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The Effects of Political Competition on the Feasibility of Economic Reform

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Abstract

This paper explores the effects of political competition on reform feasibility. In contrast to previous models, this paper shows that desirable reform may fail even in the absence of economic losers or informational asymmetries, as a result of democracy. Even if reforms were to generate economic gains for all agents, electoral gains remain a zero sum game. This model provides insight regarding the conditions under which critical elections take place as studied in the political science literature. If there is a majority party, minority parties are able to pursue low value (which do not lead to political shifts) and high value reforms (which cause a political realignment). Intermediate value reforms are harder to enact, as the electoral cost of reform is high for the dominant party. In contrast, in highly contested political environments, only high value reforms may successfully be enacted.

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JEL Classification Codes: H11, O43, P16.

1 Introduction

Explanations for failure to implement desirable reform, and for inefficient policymaking in general, focus either informational or redistributive issues. This paper shows that desirable reforms may fail even in the absence of these. In particular, I consider a costless reform which raises overall productivity and show conditions under which the reform gets blocked when there is political competition.

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1.1 Motivation

A motivating story for the paper is the case of Mexico. During the 1980s and early 1990s, Mexico pursued an aggressive economic liberalization agenda. Major state owned enterprises, such as banks, TV stations and the telephone company were privatized. Trade was also liberalized: tariffs were substantially lowered and the country joined GATT and signed NAFTA with the U.S. and Canada. During this time, the PRI was the major political party. It maintained a Congressional majority sufficient to pursue this liberalization agenda unopposed. In addition, these reforms found support from the right-leaning PAN. In 1997, the PRI lost congressional majority as a consequence of a major financial crisis which took place in 1995 and of electoral independence brough about by major political reforms. As president Zedillo attempted to continue this reform agenda, the PAN began blocking reforms. Why would the PAN block reforms which were both consistent with its ideology and beneficial to its constituents? As opposition parties saw the first real possibility of winning the Presidential election in over six decades, they had incentives to block the PRI's reforms and reduce incentives for voters to reelect the PRI. In 2000, Vicente Fox from the PAN was elected. Not without a sense of irony, the PAN attempted to pursue a very similar reform agenda as the PRI, only to find opposition from the PRI. In 2006 Felipe Calderon of the PAN barely won the presidential election. The PAN has faced several defeats in Guvernatorial, Municipal and Congressional elections. Meanwhile, the PRI has been consistently gaining electoral ground in governatorial and legislative elections and holds a fourfold lead over its closest competitor for the 2012 presidential election. A decade has passed since elections became competitive in Mexico and parties have remained unwilling to support major energy, labor and fiscal reforms.

In contrast, the liberalization experiences of Chile and Spain have shown us that it may be easier to reform economic institutions prior to political reform. China, Vietnam, Singapore and Korea offer examples where important economic reforms have led to accelerated growth in the context of non-democratic regimes.

Now, there have been cases where Democratic rule did lead to improved conditions like India, which eventually managed to produce impressive economic growth or some Post-Soviet countries like Poland, but in many of these cases, democratization was accompanied by independence from a foreign power. Furthermore, this paper does not intend to argue that Autocracy is better than Democracy, but rather to point out to a source of inefficiency that can arise in Democratic regimes.[1]

A second application of this model concerns Political Realignment in the context of the United States' political history. At least since Key (1955), it has been argued that there are some elections which change the dominant political ideology and therefore establish a long-term advantage in favor of one political

[1] This is an ongoing discussion with mixed results. Limongi and Przeworski (1993) offer an survey of this empirical question. Furthermore, democracies may be better than autocracies to the extend that they impose constraints on power, which may also prevent undesirable reforms from taking place.

party. In that context, the elections of Abraham Lincoln, Franklin Roosevelt and Ronald Reagan have been studied as decisive. In all these examples, leaders presided over important changes to the economic structure: in the case of Lincoln, emancipation led to a change in economic power from the agricultural South to the industrializing North; Roosevelt's New Deal transformed the role of government from into an active player needed to stabilize, regulate and in many cases direct economic activity. Finally the Reagan revolution reversed these policies and reduced the role of government through tax reductions and deregulation. In all these cases reform was also preceeded by a major crisis: in Lincoln's case the crisis was political as South Carolina and six other states attempted to separate from the Union, in Roosevelt and Reagan's case the crises were economic: the Great Depression and the Energy Crisis and Stagflation.

In contrast to these leaders that changed the political landscape and established their political parties as the majoritarian political force, William Clinton was unable to do so. After he won the election following a minor economic recession, he was unable to pursue major health reform. Clinton then had a successful presidency by sticking to reforms that were desirable for Conservative Republicans such as Welfare Reform. Republicans remained the dominant party and won the Presidential election in 2000 and 2004. As a major economic crisis and a failed war loom in the horizon, President Obama has an opportunity to succeed in implementing major progressive reforms and changing the political centre in favor of Democrats. Because of the magnitude of the economic crisis it is expected that most moderate Republicans will not attempt to filibuster or block reform, even if a successful Obama presidency is not favorable electorally to Republicans. In other words, given the current state of the economy, the value of reform is substantially high which may allow for Republican support in spite of electoral losses and therefore to political Realignment, a condition not feasible during Clinton's presidency.

This paper studies the effects of democratic conditions on the feasibility of desirable reforms. Even if there are economic gains for all actors from enacting reform, electoral gains are a zero sum game: When reform improves voters' conditions, political actors associated with reform get rewarded electorally. If competing political agents have veto power over reform, one of the parties may block reform if it rewards electorally its opponent.

1.2 Outline of the Model

This paper presents a game-theoretic model in which a Pareto improving reform can get enacted. There are two parties who share veto power over the decision to enact the reform, but face asymmetric electoral incentives from reform. From the perspective of voters, reform should be undertaken. For parties, the decision to enact a Pareto improving may not be trivial; if electoral gains from reform are accrued by the competing party, then the decision to support reform depends on the tradeoff between the economic gains and electoral losses.

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 repre-

sented by a party. Parties share control of the legislative branch. There is the possibility to enact an institutional reform which increases the overall productivity of the economy. While the reform is costless to implement, it only gets enacted if both parties support it. Although this sounds like a stark assumption, it is basically used to capture the idea that in functioning democracies, opposition parties have a degree of veto power over decisionmaking. This can be especially true in the case of Constitutional amendments, which may require a support of two thirds of Congress to take place. Even in the case of the U.S., the filibuster can act as a de facto tool to veto policy.[2] Finally, parties differ in their implementation ability, which in turn determines the value of reform. There can be several reasons for one party to have greater implementation efficiency. Leadership may be one reason.[3] This can be manifested as competence or honesty, and maybe crucial 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.

As voters observe whether a reform was enacted or not, they vote for the party that maximizes their expected utility. Two considerations can affect the voters' preferences: class identity, in which voters elect the party that represents them, since it chooses the voters preferred fiscal policies and implementation ability, in which voters may vote for the party that has the ability differentials are sufficient to ensure that economic benefits offset fiscal losses. Different abilities therefore can generate electoral asymmetries from reform. Some readers may be troubled with the timing of events, in which reform takes place after the election. There can be several ways to justify this assumption. The first is that in competitive democracies there is always an election taking place in the distant future. The second is that important reforms take time to implement: sometimes years if not decades, which means that they have consequences for future elections.[4] Another important thing to keep in mind is that while in this model ability differentials generate the electoral asymmetries, there may be several other reasons why reform may generate electoral asymmetries and the same idea holds. For example, reform may signal the ability or level of commitment of an incumbent party, especially when the party's campaign promises in the previous electoral cycle included those reform promises. Alternatively, when there is an asymmetric distribution of economic gains from reform, par-

[2] For a model that delas with the effects of changing the proportion of votes required to veto policy see Aghion, Alesina, and Trebbi (2004). In their model, too much unchecked power leads to abuse, while too little leads to excessive blocking of legislative action. In their model, blocking occus due to uncertainty, whereas in this model, blocking occurs due to a deliberate electoral calculation.

[3] Jones and Olken (2005) have shown empirically that leadership plays a huge role in shaping the development of a country.

[4] A more detailed discussion is present in section 3.

ties constituencies may change (e.g. Jain and Mukand (2003), Besley and Coate (1998)).

1.3 Related Literature

Papers that study why inefficient policymaking can take place, have focused on economic transfers and informational issues. Economic transfer explanations can be of two types: a) rent preservation, in which a proportion of pivotal decisionmakers prevent a reform that reduces their economic rents,[5] and b) special interest groups, in which a small group of agents solve the collective action problem and employ resources to achieve their desired set of policies (either through block voting or through bribes). Explanations which focus on informational issues argue that if incumbents have private information, an undesirable policy may get implemented opportunistically either for economic rents or reelection incentives.[6] Alternatively, the combination of uncertainty and informational asymmetries may prevent incumbents from implementing desirable reform.[7]. Finally, uncertainty about a competitor's resolve may lead to continuation of inefficient policies.[8]

This paper contrasts those models by assuming perfect information and a

[5] Rajan (2009) 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.

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 (2000) 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.

[6] 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 Majumdar, Mani, 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 Majumdar and Mukand (2004) a project whose value fell short of expectations is continued to delay its political costs. In Silbert and Rogoff (1988) political business cycles emerge as a incumbents using costly fiscal policy to delay economic deceleration to ensure reelection. In Hess and Orphanides (1995) and Hess and Orphanides (2001) inefficient wars are started to show the incumbents military leadership in times of bad economic performance.

[7] 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.

[8] In Alesina and Drazen (1991) factions start a "war of attrition" over the burden of a costly stabilization program. In Fearon (1995) two countries get into a war similar reasons.

strictly Pareto improving reform. While in practice, we live in an uncertain world and all reforms have redistributive consequences, it is easy to think of examples where it is possible for this normalization to arise. Consider the case of reforms favored by a supermajority. In that case, as Jain and Mukand (2003) argue, the reform is ex-ante welfare improving for all individuals: the benefits offset the probabilities of being an economic loser, and thus everyone wants reform. Alternatively, if the reform benefits a minority, the losers may tax the winners as suggested by Jain and Mukand (2003), Besley and Coate (1998) and Acemoglu and Robinson (2000). In any case, by making reform Pareto improving and making information complete and public, I show that even in the absence of informational frictions and economic losers, reform may still fail due to electoral calculations.

Other papers study the effect of political competition on policymaking efficiency and focus on problems of commitment credibility: in these models, the incumbent may choose inefficient policies to tie her successor's hands.[9] In contrast to those models, in this paper, the inefficient policy (blocking the reform) is used to prevent the opposing party from winning rather than to limit its policy space once it takes control of power.

The remaining of the paper proceeds as follows: the next section presents and solves the benchmark specification. Section 3 offers a discussion in which the main assumptions of the model are justified or relaxed. Section 4 summarizes the main findings of the model and the extensions and offers some concluding remarks.

2 Model

2.1 Agents

There are two types of agents in this economy, voters and parties.

2.1.1 Voters

There are $N > 2$ voters of two types who differ only in their productive ability: rich, r and poor, p. Rich voters have high productivity ability, k_r, and make up $\beta < \frac{1}{2}$ of the population; poor voters have low productive ability where $k_p = \phi k_r$ and make up $1-\beta$ of total population, where $\phi \in (0,1)$. All voters are endowed with a unit of labor, whose value depends of their respective productive ability. Total productive endowment of the economy is normalized to 1:

$$N(\beta k_r + (1-\beta)k_p) = 1 \tag{1}$$

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

[9] In Moe (1990) inefficient regulatory institutions may be placed to restrict future actions. In Alesina and Tabellini (1990) and Milsi-Ferretti and Spolaore (1994) deficits are run to prevent successors from using fiscal policy.

the following utility function:

$$u(g, y_i) = 4[\frac{1}{2}g^{\frac{1}{2}} + \frac{1}{2}y_i^{\frac{1}{2}}]^2 \tag{2}$$

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 $i \in \{p, r\}$.[10]

2.1.2 Parties

There are two parties, who share control of the legislative and compete for control of the executive. Parties are risk neutral, rational and forward looking, one party identifies with the rich while the other identifies with the poor. The party of the rich has a higher implementation ability than the party of the poor.[11] Parties care about their respective constituencies' utilities and about capturing power. Parties have the following utility function:

$$u(g, y_i) + r \tag{3}$$

where r denotes exogenous political rents from capturing the executive branch. Exogenous political rents have a value of 0 when the party loses the election and $R > 0$ when it wins the election.

2.2 Technology

Each voter of class i inelastically supplies labor to a competitive firm producing the private good with technology Z. Private production by a voter of class i is thus:

$$Y_i = Zk_i. \tag{4}$$

It follows from equation (1) that total private production is normalized to Z, the production technology of the firm.

2.2.1 Institutional Development

There is a legislative proposal to make an 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

[10] The elasticity of substitution, σ, and the preference weights, ϖ, are set equal to $\frac{1}{2}$ only to simplify exposition. The model only requires that $\sigma, \varpi \in (0, 1)$. If either $\sigma = 0$, or if $\varpi = \{0, 1\}$ individuals have the same fiscal policy preferences irrespective of their social class. The first extension to the model shows that the main result is strenghtened when this is the case. At the other extreme, if $\sigma = 1$, utlity 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.

[11] I make this assumption to help the reader focus on the interesting case, which is the one where the majority party is the low ability. If the majoritary party is the high ability, the result is trivial. Since there is no incentive to ever block by the minority party, reform always succeeds. This is the result in Claim 8.

efficiency of the party that takes control of the executive by winning the election and implements the reform. The technology of the economy therefore becomes:

$$Z = \left\{ \begin{array}{c} \Theta_H \text{ when both parties support reform and the high ability party is elected} \\ \Theta_L \text{ when both parties support reform and the low ability party is elected} \\ 1 \text{ when either party blocks reform} \end{array} \right\} \tag{5}$$

where $\Theta_H > \Theta_L > 1$. It is assumed that the party of the rich is the high ability party.

2.3 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 τ denote the tax rate faced by voters. A voter of class i pays τY_i and consumes the rest. $y_i = (1-\tau)Y_i$. Public sector production equals total public revenue. That is,

$$g = \tau N[\beta Y_r + (1-\beta)Y_p] = \tau Z \tag{6}$$

The tax rate is determined by the party that wins the election.

2.4 Timing of Events

1. Party abilities are revealed to all agents. Parties simultaneously choose whether to support or block the reform.

2. 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 utility 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.

3. The winning party chooses its optimal tax policy, τ_j^* where j denotes the class identity of the winning party.[12]

2.5 Solving the Model

2.5.1 Reexpressing Utility Functions

The voter's utility function is reexpressed as an indirect utility function (Equation 2) in terms of τ.

$$U(\tau, k_i, Z) = \{(Z\tau)^{\frac{1}{2}} + [(1-\tau)Zk_i]^{\frac{1}{2}}\}^2 \tag{7}$$

[12] See section 3 for a discussion on the timing of events.

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

Proof. $\frac{\partial U}{\partial Z} = \frac{U}{Z} \iff U = Z\frac{\partial U}{\partial Z}$. ■

The utility can be reexpressed as:

$$U(\tau, k_i, Z) = Z\{\tau^{\frac{1}{2}} + [(1-\tau)k_i]^{\frac{1}{2}}\}^2 \tag{8}$$

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 3) is therefore:

$$U(\tau, k_i, Z) + r \tag{9}$$

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 the utility of its constituents.

2.5.2 Stage 4. Selecting the Optimal Tax Policy.

The winning party solves:

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

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: $\frac{\partial U}{\partial \tau} = Z\{\tau^{\frac{1}{2}} + [(1-\tau)k_i]^{\frac{1}{2}}\}[\tau^{-\frac{1}{2}} - (1-\tau)^{-\frac{1}{2}}k_i^{\frac{1}{2}}] = 0$.

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

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

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. $\frac{\partial \tau_i^*}{\partial k_i} = -\frac{1}{(1+k_i)^2} < 0 \ \forall k_i$. ■

Remark 1 *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 $Z\frac{(1+\phi^{\frac{1}{2}}k_r)^2}{1+k_r}$ respectively, and ii) when the party of the poor is elected, the utility levels to rich and poor voters are $Z\frac{(1+\phi^{\frac{1}{2}}k_r)^2}{1+\phi k_r}$ and $Z(1+\phi k_r)$ respectively.*

2.5.3 Stage 3. Electing a Party

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.[13]

Let

$$Z^{elect} \equiv \frac{(1+\phi k_r)(1+k_r)}{(1+\phi^{\frac{1}{2}} k_r)^2}\Theta_L \tag{11}$$

Claim 4 $\frac{(1+\phi k_r)(1+k_r)}{(1+\phi^{\frac{1}{2}} k_r)^2} > 1$.

Proof. $\frac{(1+\phi k_r)(1+k_r)}{(1+\phi^{\frac{1}{2}} k_r)^2} > \frac{(1+\phi k_r)(1+k_r)}{(1+\phi k_r)^2} > 1$. ■

It follows from the previous claim that $Z^{elect} > \Theta_L$.

Claim 5 *The party of the rich is elected if and only if reform is enacted and* $\Theta_H \geq Z^{elect}$.

Proof. Notice that support from the poor is a necessary and sufficient condition for the party of the rich to get elected. Suppose first that no reform is enacted. The poor elect the party of the rich if and only if $\frac{(1+\phi^{\frac{1}{2}} k_r)^2}{1+k_r} > (1+\phi k_r) \Leftrightarrow 1 > \frac{(1+\phi k_r)(1+k_r)}{(1+\phi k_r)^2}$. It follows from the previous claim that this is a contradiction. Now suppose that the reform is enacted. The poor elect the party of the rich if and only if $\Theta_H \frac{(1+\phi^{\frac{1}{2}} k_r)^2}{1+k_r} \geq \Theta_L(1+\phi k_r) \Leftrightarrow \Theta_H \geq \frac{(1+\phi k_r)(1+k_r)}{(1+\phi^{\frac{1}{2}} k_r)^2}\Theta_L = Z^{elect}$. ■

Since $Z^{elect} > \Theta_L$, having higher ability to implement an enacted reform is not a sufficient condition for the party of the rich to get elected when a reform has been enacted. The party of the rich requires a substantial differential in ability in order to get elected by the party of the poor. In other words, the electoral benefits of being a majority party for the party of the poor are sufficient to ensure victory, as long as the ability differentials between the two parties are low.

Now let us focus on the decision to support by the parties.

2.5.4 Stage 2. Supporting or Blocking Reform

Let us first study the decision to support by the party of the rich.

Claim 6 *The party of the rich always supports reform (i.e. supporting reform always weakly dominates blocking reform for the party of the rich).*

[13] 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.

Proof. It follows from the previous claim that if both parties support and $\Theta_H \in (\Theta_L, Z^{elect})$, then the party of the poor wins and the payoff for the party of the rich is $\Theta_L \frac{(1+\phi^{\frac{1}{2}} k_r)^2}{1+\phi k_r}$. If both support and $\Theta_H \geq Z^{elect}$, then the party of the poor wins and the payoff for the party of the rich is $\Theta_H(1+k_r)+R$ and if either party blocks reform, the payoff to the party of the rich is $\frac{(1+\phi^{\frac{1}{2}} k_r)^2}{1+\phi k_r}$. Since $\frac{(1+\phi^{\frac{1}{2}} k_r)^2}{1+\phi k_r} < \Theta_L \frac{(1+\phi^{\frac{1}{2}} k_r)^2}{1+\phi k_r} < \Theta_H(1+k_r)+R$ it follows that the rich always supports reform. ■

The intuition is simple: the party of the rich can never win the election if there is no reform. Since reform is strictly welfare improving, the rich always want reform to take place. The interesting question then becomes: When does the party of the poor support or block reform?

Let

$$Z^{enact} \equiv \frac{(1+\phi k_r + R)(1+k_r)}{(1+\phi^{\frac{1}{2}} k_r)^2} \tag{12}$$

Claim 7 *The party of the poor blocks reform whenever* $\Theta_H \in [Z^{elect}, Z^{enact})$ *and supports reform otherwise.*

Proof. It follows from the previous claim that the party of the rich always supports reform. Suppose that $\Theta_H < Z^{elect}$ it follows from claim 6 that the party of the poor win the election regardless of whether reform is undertaken. Since $\Theta_L(1-\phi k_r)+R > (1-\phi k_r)+R$ the party of the poor supports reform. Now suppose that $\Theta_H \geq Z^{elect}$. In this case, it follows from claim 6 that the party of the rich wins the election if reform is enacted and the party of the poor wins the election if reform is blocked. The poor therefore support reform if and only if the utility from supporting and losing is greater or equal to the utility from blocking reform and winning. The poor therefore support reform if and only if $\Theta_H \frac{(1+\phi^{\frac{1}{2}} k_r)^2}{1+k_r} \geq 1+\phi k_r + R \Leftrightarrow \Theta_H \geq \frac{(1+\phi k_r+R)(1+k_r)}{(1+\phi^{\frac{1}{2}} k_r)^2} = Z^{enact}$ and block otherwise. ■

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 loses. When the electoral losses are less or equal to the economic gains, parties support reform. From the previous discussion, the central proposition of the paper is constructed.

Remark 2 *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 implementation efficiency and political rents are sufficiently high to entice opportunistic behavior by the low efficiency party. Let $\underline{R}$ denote the minimum level of political rents under which there is opportunistic behavior by the party of the poor.

$$\underline{R} = (Z_p - 1)(1 + \phi k_r) \tag{13}$$

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 loses. When the electoral losses are less or equal to the economic gains, parties support reform. From the previous discussion, the central proposition of the paper is constructed.

Now for completion let us focus on the least interesting case and suppose that the party of the poor is the high efficiency party.

Claim 8 *If the party of the poor is the high efficiency party, then reform always succeeds and the poor is always elected.*

Proof. It follows from claim 4 that $\Theta_H(1+\phi k_r) > \Theta_L \frac{(1+\phi \frac{1}{2} k_r)^2}{1+k_r}$ and $(1+\phi k_r) > \frac{(1+\phi \frac{1}{2} k_r)^2}{1+k_r}$ therefore, the poor never vote for the party of the rich. The party of the poor therefore supports reform if $\Theta_H(1 + \phi k_r) + R > 1 + \phi k_r + R$ and the party of the rich support reform if $\Theta_H \frac{(1+\phi \frac{1}{2} k_r)^2}{1+\phi k_r} > \frac{(1+\phi \frac{1}{2} k_r)^2}{1+\phi k_r}$. Clearly, since $\Theta_H > 1$ both parties always support reform. ■

2.5.5 Equilibria of the Model

Proposition 1 *The following equilibria can emerge:*

a) If the party of the poor is the high efficiency party, reform is always enacted and the party of the poor wins.

b) If the party of the rich is the high efficiency party and if $R > \underline{R}$ there can be up to three different outcomes:

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

ba.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.

ba.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) If $R \leq \underline{R}$ there can be up to two different outcomes:

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

bb.ii) Whenever $\Theta_H \geq Z^{elect}$ 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. a) follows from claim 8. b) Follows from direct application of claims 5, 6 and 7 and remark 2. ■

It is important to understand how different parameters affect the feasibility of reform. When $\Theta_H < Z^{elect}$ 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 majority or monopolistic control of electoral outcomes. If the majority party has a higher ability, it becomes electorally invulnerable.

The interesting solutions arise when $\Theta_H \geq Z^{elect}$. What affects the possibilities of having a party opportunistically block reform? By simple manipulation of equation (13) it can be shown that holding the high efficiency level, Θ_H, and political rents, R, constant, a smaller differential in efficiency levels (i.e. a higher Θ_L) reduces the area over which reform is blocked. The intuition is that increasing Θ_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 ϕ) reduce the area over which reform is blocked. This happens because increasing ϕ 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

counter argument 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 deterrents of new entry into the political arena. Even then it is interesting to see how relaxing the assumption of fiscal divergence affects the results. Fiscal convergence can be achieved by either making a) preferences converge which can occur if either the elasticity of substitution is 0 or if the preference weights for the public good are either 0 or 1, if 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, $\tau = \widehat{\tau} \in [\tau_r^*, \tau_p^*]$.[14] 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, $\widehat{\tau}$, 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 9 *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, $U(\widehat{\tau}, k_i, Z) = ZU(\widehat{\tau} + (1-\widehat{\tau})k_i)$ for $i = \{p, r\}$ regardless of the class identity of the party. Since $Z = 1$, under each party

[14] 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 τ_r^* (τ_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).

when reform is blocked which makes all voters indifferent, and equal to Θ_H and Θ_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. ■

This claim is the analogous to claim 5 in the benchmark and studies 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 reform by the low efficiency party depends on whether the utility from supporting reform is sufficient to offset the electoral losses.

The low efficiency party supports reform if and only if

$$\Theta_H U(\widehat{\tau} + (1 - \widehat{\tau})k_L) \geq U(\widehat{\tau} + (1 - \widehat{\tau})k_L) + \frac{R}{2} \tag{14}$$

This equation is analogous to claim 7 in the benchmark. The main difference is that now the identity of the party willing to block is no longer limited to the party of the poor. 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 10 *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 $\Theta_H U(\widehat{\tau} + (1-\widehat{\tau})k_H) + R > U(\widehat{\tau} + (1-\widehat{\tau})k_H) + \frac{R}{2}$, 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. ■

This claim is analogous to claim 6. 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 constructed.

Equilibria Under a Fixed Tax Rate

Proposition 2 *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 $R \leq 2\Theta_H(\widehat{\tau} + (1 - \widehat{\tau})k_r)$, 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 $R > 2\Theta_H(\widehat{\tau} + (1 - \widehat{\tau})k_r)$, 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 $R \leq 2\Theta_H(\widehat{\tau} + (1 - \widehat{\tau})\phi k_r)$, 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 $R > 2\Theta_H(\widehat{\tau}+(1-\widehat{\tau})\phi k_r)$, 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 9 and 10, and equation (14). ■

There are two main differences with respect to the benchmark. 1) When the party of the poor has 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 $\widehat{\tau}$ to τ° 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, $\widehat{\tau}$, 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, τ°, 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 9 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

$$V(\tau^{\circ}, k_H, \Theta_H, R) \geq U(\widehat{\tau}, k_H, 1) + \frac{R}{2} \tag{15}$$

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:

$$\begin{aligned} & \max_{\tau^{\circ}} U(\tau^{\circ}, k_L, \Theta_H) \qquad (16) \\ \text{subject to } U(\tau^{\circ}, k_H, \Theta_H) + \frac{R}{2} &\geq U(\widehat{\tau}, k_H, 1) \text{ (constraint 1)} \\ \text{and } U(\tau^{\circ}, k_L, \Theta_H) &\geq U(\widehat{\tau}, k_L, 1) + \frac{R}{2} \text{ (constraint 2)} \end{aligned}$$

where the first constraint is a reexpression of equation (15) 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.

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

Remark 3 *Notice that each party represents one social class and any equilibrium fiscal policy lies between* $\left[\tau_r^*, \tau_p^*\right]$. *It follows from claims 1 and 2 that if* $\frac{\partial U(\tau, k_L, Z)}{\partial \tau} \gtrless 0 \iff \frac{\partial U(\tau, k_H, Z)}{\partial \tau} \lessgtr 0$. *For that reason, when the low efficiency party represents the rich (poor), it reduces (increases) taxation until the point where either constraint 1 binds or the tax rate is the one preferred by the rich (poor) party.*

From the following remark and the constraints one can construct the solution to the program.

Solution 1 *i) Whenever the low ability party represents the rich, it reduces* τ *until the point where constraint 1 binds, whichever occurs first. 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* τ *until the point where either either* $\tau^{\circ} = \tau_p^*$ *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.

Equilibria Under Fiscal and Institutional Logrolling

Proposition 3 *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 $\exists$ *a* τ *such that both constraints 1 and 2 hold, then a) if at* τ_r^* *constraint 1 still holds, the party of the rich offers support for reform in exchange for a tax rate of* $\tau^\circ = \tau_r^*$*, b) if at* τ_r^* *constraint 1 fails, the party of the rich selects tax rate* $\tau^\circ = \tau^{**}$ *such that* τ^{**} *solves* $U(\tau^{**}, \phi k_r, \Theta_H) + \frac{R}{2} = U(\widehat{\tau}, \phi k_r, 1)$*. The party of the poor always accepts the fiscal logrolling offer, wins the election and implements reform efficiently.*

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

B.ii) When $\nexists$ *a* τ *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 9 and solution 1. ■

While these results seem very similar to those in the previous extension, there are two 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 4 *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, $U(\tau^\circ, k_H, \Theta_H) + \frac{R}{2} = U(\widehat{\tau}, k_H, 1) \Longrightarrow U(\tau^\circ, k_H, \Theta_H) < U(\widehat{\tau}, k_H, 1)$ which is the utility that the constituents would get in the absence of reforms. ii) When constraint 1 is not binding, (i.e. when $\tau^\circ = \tau_r^*$ when the part of the poor is high efficiency and $\tau^\circ = \tau_p^*$ when the party of the rich is high efficiency) then $U(\tau^\circ, k_H, \Theta_H) + \frac{R}{2} > U(\widehat{\tau}, k_H, 1)$, which may occur either when $U(\tau^\circ, k_H, \Theta_H) \in [U(\widehat{\tau}, k_H, 1) - \frac{R}{2}, U(\widehat{\tau}, k_H, 1))$ in which case the constituents are hurt by logrolling or when $U(\tau^\circ, k_H, \Theta_H) \geq U(\widehat{\tau}, k_H, 1)$ in which case they benefit from logrolling. ■

The interesting difference with respect to the benchmark is that when logrolling 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 simple extension is presented in which uncertainty and informational asymmetry are added to a fixed tax specification.[15] In this extension I just allow exogenous probabilities to exist for the two different parties and make those private information. The standard approach would be to make the probabilities and endogenous process which may depend on a policy choice by the parties, but those are complications that do not add to the explanation.

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.

[15] A previous version studied informational asymmetries in the context of class advantage. Results are similar but require additional restrictions.

In terms of efficiency, reform should be enacted if

$$E[Z] \equiv q_H Z_S + (1 - q_H) Z_F \geq 1 \tag{17}$$

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 $E[Z]U(\widehat{\tau}, k_H, 1) + R$ as it wins the election versus $U(\widehat{\tau}, k_H, 1) + \frac{R}{2}$ where it wins the election with a probability $\frac{1}{2}$. For the low ability party, when reform is enacted, expected utility is $E[Z]U(\widehat{\tau}, k_L, 1)$ versus $U(\widehat{\tau}, k_L, 1) + \frac{R}{2}$ when it is not.

As a result, the high ability party supports reform when

$$2(E[Z] - 1)U(\widehat{\tau}, k_H, 1) \geq -R \tag{18}$$

and the low ability party supports reform when

$$2(E[Z] - 1)U(\widehat{\tau}, k_L, 1) \geq R \tag{19}$$

Remark 4 *It follows from equations (17), (18) and (19) 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 (19).

Equilibria Under Informational Asymmetries

Proposition 5 *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 $2(E[Z] - 1)U(\widehat{\tau}, k_r, 1) \geq R$ *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 $2(E[Z] - 1)U(\widehat{\tau}, k_r, 1) < R$*, 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 $2(E[Z] - 1)U(\widehat{\tau}, \phi k_r, 1) \geq R$*, the party of the rich gets elected and reform is implemented by the party of the rich, who has the high level of efficiency.*

A.ii) When $2(E[Z] - 1)U(\widehat{\tau}, \phi k_r, 1) < R$ *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 9 and remark 4. ■

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 5 *The high efficiency party may unsuccessfully try to opportunistically support bad reforms (i.e. when* $E[Z]-1 \in [\frac{R}{2U(\widehat{\tau},k_L,1)},0]$*) 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* $E[Z]-1 \in [0 > \frac{-R}{2U(\widehat{\tau},k_H,1)})$*).*

This is an unexpected consequence of checks and balances.[16]

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 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. Fernandez and Rodrik (1991), Jain and Mukand (2003)). 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

[16] Aghion, Alesina, and Trebbi (2004) discuss the issue of optimal checks and balances by focusing on the tradeoff between granting the incuments sufficient power to ensure reform and restrainign them to prevent expropirative abuse. This model shows that electoral considerations exacerbate that tension.

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 Fernandez and Rodrik (1991) or indirectly by affecting voter's distribution as in Jain and Mukand (2003) and Besley 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), Olson (1982)). 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), Grossman and Helpman (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:

$$c_i > \Theta_H U(\tau_i, k_i, 1) - U(\tau_p^*, k_i, 1) \tag{20}$$

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.[17]

The model is studied in the context of no special interest groups and under the possibility of the rich forming a special interest group.[18] 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 $\gamma'(\cdot) > 0$.[19]

[17] 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.

[18] The special interest group offers a bribe to one of the parties. As it will become clear, only one party needs to be bribed.

[19] 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 γ has a flexible

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 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.[20] 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 (20), 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 11 *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 (20): 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 efficiency 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

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. βN is only aggregation amongst rich voters and of no importance in terms of results.

[20] It is assumed that the bribe is paid simmultaneously to the institutional reform decision in order to avoid credibility issues about the payment of the bribe.

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 12 *A necessary condition for reform to be enacted is for i)* $U(\tau_r^*, k_p, \Theta_H) - U(\tau_p^*, k_p, 1) \geq R \geq U(\tau_p^*, k_r, 1) - U(\tau_r^*, k_r, \Theta_H) - c_r$ *and ii)* $U(\tau_r^*, k_p, \Theta_H) \geq U(\tau_p^*, k_p, \Theta_L)$ *to hold.*

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 (20) is can be shown that $U(\tau_p^*, k_r, \Theta_L) - c_r < U(\tau_p^*, k_r, \Theta_L) - c_r < U(\tau_p^*, k_r, 1)$, thus the party of the rich blocks reform. Electoral success for the party of the rich is therefore a necessary condition for reform feasibility. 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. ■

The first part of the statement argues that the economic benefits from reform for the party of the poor need to outweight the electoral cost, while the electoral benefits to the party of the rich must offset the economic costs from reform, the second part of the statement argues that the poor must prefer the party of the rich in order for the reform to take place.

Claim 13 *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* $\beta N \gamma(b) = \min\{U(\tau_r^*, k_p, \Theta_H) - U(\tau_p^*, k_p, 1) - R,\ U(\tau_r^*, k_r, \Theta_H) - c_r + R - U(\tau_p^*, k_r, 1)\}$. *Furthermore, when such b exists, the rich bribe the party of the poor if* $U(\tau_r^*, k_p, \Theta_H) - U(\tau_p^*, k_p, 1) - R < U(\tau_r^*, k_r, \Theta_H) - c_r + R - U(\tau_p^*, k_r, 1)$ *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 11 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 6 *If a bribe is possible, then the rich choose to bribe the party of the poor if* $U(\tau_r^*, k_p, \Theta_H) - U(\tau_p^*, k_p, 1) - R < U(\tau_r^*, k_r, \Theta_H) - c_r + R - U(\tau_p^*, k_r, 1)$ *and the party of the rich otherwise.*

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 11, 12, 13 and remark 6.

This extension differs from the benchmark in three ways: 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 (20) that the party of the poor always wants to block reform since $U\left(\tau_p^*, k_p, 1\right) + R > \max\{U\left(\tau_p^*, k_p, \Theta_L\right) + R - c_p, U\left(\tau_r^*, k_p, \Theta_H\right) - c_p\}$. It is also clear that both the rich and the party of the rich want reform since $U\left(\tau_r^*, k_r, \Theta_H\right) > U\left(\tau_p^*, k_r, \Theta_L\right) > U\left(\tau_p^*, k_r, 1\right)$.

Claim 14 *In the absence of special interest groups, reform is always blocked.*

Proof. It follows from equation (20) that $U\left(\tau_p^*, k_p, 1\right) + R > U\left(\tau_p^*, k_p, 1\right) > \max\{U\left(\tau_p^*, k_p, \Theta_L\right) - c_p, U\left(\tau_r^*, k_p, \Theta_H\right) - c_p\}$. Therefore, the party of the poor always blocks reform. ■

Claim 15 *When special interest groups arise, a) if* $U\left(\tau_p^*, k_p, \Theta_L\right) > U\left(\tau_r^*, k_p, \Theta_H\right)$, *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* $N\beta\gamma(b) = U(\tau_p^*, k_p, 1) + c_p - U\left(\tau_p^*, k_p, \Theta_L\right)$, *b) if* $U\left(\tau_p^*, k_p, \Theta_L\right) \leq U\left(\tau_p^*, k_r, \Theta_H\right)$, *rich voters can bribe the party of the poor into supporting reform if there is a* $b < U(\tau_r^*, k_r, \Theta_H) - U(\tau_p^*, k_r, 1)$ *such that* $N\beta\gamma(b) = U(\tau_p^*, k_p, 1) + R + c_p - U\left(\tau_r, k_p, \Theta_H\right)$.

Proof. It follows from equation (20) 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 $U\left(\tau_p^*, k_p, \Theta_L\right) > U\left(\tau_r^*, k_r, \Theta_H\right)$. 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 $U\left(\tau_p^*, k_p, \Theta_L\right) \leq U\left(\tau_r^*, k_r, \Theta_H\right)$ 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 16 *Reform always fails and the party of the poor always wins the election.*

Proof. The party of the poor always wins the election as $Z_p U(\tau_p^*, k_p, 1) > Z_r U(\tau_r^*, k_p, 1)\ \forall Z_p \geq Z_r$. From equation ((20) $U(\tau_p^*, k_r, 1) > U(\tau_r^*, k_r, \Theta_H) - c_r > U(\tau_p^*, k_r, \Theta_H) - c_r$ 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 17 *In the absence of special interest groups, reform is blocked.*

Proof. The rich can never win the election: $Z_p U(\tau_p^*, k_p, 1) > Z_r U(\tau_p^*, k_r, 1)\ \forall Z_p \geq Z_r$. It follows from (20) that $U(\tau_p^*, k_p, 1) + R > U(\tau_p^*, k_r, \Theta_H) - c_r + R$ so the party of the poor always blocks reform. ■

Remark 7 *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 $N\beta\gamma(b) = U(\tau_p^*, k_p, 1) + c_p - U\left(\tau_p^*, k_p, \Theta_H\right)$.*

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 by the party of the rich.

Equilibria in the Context of Rent Preservation and Special Interest Groups

Proposition 6 *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 $U(\tau_r^*, k_p, \Theta_H) - U(\tau_p^*, k_p, 1) \geq R \geq U(\tau_p^*, k_r, 1) - U(\tau_r^*, k_r, \Theta_H) + c_r$ 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 $\beta N\gamma(U(\tau_p^*, k_r, 1) - U(\tau_r^*, k_r, \Theta_H)) < \min\{U(\tau_r^*, k_p, \Theta_H) - U(\tau_p^*, k_p, 1) - R,\ U(\tau_r^*, k_r, \Theta_H) - c_r + R - U(\tau_p^*, k_r, 1)\}$, 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 $U(\tau_r^*, k_p, \Theta_H) - U(\tau_p^*, k_p, 1) - R < \min\{\beta N\gamma(U(\tau_p^*, k_r, 1) - U(\tau_r^*, k_r, \Theta_H)), U(\tau_r^*, k_r, \Theta_H) - c_r + R - U(\tau_p^*, k_r, 1)\}$, *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 rich into blocking reform. The party of the poor wins the election.*

A.ii) When either $U(\tau_r^*, k_p, \Theta_H) - U(\tau_p^*, k_p, 1) \geq R \geq U(\tau_p^*, k_r, 1) - U(\tau_r^*, k_r, \Theta_H) + c_r$ *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) $U(\tau_r^*, k_p, \Theta_H) < U(\tau_p^*, k_p, \Theta_L)$ *and* $\beta N\gamma(U(\tau_p^*, k_r, \Theta_L) - U(\tau_p^*, k_r, 1)) < U(\tau_p^*, k_p, 1) - U(\tau_p^*, k_p, \Theta_L) + c_p$, *or c)* $U(\tau_r^*, k_p, \Theta_H) \geq U(\tau_p^*, k_p, \Theta_L)$ *and* $\beta N\gamma(U(\tau_r^*, k_r, \Theta_H) - U(\tau_p^*, k_r, 1)) < U(\tau_p^*, k_p, 1) + R - U(\tau_r^*, k_p, \Theta_H) + c_p$, *the party of the poor blocks reform and wins the election.*

B.ii.i) When there rich form a special interest group and $U(\tau_r^*, k_p, \Theta_H) < U(\tau_p^*, k_p, \Theta_L)$ *and* $\beta N\gamma(U(\tau_p^*, k_r, \Theta_L) - U(\tau_p^*, k_r, 1)) \geq U(\tau_p^*, k_p, 1) - U(\tau_p^*, k_p, \Theta_L) + c_p$, *The rich bribe the party of the poor into supporting reform. The party of the poor wins the election and implements reform.*

B.ii.ii) When the rich form a special interest group and $U(\tau_r^*, k_p, \Theta_H) \geq U(\tau_p^*, k_p, \Theta_L)$ *and* $\beta N\gamma(U(\tau_r^*, k_r, \Theta_H) - U(\tau_p^*, k_r, 1)) \geq U(\tau_p^*, k_p, 1) + R - U(\tau_r^*, k_p, \Theta_H) + c_p$, *The rich bribe the party of the poor into supporting reform. The party of the rich 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 poor 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 $\beta N\gamma(U(\tau_p^*, k_r, \Theta_H) - U(\tau_p^*, k_r, 1)) \geq U(\tau_p^*, k_p, 1) - U(\tau_p^*, k_p, \Theta_H) + c_p$, *rich voters bribe the party of the poor into supporting reform. The party of the poor wins the election and implements reform at the high efficiency level.*

Proof. Omitted. It follows from claims 11, 12, 13, 14, 15, 16, 17 and Remarks 6 and 7. ■

Several interesting results emerge. Rent preservation reduces feasibility of reform dramatically. Special interest groups somewhat mitigates the problem by allowing the rich to compensate the party of the poor. On the other hand, special interest groups lead to opportunistic 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 show the robustness of results and to link the theory to the standard explanations for reform failure. 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 have led to disappointing institutional advances. In particular, it shows that important institutional reforms may be dramatically hard to achieve. The results presented in the model are consistent with the recent literature in which democratization does not lead to important changes as elites make important investments in de facto power (Acemoglu and Robinson (2008)), through the establishment of inefficient fiscal institutions when democratization is imminent (Acemoglu, Ticchi, and Vindigni (2006), Besley and Persson (2008)). 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. Mukand and Rodrik (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.

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