Between Votes and Capital: The Politics of Redistribution in Less Developed Democracies

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Abstract
This paper builds on the democratic equilibrium established in open economies where the median voter refrains from “over-taxing” the wealthy in order to prevent capital flight, advanced in Boix (2003). I explore this equilibrium in an electoral game where a left-wing candidate announces how much he will tax if elected, in order to maximize the income of the poor, and subject to the wealthy’s decision to send a share of his capital abroad. The model establishes how the wealthy should respond to prospects of income redistribution associated to a “turn to the left” in office, as well as the conditions under which this response should affect the capacity of a left-wing incumbent to deliver his campaign promises, or instead switch to a more conservative program (lower taxation and redistribution). The model demonstrates how exogenous shocks that change the relative productivity of capital in the domestic economy, as well as increased capital mobility, are likely to affect the incumbent’s decision.

I Introduction
The relationship between politics and markets is of central concern to political economists. The tensions between capitalist systems, where future welfare depends on investors’ private decisions on how to allocate productive resources, and democratic rule, under which citizens express their preferences about the allocation of resources they do not privately own, have been extensively explored in the academic literature (Lindblom 1977, Meltzer & Richard 1981, Przeworski & Wallerstein 1982, Alesina & Rodrik 1994, Austen-Smith 2000, Bowles 2000, Bjorvatn & Cappelen 2004).
Within the neo-pluralist tradition, Lindblom’s (1977) seminal work states that markets’ automatic resistance to changes which are detrimental to business puts capital owners in a privileged position to influence political decisions vis-à-vis other groups. Attempts to redistribute income or to enforce environmental laws that reduce business profits are often times faced with investment strikes that preclude collusion or any deliberate intention to punish on the part of market players and are, for that reason, far more effective than labor strikes.

Przeworski (1985) poses similar claims from the marxist perspective, maintaining that, from the current realization of capitalists interests depends the realization, in the future, of the material interests of any other group in a market society. It follows that the capacity of capital owners to accumulate profits is a necessary – though not sufficient – condition for the future welfare of all other social groups.

Both traditions assert that the dependence of the State on capital contributes to explain governments’ awareness of the effects produced by policymaking on investors, regardless of their own ideological leaning. As established by the literature on economic voting (Fiorina 1981, Lewis-Beck 1988, Remmer 1993, Lewis-Beck & Stegmeier 2000, Samuels 2004), economic growth significantly raises the chances that an incumbent or party remains in power in democratic systems. In market economies, in turn, growth depends on private investment and, thus, on business confidence to invest. Consequently, “even a government that is a perfect agent of wage earners cannot not and will not behave much differently from one that represents capitalists” (Przeworski & Wallerstein 1982, p.12), and that is what makes the power in hands of investors structural, not contingent on politics.

This structural power constitutes a barrier to further democratic development, since it constrains governments’ capacity to respond to voters’ demands whenever they conflict with business priorities (Lindblom 1982, Swank 1992, Mitchell 1997). Marxists also recognized that conflict, and expected the tension between capitalism and democracy to pave the way towards socialism (Przeworski 1985).

Przeworski & Wallerstein (1982) provide a solution for the dilemma of stable capitalist democracies arguing that, in cases when workers are paid a salary enough to “reproduce their consent” to the system, the accumulation of profits by capitalists can go on continuously and a capitalist democracy could result in equilibrium. It is worth noting, nevertheless, that this and other early studies on the structural dependence of State on capital implicitly assumed closed

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1It is also necessary that workers are not militant, in a sense that they cannot unite to demand a salary higher than the “consent level”. 
economies, overlooking the effect of capital mobility on this equilibrium.

Later studies on financial globalization, however, recognize increased capital mobility as significantly altering the balance of power between business and other social groups, reinforcing the structural dependence of the State on capital, and renewing the tensions between capitalism and democracy. The position of capital owners gets clearly more privileged in a world of few controls on cross-border capital flows (Garrett 1998), as the easier it is for asset holders to move their capital out of a given country, the stronger become the incentives for governments to implement policies that increase domestic rates of return on investment (Keohane & Milner 1996, Rodrik 2000). Taken to a limit, the constraints imposed by capital mobility could leave governments incapable of satisfying voters expectations and unable to respond to citizens’s demands, eventually leading to apathy or revolt and posing a real threat to the basic functioning of democratic systems.

Boix (2003) formalizes the constraints imposed by capital mobility on voters’ redistributive demands in a game where voters decide how much to tax the wealthy, subject to prospects of capital flight. The author suggests that, under high levels of capital mobility, the median voter cannot redistribute as much as required by high levels of income inequality as this would lead to capital flight and lower the maximum income of the poor. Put simply, Boix’s (2003) model explains the paradox of democracies that do not redistribute, even in face of high levels of income inequality. What is not sufficiently clear in Boix’s (2003) work is why voters should accept this reduced capacity to tax, especially in the case of highly unequal countries, where significant shares of the population live below poverty lines, while investors fight back whenever they believe to be “overtaxed”.

In this paper, I add political agency as well as an electoral dynamic to Boix’s (2003) model, taking the responsibility to choose taxation from voters, and attributing it to a left-wing incumbent whose goal is to maximize the income of the poor. In doing so, of course, he has to take into consideration investors’capacity to leave the economy. This model allows me to investigate how democratic governments’ limited redistributive capacity, resulting from increased levels of capital mobility, could create a scenario where incumbents are never capable of responding to voters’s demands (voters, in my model, are assumed to choose retrospectively, re-electing the incumbent if welfare increased during his term), and speculate what could be the consequences of that to the stability of democracies.

As for its implications, the model presented here explains why a “move to the left” brought by elections should lead to capital outflows, while capital inflows should occur when the right
replaces the left in office. It also establishes the conditions under which investors’ reactions should affect incumbents’ capacity to deliver their campaign promises, or instead switch to a more conservative program (lower taxation and redistribution). Finally, the model demonstrates why left-wing incumbents are more capable of redistributing income during “good times”, and also why increased financial liberalization should be associated with governments’ decreased capacity to redistribute income to the poor.

II Income Redistribution and Capital Mobility in Less Developed Democracies

Boix (2003) proposes a game where the median voter maximizes his income, establishing a level of taxation that is constrained by investors’ decision to leave the economy. In this game, when capital mobility is low, the median voter’s decision solely depends on current levels of income inequality, and the wealthy do not represent a constraint as they cannot leave the economy. In this scenario, democracies are not stable as the wealthy have strong incentives to fight the poor in order to protect their capital from high taxes. Under high capital mobility, however, democracies should be stable since median voters refrain from “overtaxing” the wealthy (beyond their opportunity costs to invest abroad), in order to keep investment in the economy. In this equilibrium, levels of income inequality are not binding to the median voter’s decision of how much to tax.

One major assumption of Boix’s (2003) model, thus, is that voters are aware of the constraints imposed by capital mobility on governments’ capacity to redistribute income. That assumption might reasonably reflect democracies of the consociational type, where workers and capital owners are organized in encompassing institutions directly involved in policymaking, or even mature democracies more generally. Nevertheless, it is less likely to describe the reality of developing democracies, where the Executive significantly centralizes decision power, the democratic practice is still consolidating and citizen’s levels of education, information and organization are relatively low.

In an attempt to account for these different conditions, and to examine the effects of increased capital mobility on the politics of redistribution in less developed democracies, I follow Boix’s (2003) reasoning but make incumbents the ones to decide how much to tax capital. I implicitly assume that voters choose their representatives retrospectively, reelecting them in case their welfare improved during incumbents’ term. Incumbents on the left, then, are expected to maximize the income of their constituency (the poor) constrained by the wealthy’s decision to
flee the domestic economy.\footnote{I do not deal with right-wing governments in the model, but it could be argued that they maximize the income of the wealthy subject to electoral incentives to improve voters’ conditions.}

The sequence is the following: the game starts with the inauguration of $P$, a left-wing incumbent elected on the promise to tax as much as necessary to maximize the income of the poor, given his beliefs regarding investors’ willingness to send capital abroad. Nature, then, establishes the “real state of the economy”, which can be “normal” (same as observed by investors and candidates during campaign), “good” or “bad”. Given the “state of the economy”, investors and incumbents make their decisions of how much capital to send abroad and how much to tax, respectively. My goal is to determine the conditions under which incumbents are capable of taxing/redistributing as much as promised during campaign, or instead should switch to more moderate levels of taxation once in office.

The idea behind the Nature’s draw is to capture the effect of exogenous shocks in less developed economies. These shocks, in the model, affect the relative returns on investment in the economy vis-à-vis the world and therefore change investors’ “sensitivity to taxation”. The logic is simple: when an economy is particularly attractive to investment as compared to others, high returns might compensate for high taxation, and investors should be willing to accept the latter to remain in the economy. The opposite will occur in case investment in a country offers relatively lower returns than in the rest of the world. In this case, only a “better treatment” on the part of government, reflected in lower taxes, could prevent investors from sending their capital somewhere else.

Typically, these exogenously motivated changes in relative returns are associated to changes in international costs of capital – lower international interest rates make less developed economies more attractive to investment (think of the 70s and early 90s), while higher interest rates in developed countries motivate a “flight to quality” (as happened in the early 80s, late 90s). These changes can also be caused by commodity booms, which boost the growth prospects of commodity exporting countries and increase the relative returns on investment in these countries (as has been occurring since 2003 in Latin America). Their most important aspect, nonetheless, is that they are exogenous to players’ decisions.

This draw of nature can also be interpreted as capturing incumbents’ and investors’ uncertainty regarding each others’ behavior. This is a phenomenon prevalent in emerging economies, where financial markets are recent, relatively small and asymmetric, democracies are less institutionalized and high levels of inequality subject governments to strong incentives to redistribute...
income.

In a scenario as such, a left-wing incumbent might downplay the constraints imposed by investors’ capacity to leave the economy. In that case, such incumbent is likely to promise to tax more than he would do if he understood how these constraints effectively work. Once elected, and confronted with the “real state of the world” by unexpected levels of capital flight, the incumbent then updates his beliefs regarding investors’ behavior, and moderates levels of taxation and redistribution (“switches”) in order to maximize the income of the poor subject to the constraints imposed by capital mobility.

On the part of investors, the strong redistributive incentives produced by high levels of inequality, coped with uncertainty regarding governments’ awareness of capital mobility, might lead to levels of capital flight higher than should occur if both investors and incumbents shared the same information regarding the “real state of the economy”.

It is important to note that, if decisions to switch policies were mainly caused by uncertainties about players’ behavior, one should observe the frequency of switches diminishing with time. The fact that this is not observed empirically supports the claim that exogenous shocks play a significant role in affecting left-wing incumbents’ decision to deliver their campaign promises or switch to a more conservative program.

Finally, the higher sensitivity of less developed economies to exogenous shocks and higher levels of uncertainty about governments and financial markets’ behavior also explain why, despite the fact that investors respond negatively to higher prospects of taxation both in developed and less developed economies, this reaction turns into currency crises much more often in the latter, imposing stronger constrains on incumbents’ capacity to deliver redistributive promises and creating incentives for “policy switches”. The next section displays these arguments in formal terms.

### III The Model

In order to examine the conditions that affect incumbent’s decision of how much income to redistribute in an open democracy, consider an economy with two types of individuals, the poor and the wealthy. The poor constitute the majority, represented by a share of $\alpha > 1/2$ of the population, and own a capital stock of $K_p$. The income of the wealthy ($1 - \alpha$ of the population) amounts to $K_w$. The total capital in the economy is equal to $K = K_p + K_w$. The aggregate share of capital of each group is, respectively, $k_p = K_p/K$ and $k_w = K_w/K$, therefore $k_p + k_w = 1$.

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3This setup follows from Boix (2003).
As a result, the capital held by each poor citizen is given by \( k_{pi} = \frac{k_p}{\alpha} \), the same working for the capital held by a wealthy citizen, equal to \( k_{wi} = \frac{k_w}{1-\alpha} \), and it necessarily follows that \( k_{wi} > k_{pi} \).

Finally, the average capital of this given country is given by:

\[
\begin{align*}
{k_a} & = \alpha k_{pi} + (1-\alpha)k_{pi} \\
& = \frac{\alpha k_p}{\alpha} + \frac{(1-\alpha)k_p}{(1-\alpha)} \\
& = k_p + k_w = 1
\end{align*}
\]

The relative productivity of capital at home as compared to abroad (\( \sigma \)) is determined by two different factors, of an endogenous and exogenous sort. First, \( \sigma \) reflects the costs of sending capital abroad, a function of the levels of asset specificity in the economy but that is also partially determined by governments’ decision to impose barriers on crossborder capital flows. Second, the value of \( \sigma \) is also affected by exogenous factors such as international interest rates and commodity cycles, that change the relative returns of investment in a given country as compared to the rest of the world.\(^4\)

Other conditions fixed, and assuming there is some cost associated to sending capital abroad (\( \sigma \neq 0 \)), whenever capital flees the economy, it looses a share of its value, and the total cost of that transaction is proportional to \( \sigma \) and represented by a quadratic function of the amount of capital that flees the economy. This quadratic relationship establishes that, the more capital is sent abroad, the more costly it gets to send an additional unit of it, and that cost is expressed in Eq. 1:\(^5\)

\[
\frac{\sigma (k_{wi(OUT)})^2}{2} = \frac{\sigma \delta^2 k_{w}^2}{2} \tag{1}
\]

where \( \delta \) represents the share of the wealthy’s income that leaves the economy.

Following the standard practice in the political economy literature (Persson & Tabellini 2002, Boix 2003), the state taxes citizens with a linear tax \( \tau \) on their income \( k \) and then redistributes the resulting revenue equally among all individuals. As a result, each individual pays \( \tau k_j \) and receives \( \tau k_a \). The tax system generates welfare losses represented by the quadratic function \( \frac{\tau^2}{2}k_a \). The post tax income of the poor, then, is given by:

\[
k_{pi} = (1-\tau)k_{pi} + (\tau - \frac{\tau^2}{2})k_a \tag{2}
\]

\(^4\)One could argue that these effects are not independent, and lower barriers to capital movements should increase investors’ likelihood to invest in a given economy. That might be correct, but for now, for the sake of simplicity, I chose to assume these two “aspects” of \( \sigma \) to be mutually independent.

\(^5\)Suppose a capital \( k \), which at home produces \( y = k \). If sent abroad, this same capital would produce \( y^a = (1-\frac{\sigma \delta^2 k}{2})k \).
The Game

The players in this game are an incumbent \( P \) and the wealthy investor \( I \), and Nature also plays deciding whether the economy is “good”, “normal”, or “bad”. The game starts in the inauguration of \( P \), a candidate elected on the promise to tax to a level he believes to maximize the income of the poor in the economy.\(^6\) \( N \) is the first to move, establishing the real state of the economy \((\varepsilon, \text{which is a component of } \sigma, \text{the relative productivity of the domestic economy vis-à-vis the world, such as } \sigma_G = \sigma + \varepsilon \text{ and } \sigma_B = \sigma - \varepsilon)\). Investors, then, decide how much of their capital should be sent abroad, given their expectations about future levels of taxation (which are informed by \( P \)’s campaign promises) and the real state of the economy, while \( P \) chooses a tax \( \tau \) that maximizes the income of the poor constrained by capital flight. In doing so, \( P \) is also deciding whether to deliver his campaign promises (taxing as much as announced during campaign) or to switch (adopt a more moderate level of taxation/redistribution).

Natures plays “Normal”

In a game where both \( I \) and \( P \) have complete information, and where Nature plays “normal” (the state of the world is the same as investors’ and candidates’ prior expectations), the total income of the wealthy is given by:

\[
\kappa_{wi} = (1 - \tau)k_{wiIN} + \left(1 - \frac{\sigma k_{wiOUT}}{2}\right)k_{wiOUT} \\
= (1 - \tau)(1 - \delta)k_{wi} + \left(1 - \frac{\sigma \delta k_{wi}}{2}\right)\delta k_{wi} \\
= (1 - \tau)(1 - \delta)k_{wi} + \delta k_{wi} - \frac{\sigma \delta^2 k_{wi}^2}{2} 
\]

It follows that the share of \( I \)’s income \((\delta^*)\) that should be sent abroad in order to maximize his total income is determined by:

\[
\max_{\delta}[\kappa_{wi}] = \max_{\delta}[(1 - \tau)(1 - \delta)k_{wi} + \delta k_{wi} - \frac{\sigma \delta^2 k_{wi}^2}{2}] \tag{4}
\]

**PROPOSITION 1:** Solving Eq. 4 in \( \delta \), we find there is an optimal share of \( I \)’s capital that, sent abroad, maximizes his total income, and this share is given by \( \delta^* = \frac{\tau}{\sigma k_{wi}}, \max[\tau]=\min[1, \sigma k_{wi}] \).

**PROOF:** See Appendix A.

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\(^6\)It is not necessary to the game that \( P \) is elected on the basis of his electoral promises. While there might be many reasons for him to be elected, such as the failure of prior government to increase voters’ welfare, in the game this can be interpreted simply as luck of the draw.
It is worth noting that taxation is applied solely on the share of the income of the wealthy that remains in the country \((1 - \delta)\). For that reason, \(k_w\), which was equal to 1 in Eq. 2, is now equal to \(k_p + (1 - \delta)k_w\), and the income of the poor is given by:

\[
\kappa_{pi} = (1 - \tau)k_{pi} + \left(\tau - \frac{\tau^2}{2}\right)(k_p + (1 - \delta)k_w) \\
= (1 - \tau)k_{pi} + \left(\frac{\tau}{2}\right)(\alpha k_{pi} + (1 - \alpha)(1 - \delta)k_{wi})
\]  

(5)

The optimal level of taxation, subject to prospects of capital flight, then, is obtained from:

\[
\max_{\tau}\kappa_{pi} = \max_{\tau}(1 - \tau)k_{pi} + \left(\tau - \frac{\tau^2}{2}\right)(\alpha k_{pi} + (1 - \alpha)(1 - \delta)k_{wi})
\]  

(6)

**PROPOSITION 2:** Solving Eq. 6 in \(\tau\), we find that there is one \(0 < \tau^* < \sigma k_{wi}\) (\(\sigma k_{wi} < 1\)), that maximizes the income of the poor \((\kappa_{pi})\) subject to the constrains imposed by capital mobility. This is the level of taxation established by the left-wing incumbent.

**PROOF:** See Appendix B.

**IV Implications**

The model states that, other conditions fixed, the optimal share of \(I\)'s income that is sent abroad is a positive linear function of the tax \(\tau\). Figure 2(a) below illustrates this relationship and shows that, since the level of taxation established by a left-wing government is, by definition, always higher than the taxation imposed by a right-wing government (in the simulation \(\tau_L = 0.45 > \tau_R = 0.2\)), the share of \(I\)'s income that remains in the country is always higher under a conservative government (\(\delta_L \approx 0.69 < \delta_R \approx 0.88\)). It also evidences why, whenever the left replaces the right in office, that should trigger some level of capital flight, while capital should flow into the economy when the opposite occurs.

Within the same logic, the income of the poor \((k_{pi})\) is represented by a quadratic function of the level of taxation \((\tau)\), implying that redistribution raises the income of the poor up to a level where the amount redistributed does not compensate capital flight. As displayed in Figure 2(b), I assume a left-wing incumbent establishes the level of taxation that maximizes the income of the poor.

So far, I’ve assumed that incumbents are able to anticipate what investors’ response to taxation is likely to be (the value of \(\theta\) in Figure 2(a), and therefore can calculate the level of capital inflows/outflows associated to their choice of taxation \(\tau\). Similarly, investors know what
incumbents know, therefore they can anticipate the level of taxation to be established by a left wing government and decide the share of their capital that, sent abroad, maximizes their total income. Since nature plays “normal”, no exogenous shock is observed during governments’ inauguration. In this scenario, capital flees the economy when there is a “left turn” in government, but they should not cause “policy switches”, since incumbents have no reason to deviate from the level of taxation previously chosen, since it remains the level that maximizes the income of the poor.

It is possible to demonstrate, empirically, that this scenario reflects investors’ and governments’ behavior in developed economies (Campello 2006). In these countries, a series of factors prevent the “curves” above from changing significantly in time. Among them, are (1) long term financial liberalization, and therefore a long record of investors’ behavior, (2) long term democratic alternation of power, which minimizes the uncertainty about governments’ agenda, (3) developed financial markets, where players tend to be more symmetrical and competition closer to perfection than in emerging markets, and (4) lower income inequality , which implies a lower range of possible variation between left and right-wing incumbents’ optimal levels of taxation, as demonstrated in Figure 2 below.
The next section explores scenarios where Nature determines a state of the economy which is different from the one incumbents expected during campaign.

Figure 2: Left-right “Policy Distance” as a Function of Income Inequality

Notes: Simulation of the policy distance (range of possible levels of $\tau$) as function of levels of income inequality. Parameters of the simulation: share of the poor in the population ($= 0.9, = 0.55$), costs of sending capital abroad ($\sigma = 0.5$), income of one poor ($k_{pi} = 0.2$).

When Nature plays “Good” or “Bad”

When Nature plays “Good”, the relative returns of the economy vis-à-vis the world increase ($\sigma_G = \sigma + \varepsilon$), and this provides left-wing incumbents with a higher room to tax the wealthy and redistribute to the poor. Figure 3(a) evidences that effect.

When Nature plays “Bad”, however, the level of taxation promised during campaign, and that the left-wing candidate believed maximized the income of the poor, leads to unexpectedly high levels of capital flight. In this scenario, the income of the poor determined by the level of taxation promised during campaign is below optimum (Figure 3(b), where $\sigma_B = 0.2$), and an incumbent whose goal is to maximize the income of the poor has incentives to “switch to the right”, towards a lower level of taxation and redistribution.

Level of Development, Exogenous Shocks and Policy Switches

It is worth comparing how higher economic volatility (reflected in $\sigma$’s wider range of variation) increases the likelihood of policy switches. In cases where exogenous shocks have marginal
Figure 3: State of the Economy and Optimal Taxation

Notes: Simulation of the income of the poor $k_p$, as a function of taxation, in “good times”. Parameters of the simulation: share of the poor in the population ($\alpha = 0.7$), cost of sending capital abroad ($\sigma_G = 0.8$, $\sigma_0 = 0.5$, $\sigma_B = 0.2$).

Effects (pull factors are more important than push factors to determine investors’ behavior), as happens in most developed economies, one should observe capital outflows resulting from ideological changes. These flows, however, should not lead to crises nor constrain governments choices and motivate a “policy switch”. Under low volatility, reflected in a narrow range of $\sigma$, policy changes aimed to maximize the income of the poor after a negative shock are marginal (Figure 3(a)).

Conversely, in volatile economies, where typically push rather than pull factors determine capital movements, exogenous shocks explain most of the variation in countries relative returns on investment vis-à-vis the world. In these cases, the high uncertainty associated to $\sigma$ should lead to a higher likelihood of policy switches, as the policy changes required to maximize the income of the poor, after a negative exogenous shock, are significant.

Capital Mobility and Optimal Taxation

So far, I’ve analyzed exogenous factors that affect the relative returns on investment obtained in a given country. As already stated, however, there is also an endogenous determinant of these returns, which is governments’ decision to impose barriers to capital movements. These barriers increase the costs of capital outflows and, for that reason, reduce the return on investment.
Figure 3: Exogenous shocks and Policy Switches - Developed and Less Developed Economies

Notes: Simulation of the income of the poor \( k_p \), as a function of taxation, in “good” and “bad” times. Parameters of the simulation: share of the poor in the population (\( \alpha = 0.7 \)), relative productivity of capital (\( \sigma = 0.2 \)).

The effect of barriers to capital movements is similar to the one produced by exogenous shocks, where higher barriers are analogous to “good times” – allow for more taxation and

abroad as compared to the domestic market.
higher income of the poor – and lower barriers have the effect of “bad times” – constraining governments’ capacity to tax and redistribute.

Figure 3 simulates how the optimal taxation – the one that maximizes the post-tax income of the poor – varies with capital mobility. It shows that, the lower are the costs of moving capital abroad, the lower is the tax that maximizes the income of the poor. As barriers to capital increase, incumbent’s capacity to tax the wealthy and redistribute income also increase.

Conclusion: Capital Mobility, Exogenous Cycles and “Room to Redistribute”

This paper suggests that two different effects influence incumbents’ capacity to redistribute income in less developed countries. The first is a long term trend in reducing barriers to capital movements, started in the early 90s in the developing world. Figure 3 below displays that trend in Latin America.

Figure 3: Financial Liberalization in Latin America


If that was the only factor at play, the model presented here suggests that one should observe a clear convergence of economic policies towards an “investor-friendly” model of small State, and a decreasing capacity of governments to redistribute income.7 It is important to note that, while increased capital mobility explains lower taxation, it should not impact incumbents’ capacity to deliver campaign promises.8 While not associated to policy switches, however, this effect

7In this model designated by low taxation and redistribution but, following Przeworski’s “poetic license”, that represents a wider set of policies that aim to redistribute income in a given economy.
8It affects the expected value of σ but not the spread of its distribution.
contributes to explain the progressively less ambitious redistributive promises observed in Latin American campaigns.

Another effect, however, that results from exogenous factors such as international interest rates and commodity prices, provides left-wing governments with room to redistribute income that is contingent on whether economy is doing relatively “good” or “bad”. In “good” times, investors’ willingness to remain in the economy increases governments’ room to redistribute, and might compensate or slow down the downward trend determined by lower barriers to capital flows. Opposed to that, in “bad” times both effects work to constrain governments’ capacity to tax capital and redistribute to the poor, and these should be the times when investors are the most capable of influencing governments’ policy choices.\(^9\)

A very preliminary evidence of this movement is provided in Figure 4 below. It shows an index of market reforms in Latin America, that encompasses trade and financial liberalization, tax reforms and privatization, among other reforms traditionally pushed by the investment community. It is noticeable that annual changes\(^10\) in the implementation of these reforms in Latin America coincide with “scarcity” and “abundance” of investment in the region – reforms decrease during the 70s (abundance) until a little before the debt crisis, and increase significantly after the crisis, during the “bad times” of the 80s. When capital starts to resume to Latin America in early 90s advances decelerate once again.

A major implication of the analysis presented here is that, even if smoothed by “good times”, less developed countries trend towards financial liberalization is likely to progressively reduce governments’ capacity to redistribute income to the poor. If Boix (2003) is correct, this should also be associated to increased chances of democratic consolidation, as far as voters understand (and accept) governments’ incapacity to redistribute. It seems worth considering, however, a scenario where this incapacity reaches a limit where no government can improve voters’ material conditions as compared to the previous one and, since voters choose retrospectively, re-election ceases to occur. Opposition wins, cannot do much more than the preceding government, and is also rejected in the end of the term. It is not hard to make the case that, in a scenario as such, voters are likely to become apathetic or else to revolt, as the political system proves incapable of improving citizens’ lives. This hypothetical scenario suggests that maybe the relationship between democracy and capital mobility is not one of a ever increasing sort, but instead a

\(^9\)Once again using Przeworski’s “poetic license”, it is important to mention that, while in the model investors' influence reflects on levels of taxation and redistribution, that reasoning applies to any policies that have redistributive implications, such as removal of trade barriers or privatization of State assets.

\(^10\)It is worth noting, mostly positive
shape where, after reaching maximum likelihood of democracy in a given level of capital mobility, increased mobility should decrease the poor’s commitment with the system and therefore its stability.

Notes: Index of Market Reform in Latin America (Lora 1998) updated to 2003.
Appendix

A  Maximization of Investors’ Income

\[ \text{max}_\delta [\kappa_{w_i}] = \text{max}_\delta [(1 - \delta)(1 - \tau)k_{w_i} + \delta k_{w_i} - \frac{\sigma \delta^2 k_{w_i}^2}{2}] \]  

(7)

Solving that maximization, we have:

\[-(1 - \tau)k_{w_i} + k_{w_i} - \delta(k_{w_i})^2 \sigma = 0\]
\[k_{w_i}(\tau - \delta k_{w_i} \sigma) = 0\]
\[\tau - \delta k_{w_i} \sigma = 0\]
\[\delta^* = \frac{\tau}{\sigma k_{w_i}}\]

(8)

The fact that \(0 \leq \delta^* \leq 1\) implies that:

\[\frac{\tau}{\sigma k_{w_i}} \leq 1 \rightarrow \tau \leq \sigma k_{w_i}\]

Hence,

\[\text{max}[\tau] = \text{min}[1, \sigma k_{w_i}]\]

(9)

B  Maximization of the Income of the Poor

From Eq. 6 we have that:

\[\text{max}_\tau [\kappa_{p_i}] = \text{max}_\tau [(1 - \tau)k_{p_i} + (\tau - \frac{\tau^2}{2})(\alpha k_{p_i} + (1 - \alpha)(1 - \delta)k_{w_i})]\]

Rearranging the terms, we have:

\[\text{max}_\tau [(1 - \tau)k_{p_i} + (\tau - \frac{\tau^2}{2})(\alpha k_{p_i} + (1 - \alpha)(1 - \delta)k_{w_i})] = 0\]
\[\text{max}_\tau [(1 - \tau)k_{p_i} + (\tau - \frac{\tau^2}{2})(\alpha k_{p_i} + (1 - \alpha)(1 - \frac{\tau}{\sigma k_{w_i}})k_{w_i})] = 0\]

Solving it in \(\tau\) we obtain:

\[-k_{p_i} + (1 - \tau)(\alpha k_{p_i} + (1 - \alpha)k_{w_i} - \frac{(1 - \alpha)}{\sigma} \tau) - (\tau - \frac{\tau^2}{2})(\frac{1 - \alpha}{\sigma}) = 0\]
\[\frac{3(1 - \alpha)\tau^2}{2\sigma} - (\alpha k_{p_i} + (1 - \alpha)k_{w_i} + \frac{2(1 - \alpha)}{\sigma})\tau + (1 - \alpha)(k_{w_i} - k_{p_i}) = 0\]

(10)

\[\text{That condition is binding only when } \sigma k_{w_i} \leq 1, \text{ since } 0 \leq \tau \leq 1.\]
When $\tau = 0$, $LHS > 0$:

$$(1 - \alpha)((k_{w_i} - k_{p_i}) > 0$$

When $\tau = 1$, $LHS < 0$:

$$-(1 - \alpha) \frac{2\sigma - k_{p_i}}{2\sigma} < 0$$

When $\tau = \sigma k_{w_i}$, $LHS < 0$: In order to verify the signal of this Eq. 10 when $\tau = \sigma k_{w_i}$, one can divide it into 3 terms:

$$\begin{align*}
-k_{p_i} + (1 - \tau)(\alpha k_{p_i}) \\
(1 - \alpha)k_{w_i} - \frac{(1 - \alpha)}{\sigma} \tau \\
-(\tau - \tau^2)\frac{(1 - \alpha)}{2\sigma}
\end{align*}$$

It is possible to show that the terms (11) and (13) are negative, while (12) is equal to zero. Starting with (11), we have:

$$-k_{p_i} + (1 - \tau)(\alpha k_{p_i}) = k_{p_i} (\alpha - 1) - \tau \alpha k_{p_i} k_{w_i}$$

Where

$$k_{p_i} (\alpha - 1) < 0, \text{ for any } \alpha < 1, \text{ and}$$

$$-\tau \alpha k_{p_i} k_{w_i} < 0, \text{ for } \tau > 0 \text{ and } \alpha > 0$$

From term (12), replacing $\tau = \sigma k_{w_i}$, we have:

$$(1 - \alpha)k_{w_i} - \frac{(1 - \alpha)}{\sigma} \sigma k_{w_i} = 0$$

Finally, from the negative term (13):

$$(\tau - \tau^2) > 0, \text{ and}$$
\[
\frac{1 - \alpha}{\sigma} > 0, \quad \text{for any } \alpha < 1
\]

It follows that there is one \(0 < \tau^* < \sigma k w_i\) (\(\sigma k w_i < 1\)), for which \(LHS = 0\), that maximizes the income of the poor \(k_{p_i}\) constrained by the threat of capital flight. This is the level of taxation established by the pragmatic incumbent once in office (Eq. B).
References


