial U(\tau, k_H, Z)}{\partial \tau} \leq 0 \). For that reason, when the low efficiency party represents the rich (poor), it reduces (increases) taxation until either the first or third constraint binds.

From the previous remark and solution, one can construct the solution to the program.

**Solution 16** i) Whenever the low ability party represents the rich, it reduces \( \tau \) until the point where either constraint 1 or constraint 3 binds. If at that level, constraint 2 holds, then a solution is found, if constraint 2 does not hold, then there is no solution to the problem and the party simply blocks reform. ii) Whenever the low ability party represents the poor, it increases \( \tau \) until the point where either constraint 1 or constraint 3 binds. If at that level, constraint 2 still holds, then a solution is found, if constraint 2 does not hold, then there is no solution to the problem and the party simply blocks reform.

From the previous remark and solution, a central proposition can be constructed.

\(^{13}\)As shown in a previous footnote, whenever \( \tau < \tau^*_r \) (\( \tau > \tau^*_p \)) increasing (decreasing) \( \tau \) to \( \tau^*_r \) (\( \tau^*_p \)) leads to a Paretto improvement.
Equilibria Under Fiscal and Institutional Logrolling

**Proposition 17** When there is fiscal and institutional logrolling, there can emerge the following political equilibria:

A. If the party of the poor has higher efficiency, there can be two outcomes:

A.i) When $\exists \tau$ such that both constraints 1 and 2 hold, then a) if at $\tau_p^*$ constraint 1 still holds, the party of the rich offers support for reform in exchange for a tax rate of $\tau^* = \tau_p^*$, b) if at $\tau_p^*$ constraint 1 fails, the party of the rich selects tax rate $\tau^* = \tau^{**}$ such that $\tau^{**}$ solves $U(\tau^{**}, k_r, \Theta_H) + \frac{R}{2} = U(\tilde{\tau}, k_r, 1)$. The party of the poor always accepts the fiscal logrolling offer, wins the election and implements reform efficiently.

A.ii) When $\exists \tau$ such that constraints 1 and 2 hold, the reform is opportunistically blocked by the party of the rich, each party wins the election with a $\frac{1}{2}$ probability.

B. If the party of the rich has higher efficiency, there can be two outcomes:

B.i) When $\exists \tau$ such that both constraints 1 and 2 hold, then a) if at $\tau_p^*$ constraint 1 still holds, the party of the poor offers support for reform in exchange for a tax rate of $\tau^* = \tau_p^*$, b) if at $\tau_p^*$ constraint 1 fails, the party of the poor selects tax rate $\tau^* = \tau^{**}$ such that $\tau^{**}$ solves $U(\tau^{**}, k_r, \Theta_H) + \frac{R}{2} = U(\tilde{\tau}, k_r, 1)$. The party of the rich always accepts the fiscal logrolling offer, wins the election and implements reform efficiently.

B.ii) When $\exists \tau$ such that constraints 1 and 2 hold, the reform is blocked and each party wins the election with a $\frac{1}{2}$ probability.

**Proof.** Omitted, it follows directly from claim 12 and solution 16.

While these results seem very similar to those in the previous extension, there are two very important differences. Logrolling allows the low ability party to be compensated for its losses sometimes, so it reduces the area under which reform fails, and therefore improves efficiency. Logrolling on the other hand has its disadvantages, as it may lead to opportunistic behavior by the high efficiency party.

**Proposition 18** a) When logrolling occurs and constraint 1 binds, the high efficiency party is opportunistically supporting a logrolling offer that hurts its constituents. Alternatively when logrolling occurs, and constraint 1 does not bind, the high ability party may or may not be opportunistically supporting a logrolling offer that hurts its constituents.

**Proof.** a) When constraint 1 binds, $U(\tau^*, k_H, \Theta_H) + \frac{R}{2} = U(\tilde{\tau}, k_H, 1)$ which is the utility that the constituents would get in the absence of reforms. ii) When constraint 1 is not binding, (i.e. when $\tau^* = \tau_p^*$ when the part of the poor is high efficiency and $\tau^* = \tau_p^*$ when the party of the rich is high efficiency) then $U(\tau^*, k_H, \Theta_H) + \frac{R}{2} > U(\tilde{\tau}, k_H, 1)$, which may occur either when $U(\tau^*, k_H, \Theta_H) \in [U(\tilde{\tau}, k_H, 1) - \frac{R}{2}, U(\tilde{\tau}, k_H, 1))$ in which case the constituents are hurt by logrolling or when $U(\tau^*, k_H, \Theta_H) \geq U(\tilde{\tau}, k_H, 1)$ in which case they benefit from logrolling.
The interesting difference with respect to the benchmark is that when logrollings is present, the high efficiency party, may be induced into opportunistic behavior by agreeing to an undesirable fiscal policy in exchange for the electoral benefits from reform.

Another point to discuss is the effect of informational asymmetries.

### 3.3 Informational Issues

In contrast with models that require informational asymmetries to justify inefficient policies, even under perfect information, politicians still block good policies for political reasons. Uncertainty gives more credence to the story: Suppose that parties have conducted research on the potential benefits and costs of a given reform. If voters believe that one party has better chances of successfully implementing reform, asymmetrical political gains arise. Since information is private, the low efficiency party might underestimate the value of the reform, while the high efficiency party might overestimate them.

In order to study the effects of uncertainty and informational asymmetry, a very simple extension is presented in which uncertainty and informational asymmetry are added to a fixed tax specification.\(^{14}\)

#### 3.3.1 Extension 3: Informational Asymmetries

The tax rate is fixed as in the first extension of the model. There is an institutional reform with uncertain outcomes: if reform is successful then the level of institutional efficiency increases to \(Z_S > 1\). If it fails, the level of institutional efficiency becomes \(Z_F < 1\). The probability of success depends on which party gets elected, as they are in charge of implementation. The high efficiency party has a probability of successful implementation equal to \(q_H\) while the low efficiency party has a probability \(q_L\). Voters are risk neutral. Voters can correctly observe which party is the high efficiency party, but not the actual values of \(q_H\) and \(q_L\).

The timing of events is as follows:

1) Nature determines the identities and abilities of parties. Parties observe \(q_H, q_L, Z_S\) and \(Z_F\). Voters observe \(Z_S\) and \(Z_F\) and know that \(q_H > q_L\).

2) Parties support or block reform, reform gets enacted if both parties support it.

3) Voters observe whether reform is enacted and elect a party to government.

4) The winner implements reform if it was enacted.

Since there is no class advantage, claim 12 holds: successful enactment of reform leads to electoral success and reform implementation by the high efficiency party.

In terms of efficiency, reform should be enacted if

\[
E[Z] \equiv q_H Z_S + (1 - q_H) Z_F \geq 1
\]

\(^{14}\)A previous version studied informational asymmetries in the context of class advantage. Results are similar but require additional restrictions.
Parties compare their expected utility when reform is enacted and when it fails in order to decide whether to support or block reform. The expected value of an enacted reform for the high ability is $E[Z]U(\hat{\tau}, k_H, 1) + R$ as it wins the election versus $U(\hat{\tau}, k_H, 1) + \frac{R}{2}$ where it wins the election with a probability $\frac{1}{2}$. For the low ability party, when reform is enacted, expected utility is $E[Z]U(\hat{\tau}, k_L, 1)$ versus $U(\hat{\tau}, k_L, 1) + \frac{R}{2}$ when it is not.

As a result, the high ability party supports reform when

$$2(E[Z] - 1)U(\hat{\tau}, k_H, 1) \geq -R \quad (19)$$

and the low ability party supports reform when

$$2(E[Z] - 1)U(\hat{\tau}, k_L, 1) \geq R \quad (20)$$

Remark 19 It follows from equations (18), (19) and (20) that support for reform by the high ability party is a necessary but not sufficient condition for reform to be desirable. Reform desirability is a necessary but not sufficient condition for the low ability party to support it. Support from the low ability is a sufficient condition for the reform to be desirable and enacted.

Consequently, the solution set can be constructed from equation (20).

Equilibria Under Informational Asymmetries

Proposition 20 When class advantage is suppressed and informational asymmetries arise, there can emerge the following political equilibria:

A. If the party of the poor has higher efficiency, there can be two outcomes:

A.i) When $2(E[Z] - 1)U(\hat{\tau}, k_r, 1) \geq R$ the party of the poor gets elected and reform is implemented by the party of the poor, who has the high level of efficiency.

A.ii) When $2(E[Z] - 1)U(\hat{\tau}, k_r, 1) < R$, each party gets elected with probability $\frac{1}{2}$, and reform is blocked by the party of the rich.

B. If the party of the rich has higher efficiency, there can be two outcomes:

B.i) When $2(E[Z] - 1)U(\hat{\tau}, k_r, 1) \geq R$, the party of the rich gets elected and reform is implemented by the party of the rich, who has the high level of efficiency.

B.ii) When $2(E[Z] - 1)U(\hat{\tau}, k_r, 1) < R$ each party gets elected with probability $\frac{1}{2}$, and reform is blocked by the party of the rich.

Proof. Omitted: It follows from claim 12 and remark 19.

The low efficiency party tends to over-block reform, while the high efficiency party tends to over-support. It is important to understand when the outcomes are inefficient.

Remark 21 The high efficiency party may unsuccessfully try to opportunistically support bad reforms (i.e. when $E[Z] - 1 \in (\frac{R}{2U(\hat{\tau}, k_H, 1)}, 0]$) but it is preempted by the low efficiency party. The low efficiency party, on the other hand, can successfully block good reforms opportunistically (i.e. when $E[Z] - 1 \in [0 > \frac{-R}{2U(\hat{\tau}, k_H, 1)}]$).
This is an unexpected consequence of checks and balances.\textsuperscript{15} This extension uncovers another source of opportunistic behavior. The main difference with the benchmark is that voters cannot tell whether the high ability party opportunistically supporting an undesirable reform or whether the low efficiency party is opportunistically blocking a desirable reform from being enacted. Uncertainty and informational asymmetries present a justification why parties may get away with blocking beneficial reform without getting punished by constituents within a repetitive game.

Another justification for unpunished opportunistic blockage of reform has to do with concentration of political power, and is implicitly assumed in this model. When there are limited political actors due to high levels of entry, voters face limited options. If voters have preferences that depend on both the "moral character" of a party or candidate and its policies, voters are forced into accepting "character flaws" as long as the policies are sufficiently similar to those those of the voters.

The other main factors through which political competition and reform inefficiencies have been linked are rent expropriation and special interest groups.

3.4 Rent Preservation and Special Interest Groups

Rent preservation is perhaps the most popular explanation for reform failure. When reform leads to economic losses by some groups in society, these may oppose reform. An example of a reform leading to asymmetric economic gains and losses is the reduction of trade barriers (e.g. Rodrik and Fernandez 1991, Jain and Mukand 1996). In that case the protected sector may vote against reform due to potential losses.

In the context of this model, since the differing groups are the rich and the poor on could think of many reforms that benefit the rich at the expense of the poor. For example, the adoption of new technologies may create a skill bias which hurts unskilled labor. Alternatively, liberalization of the labor market through immigration reform could reduce unskilled labor’s real wages by increasing supply. Other reforms benefit the poor at the expense of the rich. For example if oligopolistic profits arise due to regulatory and institutional rules that discourage competition and innovation, regulation changes would benefit consumers at the expense of the oligopolist. Many of the privatization of the 1990’s led to the establishment of rich oligopolists in developing countries in sectors such as telecommunications, energy and construction materials. Rules to limit the power of oligarchs in strategic sectors would benefit consumers.

Two sources of inefficiencies dealing with rent preservation have been identified in the literature: potentially beneficial reforms may be blocked if they hurt the pivotal decisionmaker (either directly as in Rodrik and Fernandez 1991 or indirectly by affecting voter’s distribution as in Jain and Mukand 1996 and Besley

\textsuperscript{15} Aghion, Alesina and Trebbi (2004) discuss the issue of optimal checks and balances by focusing on the tradeoff between granting the incumbents sufficient power to ensure reform and restraining them to prevent expropriative abuse. This model shows that electoral considerations further exacerbate that tension.
and Coate 1998). Alternatively, reform may be blocked if it hurts small groups which might face different organizational incentives than large constituencies. Small, homogeneous groups are more efficient at solving collective action problems than large heterogenous groups: small size makes enforceability easier while homogeneity leads to converging incentives and large concentration of benefits (Olson 1965, 1982, 2000). Consequently special interest groups, may utilize their organizational ability to grant either pecuniary or political benefits to political parties. These types of explanations have been studied in the context of trade protection (Grossman and Helpman 1994, 1996) and the undertaking of inefficient public projects (Coate and Morris 1995).

3.4.1 Extension 4: Rent Preservation and Special Interest Groups

In contrast with the previous extensions, class identity matters, so the tax rates, are decided by each party to cater to their respective constituencies. The benchmark specification is thus employed with two minor changes: 1) Reforms now become costly and costs are borne by one of the social classes and 2) rich voters are allowed to form special interest groups which may bribe either party in order to get their desired policy enacted.

In order to study the effects of rent preservation, reform has costs that are borne by one of the groups. The interesting results arise when the costs are explicitly larger than any efficiency or fiscal gains the group might obtain. For that reason it is assumed that:

\[ c_i > \Theta_H U(\tau_i, k_i, 1) - U(\tau_i^*, k_i, 1) \]  

(21)

where \( i \) denotes the identity of the social class that bears the costs and is subtracted from the utility for the group and the party of identity \( i \). The other group bears no costs from reform.\(^{16}\)

The model is studied in the context of no special interest groups and under the possibility of the rich forming a special interest group.\(^{17}\) Whenever rich voters can organize to form a special interest group, they can decide on a level \( b_j \) to be subtracted from their utility level in order to increase the utility level of party \( j \) by \( \beta N \gamma(b_j) \) such that \( \gamma'(\cdot) > 0 \).\(^{18}\)

Timing of events is as follows: 1) Class identities and implementation efficiency levels are realized and observed by all agents in the economy. The identity of the cost bearers from reform is realized and observed, as well as whether rich voters can organize and offer a bribe to one of the parties in order to affect

\(^{16}\)The costs hit utility directly in an additive, reduced-form way. This is the simplest way of showing the effects of rent preservation issues ion the model.

\(^{17}\)The special interest group offers a bribe to one of the parties. As it will become clear, only one party needs to be bribed.

\(^{18}\)This is the simplest way to study this problem. Alternatively, a proportion of the untaxed private good could be employed to finance the bribe. Ultimately, since \( \gamma \) has a flexible functional form, this reduced form treatment of the bribe is not without generality: in either case, there would be are reduction in the utility of rich voters to finance an increase in utility for one of the parties. \( \beta N \) is only aggregation amongst rich voters and of no importance in terms of results.
its decision concerning reform. 2) When the rich are able to organize, the rich may offer a bribe to one of the parties in order to induce support or opposition to reform. 3) Both parties simultaneously choose whether to support or block reform. If the party that is offered the bribe decides to accept the bribe offer, it simultaneously accepts the bribe and chooses the policy that rich voters prefer. 4) Voters observe whether the reform was enacted and elect the party that maximizes their expected utility. 5) The winner of the election implements the reform if it was enacted.

This game is solved by backward induction.

There are three main parameters over which cases differ: the class identity of the high efficiency party, the class identity of the social group that bears the costs and whether there are special interest groups (i.e. whether the rich can organize effectively to bribe the parties).

For ease of exposition, each combination of class identity of high efficiency party and class identity of cost bearer are studied individually. Additionally, the effects of the existence of a special interest group are discussed at the end of each of the four cases. After all cases have been presented, a general statement discusses all the possible equilibria.

3.4.2 Case 1: The High Efficiency Party Represents the Rich, The Rich are Hurt by Reform

It follows from equation (21), that rich voters always oppose reform, so if they form a special interest group, it is employed to block reform. Let us focus on the last stage of the game.

**Claim 22 When no reform takes place, the party of the poor gets elected, when reform takes place, the party of the rich gets elected.**

**Proof.** It follows from comparing the utility of poor voters under each party, $U(\tau^*_p, k_p, 1) > U(\tau^*_r, k_p, 1)$. The second part of the statement follows from equation (21): Since $U(\tau^*_p, k_r, 1) > U(\tau^*_r, k_r, \Theta_H) + c_r > U(\tau^*_p, k_r, \Theta_L) + c_r$, the party of the rich only supports reform when it leads to its electoral success i.e. $U(\tau^*_r, k_p, \Theta_H) > U(\tau^*_p, k_p, \Theta_L)$. 

The difference with the benchmark at this stage is that the solution where the low ability party implements is not available. The reason is that since reform hurts the rich, the party of the rich may only accept reform if it leads to electoral gains which offset reform costs. For that reason, if efficiency differentials are insufficient to make poor voters elect the party of the rich, it has no incentives to ever support reform.

**Claim 23** A necessary condition for reform to be enacted is for i) $U(\tau^*_r, k_p, \Theta_H) - U(\tau^*_r, k_p, 1) \geq R \geq U(\tau^*_r, k_r, 1) - U(\tau^*_r, k_r, \Theta_H) + c_r$ and ii) $U(\tau^*_r, k_p, \Theta_H) \geq U(\tau^*_p, k_p, \Theta_L)$ to hold.

---

19It is assumed that the bribe is paid simultaneously to the institutional reform decision in order to avoid credibility issues about the payment of the bribe.
Proof. ii) By contradiction, assume equation ii) does not hold. In that case, the party of the poor gets elected when reform takes place. Using equation (21) is can be shown that

\[ U(p; k_r; L) - c_r < U(p; k_r; L) - c_r < U(p; k_r, 1), \]

thus the party of the rich blocks reform. Electoral success for the party of the rich is therefore a necessary condition for reform feasibilty. Assuming reform gets the party of the rich elected, reform gets enacted only when the expected utility from supporting is greater than blocking for both parties. The left part of equation i) is directly derived from the utility comparisons for the party of the poor of supporting reform and losing election blocking reform and winning election whereas the right part is directly derived from the utility comparisons for the party of the rich of supporting the costly reform and winning the election versus blocking reform and losing the election.

Claim 24 If there are special interest groups, reform may be blocked whenever \(\exists a b < U(\tau_p^*, k_r, 1) - U(\tau_r^*, k_r, \Theta_H) + c_r\) such that \(\beta N \gamma(b) = \min\{U(\tau_p^*, k_p, \Theta_H) - U(\tau_p^*, k_p, 1) - R, U(\tau_r^*, k_r, \Theta_H) - c_r + R - U(\tau_p^*, k_r, 1)\}\). Furthermore, when such \(b\) exists, the rich bribe the party of the poor if \(U(\tau_p^*, k_p, \Theta_H) - U(\tau_p^*, k_p, 1) - R < U(\tau_r^*, k_r, \Theta_H) - c_r + R - U(\tau_p^*, k_r, 1)\) and the party of the rich otherwise.

Proof. A bribe is possible whenever it is costlier to bear the costs of reform than to bribe a party into blocking reform. It follows from claim 22 that whenever reform is blocked the party of the poor wins, therefore, the rich know that they can block reform if there is a bribe under which either party is indifferent between blocking and supporting such that the payoffs to the rich are greater than allowing reform.

Remark 25 If a bribe is possible, then the rich choose to bribe the party of the poor if \(U(\tau_p^*, k_p, \Theta_H) - U(\tau_p^*, k_p, 1) - R < U(\tau_r^*, k_r, \Theta_H) - U(\tau_r^*, k_r, 1)\) and the party of the rich otherwise.

The rich want to minimize their bribe burden, so they choose the cheapest party to bribe.

The solution set for this case can be constructed from claims 22, 23 and 24 and remark 25.

There are three interesting differences which emerge in this extension: 1) the party of the rich may opportunistically support a reform that hurts its constituents in order to get elected. 2) Rich voters may either have to bribe their own party or make an unlikely alliance with the party of the poor to prevent reform. 3) When the party of the poor accepts the bribe, it is acting against the best interests of its constituents as well.
3.4.3 Case 2: The High Efficiency Party Represents the Rich, The Poor Are Hurt by Reform

In this case, it follows from equation (21) that the party of the poor always wants to block reform since \( U(\tau_p^*, k_p, 1) + R > \{ U(\tau_p^*, k_p, \Theta_L) + R - c_p,\ U(\tau_r^*, k_p, \Theta_H) - c_p \} \). It is also clear that both the rich and the party of the rich want reform since \( U(\tau_r^*, k_r, \Theta_H) > U(\tau_r^*, k_r, \Theta_L) > U(\tau_p^*, k_r, 1) \).

Claim 26 In the absence of special interest groups, reform is always blocked.

Proof. It follows from equation (21) that \( U(\tau_p^*, k_p, 1) > U(\tau_p^*, k_p, \Theta_H) - c_p > \max\{ U(\tau_p^*, k_p, \Theta_L) - c_p, U(\tau_p^*, k_p, \Theta_H) - c_p \} \). Therefore, in stage 3 of the game, the party of the poor always blocks reform.

Claim 27 When special interest groups arise, a) if \( U(\tau_p^*, k_p, \Theta_L) > U(\tau_p^*, k_p, \Theta_H) \), rich voters can bribe the party of the poor into supporting reform if there is a \( b < U(\tau_p^*, k_r, \Theta_L) - U(\tau_p^*, k_r, 1) \) such that \( N\beta\gamma(b) = U(\tau_p^*, k_p, 1) + c_p - U(\tau_p^*, k_p, \Theta_L) \), b) if \( U(\tau_p^*, k_p, \Theta_L) \leq U(\tau_p^*, k_r, \Theta_H) \), rich voters can bribe the party of the poor into supporting reform if there is a \( b < U(\tau_p^*, k_r, \Theta_H) - U(\tau_p^*, k_r, 1) \) such that \( N\beta\gamma(b) = U(\tau_p^*, k_p, 1) + R + c_p - U(\tau_r, k_p, \Theta_H) \).

Proof. It follows from equation (21) that reform is always blocked in the absence of bribes to the party of the poor. Rich voters must therefore compensate the party of the poor into being indifferent between blocking reform and supporting it. In stage 4 of the game, the party of the poor gets elected when \( U(\tau_p^*, k_p, \Theta_L) > U(\tau_r^*, k_r, \Theta_H) \). For that reason, the party of the poor faces a loss of rich voters bribe the party of the poor into supporting if reform is sufficiently valuable to make them better off after compensating the party of the poor for its costs of implementing reform. When \( U(\tau_p^*, k_p, \Theta_L) \leq U(\tau_p^*, k_r, \Theta_H) \) rich voters can bribe the party of the poor if the utility differentials are sufficient to compensate the party of the poor for fiscal and electoral losses as well as implementation costs.

In the absence of bribes, the incentives for both parties are perfectly aligned with those of their constituencies. The incorporation of bribes can help the rich achieve its desired policy allowing the party of the poor to opportunistically overcome resistance to reform.

3.4.4 Case 3: The High Efficiency Party Represents the Poor, The Rich Are Hurt by Reform

Claim 28 Reform always fails and the party of the poor always wins the election.

Proof. The party of the poor always wins the election as \( Z_p U(\tau_p^*, k_p, 1) > Z_r U(\tau_r^*, k_r, 1) \) \( \forall Z_p \geq Z_r \). From equation ((21)) \( U(\tau_p^*, k_r, 1) > U(\tau_r^*, k_r, \Theta_H) - c_r > U(\tau_r^*, k_r, \Theta_H) - c_r \) so the party of the rich always blocks reform.

In this case, the incentives of rich voters and their party are perfectly aligned. Since the party has the ability to prevent reform from occurring, reform is blocked.
3.4.5 Case 4: The High Efficiency Party Represents the Poor, The Poor are Hurt by Reform

Claim 29 In the absence of special interest groups, reform is blocked.

Proof. The rich can never win election: $Z_p U(\tau^*_p, k_p, 1) > Z_r U(\tau^*_r, k_r, 1) \forall Z_p \geq Z_r$. It follows from (21) that $U(\tau^*_p, k_p, 1) + R > U(\tau^*_r, k_r, \Theta_H) - c_r + R$ so the party of the poor always blocks. □

Claim 30 Remark 31 When special interest groups arise, reform is enacted and implemented by the party of the poor if there is $b < U(\tau^*_p, k_r, \Theta_H) - U(\tau^*_p, k_r, 1)$ such that $N \beta \gamma(b) = U(\tau^*_p, k_p, 1) + c_p - U(\tau^*_p, k_p, \Theta_H)$.

It follows from the previous claim that the party of the rich can never win the election. Both the party of the rich and rich voters want reform since $U(\tau^*_p, k_p, \Theta_H) > U(\tau^*_p, k_p, 1)$. Reform can be achieved if rich voters compensate the party of the poor into supporting reform.

Incorporating special interests biases outcomes in favor of the rich’s preferred policies. Asymmetric distribution of costs of reform may induce opportunistic support for reform.

Equilibria in the Context of Rent Preservation and Special Interest Groups

Proposition 32 In the presence of asymmetric economic costs from reform and the absence of special interest groups, the following equilibria can emerge:

A) When costs are borne by the rich and the party of the rich is the high efficiency party, there can be the following equilibria:

A.i) When $U(\tau^*_r, k_p, \Theta_H) - U(\tau^*_p, k_p, 1) \geq R \geq U(\tau^*_r, k_r, 1) - U(\tau^*_p, k_r, \Theta_H) + c_r$ and $U(\tau^*_r, k_p, \Theta_H) \geq U(\tau^*_p, k_p, \Theta_L)$ there can be several outcomes:

A.i.i) In the absence of special interest groups or if $\beta N \gamma(U(\tau^*_p, k_r, 1) - U(\tau^*_r, k_r, \Theta_H)) < \min\{U(\tau^*_p, k_p, \Theta_H) - U(\tau^*_r, k_p, 1) - R, U(\tau^*_p, k_r, \Theta_H) - c_r + R - U(\tau^*_p, k_r, 1)\}$, the party of the rich opportunistically supports reform, wins the election and implements reform at the highest level of efficiency.

A.i.ii) If there are special interest groups and $U(\tau^*_r, k_p, \Theta_H) - U(\tau^*_p, k_p, 1) - R < \min\{\beta N \gamma(U(\tau^*_p, k_r, 1) - U(\tau^*_r, k_r, \Theta_H)), U(\tau^*_p, k_p, \Theta_H) - c_r + R - U(\tau^*_p, k_r, 1)\}$, rich voters bribe the party of the poor into blocking reform. The party of the poor wins the election.

A.i.iii) If there are special interest groups and $U(\tau^*_r, k_r, \Theta_H) - c_r + R - U(\tau^*_p, k_r, 1) < \min\{\beta N \gamma(U(\tau^*_p, k_r, 1) - U(\tau^*_r, k_r, \Theta_H)), U(\tau^*_r, k_p, \Theta_H) - U(\tau^*_p, k_p, 1) - R\}$ rich voters bribe the party of the poor into blocking reform. The party of the poor wins the election.

A.ii) When either $U(\tau^*_r, k_p, \Theta_H) - U(\tau^*_p, k_p, 1) \geq R \geq U(\tau^*_r, k_r, 1) - U(\tau^*_p, k_r, \Theta_H) + c_r$ fails or $U(\tau^*_r, k_p, \Theta_H) < U(\tau^*_p, k_p, \Theta_L)$, reform is blocked without the need for bribes, and the party of the poor wins the election.

B. When costs are borne by the poor and the party of the rich is the high efficiency party, the following equilibria can emerge.
B. i) When either a) special interest groups are absent or b) \( U(\tau^*_p, k_p, \Theta_H) < U(\tau^*_p, k_p, \Theta_L) \) and \( \beta N \gamma (U(\tau^*_p, k_r, \Theta_H) - U(\tau^*_p, k_r, 1)) < U(\tau^*_p, k_p, 1) - U(\tau^*_p, k_p, \Theta_L) + c_p \), or c) \( U(\tau^*_p, k_p, \Theta_H) \geq U(\tau^*_p, k_p, \Theta_L) \) and \( \beta N \gamma (U(\tau^*_p, k_r, \Theta_H) - U(\tau^*_p, k_r, 1)) < U(\tau^*_p, k_p, 1) + R - U(\tau^*_p, k_p, \Theta_H) + c_p \), the party of the poor blocks reform and wins the election.

B. ii) When there is a strategic alliance between rich voters and the party of the poor, who block a reform which benefits its constituents in exchange for a bribe from rich voters. The party of the poor wins the election and implements reform.

C. When costs are borne by the rich and the party of the poor is the high efficiency, reform is blocked by the party of the rich.

D. When costs are borne by the poor and the party of the rich is the high efficiency

D. i) in the absence of special interest groups or if \( \beta N \gamma (U(\tau^*_p, k_r, \Theta_H) - U(\tau^*_p, k_r, 1)) < U(\tau^*_p, k_p, 1) - U(\tau^*_p, k_p, \Theta_H) + c_p \), the reform is blocked by the party of the poor and the party of the poor wins the election.

D. ii) When the rich form a special interest group and \( \beta N \gamma (U(\tau^*_p, k_r, \Theta_H) - U(\tau^*_p, k_r, 1)) \geq U(\tau^*_p, k_p, 1) + R - U(\tau^*_p, k_p, \Theta_H) + c_p \), rich voters bribe the party of the poor into supporting reform. The party of the poor wins the election and implements reform.


Several interesting results emerge. Rent preservation reduces feasibility of reform dramatically. Special interest groups somewhat mitigate the problem by allowing the rich to compensate the party of the poor. On the other hand, special interest groups lead to opportunist behavior in which reforms which hurt the majority are enacted. Another source of opportunism emerges as a result of a divorce between the interest of rich voters and the party of the rich. When reform is costly for the rich, but electorally advantageous for the party of the rich, it may choose to support a reform that hurts its constituency. Consequently, it is possible to observe a strategic alliance between rich voters and the party of the poor, who block a reform which benefits its constituents in exchange for a bribe from rich voters.

4 Summary of Results and Concluding Remarks

The main result of the paper is introduced in the benchmark: the existence of political competition can have a negative effect on reform feasibility. As reform generates asymmetric electoral gains, electoral losers face incentives to block reform for electoral reasons. This result is shown under highly optimistic
conditions for reform feasibility: in the absence of informational frictions or asymmetric economic costs. Several extensions are presented in order to check the robustness of results. As further restrictions are introduced into the model, the main result is strengthened. Additionally, different mechanisms also affect reform feasibility. The first extension relaxes the assumption of class advantage. As a result, political competition becomes fierce and opportunistic blocking of reform becomes more pervasive. In the second extension, logrolling is employed as a mechanism to mitigate electoral inefficiencies by compensating electoral losers through fiscal benefits: Logrolling reduces electoral inefficiencies to some extent but cause a different problem. Potential electoral winners are tempted into logrolling institutional reform support in exchange for fiscal concessions which may have a negative net effect on their constituents, as long as these ensure electoral success. A third extension deals with informational asymmetries and shows that informational asymmetries between voters and parties can cause parties to either overstate or understate the expected benefits of reform, depending on which is electorally beneficial for the party. This makes it difficult for voters to recognize opportunistic behavior. The last extension deals with rent preservation and the existence of special interests. Rent preservation makes reform unlikely, the existence of special interests biases reform towards reforms that help the rich and makes reforms that hurt the rich unlikely.

The combination of these factors explains why democratic transition in some Latin American and Eastern European countries has led to disappointing institutional advances. The In particular, it shows that important institutional reforms may be dramatically hard to achieve. The results presented in the model are consistent with the work by Acemoglu and Robinson (2008) in which democratization does not lead to big changes as elites make important investments in de facto power. This model shows that investments need not be large, as the combination of democratic checks and balances and political competition has a strong institutional status quo bias.

Another important contribution of the model its methodological emphasis. The literature which studies the political economy of reform and policymaking has made large process, in large part due to the usage of a pivotal decisionmaker, whose motivations affect policy. By using the median voter theorem, this analysis has been applied to democratic regimes. Even when the median voter is not explicitly invoked, the threat of political competition affects the policies chosen by an incumbent and thus generates predictions from the actions of a single player (e.g. Rodrik and Mukand 2005, Coate and Morris 1999). This way of studying policymaking in democratic regimes can be unsatisfactory, however. Division of power and frequent electoral competition are the two bastions of modern democracy. Sensible models focusing on policymaking in democratic settings must incorporate these active interactions between competing political agents. This model breaks away from the tradition of a single political actor in order to study these interactions.
5 References

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