Efficiency of Flexible Budgetary Institutions *

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Abstract

Which budgetary institutions result in efficient provision of public goods? We analyze a model with two parties bargaining over the allocation to a public good each period. Parties place different values on the public good, and these values may change over time. We model a budgetary institution as the rules governing feasible allocations to mandatory and discretionary spending programs. Mandatory spending is enacted by law and remains in effect until changed, and thus induces an endogenous status quo, whereas discretionary spending is periodic appropriations that are not allocated if no new agreement is reached. We show that discretionary only institutions lead to dynamic inefficiencies and mandatory only institutions can lead to both dynamic and static inefficiencies. By introducing flexibility into budgetary institutions, either through a combination of mandatory and discretionary spending, or through a state-contingent mandatory program, we obtain static and dynamic efficiency.

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1 Introduction

Allocation of resources to public goods are typically decided through government budget negotiations. In many democracies these negotiations occur annually, and are constrained by the budgetary institutions in place. In designing budgetary institutions, one may have various goals, such as responsiveness to citizens’ preferences, efficiency and accountability. There has been increasing attention among policy-makers in recent years to understanding the role of specific aspects of budgetary institutions in achieving these goals in both developed and developing countries (see for example, Santiso, 2006; Shah, 2007). Economic research has also recognized the importance of budgetary institutions (for example, Hallerberg, Strauch and von Hagen, 2009). These studies emphasize the importance of various dimensions of budgetary institutions including transparency, and centralization of decision-making. The dimension we focus on is the rules governing feasible allocations to mandatory and discretionary spending programs. Discretionary programs require periodic appropriations; no spending is allocated if no new agreement is reached. By contrast, mandatory programs are enacted by law, and spending continues into the future until changed. Thus under mandatory programs, spending decisions today determine the status quo level of spending for tomorrow.

Naturally, there may be disagreement among groups on the appropriate level of public spending, thus the final spending outcome is the result of negotiations between parties that represent these groups’ interests. Negotiations are typically led by the party in power whose identity may change over time, bringing about turnover in agenda-setting power. Bowen, Chen and Eraslan (2014) show that in an environment without changing preferences, mandatory programs improves the efficiency of public good provision over discretionary programs. However, the economic environment may be changing over time, potentially resulting in

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1The OECD has devoted resources to surveying budget practices and procedures across countries since 2003. See International Budget Practices and Procedures Database, OECD (2012).

2See also Alesina and Perotti (1995) for a survey of the early literature recognizing the importance of budgetary institutions.

3This terminology is used in the United States budget. Related institutions exist in other budget negotiations, for example the budget of the European Union is categorized into commitment and payment appropriations. The main distinction is that one has dynamic consequences because agreements are made for future budgets, and the other does not.
changes in preferences. Hence, the party in power today must consider how current spending on the public good affects future spending when preferences and the agenda-setter are possibly different from today. In this paper we investigate the role of budgetary institutions in the efficient provision of public goods in an environment with these features - disagreement over the value of the public good, a changing economic environment, and turnover in political power.

In this environment it is natural to expect that mandatory programs may have some drawbacks. For example, Riboni and Ruge-Murcia (2008), Zapal (2011) and Dziuda and Loeper (2013) note that inefficiency can arise from mandatory spending programs when preferences are changing. In accord with these papers, we first show that mandatory programs in isolation lead to inefficiency in public good spending; however, when appropriate flexibility is added to mandatory programs, either through an endogenous choice of mandatory and discretionary program, or by making the mandatory program state-contingent, efficiency can be restored.

We begin by analyzing a model in which two parties bargain over the allocation to a public good in each of two periods. The parties place different values on the public good, reflecting possible disagreement, and these values may change over time, reflecting changes in the underlying economic environment. To capture turnover in political power, we assume the proposing party is selected at random each period. Unanimity is required to implement the proposed spending on the public good. We investigate the efficiency properties of the equilibrium outcome of this bargaining game under different budgetary institutions.

We distinguish between static Pareto efficiency and dynamic Pareto efficiency. A statically Pareto efficient allocation in a given period is an allocation such that there is no alternative allocation that would make both parties better off and at least one of them strictly better off in that period. A dynamically Pareto efficient allocation is a sequence of allocations, one for each period, that needs to satisfy a similar requirement except that the utility possibility frontier is constructed using the discounted sum of utilities. Dynamic efficiency puts intertemporal restrictions on allocations in addition to requiring static efficiency for

\footnote{We discuss how our results relate to these papers in more detail at the end of the Introduction.}
each period, making it is a stronger requirement than static Pareto efficiency. We show that if parties disagree about the value of the public good in all periods, then any equilibrium in which spending varies with the identity of the proposer cannot be dynamically Pareto efficient. That is, dynamic Pareto efficiency requires that parties insure against political risk. We further show that when preferences are changing over time, dynamic Pareto efficiency generically requires that allocations also change over time. This means that with changing preferences dynamic Pareto efficiency requires that parties avoid gridlock.

Comparing equilibrium public good allocations with the efficient ones, we show that discretionary only institutions lead to static efficiency but dynamic inefficiency, mandatory only institutions can lead to static and dynamic inefficiency, whereas allowing an endogenous choice between mandatory and discretionary programs results in public good allocations that are statically and dynamically Pareto efficient if the value of the public good is decreasing over time. Furthermore, we show that if temporary cuts to mandatory programs are allowed, an endogenous choice of mandatory and discretionary programs results in public good allocations that are dynamically and statically Pareto efficient, for any deterministic change in the value of the public good.

The intuition behind dynamic inefficiency of discretionary only budget institutions is that they lead to political risk. Specifically, since the status quo of a discretionary spending program is exogenous, the level of spending implemented in equilibrium depends on which political party is in power.

Turning to mandatory only budgetary institutions, we show that in any equilibrium, the second period’s public good allocation either varies with the identity of the proposing party or is equal to the first period’s level. This implies that any equilibrium either involves political risk or gridlock and therefore is dynamically inefficient. Static inefficiency may also obtain with mandatory only budget institutions. The reason is that the first period’s public good spending becomes the status quo in the second period and thus determines the parties’ bargaining positions. Concerns about their future bargaining positions can lead the parties to reach an outcome that goes against their first-period interests, resulting in static inefficiency.

Dynamic efficiency when both discretionary and mandatory programs are allowed arises
due to two ingredients. First, the party in power in the first period finds it optimal to set the size of the mandatory program so that it is statically efficient in the second period. If the status quo allocation is statically efficient in the second period, then it is maintained, and hence the second period’s public good allocation is independent of the identity of the party in power, thereby eliminating the political risk. Second, the party in power in the first period can use discretionary spending to tailor the level of the first period’s public good spending to her preferences, avoiding gridlock. We obtain dynamic efficiency if the discretionary spending can be negative, which we interpret as a temporary cut of mandatory programs, as this allows the party in power in the first period to accommodate any time profile of public good spending (either increasing or decreasing) that dynamic efficiency might require. If we restrict discretionary spending to be positive, we obtain dynamic efficiency only if the value of the public good decreases for the two parties since dynamic efficiency requires a decreasing time profile of public good spending in that case. In both cases, the flexibility afforded by the combination of mandatory and discretionary programs delivers dynamic efficiency.

We show that when preferences are stochastic, allowing state-contingent mandatory spending programs provides sufficient flexibility to achieve dynamic efficiency. To do this we consider an extension of the model in which preferences are random and the time horizon is arbitrary. We consider a budgetary institution in which proposers choose a spending rule that gives spending levels conditional on the realization of the state. The first period proposer chooses a rule that is dynamically Pareto efficient and once selected, this spending rule is retained because no future proposer can make a different proposal that is better for itself and acceptable to the other party.

The use of state-contingent programs dates back to at least Ancient Egypt, where the rate of taxation depended on the extent of Nile flooding in any given year (see Breasted 1945, page 191). In modern economies they can still be found in practice. In the United States unemployment insurance may fluctuate with the unemployment rate through, for example, “extended” or “emergency” benefits. These extended and emergency benefits have been a feature of the unemployment insurance law since 1971, and are triggered by recession on the
basis of certain unemployment indicators (see Nicholson and Needels, 2006). Similarly, in Canada the maximum number of weeks one can be receiving unemployment benefits depends on the local rate of unemployment (see Canadian Minister of Justice, 2014, Schedule I, page 180). The efficiency of state-contingent spending programs may explain why they are successfully implemented in practice.

Our work is related to several strands of literature. A large body of political economy literature studies policies that arise from bargaining of political actors under different decision-making rules governing their interaction (see for example, Acemoglu, Egorov and Sonin, 2010; Acemoglu and Robinson, 2012; Austen-Smith and Banks, 1988; Besley and Persson, 2011; Dixit, Grossman and Gul, 2000; Persson and Tabellini, 2000; 2003; Persson, Roland and Tabellini, 1997; Lizzeri and Persico, 2001). Still in the same category but more closely related to our are papers highlighting inefficiency of policies that arise in political equilibrium (see for example, Acemoglu, Golosov and Tsyvinski, 2008; 2011; Aguiar and Amador, 2011; Alesina and Tabellini, 1990; Azzimonti, 2011; Besley and Coate, 1998; Battaglini and Coate, 2007; Krusell and Rios-Rull, 1996; Bai and Lagunoff, 2011; Persson and Svensson, 1984; Van Weelden, 2013). Inefficiency in these papers arises either because efficient policies yield benefits in the future when the current political representation is not in the position to enjoy them, or because efficient policies alter the choices of future policy makers, or because efficient policies lower the probability of the current political representation remaining in power (see Besley and Coate, 1998; Bai and Lagunoff, 2011 for discussion of possible sources of inefficiencies). Our paper shares with the rest of the literature the first two sources of inefficiency, but unlike the rest of the literature, our main focus is on linking these sources of inefficiency to budgetary institutions that specify the rules governing feasible allocations to mandatory and discretionary spending programs.

Modeling mandatory spending programs as an endogenous status quo links our work to a growing dynamic bargaining literature. This literature includes Anesi and Seidmann (2012); Baron (1996); Baron and Bowen (2014); Bowen, Chen and Eraslan (2014); Battaglini and

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Palfrey (2012); Chen and Eraslan (2014); Diermeier, Egorov and Sonin (2013); Diermeier and Fong (2011); Duggan and Kalandrakis (2012); Dziuda and Loeper (2013); Forand (2014); Kalandrakis (2004, 2010); Piguillem and Riboni (2012, 2013); Riboni and Ruge-Murcia (2008); Levy and Razin (2013); Nunnari and Zapal (2013); Zapal (2011). With the exception of Bowen, Chen and Eraslan (2014) and Zapal (2011) this literature has focused on studying models with only policies that have the endogenous status quo property. In the language of our model, this literature has focused on mandatory spending programs only. Bowen, Chen and Eraslan (2014) model discretionary and mandatory public good spending programs, but do not allow for an endogenous choice of these two types of programs (transfers between parties in their model are modeled as discretionary). Unlike in their model, we allow the values parties put on the public good to vary over time, which plays an important role in our results. Bowen, Chen and Eraslan (2014) show that mandatory programs Pareto dominate discretionary programs, whereas we show that with changing preferences mandatory programs with appropriate flexibility achieves dynamic Pareto efficiency. Zapal (2011) demonstrates that a budgetary institution that allows for distinct current-period policy and future-period status quo eliminates static inefficiency. This result parallels the efficiency of an endogenous choice of mandatory and discretionary programs that we show, but we do this in an environment with more general variation in preferences, and changes in agenda-setting power. Furthermore, we also demonstrate the efficiency of state-contingent mandatory programs in this richer setting.

Our focus on budgetary institutions also relates our work to papers studying fiscal rules, for example, Azzimonti, Battaglini and Coate (2010); Besley and Smart (2007); Caballero and Yared (2010); Halac and Yared (2014); Stockman (2001); Yared (2010). This literature analyzes the role of fiscal rules in constraining government spending and taxation, preventing public debt accumulation or prohibiting public deficits. In contrast we examine mandatory and discretionary spending programs and analyze their role in efficient public good provision.

In the next section we describe the model of budgetary institutions. In Section 3 we discuss Pareto efficient allocations and define Pareto efficient equilibria. We discuss an institution with only discretionary spending in Section 4. In Section 5 we give properties of equilibria
when the institution allows mandatory spending (with or without discretionary), and give
efficiency properties of mandatory only institutions. Section 6 discusses institutions that
allow for an endogenous choice of mandatory and discretionary spending, and Section 7
considers state-contingent mandatory spending. Section 8 concludes.

2 Model

Consider a stylized economy and political system with two parties labeled A and B. There are two time periods indexed by $t \in \{1, 2\}$. In each period $t$, the two parties decide an allocation to a public good $x_t \in \mathbb{R}_+$. The stage utility for party $i$ from the public good in period $t$ is $u_{it}(x_t)$. We assume $u_{it}()$ is twice continuously differentiable, strictly concave, and attains a maximum at $\theta_{it}$ for all $i \in \{A, B\}$ and $t \in \{1, 2\}$. This implies $u_{it}()$ is single-peaked with $\theta_{it}$ denoting party $i$’s static ideal level of the public good in period $t$.

We assume parties’ ideal levels of the public good are positive and party A’s ideal is lower than party B’s. That is, $0 < \theta_{At} \leq \theta_{Bt}$ for all $t$. Parties’ ideal levels of the public good may vary across periods. In particular, these may be increasing with $\theta_{i1} < \theta_{i2}$ for all $i \in \{A, B\}$, decreasing with $\theta_{i1} > \theta_{i2}$ for all $i \in \{A, B\}$, divergent with $\theta_{A2} < \theta_{A1} < \theta_{B1} < \theta_{B2}$, or convergent with $\theta_{A1} < \theta_{A2} < \theta_{B2} < \theta_{B1}$.

The parties have a common discount factor $\delta \in (0, 1]$. Party $i$ seeks to maximize its discounted dynamic payoff from the sequence of public good allocations, $u_{i1}(x_1) + \delta u_{i2}(x_2)$.

Political system

We consider a political system with unanimity rule. Each period a party is randomly selected to make a proposal for the allocation to the public good. The probability that party $i$ proposes in a period is $p_i \in (0, 1)$.

At the beginning of each period, the identity of the proposing party is realized. The

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6In Section 3 we characterize Pareto efficient allocations for a model with any number of periods, and in Section 7 we consider a more general model with any number of periods and random preferences.

7Because of the opportunity cost of providing public goods, it is reasonable to model parties’ utility functions as single-peaked as in, for example, Baron (1996).

8Most political systems are not formally characterized by unanimity rule, however, many have institutions that limit a single party’s power, for example, the “checks and balances” included in the U.S. Constitution. Under these institutions, if the majority party’s power is not sufficiently high, then it needs approval of the other party to set new policies.
proposing party makes a proposal for the allocation to the public good. Spending on the public good may be allocated via different programs - a discretionary program, which expires after the first period, or a mandatory program, for which spending will continue in the next period unless the parties agree to change it. Denote the proposed amount allocated to a discretionary program in period \( t \) as \( k_t \), and to a mandatory program as \( g_t \). If the responding party agrees to the proposal, the implemented allocation to the public good for the period is the sum of the discretionary and mandatory allocations proposed, so \( x_t = k_t + g_t \); otherwise, \( x_t = g_{t-1} \).

Denote a proposal by \( z_t = (k_t, g_t) \). We require \( g_t \geq 0 \) to ensure a positive status quo each period. Let \( Z \subseteq \mathbb{R} \times \mathbb{R}_+ \) be the set of feasible proposals. The set \( Z \) is determined by the rules governing mandatory and discretionary programs, hence we call \( Z \) the budgetary institution. We explore efficiency implications of mandatory and discretionary programs for different budgetary institutions. Specifically, we consider the following institutions: only discretionary programs, in which case \( Z = \mathbb{R}_+ \times \{0\} \) and \( g_{t-1} = 0 \) for all \( t \); only mandatory programs, in which case \( Z = \{0\} \times \mathbb{R}_+ \); both mandatory and positive discretionary, in which case \( Z = \mathbb{R}_+ \times \mathbb{R}_+ \); and both mandatory and discretionary where discretionary spending may be positive or negative, in which case \( Z = \{(k_t, g_t) \in \mathbb{R} \times \mathbb{R}_+ : k_t + g_t \geq 0\} \). It is natural to think of spending as positive, however, it is also possible to have temporary cuts to spending on mandatory programs, for example government furloughs that temporarily reduce salaries to public employees. This temporary reduction in mandatory spending can be thought of as negative discretionary spending as it reduces total spending in the current period on a particular good, but does not affect the status quo for the next period.

We consider subgame perfect equilibria of the game between parties \( A \) and \( B \). A pure strategy for party \( i \) in period \( t \) is a pair of functions \( \sigma_{it} = (\pi_{it}, \alpha_{it}) \), where \( \pi_{it} : \mathbb{R}_+ \rightarrow Z \) is a proposal strategy for party \( i \) in period \( t \) and \( \alpha_{it} : \mathbb{R}_+ \times Z \rightarrow \{0, 1\} \) is an acceptance strategy for party \( i \) in period \( t \).\(^9\) Party \( i \)'s proposal strategy \( \pi_{it} = (\kappa_{it}, \gamma_{it}) \) associates with each status

\(^9\)In this two-period model, we show that equilibrium strategies in the second period are unique. Thus, in equilibrium, the second-period strategy does not depend on the history except through the status quo, so writing strategies as depending on history only through the status quo is without loss of generality. This result extends to the finite-horizon case of state-contingent mandatory spending considered in Section 7. For
quo \( g_{t-1} \) an amount of public good spending in discretionary programs, denoted by \( \kappa_{it}(g_{t-1}) \) and an amount in mandatory programs, denoted by \( \gamma_{it}(g_{t-1}) \). Party \( i \)'s acceptance strategy \( \alpha_{it}(g_{t-1}, z_t) \) takes the value 1 if party \( i \) accepts the proposal \( z_t \) offered by party \( j \neq i \) when the status quo is \( g_{t-1} \), and 0 otherwise.\(^{10}\)

We restrict attention to equilibria in which (i) \( \alpha_{it}(g_{t-1}, z_t) = 1 \) when party \( i \) is indifferent between \( g_{t-1} \) and \( z_t \); and (ii) \( \alpha_{it}(g_{t-1}, \pi_{jt}(g_{t-1})) = 1 \) for all \( t, g_{t-1} \in \mathbb{R}_+, i, j \in \{A, B\} \) with \( j \neq i \). That is, the responder accepts any proposal that it is indifferent between accepting and rejecting, and the equilibrium proposals are always accepted. We henceforth refer to a subgame perfect equilibrium that satisfies (i) and (ii) simply as an equilibrium.

Denote an equilibrium as \( \sigma^* \). Given conditions (i) and (ii), if party \( i \in \{A, B\} \) is the proposer and party \( j \neq i \) is the responder in period 2, then for any \( g_1 \) admissible under \( Z \) the equilibrium proposal strategy \( (\kappa^*_{i2}(g_1), \gamma^*_{i2}(g_1)) \) of party \( i \) in period 2 solves

\[
\max_{(k_2, g_2) \in Z} \quad u_{i2}(k_2 + g_2) \\
\text{s.t.} \quad u_{j2}(k_2 + g_2) \geq u_{j2}(g_1).
\]

\((P_2)\)

\(V_i(g; \sigma_2) \) be the expected second-period payoff for party \( i \) given first-period mandatory spending \( g \) and second-period strategies \( \sigma_2 = (\sigma_{A2}, \sigma_{B2}) \). That is

\[V_i(g; \sigma_2) = p_A u_{i2}(\kappa_{A2}(g) + \gamma_{A2}(g)) + p_B u_{i2}(\kappa_{B2}(g) + \gamma_{B2}(g)).\]

If party \( i \in \{A, B\} \) is the proposer and party \( j \neq i \) is the responder in period 1, then for any \( g_0 \) admissible under \( Z \) the equilibrium proposal strategy \( (\kappa^*_{i1}(g_0), \gamma^*_{i1}(g_0)) \) of party \( i \) in period 1 solves

\[
\max_{(k_1, g_1) \in Z} \quad u_{i1}(k_1 + g_1) + \delta V_i(g_1; \sigma^*_2) \\
\text{s.t.} \quad u_{j1}(k_1 + g_1) + \delta V_j(g_1; \sigma^*_2) \geq u_{j1}(g_0) + \delta V_j(g_0; \sigma^*_2).
\]

\((P_1)\)

the infinite-horizon case, the restriction on strategies implies a Markov restriction on the equilibrium.\(^{10}\)

We are interested in efficiency properties of budgetary institutions. Because the utility functions are strictly concave, Pareto efficient allocations do not involve randomization. Hence, if any pure strategy equilibrium is inefficient, allowing mixed strategies does not improve efficiency.
3 Pareto efficiency

In this section we characterize Pareto efficient allocations and define Pareto efficient equilibria, both in the static and the dynamic sense.

3.1 Pareto efficient allocations

As a benchmark we characterize the Pareto efficient allocations. We distinguish between the social planner’s static problem (SSP) which determines static Pareto efficient allocations, and the social planner’s dynamic problem (DSP) which determines dynamic Pareto efficient allocations.\textsuperscript{11}

We define a statically Pareto efficient allocation in period $t$ as the solution to the following maximization problem

$$\max_{x_t \in \mathbb{R}} \quad u_i(x_t)$$

s.t. \quad $u_{jt}(x_t) \geq \bar{u}$

for some $\bar{u} \in \mathbb{R}$, $i, j \in \{A, B\}$ and $i \neq j$.\textsuperscript{12} By Proposition 1, statically Pareto efficient allocations are all those between the ideal points of the parties.

**Proposition 1.** An allocation $x_t$ is statically Pareto efficient in period $t$ if and only if $x_t \in [\theta_{At}, \theta_{Bt}]$.

Denote a sequence of allocations by $x = (x_1, x_2)$ and party $i$’s discounted dynamic payoff from $x$ by $U_i(x) = \sum_{t=1}^{2} \delta^{t-1} u_i(x_t)$. We define a dynamically Pareto efficient allocation as the solution to the following maximization problem

$$\max_{x \in \mathbb{R}^2_+} \quad U_i(x)$$

s.t. \quad $U_j(x) \geq \bar{U}$

for some $\bar{U} \in \mathbb{R}$, $i, j \in \{A, B\}$ and $i \neq j$. Denote the sequence of party $i$’s static ideals

\textsuperscript{11}Previous authors, for example, Dziuda and Loeper (2013) or Riboni and Ruge-Murcia (2008) have demonstrated that an endogenous status quo can lead to static inefficiency due to dynamic incentives. The latter paper also shows that the endogenous status-quo does not necessarily lead to dynamic efficiencies in a different model, and in the context of central bank decision-making.

\textsuperscript{12}The social planner’s static problem (SSP) is a standard concave programming problem so the solution is unique for a given $\bar{u}$ if it exists.
by \( \theta_i = (\theta_{i1}, \theta_{i2}) \) for all \( i \in \{A, B\} \), and denote the solution to (DSP) as \( \mathbf{x}^* = (x^*_1, x^*_2) \). Proposition 2 characterizes the dynamically Pareto efficient allocations.

**Proposition 2.** A dynamically Pareto efficient allocation \( \mathbf{x}^* \) satisfies the following properties:

1. For all \( t \), \( x^*_t \) is statically Pareto efficient. That is, \( x^*_t \in [\theta_{At}, \theta_{Bt}] \) for all \( t \).

2. Either \( x^* = \theta_A \), or \( x^* = \theta_B \), or \( u'_{At}(x^*_t) + \lambda^* u'_{Bt}(x^*_t) = 0 \) for some \( \lambda^* > 0 \), for all \( t \).

Proposition 2 part 2 implies that if \( x^* \neq \theta_i \) for all \( i \in \{A, B\} \), and \( \theta_{At} \neq \theta_{Bt} \) in period \( t \) then we must have

\[
\frac{u'_{At}(x^*_t)}{u'_{Bt}(x^*_t)} = \lambda^* \tag{1}
\]

for some \( \lambda^* > 0 \). This is because if \( u'_{Bt}(x^*_t) = 0 \), then part 2 of Proposition 2 implies that we must also have \( u'_{At}(x^*_t) = 0 \) which is not possible when \( \theta_{At} \neq \theta_{Bt} \).

By (1) if parties A and B do not have the same ideal level of the public good in any two periods \( t \) and \( t' \), then in a dynamically Pareto efficient allocation, either the allocation is equal to party A’s or party B’s ideal in both periods, or the ratio of their marginal utilities is equal across these two periods, i.e., \( \frac{u'_{At}(x^*_t)}{u'_{Bt}(x^*_t)} = \frac{u'_{At}(x^*_{t'})}{u'_{Bt}(x^*_{t'})} \). In both cases there is a dynamic link across periods.

### 3.2 Pareto efficient equilibrium

We define a dynamically Pareto efficient equilibrium given an initial status quo \( g_0 \) as an equilibrium that results in a dynamically Pareto efficient allocation for any realization of the sequence of proposers. More precisely, denote a strategy profile as \( \sigma = (\sigma_A, \sigma_B) \) with \( \sigma_{it} = ((\kappa_{it}, \gamma_{it}), \alpha_{it}) \). Recall that the total spending on the public good in period \( t \) is the sum of the mandatory spending and the discretionary spending. An *equilibrium allocation* for \( \sigma \) given initial status quo \( g_0 \) is a possible realization of total public good spending for each period \( \mathbf{x}^\sigma(g_0) = (x^\sigma_1(g_0), x^\sigma_2(g_0)) \), where \( x^\sigma_1(g_0) = \kappa_{i1}(g_0) + \gamma_{i1}(g_0) \), and

\[\text{Note the solution to (DSP) depends on } \mathcal{U}, \text{ but for notational simplicity we suppress this dependency and denote the solution to (DSP) as } \mathbf{x}^*. \text{ The solution to (DSP) is unique for a given } \mathcal{U} \text{ if it exists. In the proof of Proposition 2 in the Appendix we present (DSP) for any number of periods, and prove Proposition 2 for this more general problem.} \]
\[ x_2^\sigma(g_0) = \kappa_{j2}(\gamma_{i1}(g_0)) + \gamma_{j2}(\gamma_{i1}(g_0)) \] for some \( i, j \in \{A, B\} \). The random determination of proposers each period induces a probability distribution over allocations given an equilibrium \( \sigma \), thus any element in the support of this distribution is an equilibrium allocation for \( \sigma \).\footnote{For example, if \( A \) is the proposer in period 1 and \( B \) is the proposer in period 2, then the equilibrium allocation is \( x_1^\sigma(g_0) = \kappa_{A1}(g_0) + \gamma_{A1}(g_0) \), and \( x_2^\sigma(g_0) = \kappa_{B2}(\gamma_{A1}(g_0)) + \gamma_{B2}(\gamma_{A1}(g_0)) \).}

We require every allocation in the support of this distribution to be dynamically Pareto efficient for the equilibrium to be dynamically Pareto efficient.

**Definition 1.** A profile of strategies \( \sigma \) is a *dynamically Pareto efficient equilibrium given initial status quo* \( g_0 \in \mathbb{R}_+ \) if and only if

1. \( \sigma \) constitutes an equilibrium.

2. Every equilibrium allocation \( x^\sigma(g_0) \) for \( \sigma \) given initial status quo \( g_0 \) is dynamically Pareto efficient.

A *statically Pareto efficient equilibrium given initial status quo* \( g_0 \) is analogously defined as an equilibrium in which the realized allocation to the public good is statically Pareto efficient in all periods \( t \) given initial status quo \( g_0 \). Thus a necessary condition for a strategy profile \( \sigma \) to be a dynamically Pareto efficient equilibrium is that \( \sigma \) is a statically Pareto efficient equilibrium. In the next sections we analyze which budgetary institutions result in a statically or dynamically Pareto efficient equilibrium.

The analysis of a dynamically Pareto efficient equilibrium is aided by the following lemmas.

**Lemma 1.** Suppose \( \theta_{At} \neq \theta_{Bt} \) for any \( t \). If allocations \( x \) and \( \bar{x} \) are both dynamically Pareto efficient and \( x_{t'} = \bar{x}_{t'} \) for some \( t' \), then \( x = \bar{x} \).

An implication of Lemma 1 is that if parties’ ideal levels of the public good are different in both periods, then given an allocation in the first period, the dynamically Pareto efficient allocation in the second period is uniquely determined. This means that if the equilibrium level of spending in period 2 varies with the identity of the period-2 proposer, then the equi-
librium cannot be dynamically Pareto efficient. Thus dynamically Pareto efficient equilibria avoid political risk.

To state the second lemma, we first define two conditions satisfied by commonly used utility functions, for example, \( u_{it}(x_t) = -(x_t - \theta_{it})^2 \).

**Definition 2.** We say that utilities are regular if \( u_{it}(x_t) = u_i(x_t, \theta_{it}) \) for all \( t \) and all \( i \in \{A, B\} \). We say that utilities are regular with increasing marginal returns if utilities are regular and \( \frac{\partial u_i}{\partial x_t} \) is strictly increasing in \( \theta_{it} \) for all \( t \) and all \( i \in \{A, B\} \).

**Lemma 2.** Under any of the following conditions, generically \( x^*_1 \neq x^*_2 \):

1. Parties’ ideals are increasing or decreasing and not overlapping, that is, \( \theta_{A1} < \theta_{B1} < \theta_{A2} < \theta_{B2} \) or \( \theta_{A2} < \theta_{B2} < \theta_{A1} < \theta_{B1} \).

2. Parties’ ideals are increasing or decreasing, and utilities are regular with increasing marginal returns.

3. Parties’ ideals are divergent or convergent, and \( u_{it}(x_t) = -|x_t - \theta_{it}|^r \) with \( r > 1 \) for all \( t \) and \( i \in \{A, B\} \).

This lemma shows that generically dynamic Pareto efficiency requires variation across periods. We say that the parties are in gridlock if the spending in period 2 does not change when preferences are different from period 1. Thus dynamically Pareto efficient allocations generically avoid gridlock. Although we state a generic result in Lemma 2 under either condition 1 or 2, all dynamically Pareto efficient allocations satisfy \( x^*_1 \neq x^*_2 \). We use the qualifier ‘generically’ because under condition 3, there is one dynamically Pareto efficient allocation that satisfies \( x^*_1 = x^*_2 \).

\[^{15}\text{Note that our definition of a dynamically Pareto equilibrium requires ex-post dynamic Pareto efficiency, that is, allocations must be dynamically Pareto efficient for each realized path of proposers. Two other notions of a dynamically Pareto efficient equilibrium might be considered: Ex-ante dynamic Pareto efficiency, before the realization of the first-period proposer, and interim dynamic Pareto efficiency, after the realization of the first-period proposer but before the realization of the second-period proposer. By Lemma 1, if } \theta_{At} \neq \theta_{Bt} \text{ for any } t, \text{ then ex-post efficiency implies interim efficiency. We can interpret our results as showing which budgetary institutions result in dynamically Pareto efficient allocations conditional on the party in power. Ex-ante Pareto efficiency would require the first-period allocation to be invariant to the party in power, a stronger requirement than ex-post or interim Pareto efficiency.}\]
4 Discretionary spending

Suppose spending is allocated through discretionary programs only, implying that the status quo in each period is exogenous and equal to 0. In this case there is no dynamic link between the previous period’s policy and the current period’s status quo, and \( Z = \mathbb{R}_+ \times \{0\} \). Without the dynamic link between periods, the bargaining between the two parties is a static problem, similar to the monopoly agenda-setting model in Romer and Rosenthal (1978, 1979).

We next characterize the equilibrium and its efficiency properties.

For this section we denote a proposal in period \( t \) by \( k_t \) since \( g_t \) is zero. Consider any period \( t \). Since \( u_{At} \) is single-peaked at \( \theta_{At} \) and \( 0 < \theta_{At} \leq \theta_{Bt} \), we have \( u_{At}(0) \leq u_{At}(\theta_{At}) \). Hence, if party A is the proposer in period \( t \), it proposes its ideal policy \( k_t = \theta_{At} \), which is accepted by party B. If party B is the proposer in period \( t \), however, whether it can implement its ideal policy depends on the locations of the parties’ ideal points relative to the status quo, which is equal to 0. Specifically, let \( \phi_{At}^o \) be the highest policy that makes party A as well off as the status quo in period \( t \). That is,

\[
\phi_{At}^o = \max \{ x \in \mathbb{R}_+ \mid u_{At}(x) \geq u_{At}(0) \}.
\]

Note that \( \phi_{At}^o \geq \theta_{At} \). Since status quo spending is 0, party A accepts any proposal \( k_t \) such that \( 0 \leq k_t \leq \phi_{At}^o \). To find party B’s optimal proposal, there are two cases to consider.

(i) Suppose \( \theta_{Bt} \leq \phi_{At}^o \). Then, since \( u_{At} \) is single-peaked at \( \theta_{At} \leq \theta_{Bt} \), we have \( u_{At}(\theta_{Bt}) \geq u_{At}(\phi_{At}^o) = u_{At}(0) \) and therefore party A accepts \( k_t = \theta_{Bt} \) in period \( t \). In this case, party B’s optimal proposal in period \( t \) is equal to its ideal point \( \theta_{Bt} \). (ii) Suppose \( \theta_{Bt} > \phi_{At}^o \). Then, given the single-peakedness of \( u_{Bt} \), the optimal policy for B that is acceptable to A is equal to \( \phi_{At}^o \). In this case, party B proposes \( k_t = \phi_{At}^o \). To summarize, party B’s optimal proposal is equal to \( \min \{ \theta_{Bt}, \phi_{At}^o \} \).

Since the policy implemented in period \( t \) is equal to \( \theta_{At} \) when party A is the proposer and equal to \( \min \{ \theta_{Bt}, \phi_{At}^o \} \geq \theta_{At} \) when party B is the proposer, the policy implemented in period \( t \) is in \( [\theta_{At}, \theta_{Bt}] \) and therefore statically Pareto efficient by Proposition 1.

\[\text{Note that when only discretionary spending is allowed, } g_0 = g_1 = 0, \text{ and hence the proposer’s first-period problem } (P_1) \text{ becomes a static problem identical to } (P_2).\]
the equilibrium’s dynamic efficiency properties, we consider the following two cases. (i) Suppose \( \theta_{At} \neq \theta_{Bt} \) for all \( t \). In this case, \( \min\{\theta_{Bt}, \phi_{At}^o\} > \theta_{At} \), which implies that the policy implemented in period \( t \) varies with the identity of the proposer. By Lemma 1, this implies dynamic Pareto inefficiency arising from political risk. (ii) Suppose there is at most one \( t' \) such that \( \theta_{At} \neq \theta_{Bt'} \). In this case, as we show in Lemma A3 in the Appendix, an allocation \( x \) is dynamically Pareto efficient if and only if \( x_t \) is statically Pareto efficient in all periods. This is true because for all \( t \neq t' \) it must be that \( x_t = \theta_{At} \), and only in period \( t' \) must equation (1) hold, and hence there is no dynamic link across periods. Thus, the equilibrium is dynamically Pareto efficient in this case. The following proposition summarizes these results.¹⁷

**Proposition 3.** Under a budgetary institution that allows only discretionary spending programs, given the initial status quo of zero:

1. The equilibrium is statically Pareto efficient.
2. The equilibrium is dynamically Pareto inefficient if and only if \( \theta_{At} \neq \theta_{Bt} \) for all \( t \).

Specifically, the equilibrium level of spending in period \( t \) is \( x_t = \theta_{At} \) if party A is the proposer and is \( x_t = \min\{\theta_{Bt}, \phi_{At}^o\} \in [\theta_{At}, \theta_{Bt}] \) if party B is the proposer.

## 5 Mandatory spending

When spending can be allocated by way of mandatory programs, the party selected to propose in the first period has to take into account the effect of the amount of public good allocated to mandatory program on the second-period spending because it becomes the status quo spending in the second period. This creates a dynamic link between periods.

### 5.1 Preliminaries

We first show that this dynamic game admits an equilibrium and give properties of the equilibrium proposal strategies in period 2.¹⁸ The proposition applies to any budgetary

¹⁷The result is stated for the two-period model, but a straightforward generalization of the argument shows that in a model with an arbitrary number of periods, Proposition 3 holds if the condition in part 2 is replaced by \( \theta_{At} \neq \theta_{Bt} \) for at least two periods.

¹⁸Equilibrium existence is not immediate because the constraint set in the second period is determined by the responder’s acceptance condition [see \( P_3 \)]. The constraint is not monotone in the proposer’s first-period
institution that allows mandatory spending programs, in combination with discretionary spending or in isolation.

To state the proposition we define the functions $\phi_{At}: \mathbb{R}_+ \to \mathbb{R}_+$ and $\phi_{Bt}: \mathbb{R}_+ \to \mathbb{R}_+$. The value $\phi_{At}(g_{t-1})$ is the highest spending level that makes party $A$ as well off as under the status quo $g_{t-1}$, and $\phi_{Bt}(g_{t-1})$ is the lowest spending level that makes party $B$ as well off as under the status quo. That is,

$$
\phi_{At}(g_{t-1}) = \max \{ x \in \mathbb{R}_+ | u_{At}(x) \geq u_{At}(g_{t-1}) \}
$$

$$
\phi_{Bt}(g_{t-1}) = \min \{ x \in \mathbb{R}_+ | u_{Bt}(x) \geq u_{Bt}(g_{t-1}) \}.
$$

These are illustrated below in Figure 1. If $g_{t-1} < \theta_{At}$, then $\phi_{At}(g_{t-1}) > g_{t-1}$ and if $g_{t-1} \geq \theta_{At}$, then $\phi_{At}(g_{t-1}) = g_{t-1}$. If $g_{t-1} \leq \theta_{Bt}$, then $\phi_{Bt}(g_{t-1}) = g_{t-1}$ and if $g_{t-1} > \theta_{Bt}$, then $\phi_{Bt}(g_{t-1}) < g_{t-1}$.

![Figure 1: $\phi_{At}$ and $\phi_{Bt}$](image)

**Proposition 4.** Under any budgetary institution that allows mandatory spending programs, an equilibrium exists. For any $g_1 \in \mathbb{R}_+$, any equilibrium $\sigma^* = ((\sigma^*_{A1}, \sigma^*_{A2}), (\sigma^*_{B1}, \sigma^*_{B2}))$ with $\sigma^*_u = ((\kappa^*_u, \gamma^*_u), \alpha^*_u)$ satisfies

$$
k^*_{A2}(g_1) + \gamma^*_{A2}(g_1) = \max \{ \theta_{A2}, \phi_{B2}(g_1) \}
$$

$$
k^*_{B2}(g_1) + \gamma^*_{B2}(g_1) = \min \{ \theta_{B2}, \phi_{A2}(g_1) \}.
$$

choice variable $g_1$. Rather, $g_1$ determines both the lowest and the highest policy the second-period responder is willing to accept. This requires a non-trivial proof of lower-hemicontinuity of the second-period acceptance correspondence to show continuity of the first period payoff. This proof is given in the Appendix.
Furthermore:

1. \( \kappa_{i2}^*(g_1) + \gamma_{i2}^*(g_1) \in [\theta_{A2}, \theta_{B2}] \) for all \( i \in \{A, B\} \) and all \( g_1 \in \mathbb{R}_+ \).

2. If \( \theta_{A2} \neq \theta_{B2} \), then

\[
\begin{align*}
\kappa_{A2}^*(g_1) + \gamma_{A2}^*(g_1) &= \kappa_{B2}^*(g_1) + \gamma_{B2}^*(g_1) = g_1 \quad \text{if} \quad g_1 \in [\theta_{A2}, \theta_{B2}], \\
\kappa_{A2}^*(g_1) + \gamma_{A2}^*(g_1) &< \kappa_{B2}^*(g_1) + \gamma_{B2}^*(g_1) \quad \text{if} \quad g_1 \notin [\theta_{A2}, \theta_{B2}].
\end{align*}
\]

Proposition 4 gives the equilibrium level of total spending in the second period. The proposition implies that the equilibrium total spending is unique for any status quo. Proposition 4 part 1 implies that the equilibrium level of spending in period 2 is statically Pareto efficient. Part 2 gives properties of the equilibrium spending if the parties’ ideals are different. If the status quo is statically Pareto efficient, then it is maintained. If the status quo is not statically Pareto efficient, then the equilibrium proposal is different from the status quo and depends on the identity of the proposer - specifically, it is lower when \( A \) is the proposer than when \( B \) is the proposer.

![Figure 2](image)

**Figure 2**: Period 2 equilibrium strategies with mandatory spending for \( u_i(x_i) = -(x_i - \theta_i)^2 \)

Figure 2 is an example of equilibrium spending in period 2 for quadratic loss utility. While the exact form depends on the specific utility function, any second-period strategy has similar properties. Consider party \( A \) as the proposer in period 2. If the status quo is \( g_1 < \theta_{A2} \), then,
since \( u_{B2}(g_1) < u_{B2}(\theta_{A2}) \), party A proposes its ideal policy \( x_2 = \theta_{A2} \), which is accepted. If \( g_1 \in [\theta_{A2}, \theta_{B2}] \), then, since any \( x_2 < g_1 \) would be rejected by party B and party A prefers \( g_1 \) to any \( x_2 > g_1 \), party A proposes \( x_2 = g_1 \). If \( g_1 > \theta_{B2} \), then party B accepts any proposal in \([\phi_{B2}(g_1), g_1]\), the interval of policies closer to \( \theta_{B2} \) than \( g_1 \) is. Since \( \theta_{A2} < \theta_{B2} < g_1 \), either \( \theta_{A2} \in [\phi_{B2}(g_1), g_1] \) or \( \theta_{A2} < \phi_{B2}(g_1) \). If \( \theta_{A2} \in [\phi_{B2}(g_1), g_1] \), then party A proposes \( x_2 = \theta_{A2} \). If \( \theta_{A2} < \phi_{B2}(g_1) \), then party A proposes the policy closest to \( \theta_{A2} \) that is acceptable to \( B \), which is \( \phi_{B2}(g_1) \). For quadratic loss utility function, if \( g_1 \geq \theta_{B2} \) and \( \phi_{B2}(g_1) \geq \theta_{A2} \), we have \( \phi_{B2}(g_1) = 2\theta_{B2} - g_1 \), which is decreasing in \( g_1 \). For general strictly concave \( u_{B2} \), if \( g_1 \geq \theta_{B2} \) and \( \phi_{B2}(g_1) \geq \theta_{A2} \), then \( \phi_{B2}(g_1) \) is decreasing in \( g_1 \).

Figure 2 indicates the potential sources of dynamic inefficiency with mandatory programs. If the status quo in period 2 is in the interval \([\theta_{A2}, \theta_{B2}]\), then the period-2 spending is equal to the status quo, so there is potential for gridlock. If the period-2 status quo is outside the interval \([\theta_{A2}, \theta_{B2}]\) then the period-2 spending depends on the identity of the proposer and political risk is a source of dynamic inefficiency. We show in the next section that with only mandatory spending programs, in general, at least one of these sources of dynamic inefficiency arises.

5.2 General inefficiency with mandatory spending only

Suppose now that spending is allocated through mandatory programs only, such that \( Z = \{0\} \times \mathbb{R}_+ \). Since \( k_t \) is zero for any \( t \), the equilibrium discretionary proposal \( \kappa_t^*(g_{t-1}) \) is zero for all \( i \in \{A, B\} \), all \( t \) and all \( g_{t-1} \in \mathbb{R}_+ \). For the rest of the section we thus denote a proposal in period \( t \) by \( g_t \).

We begin by noting that equilibrium allocations can be dynamically Pareto efficient in the absence of a conflict in period 2 or in the absence of variation in ideal levels of public good spending, but these are special cases.\(^{19}\) We show that equilibrium allocations are in general dynamically Pareto inefficient and can even be statically Pareto inefficient with mandatory spending programs only. Proposition \(^5\) gives conditions under which equilibria are dynamically Pareto inefficient.

\(^{19}\)We show this in the Appendix Section A3.5.
Proposition 5. Under a budgetary institution that allows only mandatory spending programs, any equilibrium $\sigma^*$ is dynamically Pareto inefficient for any initial status quo $g_0 \in \mathbb{R}_+$, if either of the following conditions holds:

1. Parties’ ideals are increasing or decreasing and not overlapping, that is $\theta_{A1} < \theta_{B1} < \theta_{A2} < \theta_{B2}$ or $\theta_{A2} < \theta_{B2} < \theta_{A1} < \theta_{B1}$.

2. Parties’ ideals are increasing or decreasing, $\theta_{At} \neq \theta_{Bt}$ for all $t$ and $u_{it}$ is regular with increasing marginal returns for all $i \in \{A, B\}$.

Furthermore, if parties’ ideals are divergent or convergent and $u_{it}(x_t) = -(|x_t - \theta_{it}|)^r$ with $r > 1$, then for any equilibrium $\sigma^*$, there exists a finite set $\mathcal{E}$ such that $\sigma^*$ is dynamically Pareto inefficient for any initial status quo $g_0 \in \mathbb{R}_+ \setminus \mathcal{E}$.

Proposition 5 covers all possible ways in which ideal levels of public good spending of the two parties can vary: increasing, decreasing, convergent or divergent. Proposition 5 parts 1 and 2 give conditions under which equilibria are dynamically Pareto inefficient for all initial status quo, when parties’ ideals are increasing or decreasing. The final part of the proposition states that when preferences are divergent or convergent, for a certain class of utility functions, dynamic efficiency is obtained only for a finite set of status quos.

The reason behind the dynamic Pareto inefficiency of any equilibrium in the proposition is the combination of the variance in parties’ ideals with budgetary institution restricted to mandatory spending programs. Without discretionary spending, the level of public good spending in period 1 becomes the status quo in period 2. Because of the second-period conflict between the two parties, either none of the parties is willing to change the status quo and the level of public good spending is constant, or the level of public good spending in period 2 depends on the identity of the proposing party. In each case the equilibrium allocation violates dynamic Pareto efficiency, which requires variation in allocations across time, but precludes variation in allocation in a given period.

20Dynamic inefficiency also obtains in a finite-horizon model with more than two periods under the conditions in Proposition 5 when the changes in preferences apply to the last two periods.
The next result shows that equilibrium allocations under mandatory spending programs can violate not only dynamic, but also static Pareto efficiency.

**Proposition 6.** Suppose \( u_{it}(x_t) = -(x_t - \theta_{it})^2 \) for all \( i \in \{A, B\} \) and all \( t \). Under a budgetary institution that allows only mandatory spending programs, if either \( \frac{\theta_{A1} - \theta_{A2}}{\theta_{B2} - \theta_{A2}} \in (0, 1) \) or \( \frac{\theta_{B2} - \theta_{B1}}{\theta_{B2} - \theta_{A2}} \in (0, 1) \), then there exists set \( I \) of non-zero measure such that any equilibrium \( \sigma^* \) is statically Pareto inefficient for any initial status quo \( g_0 \in I \).

The key condition of Proposition 6 is stated in terms of \( \frac{\theta_{A1} - \theta_{A2}}{\theta_{B2} - \theta_{A2}} \) and \( \frac{\theta_{B2} - \theta_{B1}}{\theta_{B2} - \theta_{A2}} \). Each of these fractions has natural interpretation as the ratio of preference variation of party \( i \in \{A, B\} \) to future polarization between the two parties in period 2. If this ratio is small, static Pareto inefficiency arises in equilibrium. Because the proposition requires the ratio to be positive, static Pareto inefficiency potentially arises when the ideal levels are increasing, decreasing or divergent. And since the proposition does not rule out \( \theta_{A1} = \theta_{B1} \), static Pareto inefficiency can arise even in the absence of first-period conflict between the two parties.

Figure 3 illustrates Proposition 6. The parameters used satisfy the conditions in Proposition 6. Specifically, the ideal levels of the two parties diverge and \( \frac{\theta_{A1} - \theta_{A2}}{\theta_{B2} - \theta_{A2}} = \frac{\theta_{B2} - \theta_{B1}}{\theta_{B2} - \theta_{A2}} = \frac{1}{3} \). The figure plots equilibrium public good spending in period 1 proposed by each party for initial status quo \( g_0 \in [0, 2] \). What the figure shows is that unless \( g_0 \in [\theta_{A1}, \theta_{B1}] \), we have \( \gamma^*_i(g_0) \notin [\theta_{A1}, \theta_{B1}] \) for at least one of the parties, i.e., the equilibrium is statically Pareto inefficient.

The tendency of the parties to propose \( g_1 \notin [\theta_{A1}, \theta_{B1}] \) is due to the dual role of first-period public good spending. It represents spending in a standard sense but it also determines the status quo in period 2. Party \( i \) selected to propose has an incentive to propose \( g_1 \) trading off these two roles. The first one pushes towards proposing \( \theta_{i1} \) while the second one pushes towards \( \theta_{i2} \). When party \( i \) is unconstrained by the acceptance of party \( j \neq i \), it proposes \( g_1 \) that is a weighted average of \( \theta_{i1} \) and \( \theta_{i2} \). For \( i = A \), when \( \theta_{i2} < \theta_{i1} \) this weighted average is below \( \theta_{A1} \), giving rise to static Pareto inefficiency.

\(^{21}\)The proposition assumes quadratic stage utilities. This is for convenience, as it facilitates derivation of analytical expressions, rather than out of necessity.
6 Mandatory and discretionary combined

In this section we consider that parties can endogenously choose how much public good to allocate to mandatory and discretionary spending. We begin by showing that when discretionary spending can only be positive, that is, $Z = R_+ \times R_+$, we obtain dynamic Pareto efficiency under certain conditions.

**Proposition 7.** Under a budgetary institution that allows positive discretionary and mandatory spending, if utilities are regular with increasing marginal returns and parties’ ideals are decreasing, then every equilibrium is dynamically Pareto efficient for any initial status quo $g_0 \in R_+$.

The proof of Proposition 7 is instructive so we include it. First, consider the following alternative way of writing the social planner’s dynamic problem:

$$
\max_{(x_1, x_{A2}, x_{B2}) \in \mathbb{R}_+^3} u_i(x_1) + \delta[p_Au_{i2}(x_{A2}) + p_Bu_{i2}(x_{B2})]
$$

s.t. $u_j(x_1) + \delta[p_Au_{j2}(x_{A2}) + p_Bu_{j2}(x_{B2})] \geq U$,

for some $U \in \mathbb{R}$, $i, j \in \{A, B\}$ and $i \neq j$. The difference between the original social planner’s problem (DSP) and the modified social planner’s problem (DSP') is that in the modified problem, the social planner is allowed to choose a distribution of allocations in period 2. Since the utility functions are concave, it is not optimal for the social planner to randomize and
therefore the solution to \([\text{DSP}]\) is also the solution to \([\text{DSP}']\). To state this result formally, recall that given \(U \in \mathbb{R}\) we denote the solution to \([\text{DSP}]\) as \(x^*(U) = (x^*_1(U), x^*_2(U))\).

**Lemma 3.** The solution to the modified social planner’s problem \([\text{DSP}']\) is \(x_1 = x^*_1(U)\) and \(x_{A2} = x_{B2} = x^*_2(U)\).

Now fix the initial status quo \(g_0\). Denote \(f_j(g_0)\) as responder \(j\)’s status quo payoff. That is \(f_j(g_0) = u_{j1}(g_0) + \delta V_j(g_0; \sigma^*_2)\) with \(\sigma^*_2\) given in Proposition 4. The next result characterizes the equilibrium proposal in period 1.

**Lemma 4.** Under a budgetary institution that allows positive discretionary and mandatory spending, if utilities are regular with increasing marginal returns and parties’ ideals are decreasing, then for any equilibrium \(\sigma^*\), given initial status quo \(g_0\), the equilibrium proposal strategy for party \(i\) in period 1 satisfies \(\gamma^*_i(g_0) = x^*_2(U)\) and \(\kappa^*_i(g_0) = x^*_1(U) - x^*_2(U)\), where \(U = f_j(g_0)\) and \(j \neq i\).

**Proof.** If party \(i\) is the proposer in period 1, then party \(i\)’s equilibrium proposal strategy \((\kappa^*_i(g_0), \gamma^*_i(g_0))\) is a solution to

\[
\max_{(k_1, g_1) \in \mathbb{R}_+^2} u_{i1}(k_1 + g_1) + \delta V_i(g_1; \sigma^*_2) \\
\text{s.t. } u_{j1}(k_1 + g_1) + \delta V_j(g_1; \sigma^*_2) \geq u_{j1}(g_0) + \delta V_j(g_0; \sigma^*_2),
\]

where

\[
V_i(g; \sigma^*_2) = p_A u_{i2}(\kappa^*_{A2}(g) + \gamma^*_{A2}(g)) + p_B u_{i2}(\kappa^*_{B2}(g) + \gamma^*_{B2}(g)).
\]

For notational simplicity we write \(x^*_1\) and \(x^*_2\) instead of \(x^*_1(U)\) and \(x^*_2(U)\). We first show that \((x^*_1 - x^*_2, x^*_2)\) is in the feasible set for \([P_1]\). As shown in Lemma A1 in the Appendix, if the parties’ ideals are decreasing and utilities are regular with increasing marginal returns, any Pareto efficient allocation is decreasing. This implies \(x^*_1 > x^*_2\), and thus \((x^*_1 - x^*_2, x^*_2) \in \mathbb{R}_+^2\) is feasible.

We next show that if \(\gamma^*_i(g_0) = x^*_2\) and \(\kappa^*_i(g_0) = x^*_1 - x^*_2\), then the induced equilibrium allocation is \(x^*_1\) in period 1 and \(x^*_2\) in period 2. It is straightforward to see \(x_{i1}^*(g_0) = \gamma^*_i(g_0) + \kappa^*_i(g_0) = x^*_1\). To see that \(x_{i2}^*(g_0) = x^*_2\), first note that by Proposition 2 part 1, \(x^*_1 \in [\theta_{A2}, \theta_{B2}]\). Proposition 4 part 2 then implies that \(\kappa^*_A(x^*_2) + \gamma^*_A(x^*_2) = \kappa^*_B(x^*_2) + \gamma^*_B(x^*_2) = x^*_2\).
Finally, we show by contradiction that \((x_1^* - x_2^*, x_2^*)\) is the maximizer of \((P_1)\). Suppose not. Then proposing \((\kappa_1^*(g_0), \gamma_1^*(g_0))\) is better than proposing \((x_1^* - x_2^*, x_2^*)\). That is, proposing \((\kappa_1^*(g_0), \gamma_1^*(g_0))\) gives proposer \(i\) a higher dynamic payoff while giving the responder \(j\) a dynamic payoff at least as high as \(f_j(g_0)\). Hence, if \((\kappa_1^*(g_0), \gamma_1^*(g_0)) \neq (x_1^* - x_2^*, x_2^*)\), then the allocation with \(x_1 = \gamma_1^*(g_0) + \kappa_1^*(g_0), x_{A2} = \gamma_{A2}(\gamma_1^*(g_0)), x_{B2} = \gamma_{B2}(\gamma_1^*(g_0))\) does better than \(x_1 = x_1^*\) and \(x_{A2} = x_{B2} = x_2^*\) in \([DSP]\), which contradicts Lemma 3.

By Lemma 4 for status quo \(g_0\) and period-1 proposer \(i \in \{A, B\}\), the equilibrium outcome is \(x^*(g_0) = \{x_t^*(U)\}_{t=1}^2\) where \(U = f_j(g_0)\) and \(j \neq i\). Hence \(\sigma^*\) is a dynamically Pareto efficient equilibrium for any sequence of proposers, and for any \(g_0 \in \mathbb{R}_+\). This completes the proof of Proposition 7.

If the parties' ideals are increasing, and only positive discretionary spending is allowed together with mandatory spending, in general we do not obtain Pareto efficiency. This is because with increasing ideals to achieve efficiency we need the discretionary spending in period 1 to be \(x_1^* - x_2^* < 0\), which is not feasible. This suggests however that allowing negative discretionary spending restores dynamic Pareto efficiency, and indeed we have this result.

**Proposition 8.** Under a budgetary institution that allows positive and negative discretionary spending and positive mandatory spending, that is, \(Z = \{(k_t, g_t) \in \mathbb{R} \times \mathbb{R}_+: k_t + g_t \geq 0\}\), every equilibrium \(\sigma^*\) is dynamically Pareto efficient for any status quo \(g_0 \in \mathbb{R}_+\).

We omit the proof of Proposition 8 since it is a slight modification of the proof of Proposition 7. Figure 4 below provides an example of equilibrium allocations for budgetary institutions that allow for mandatory spending programs, either in isolation or in combination with discretionary spending. The parameters used are the same as in Figure 3.

In Figure 4 the dashed blue line illustrates the set of dynamically Pareto efficient allocations, and the red line illustrates the set of equilibrium allocations - an initial status quo and a sequence of proposers induces an equilibrium allocation in the set. As shown in panels 4a and 4b, when mandatory spending and only positive discretionary spending are allowed, for some status quos and some realization of proposers, equilibrium allocations do not coincide.
Fig. 4: Equilibrium allocations under different budgetary institutions

\[ \begin{align*}
\theta_A &= (0.4, 0.2), \quad \theta_B = (0.6, 0.8), \quad p_A = p_B = \frac{1}{2}, \quad \delta = 1, \quad u_{it}(x_t) = -(x_t - \theta_{it})^2
\end{align*} \]

with any dynamically Pareto efficient allocation. By contrast, when both positive and negative discretionary spending are allowed, for any status quo and any realization of proposers, the equilibrium allocation coincides with a dynamically Pareto efficient allocation.

The reason the combination of mandatory and discretionary spending achieves dynamic Pareto efficiency is that the proposer in the first period can perfectly tailor the spending in that period to first-period preferences, and independently choose the next period’s status quo. This simultaneously avoids gridlock and political risk because spending fluctuates with preferences and the second-period status quo is maintained. Allowing positive and negative discretionary spending together with mandatory spending provides sufficient flexibility to achieve this. This suggests that the efficiency result may no longer hold in a model with $T > 2$ periods, unless further flexibility is allowed. In the next section we consider a model with more than two periods and stochastic preferences and show that state-contingent mandatory spending provides such flexibility.

7 State-contingent mandatory spending

In this section we consider a richer environment in which parties bargain in $T \geq 2$ periods and preferences are stochastic in each period reflecting uncertainties in the economy. The economic state (henceforth we refer to the economic state as simply the state) in each period
is $s_t \in S$ where $S$ is a finite set of $n = |S|$ possible states. We assume the distribution of states has full support in every period, but do not require the distribution to be the same across periods. The utility of party $i$ in period $t$ when the spending is $x$ and the state is $s$ is $u_i(x, s)$. As before, we assume $u_i(x, s)$ is twice continuously differentiable and strictly concave in $x$. Further, $u_i(x, s)$ attains a maximum at $\theta_{is}$ and we assume $0 < \theta_{As} < \theta_{Bs}$ for all $s \in S$. The state is drawn at the beginning of each period before a proposal is made.

In this setting, we consider a budgetary institution that allows state-contingent mandatory spending. As discussed in the Introduction, these state-contingent programs have been used historically and in current times.

A proposal in period $t$ is a spending rule $g_t : S \rightarrow \mathbb{R}_+$ where $g_t(s)$ is the level of public good spending proposed to be allocated to the mandatory program at time $t$ in state $s$. If the responding party agrees to the proposal, the allocation implemented in period $t$ is $g_t(s_t)$; otherwise the allocation in period $t$ is given by the status quo spending rule $g_{t-1}(s_t)$. In this environment, a strategy for party $i$ in period $t$ is $\sigma_{it} = (\gamma_{it}, \alpha_{it})$. Let $\mathcal{M}$ be the space of all functions from $S$ to $\mathbb{R}_+$. Then $\gamma_{it} : \mathcal{M} \times S \rightarrow \mathcal{M}$ is a proposal strategy for party $i$ in period $t$ and $\alpha_{it} : \mathcal{M} \times S \times \mathcal{M} \rightarrow \{0, 1\}$ is an acceptance strategy for party $i$ in period $t$. A strategy for party $i$ is $\sigma_i = (\sigma_{i1}, \ldots, \sigma_{iT})$ and a profile of strategies is $\sigma = (\sigma_1, \sigma_2)$.

### 7.1 Pareto efficiency with stochastic preferences

With stochastic preferences the social planner chooses an allocation rule $x_t : S \rightarrow \mathbb{R}_+$ for all $t \in \{1, \ldots, T\}$ to maximize the expected payoff of one of the parties subject to providing the other party with a minimum expected dynamic payoff. Formally, a dynamically Pareto efficient allocation rule solves the following maximization problem:

$$\max_{\{x_t : S \rightarrow \mathbb{R}_+\}_{t=1}^T} \sum_{t=1}^T \delta^{t-1}E_{s_t}[u_i(x_t(s_t), s_t)]$$

s.t. $\sum_{t=1}^T \delta^{t-1}E_{s_t}[u_j(x_t(s_t), s_t)] \geq U$,

for some $U \in \mathbb{R}$, $i, j \in \{A, B\}$ and $i \neq j$. We denote the solution to (DSP-S) by the sequence of functions $x^* = \{x_t^*\}_{t=1}^T$. The next proposition characterizes dynamically Pareto efficient allocation rules, analogous to Proposition 2.
Proposition 9. Any dynamically Pareto efficient allocation rule satisfies:

1. For any \( t \) and \( t' \), \( x^*_t = x^*_{t'} \).

2. For all \( s \in S \) and all \( t \), either

\[
-\frac{u'_i(x^*_t(s), s)}{u'_j(x^*_t(s), s)} = \lambda^*
\]

for some \( \lambda^* > 0 \), or \( x^*_t(s) = \theta_{As} \), or \( x^*_t(s) = \theta_{Bs} \).

Proposition 9 first says that the dynamically Pareto efficient allocation rule is independent of time, i.e., the same allocation rule is used each period. The second part of the proposition says that the dynamically Pareto efficient allocation rule either satisfies the condition that the ratio of the parties’ marginal utilities is constant across states, or is one party’s ideal each period.

We next define a dynamically Pareto efficient equilibrium and state the efficiency result for state-contingent mandatory spending. Define recursively \( x^\sigma_t(g_0) \) for \( t \in \{1, \ldots, T\} \) by \( x^\sigma_t(g_0) = \gamma_{i1}(g_0, s_1) \) for some \( i \in \{1, 2\} \) and some \( s_1 \in S \) and \( x^\sigma_t(g_0) = \gamma_{it}(x^\sigma_{t-1}(g_0), s_t) \) for some \( i \in \{1, 2\} \) and some \( s_t \in S \) and \( t \in \{2, \ldots, T\} \). An equilibrium allocation rule for \( \sigma \) given initial status quo \( g_0 \) is a possible realization of a spending rule for each period, \( x^\sigma(g_0) = \{x^\sigma_t(g_0)\}_{t=1}^T \). The random determination of proposers and states in each period induces a probability distribution over allocation rules given an equilibrium \( \sigma \), thus any element in the support of this distribution is an equilibrium allocation rule for \( \sigma \).

Definition 3. A profile of strategies \( \sigma \) is a dynamically Pareto efficient equilibrium given initial status quo \( g_0 \in \mathcal{M} \) if and only if

1. \( \sigma \) constitutes an equilibrium.

2. Every equilibrium allocation rule \( x^\sigma(g_0) \) for \( \sigma \) given initial status quo \( g_0 \) is dynamically Pareto efficient.

Proposition 10. Under state-contingent mandatory spending, an equilibrium is either dynamically Pareto efficient for any initial status quo \( g_0 \in \mathcal{M} \) or is outcome-equivalent to a dynamically Pareto efficient equilibrium.
The result in Proposition 10 is in stark contrast to the inefficiency results for mandatory spending given in Propositions 5 and 6. Note that dynamic efficiency fails in the model with changing (deterministic) preferences and fixed mandatory spending because the proposer in period 1 cannot specify spending in the current period separately from the status quo for the next period. Thus either spending is constant across periods or varies with the identity of the proposer, both of which violates dynamic Pareto efficiency.

The result with stochastic preferences is understood in an analogous way to the model with discretionary and mandatory spending. In the first period the proposer can tailor the status quo for each state such that the future proposer in that state has no incentive to change it. This avoids gridlock by allowing spending to fluctuate with the economic state, and eliminates political risk by ensuring that the spending levels do not depend on the identity of future proposers.

8 Conclusion

In this paper we study the efficiency properties of budgetary institutions. We demonstrate that discretionary only and mandatory only budget institutions may result in dynamic inefficiency, and static inefficiency in the case of mandatory only budget institutions. However, we show that bargaining achieves dynamic Pareto efficiency when flexibility is introduced through either the endogenous choice of mandatory and discretionary programs (in the case of two periods and fluctuating, but deterministic, preferences), or through a state-contingent mandatory program. We show that these budgetary institutions eliminate political risk and gridlock by allowing the proposer to choose a status quo that is not changed by future proposers because they fully account for future changes in preferences.

We have considered mandatory spending programs that are fully state-contingent, but it is possible that factors influencing parties’ preferences, such as the mood of the electorate, cannot be contracted on. In this case it seems there is room for inefficiency even with mandatory spending that depends on the part of the state that can be contracted on. It is possible that further flexibility with discretionary spending may be helpful. Such combinations are observed in practice, for example, in the United States unemployment insurance is provided
through both state-contingent mandatory programs and discretionary programs. However, including discretionary spending may leave more room for political risk. We leave for future work exploring efficiency implications of discretionary and mandatory spending when a part of the state may not be contracted on.

References


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URL: http://www.oecd.org/gov/budgeting/


Appendix

A1 Pareto efficiency

A1.1 Proof of Proposition 1

First, we show that if $x_t$ is statically Pareto efficient, then $x_t \in [\theta_A, \theta_B]$. Consider $x_t / \in [\theta_A, \theta_B]$. Then we can find $x_t'$ in either $(x_t, \theta_A)$ or $(\theta_B, x_t)$ such that $u_A(x_t') > u_A(x_t)$ and $u_B(x_t') > u_B(x_t)$, and therefore $x_t$ is not a solution to (SSP).

Second, we show that if $\tilde{x}_t \in [\theta_A, \theta_B]$, then $\tilde{x}_t$ is statically Pareto efficient. Let $u = u_{jt}(\tilde{x}_t)$. Denote the solution to (SSP) as $\hat{x}_t(u)$. Since $u_A'(x_t) < 0$ and $u_B'(x_t) > 0$ for all $x_t \in (\theta_A, \theta_B)$, the solution to (SSP) is $\hat{x}_t(u) = \tilde{x}_t$ for any $\tilde{x}_t \in [\theta_A, \theta_B]$.

A1.2 Proof of Proposition 2

We prove the result for a more general model with $T \geq 2$. Denote a sequence of allocations by $x = \{x_t\}_{t=1}^T$ and party $i$’s discounted dynamic payoff from $x = \{x_t\}_{t=1}^T$ by $U_i(x) = \sum_{t=1}^T \delta^{t-1} u_{it}(x_t)$. We define a dynamically Pareto efficient allocation in the $T$-period problem as the solution to the following maximization problem

$$\begin{align*}
\max_{x \in \mathbb{R}_+^T} & \quad U_i(x) \\
\text{s.t.} & \quad U_j(x) \geq U
\end{align*}$$

(DSP)

for some $U \in \mathbb{R}$, $i, j \in \{A, B\}$ and $i \neq j$. Denote the sequence of party $i$’s static ideals by $\theta_i = \{\theta_{it}\}_{t=1}^T$ for all $i \in \{A, B\}$, and denote the solution to (DSP) as $x^* = \{x^*_t\}_{t=1}^T$.

To prove part 1 by way of contradiction, suppose $x^*_t / \in [\theta_A', \theta_B']$. By Proposition 1 there exists $\hat{x}'$ such that $u_{it}(\hat{x}') > u_{it}(x^*_t)$ for all $i \in \{A, B\}$, and $u_{it}(\hat{x}') > u_{it}(x^*_t)$ for at least one $i \in \{A, B\}$. Now consider $\hat{x} = \{\hat{x}_t\}_{t=1}^T$, with $\hat{x}_t = x^*_t$ for all $t \neq t'$. Then $U_i(\hat{x}) > U_i(x^*)$ for all $i \in \{A, B\}$, and $U_i(\hat{x}) > U_i(x^*)$ for at least one $i \in \{A, B\}$. Thus $x^*$ is not dynamically Pareto efficient.

Next we prove part 2 by considering possible values of $U$. Fix $i, j \in \{A, B\}$ with $i \neq j$. For any $\overline{U} > U_j(\theta_j)$ the solution does not exist, so assume $\overline{U} \leq U_j(\theta_j)$.

For $\overline{U} = U_j(\theta_j)$, the solution to (DSP) is $x^* = \theta_j$ and for any $\overline{U} \leq U_j(\theta_i)$, the solution to
\((\text{DSP})\) is \(x^* = \theta_i\). What remains is to consider the case when \(U \in (U_j(\theta_i), U_j(\theta_j))\). Suppose \(\theta_A = \theta_B\), then \(U_j(\theta_i) = U_j(\theta_j)\), which implies \(x^* = \theta_i\). So consider \(\theta_A \neq \theta_B\).

For the rest of the proof, suppose \(U \in (U_j(\theta_i), U_j(\theta_j))\) and \(\theta_A \neq \theta_B\). By part 1 we can drop the \(x \in \mathbb{R}_+^T\) constraint from \((\text{DSP})\) since this will be satisfied.

The Lagrangian of the modified problem is

\[
L(x, \lambda) = U_i(x) - \lambda \left[-U_j(x) + U\right].
\]

By Takayama (1974, Theorem 1.D.4), if the Jacobian of the constraint has rank 1 then the solution to \((\text{DSP})\) satisfies

\[
\frac{\partial L(x^*, \lambda^*)}{\partial x_i} = \delta^{i-1}u_i^t(x_i^*) + \lambda^* \delta^{i-1}u_j^t(x_i^*) = 0
\]

with \(\lambda^* \geq 0\). The Jacobian is

\[
\left[\left(\delta^{i-1} \frac{\partial u_j^t(x_i^*)}{\partial x_i^t}\right)\right]_{t=1}^T,
\]

and it has rank 1 if there exists \(t'\) such that \(x_{i'}^* \neq \theta_{j't'}\), which we show next. Suppose \(x^* = \theta_j\).

This implies \(U_j(x^*) > U\). Because there exists \(t'\) such that \(\theta_{i't'} \neq \theta_{j't'}\), we can find \(\alpha \in (0, 1)\) such that \(x_{i'} = \alpha \theta_{i't'} + (1 - \alpha) \theta_{j't'}\) satisfies the constraints in \((\text{DSP})\) and strictly increases the value of the objective function relative to \(x_{i'}^*\).

If \(\lambda^* = 0\), we obtain \(x^* = \theta_i\), violating the \(U_j(x) \geq U\) constraint, and hence \(\lambda^* > 0\). □

### A1.3 Proof of Lemma 1

Since \(x\) and \(\tilde{x}\) are dynamically Pareto efficient, by Proposition 2 part 1 \(x_t \in [\theta_{At}, \theta_{Bt}]\) and \(\tilde{x}_t \in [\theta_{At}, \theta_{Bt}]\) for all \(t\). There are three possible cases.

**Case (i):** \(x_{i'} = \tilde{x}_{i'} = \theta_{Ai'}\). By Proposition 2 part 1 either \(x = \theta_A\), or \(x = \theta_B\), or \(u_{Ai'}'(x_{i'}) + \lambda^* u_{Bi'}'(x_{i'}) = 0\) for some \(\lambda^* > 0\). Since \(\theta_{At} \neq \theta_{Bt}\) for any \(t\), \(x_{i'} = \theta_{Ai'}\) implies \(x \neq \theta_B\).

Next note that \(u_{At}(\theta_{At}) = 0\) for all \(t\) and \(u_{Bt}(\theta_{At}) \neq 0\) for any \(t\), hence \(u_{Ai'}'(x_{i'}) + \lambda^* u_{Bi'}'(x_{i'}) \neq 0\) for any \(\lambda^* > 0\). Thus, it must be that \(x = \theta_A\). A similar argument shows that \(\tilde{x} = \theta_A\), proving that \(x = \tilde{x}\).

**Case (ii):** \(x_{i'} = \tilde{x}_{i'} = \theta_{Bt}\). Analogous to case (i), if \(x_{i'} = \tilde{x}_{i'} = \theta_{Bt}\), then \(x = \tilde{x} = \theta_B\).

**Case (iii):** \(x_{i'} = \tilde{x}_{i'} \in (\theta_{Ai'}, \theta_{Bt})\). Note that \(x \neq \theta_i\) for any \(i\), so by Proposition 2 part
it must be that $u'_{A'}(x_{t'}) + \lambda^* u'_{B'}(x_{t'}) = 0$ for some $\lambda^* > 0$. This implies $-\frac{u'_{A'}(x_{t'})}{u'_{B'}(x_{t'})} = \lambda^*$. Similarly, $u'_{A'}(\bar{x}_{t'}) + \tilde{\lambda}^* u'_{B'}(\bar{x}_{t'}) = 0$ for some $\tilde{\lambda}^* > 0$, implying $-\frac{u'_{A'}(\bar{x}_{t'})}{u'_{B'}(\bar{x}_{t'})} = \lambda^*$. Since $x_{t'} = \bar{x}_{t'}$ it follows that $\lambda^* = \tilde{\lambda}^*$. Then by Proposition 2 part 2 $-\frac{u'_{A'}(x_t)}{u'_{B'}(x_t)} = -\frac{u'_{A'}(\tilde{x}_t)}{u'_{B'}(\tilde{x}_t)} = \lambda^*$ for all $t$. To prove $x_t = \tilde{x}_t$ for all $t$, it remains to show that $-\frac{u'_{A'}(x_t)}{u'_{B'}(x_t)} = \lambda^*$ has a unique solution for any $\lambda^* > 0$. To see this, first note that $x \neq \theta_i$ for any $i$ implies $x_t \in (\theta_{At}, \theta_{Bt})$ for all $t$ because otherwise, $x_t = \theta_i$ for some $i$ and some $t$, and by previous arguments this implies $x = \theta_i$, which is a contradiction. From properties of $u_{A'}$ and $u_{B'}$, we know that $-\frac{u'_{A'}(x)}{u'_{B'}(x)}$ is continuous on $(\theta_{At}, \theta_{Bt})$, $-\frac{u'_{A'}(x)}{u'_{B'}(x)} > 0$ for all $x \in (\theta_{At}, \theta_{Bt})$, $\lim_{x \to \theta_{A'}} -\frac{u'_{A'}(x)}{u'_{B'}(x)} = 0$, $\lim_{x \to \theta_{B'}} -\frac{u'_{A'}(x)}{u'_{B'}(x)} = \infty$ and $\frac{\partial}{\partial x} \left[ -\frac{u'_{A'}(x)}{u'_{B'}(x)} \right] = -\frac{u''_{A'}(x)u_{B'}(x) - u'_{A'}(x)u''_{B'}(x)}{(u'_{B'}(x))^2} > 0$ for all $x \in (\theta_{At}, \theta_{Bt})$. Hence, by the Intermediate Value Theorem, a solution to $-\frac{u'_{A'}(x)}{u'_{B'}(x)} = \lambda^*$ exists and by the strict monotonicity of $-\frac{u'_{A'}(x)}{u'_{B'}(x)}$, it is unique.

A1.4 Proof of Lemma 2

To show part 1 note that by Proposition 2 part 1 any dynamically Pareto efficient allocation $x^*$ satisfies $x^*_1 \in [\theta_{A1}, \theta_{B1}]$ and $x^*_2 \in [\theta_{A2}, \theta_{B2}]$. If $\theta_{B1} < \theta_{A2}$ or $\theta_{B2} < \theta_{A1}$, then $x^*_1 \neq x^*_2$.

Part 2 follows from Lemma A1 below and part 3 follows from Lemma A2 below.

Lemma A1. Suppose utilities are regular with increasing marginal returns. If $\theta_{it'} > \theta_{it''}$ for all $i \in \{A, B\}$, then any dynamically Pareto efficient allocation $x^*$ satisfies $x^*_t = x^*_t$.

Proof. Since $x^*$ is dynamically Pareto efficient, it follows that for some $\alpha \in [0, 1]$, $x^*$ is a solution to the following maximization problem

$$\max_{\mathbf{x} \in \mathbb{R}_+^d} \alpha U_A(\mathbf{x}) + (1 - \alpha) U_B(\mathbf{x}),$$

which implies that $x^*_t$ is a solution to the following maximization problem

$$\max_{x_t \in \mathbb{R}_+^d} \alpha u_A(x_t, \theta_{At}) + (1 - \alpha) u_B(x_t, \theta_{Bt})$$

for all $t$.

Let $f(x_t, \theta_{At}, \theta_{Bt}) = \alpha u_A(x_t, \theta_{At}) + (1 - \alpha) u_B(x_t, \theta_{Bt})$. Since $\frac{\partial f}{\partial x_t}$ is strictly increasing in $\theta_{it}$ for all $i$, we have that $\frac{\partial f}{\partial x_t}$ is strictly increasing in $\theta_{it}$ for all $i$. It follows from standard
Lemma A2. Suppose \( u_t(x_t) = -(|x_t - \theta_t|^r \text{ where } r > 1 \). Then an allocation \( x \) is dynamically Pareto efficient if and only if \( x = \alpha \theta_i + (1 - \alpha) \theta_j \) for some \( \alpha \in [0, 1] \).

Proof. Fix \( i, j \in \{A, B\} \) with \( i \neq j \) in \( \text{(DSP)} \). For any \( \bar{U} > U_j(\theta_j) \) the solution to \( \text{(DSP)} \) does not exist, so assume \( \bar{U} \leq U_j(\theta_j) \).

Suppose \( \theta_i = \theta_j \). Then for any \( \bar{U} \leq U_j(\theta_j) \) there exists a unique solution to \( \text{(DSP)} \), \( x^* = \theta_i \). In this case \( x^* = \alpha \theta_i + (1 - \alpha) \theta_j \) for any \( \alpha \in [0, 1] \).

Suppose \( \theta_i \neq \theta_j \). For \( \bar{U} = U_j(\theta_j) \), the solution is \( x^* = \theta_j = \alpha \theta_i + (1 - \alpha) \theta_j \) where \( \alpha = 0 \). For any \( \bar{U} \leq U_j(\theta_j) \), the solution is \( x^* = \theta_i = \alpha \theta_i + (1 - \alpha) \theta_j \) where \( \alpha = 1 \).

For the rest of the proof, suppose \( \bar{U} \in (U_j(\theta_i), U_j(\theta_j)) \) and \( \theta_i \neq \theta_j \). Consider a relaxed version of \( \text{(DSP)} \) with the constraint \( x \in \mathbb{R}^T_+ \) dropped. Denote the solution to the relaxed problem as \( \hat{x} = (\hat{x}_1, \hat{x}_2) \). Similar to the proof of Proposition 2 part 1 if \( \hat{x} \notin [\theta_A, \theta_B] \), then both parties can be made strictly better off in period \( t \). Thus if \( \hat{x} \) is a solution to the relaxed problem, then \( \hat{x}_t \in [\theta_A, \theta_B] \) for all \( t = 1, 2 \). It follows that the solution to the relaxed problem is the same as the solution to \( \text{(DSP)} \). The Lagrangian of the relaxed problem is \( L(x, \lambda) = U_i(x) - \lambda [-U_j(x) + \bar{U}] \). Since \( U_j(x) > \bar{U} \) when \( x = \theta_j \), by \cite{Takayama_1974} Theorem 1.D.2, \( \frac{\partial L(\hat{x}, \lambda)}{\partial x_t} = 0 \) with \( \hat{\lambda} \geq 0 \) for all \( t \) is both sufficient and necessary for \( \hat{x} \).

Assume \( i = A \). If \( i = B \), the argument is similar and omitted. Since \( \hat{x}_t \in [\theta_A, \theta_B] \) for all \( t \), we have \( \frac{\partial L(\hat{x}, \lambda)}{\partial x_t} \frac{1}{\hat{x}_t} = -(\hat{x}_t - \theta_A)^{r-1} + \hat{\lambda}(\theta_B - \hat{x}_t)^{r-1} \). Hence \( \frac{\partial L(\hat{x}, \lambda)}{\partial x_t} = 0 \) is equivalent to \( -(\hat{x}_t - \theta_A)^{r-1} + \hat{\lambda}(\theta_B - \hat{x}_t)^{r-1} = 0 \). If \( \hat{\lambda} = 0 \), we obtain \( \hat{x} = \theta_A \), violating the \( U_B(x) \geq \bar{U} \) constraint, and hence \( \hat{\lambda} > 0 \). If \( \theta_A \neq \theta_B \), then \( \frac{\partial L(\hat{x}, \lambda)}{\partial x_t} = 0 \) cannot be satisfied if \( \hat{x}_t = \theta_A \) or \( \hat{x}_t = \theta_B \). Hence for all \( t \) such that \( \theta_A \neq \theta_B \), we have \( \hat{x}_t \in (\theta_A, \theta_B) \) and therefore \( \frac{\hat{x}_t - \theta_A}{\theta_B - \hat{x}_t} = \hat{\lambda}^{-1} \) with \( \hat{\lambda} > 0 \).

Fix \( t' \) such that \( \theta_B \neq \theta_{A'} \). If \( \theta_{A'} \neq \theta_B \), then \( \theta_B - \hat{x}_t = (\theta_B - \hat{x}_{t'}) \frac{\theta_B - \theta_{A'}}{\theta_{B'} - \theta_{A'}} \). Since \( \frac{\hat{x}_t - \theta_A}{\theta_B - \hat{x}_t} = \hat{\lambda}^{-1} \) and \( \frac{\hat{x}_{t'} - \theta_{A'}}{\theta_{B'} - \theta_{A'}} = \hat{\lambda}^{-1} \hat{\lambda} \). If \( \theta_A = \theta_B \), then \( \hat{x}_t = \theta_B \), and so again we have \( \theta_B - \hat{x}_t = (\theta_B - \hat{x}_{t'}) \frac{\theta_B - \theta_{A'}}{\theta_{B'} - \theta_{A'}} \). Thus \( U_B(x) = (\frac{\theta_B - \theta_{A'}}{\theta_{B'} - \theta_{A'}})^r \sum_{t=1}^T \delta_{t-1} (-\theta_B - \theta_A)^r = (\frac{\theta_B - \theta_{A'}}{\theta_{B'} - \theta_{A'}})^r U_B(\theta_A) \).

Since \( \hat{\lambda} > 0 \), we have \( U_B(\hat{x}) = \bar{U} \). Hence, \( (\frac{\theta_B - \theta_{A'}}{\theta_{B'} - \theta_{A'}})^r U_B(\theta_A) = \bar{U} \) is necessary and sufficient.
for \( \hat{x} \) to solve (DSP) with \( U \). Rearranging, we get \( \hat{x}_{t'} = \alpha \theta_{A_{t'}} + (1 - \alpha) \theta_{B_{t'}} \) where \( \alpha = \left( \frac{r}{U_B(\theta_A)} \right)^{\frac{1}{2}} \). To conclude the proof, note that if \( U_B(\theta_A) \prec U < U_B(\theta_B) = 0 \), then \( \alpha \in (0, 1) \), and conversely, for any \( \alpha \in (0, 1) \), the allocation \( x = \alpha \theta_i + (1 - \alpha) \theta_j \) solves (DSP) with \( U = \alpha^r U_B(\theta_A) \).

\[ \blacksquare \]

A2 Discretionary spending

**Lemma A3.** Suppose there exists at most one \( t' \) such that \( \theta_{A_{t'}} \neq \theta_{B_{t'}} \). Then an allocation \( x \) is dynamically Pareto efficient if and only if \( x_t \) is statically Pareto efficient in period \( t \) for all \( t \).

**Proof.** The “only if” part follows from Proposition 2 part 1 which states that if \( x = \{x_t\}_{t=1}^T \) is dynamically Pareto efficient, then \( x_t \) satisfies static Pareto efficiency for all \( t \).

To show the “if” part, suppose \( x = \{x_t\}_{t=1}^T \) is an allocation such that \( x_t \) is statically Pareto efficient in period \( t \) for all \( t \). The proof is trivial if \( \theta_A = \theta_B \), so we consider the case when there is a unique \( t' \) such that \( \theta_{A_{t'}} \neq \theta_{B_{t'}} \). We will show that \( x \) solves (DSP). Since \( \theta_{At} = \theta_{Bt} \) for \( t \neq t' \), by Proposition 1, \( x_t = \theta_{At} \) for all \( t \neq t' \) and \( x_{t'} \) solves

\[
\max_{x \in \mathbb{R}^+} u_{it'}(x) \quad \text{s.t.} \quad u_{jt'}(x) \geq \bar{u}
\]

for some \( \bar{u} \). Since \( x_{t'} \) solves (SSP*), it also solves

\[
\max_{x \in \mathbb{R}^+} u_{it'}(x) + \sum_{t \neq t'} u_{it}(\theta_{At}) \quad \text{s.t.} \quad u_{jt'}(x) + \sum_{t \neq t'} u_{jt}(\theta_{At}) \geq \bar{u} + \sum_{t \neq t'} u_{jt}(\theta_{At}).
\]

Since \( \{\theta_{At}\}_{t \neq t'} \) maximizes \( \sum_{t \neq t'} u_{it}(x_t) \) and \( \sum_{t \neq t'} u_{jt}(x_t) \), it follows that \( x \) solves (DSP) with \( \bar{U} = \bar{u} + \sum_{t \neq t'} u_{jt}(\theta_{At}) \). \[ \blacksquare \]

A3 Mandatory spending

A3.1 Proof of Proposition 4

We first prove equilibrium existence by showing that a solution exists for the proposer’s problem in period 2 given any status quo \( g_1 \), and given this solution, a solution exists for the
Consider the problem of the proposing party $i \in \{A, B\}$ in the second period under status quo $g_1 \in \mathbb{R}_+$ and budgetary institution $Z$ that allows for mandatory spending. The proposing party’s maximization problem is:

$$\max_{(k_2, g_2) \in Z} u_{i2}(k_2 + g_2) \quad (P_2)$$

s.t. $u_{j2}(k_2 + g_2) \geq u_{j2}(g_1)$.

Consider the related problem

$$\max_{x_2 \in A_{j2}(g_1)} u_{i2}(x_2) \quad (P'_2)$$

where $A_{j2}(g_1) = \{x \in \mathbb{R}_+ | u_{j2}(x) \geq u_{j2}(g_1)\}$ is the responder’s acceptance set under status quo $g_1$. If $\hat{x}_2$ is a solution to $[P'_2]$, then any $(\hat{k}_2, \hat{g}_2) \in Z$ such that $\hat{k}_2 + \hat{g}_2 = \hat{x}_2$ is solution to $[P_2]$.

We next show that for any $g_1 \in \mathbb{R}_+$, a solution exists for $[P'_2]$. To show this, we prove that for any $g_1 \in \mathbb{R}_+$, acceptance set $A_{j2}(g_1)$ is non-empty and compact, and apply the Weierstrass’s Theorem. Non-emptiness follows from $g_1 \in A_{j2}(g_1)$ for all $g_1 \in \mathbb{R}_+$. To show compactness, we show that $A_{j2}(g_1)$ is closed and bounded for all $g_1 \in \mathbb{R}_+$. Closedness follows from continuity of $u_{j2}$ and boundedness follow from $\lim_{x \to \infty} u_{j2}(x) = -\infty$. To see that $\lim_{x \to \infty} u_{j2}(x) = -\infty$, note that $u_{j2}$ is continuous, differentiable and strictly concave, which implies that $u_{j2}(x) < u_{j2}(y) + u'_{j2}(y)(x - y)$ for any $x, y \in \mathbb{R}_+$. Selecting $y > \theta_{j2}$ gives $u'_{j2}(y) < 0$ and taking limit as $x \to \infty$ shows the claim.

We next show that a solution exists to the proposer’s problem in period 1. The proposer’s problem in period 1 is

$$\max_{(k_1, g_1) \in Z} u_{i1}(k_1 + g_1) + \delta V_i(g_1; \sigma^*_2) \quad (P_1)$$

s.t. $u_{j1}(k_1 + g_1) + \delta V_j(g_1; \sigma^*_2) \geq u_{j1}(g_0) + \delta V_j(g_0; \sigma^*_2)$.

To apply Weierstrass’s Theorem, we show $V_i(g_1; \sigma^*_2)$ is continuous in $g_1$ and the constraint set is compact. The continuation value $V_i$ is given by

$$V_i(g_1; \sigma^*_2) = p_A u_{i2}(\kappa^*_A(g_1) + \gamma^*_A(g_1)) + p_B u_{i2}(\kappa^*_B(g_1) + \gamma^*_B(g_1)), \quad (A5)$$

where $(\kappa^*_i, \gamma^*_i)$ is a solution to $[P_2]$ for all $i \in \{A, B\}$. We show that $\kappa^*_i(g_1) + \gamma^*_i(g_1)$ is
continuous in \( g_1 \), by first showing \( \kappa_{i2}^*(g_1) + \gamma_{i2}^*(g_1) \) is unique for any \( g_1 \in \mathbb{R}_+ \), and then using the Maximum Theorem.

Strict concavity of \( u_{j2} \) implies that \( A_{j2}(g_1) \) is convex. Given that \( u_{i2} \) is strictly concave, the solution to \( [P_2] \) is unique for any \( g_1 \). To apply the Maximum Theorem we need to show that the correspondence \( A_{j2} \) has non-empty and compact values and is continuous. We already proved the first two properties. We next establish upper and lower hemicontinuity.

**Lemma A4.** Let \( X \subseteq \mathbb{R} \) be closed and convex, let \( Y \subseteq \mathbb{R} \) and let \( f : X \rightarrow Y \) be a continuous function. Define \( \varphi : X \rightarrow X \) by

\[
\varphi(x) = \{ y \in X | f(y) \geq f(x) \}. \tag{A6}
\]

1. If \( \varphi(x) \) is compact \( \forall x \in X \), then \( \varphi \) is upper hemicontinuous.

2. If \( f \) is strictly concave, then \( \varphi \) is lower hemicontinuous.

**Proof.** To show part 1, it suffices to prove that if two sequences \( x_n \rightarrow x \) and \( y_n \rightarrow y \) satisfy \( y_n \in \varphi(x_n) \) for all \( n \in \mathbb{N} \), then \( y \in \varphi(x) \). Suppose, towards a contradiction, that \( y \notin \varphi(x) \). Then \( f(y) < f(x) \). Since \( f \) is continuous, \( x_n \rightarrow x \) and \( y_n \rightarrow y \), we can find \( n' \) such that \( f(y_n) < f(x_n) \) for all \( n' \geq n \), which contradicts \( y_n \in \varphi(x_n) \) for all \( n \in \mathbb{N} \).

To show part 2, let \( x_n \rightarrow x \) and \( y \in \varphi(x) \). We show that for each sequence \( x_n \rightarrow x \) there exists a sequence \( y_n \rightarrow y \) and \( n' \) such that \( y_n \in \varphi(x_n) \) for all \( n \geq n' \). First suppose \( f(y) > f(x) \). Set \( y_n = y \). Clearly, \( y_n \rightarrow y \). By continuity of \( f \), there exists \( n' \) such that \( f(y_n) \geq f(x_n) \) for all \( n \geq n' \), that is, \( y_n \in \varphi(x_n) \). Next suppose \( f(y) = f(x) \). There are two cases to consider. First, if \( y = x \), set \( y_n = x_n \). Clearly \( y_n \rightarrow y \) and \( y_n \in \varphi(x_n) \) for all \( n \). Second, suppose \( y \neq x \). By strict concavity of \( f \), there exist at most one such \( y \in X \). Set \( y_n = y \) whenever \( f(x_n) \leq f(x) \). When \( f(x_n) > f(x) \), by strict concavity of \( f \) and the Intermediate Value Theorem, because \( x_n \rightarrow x \), there exists \( n' \) such that for all \( n \geq n' \), there is a unique \( y_n \neq x_n \) such that \( f(y_n) = f(x_n) > f(x) \). Because \( y_n = y \) whenever \( f(x_n) \leq f(x) = f(y) \) and \( f(y_n) = f(x_n) \) whenever \( f(x_n) > f(x) \), \( y_n \in \varphi(x_n) \) for all \( n \geq n' \) and \( y_n \rightarrow y \) follows from continuity of \( f \). \( \square \)
By the Maximum Theorem, the proposer’s value function in \([P_2]\) is continuous in \(g_1\) and the correspondence of maximizers is upper hemicontinuous in \(g_1\). Moreover, as shown before, \([P_2]\) has a unique solution for any \(g_1\). Since a singleton-valued upper hemicontinuous correspondence is continuous as a function, for any \(g_1 \in \mathbb{R}_+\) there exists a unique equilibrium level of public good spending \(\kappa_{i2}^*(g_1) + \gamma_{i2}^*(g_1)\) that varies continuously in \(g_1\).

Denote \(V_i(g_1) = V_i(g_1; \sigma^*_2)\) for any \(g_1 \in \mathbb{R}_+\) and \(i \in \{A, B\}\). We have just shown that \(V_i(g_1)\) is continuous in \(g_1\) for any \(i \in \{A, B\}\). We also note that \(V_i(g_1) \in [u_{i2}(\theta_{j2}), u_{i2}(\theta_{i2})]\) for any \(i \in \{A, B\}, j \neq i\) and any \(g_1 \in \mathbb{R}_+\). The upper bound because \(\theta_{i2}\) is the unique maximizer of \(u_{i2}\). The lower bound because, for any \(g_1 \in \mathbb{R}_+, u_{i2}(\kappa_{i2}^*(g_1) + \gamma_{i2}^*(g_1)) \geq u_{i2}(\theta_{i2})\), if not then \(i\) could make alternative proposal \(j\) would accept and \(i\) would strictly prefer, and \(u_{i2}(\kappa_{j2}^*(g_1) + \gamma_{j2}^*(g_1)) \geq u_{i2}(\theta_{j2})\), if not then \(j\) could make alternative proposal that \(i\) would accept and \(j\) would strictly prefer.

Let \(F_i(k_1, g_1)\) for any \(i \in \{A, B\}\) denote overall (dynamic) utility of party \(i\) under budgetary institutions that allow for both mandatory and discretionary spending programs. Let \(f_i(g_1)\) denote the same utility when only mandatory spending programs are allowed. Formally,

\[
F_i(k_1, g_1) = u_{i1}(k_1 + g_1) + \delta V_i(g_1)
\]

\[
f_i(g_1) = u_{i1}(g_1) + \delta V_i(g_1).
\]

Because \(V_i(g_1)\) is continuous in \(g_1\), \(F_i(k_1, g_1)\) is jointly continuous in \((k_1, g_1)\) and \(f_i(g_1)\) is continuous in \(g_1\).

Fix the initial status quo \(g_0 \in \mathbb{R}_+\). When only mandatory spending programs are allowed, \(Z = \{0\} \times \mathbb{R}_+\), and \(i\)'s equilibrium proposed public good spending satisfies \(\kappa_{i1}^*(g_0) = 0\) and

\[
\gamma_{i1}^*(g_0) \in \arg \max_{g_1 \in \mathbb{R}_+} f_i(g_1) \quad \text{s.t.} \quad f_j(g_1) \geq f_j(g_0).
\]

When both types of spending are allowed, either \(Z = \mathbb{R}_+ \times \mathbb{R}_+\) or \(Z = \{(k_i, g_i) \in \mathbb{R} \times \mathbb{R}_+ | k_i + g_i \geq 0\}\), depending on whether discretionary spending can be negative. In equilibrium party \(i\) proposes public good spending

\[
(\kappa_{i1}^*(g_0), \gamma_{i1}^*(g_0)) \in \arg \max_{(k_1, g_1) \in Z} F_i(k_1, g_1) \quad \text{s.t.} \quad F_j(k_1, g_1) \geq F_j(0, g_0).
\]

(A9)
Note that in each of these problems, the objective function is continuous and the constraint set is compact for any $g_0 \in \mathbb{R}_+$. Continuity of $F_i$ and $f_i$ has been noted above and since $V_i$ is bounded, compactness follows from an argument analogous to the one made for the second period. Hence for any $g_0 \in \mathbb{R}_+$, a solution to each of the optimization problems exists, and therefore an equilibrium exists.

We now show that for any $g_1 \in \mathbb{R}_+$

\begin{align}
\kappa^*_A(g_1) + \gamma^*_A(g_1) &= \max\{\theta_A, \phi_B(g_1)\} \quad \text{(A10)} \\
\kappa^*_B(g_1) + \gamma^*_B(g_1) &= \min\{\theta_B, \phi_A(g_1)\}. \quad \text{(A11)}
\end{align}

Consider the first equality. The proof of the second equality is similar and omitted. From the discussion of $F_2$ at the beginning of this proof, we know that if $\hat{x}_2$ is a solution to max $u_A(x_2)$ subject to $x_2 \in A_B(g_1) = \{x \in \mathbb{R}_+ | u_B(x) \geq u_B(g_1)\}$, then $\kappa^*_A(g_1) + \gamma^*_A(g_1) = \hat{x}_2$. By definition $\phi_B(g_1) = \min\{x \in \mathbb{R}_+ | u_B(x) \geq u_B(g_1)\} = \min A_B(g_1)$. There are two possible cases.

**Case (i):** $\phi_B(g_1) \leq \theta_A$. Since $\theta_B \in A_B(g_1)$, $\phi_B(g_1) \in A_B(g_1)$ and $\theta_A \in [\phi_B(g_1), \theta_B]$, by convexity of $A_B(g_1)$, we have $\theta_A \in A_B(g_1)$. Since $\theta_A$ maximizes $u_A$, it follows that $\hat{x}_2 = \theta_A = \max\{\theta_A, \phi_B(g_1)\}$.

**Case (ii):** $\phi_B(g_1) > \theta_A$. Since $\phi_B(g_1) = \min A_B(g_1)$, for any $x \in \phi_B(g_1)$ we have $x \notin A_B(g_1)$. Since $u_A(x)$ is strictly decreasing for $x > \theta_A$, we have $\hat{x}_2 = \phi_B(g_1) = \max\{\theta_A, \phi_B(g_1)\}$.

We now prove parts [1] and [2]. For part [1] let $Z$ be a budgetary institution that allows mandatory spending. If $\kappa^*_2(g_1) + \gamma^*_2(g_1) \notin [\theta_A, \theta_B]$, there exists $(k'_2, g'_2) \in Z$ with $k'_2 + g'_2 = x'_2 \in [\theta_A, \theta_B]$ such that $u_A(\kappa^*_2(g_1) + \gamma^*_2(g_1)) < u_A(x'_2)$ and $u_B(\kappa^*_2(g_1) + \gamma^*_2(g_1)) < u_B(x'_2)$. Hence $(\kappa^*_2(g_1), \gamma^*_2(g_1))$ does not solve the proposer’s second period problem.

For part [2] assume $\theta_A \neq \theta_B$. There are three possible cases.

**Case (i):** $g_1 \in [\theta_A, \theta_B]$. Because $u_A(k_2 + g_2) < u_A(g_1)$ for any $k_2 + g_2 > g_1$ and $u_B(k_2 + g_2) < u_B(g_1)$ for any $k_2 + g_2 < g_1$, party $A$ does not propose or accept any $k_2 + g_2 > g_1$ and party $B$ does not propose or accept any $k_2 + g_2 < g_1$. Hence $\kappa_A^*(g_1) + \gamma_A^*(g_1) = \kappa_B^*(g_1) + \gamma_B^*(g_1) = g_1$. 

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Case (ii): \( g_1 < \theta_{A2} \). In this case \( \kappa^*_A(g_1) + \gamma^*_A(g_1) = \theta_{A2} \) since \( \theta_{A2} \) is the unique maximizer of \( u_{A2} \) and \( u_{B2}(\theta_{A2}) > u_{B2}(g_1) \). By the definition of \( \phi_{A2} \) we have \( \phi_{A2}(g_1) > \theta_{A2} \) when \( g_1 < \theta_{A2} \). Hence from (A11) we have, \( \kappa^*_B(g_1) + \gamma^*_B(g_1) > \theta_{A2} \).

Case (iii): \( g_1 > \theta_{B2} \). Using an argument analogous to case (ii), we have \( \kappa^*_B(g_1) + \gamma^*_B(g_1) = \theta_{B2} \) and \( \kappa^*_A(g_1) + \gamma^*_A(g_1) < \theta_{B2} \). \( \blacksquare \)

### A3.2 Proof of Proposition 5

First note that the proposition applies only when \( \theta_{At} \neq \theta_{Bt} \) for all \( t \). The following claim is useful.

**Claim A1.** Suppose \( \theta_{At} \neq \theta_{Bt} \) for all \( t \). For any \( g_0 \in \mathbb{R}_+ \), if \( \sigma^* \) is a dynamically Pareto efficient equilibrium given \( g_0 \), then any equilibrium allocation \( x^{\sigma^*}(g_0) \) satisfies \( x^{\sigma^*}_1(g_0) = x^{\sigma^*}_2(g_0) \).

**Proof.** Fix an equilibrium \( \sigma^* \). The equilibrium spending in period 2 is either \( \gamma^*_A(x^{\sigma^*}_1(g_0)) \) or \( \gamma^*_B(x^{\sigma^*}_1(g_0)) \). Since \( \theta_{At} \neq \theta_{Bt} \) for all \( t \), by Proposition 4 part 2 we have either \( \gamma^*_A(x^{\sigma^*}_1(g_0)) \neq \gamma^*_B(x^{\sigma^*}_1(g_0)) \) or \( x^{\sigma^*}_2(g_0) = \gamma^*_A(x^{\sigma^*}_1(g_0)) = \gamma^*_B(x^{\sigma^*}_1(g_0)) = x^{\sigma^*}_1(g_0) \). In the former case, the level of spending in period 2 depends on the identity of the period-2 proposer, and hence \( \sigma^* \) cannot be dynamically Pareto efficient given \( g_0 \) by Lemma 1. Thus, \( x^{\sigma^*}_1(g_0) = x^{\sigma^*}_2(g_0) \). \( \blacksquare \)

Assume \( \sigma^* \) is a dynamically Pareto efficient equilibrium given \( g_0 \in \mathbb{R}_+ \). By Claim A1 we have \( x^{\sigma^*}_1(g_0) = x^{\sigma^*}_2(g_0) \). To prove part 1 note that Proposition 2 part 1 implies that \( x^{\sigma^*}_1(g_0) \in [\theta_{A1}, \theta_{B1}] \) and \( x^{\sigma^*}_2(g_0) \in [\theta_{A2}, \theta_{B2}] \), which is impossible if \( \theta_{A1} < \theta_{B1} < \theta_{A2} < \theta_{B2} \) or if \( \theta_{A2} < \theta_{B2} < \theta_{A1} < \theta_{B1} \). To prove part 2 note that Lemma A1 implies that when parties’ ideals are increasing or decreasing and \( \theta_{At} \neq \theta_{Bt} \) for all \( t \), we have \( x^*_1 \neq x^*_2 \), which cannot be satisfied by \( (x^{\sigma^*}_1(g_0), x^{\sigma^*}_2(g_0)) \). Hence, in either case, \( \sigma^* \) is not a dynamically Pareto efficient equilibrium given \( g_0 \).

To see the final result, we first show that if a dynamically Pareto efficient equilibrium allocation exists, it is unique. By Lemma A2 \( x \) is a dynamically Pareto efficient allocation if and only if \( x = \alpha \theta_A + (1 - \alpha) \theta_B \) for any \( \alpha \in [0, 1] \). This implies any dynamically Pareto efficient allocation \((x^*_1, x^*_2)\) can be written as \( x^*_1(\alpha) = \alpha \theta_{A1} + (1 - \alpha) \theta_{B1} \) and \( x^*_2(\alpha) = \alpha \theta_{A2} + (1 - \alpha) \theta_{B2} \) for all \( \alpha \in [0, 1] \).
\(\alpha \theta_A + (1 - \alpha) \theta_B\). By Claim A1 if \(\sigma^*\) is a dynamically Pareto efficient equilibrium given \(g_0\), then \(x_1^\sigma(g_0) = x_2^\sigma(g_0)\). Thus \(x_1^\sigma(g_0) = x_2^\sigma(g_0) = x_3^\sigma(g_0) = x_2^\sigma(g_0)\), where \(\alpha^*\) solves \(x_1^\sigma(\alpha^*) = x_2^\sigma(\alpha^*)\). Straightforward algebra shows \(\alpha^* = \frac{\theta_B - \theta_A}{\theta_B - \theta_A + \theta_A - \theta_B}\) thus is unique.

Next we show that there exists a unique value of \(f_j(g_0)\) such that the solution to the proposer’s problem is \((x_1^\sigma(g_0), x_2^\sigma(g_0))\). Note that there exists a unique value of \(\bar{U}\) that corresponds with the social planner’s problem (DSP) for any dynamically Pareto efficient allocation \((x_1^\sigma, x_2^\sigma)\). Thus fixing a proposer \(i\) and responder \(j\) the unique dynamically Pareto efficient equilibrium allocation \((x_1^\sigma(g_0), x_2^\sigma(g_0))\), corresponds with a unique value of \(\bar{U}\). Denote this value as \(\bar{U}^*\). Consider the modified social planner’s problem equivalent to (DSP′) with \(\bar{U} = \bar{U}^*\). The solution to the proposer’s problem is the solution to the modified social planner’s problem with \(f_j(g_0) = \bar{U}^*\).

To conclude the proof, we show that there exists a finite set of status quos such that \(f_j(g_0) = \bar{U}^*\). Define the sets \(Q_k \subset \mathbb{R}_+\) for \(k = 1, \ldots, 5\) as

\[
\begin{align*}
Q_1 &= (0, \max \{0, 2\theta_A - \theta_B\}) \\
Q_2 &= (\max \{0, 2\theta_A - \theta_B\}, \theta_A) \\
Q_3 &= (\theta_A, \theta_B) \\
Q_4 &= (\theta_B, 2\theta_B - \theta_A) \\
Q_5 &= (2\theta_B - \theta_A, \infty).
\end{align*}
\]

Note that \(Q_k\) may be empty for some \(k\). We use the following result.

**Lemma A5.** Suppose \(u_{it}(x_t) = -(|x_t - \theta_{it}|)^r\) where \(r > 1\) and \(Z = \{0\} \times \mathbb{R}_+\). Then for all \(i \in \{A, B\}\) and all for all \(g_1 \in \bigcup_{k \in \{1, \ldots, 5\}} Q_k\) and for all \(i \in \{A, B\}\), \(V_{i''}(g_1)\) exists and \(V_{i''}(g_1) \leq 0\).

**Proof.** First, by Proposition 4 and \(u_{it}(x_t) = -(|x_t - \theta_{it}|)^r\) the second period equilibrium strategies are

\[
\begin{align*}
\gamma^*_A(g_1) &= \max \{\theta_A, \min \{g_1, 2\theta_B - g_1\}\} \\
\gamma^*_B(g_1) &= \min \{\theta_B, \max \{g_1, 2\theta_A - g_1\}\}.
\end{align*}
\]

Second, note \(\gamma^*_A(g_1)\) is constant in \(g_1\) on \(Q_1 \cup Q_2 \cup Q_5\), equal to \(g_1\) on \(Q_3\) and equal to
$2\theta_{B2} - g_1$ on $Q_4$. Similarly, $\gamma^*_B(g_1)$ is constant in $g_1$ on $Q_1 \cup Q_4 \cup Q_5$, equals $2\theta_{A2} - g_1$ on $Q_2$ and equals $g_1$ on $Q_3$. This implies

$$V_i'(g_1) = \begin{cases} -p_Bu'_2(2\theta_{A2} - g_1) & \text{if } g_1 \in Q_2 \\ u'_2(g_1) & \text{if } g_1 \in Q_3 \\ -p_Au'_2(2\theta_{B2} - g_1) & \text{if } g_1 \in Q_4 \\ 0 & \text{if } g_1 \in Q_1 \cup Q_5. \end{cases} \quad (A12)$$

Thus $V''_i(g_1)$ exists and, by strict concavity of the stage utilities, $V''_i(g_1) \leq 0$ for all $i \in \{A, B\}$ and for all $g_1 \in Q_k$ for $k \in \{1, \ldots, 5\}$. \hfill \blacksquare

Returning to the proof of the proposition, we need to show that there exists a finite set of initial status quo $g_0$ that solve $f_j(g_0) = \overline{U}^*$. By Lemma A5, $f''_j(g_0) = u''_j(g_0) + \delta V''_j(g_0) < 0$ for any $g_0 \in \cup_{k \in \{1, \ldots, 5\}} Q_k$. Since $f_j(g_0)$ is strictly concave on $Q_k$ we have that $f_j(g_0) = \overline{U}^*$ has at most two solutions on $Q_k$ for each $k \in \{1, \ldots, 5\}$. Since $\mathbb{R}_+ \setminus \cup_{k \in \{1, \ldots, 5\}} Q_k$ includes at most a finite set of points \{2\theta_{A2} - \theta_{B2}, \theta_{A2}, \theta_{B2}, 2\theta_{B2} - \theta_{A2}\}, the set of solutions of $f_j(g_0) = \overline{U}^*$ on $\mathbb{R}_+$ is finite. \hfill \blacksquare

A3.3 Proof of Proposition 6

The strategy of the proof is to show that if $Z = \{0\} \times \mathbb{R}_+$ and $u_{it}(x_t) = -(x_t - \theta_{it})^2$ for all $i \in \{A, B\}$ and all $t$, then $\frac{\theta_{A1} - \theta_{A2}}{\theta_{B2} - \theta_{A2}} \in (0, \psi(\delta, p_A))$ implies that $f_A(g_1)$ has unique global maximum at $g_A^* < \theta_{A1}$ and $\frac{\theta_{B2} - \theta_{B1}}{\theta_{B2} - \theta_{A2}} \in (0, \psi(\delta, p_B))$ implies that $f_B(g_1)$ has unique global maximum at $g_B^* > \theta_{B1}$. For initial status quo $g_0 = g^*_i$ for some $i \in \{A, B\}$, this implies that the only proposal $i$ is willing to accept is $(0, g^*_i)$ and we know, by Proposition 1, that $0 + g^*_i \notin [\theta_{A1}, \theta_{B1}]$ is statically Pareto inefficient. That the inefficiency extends to a set $\mathcal{I}$ of non-zero measure follows from continuity of $f_i$ shown in the proof of Proposition 4 and from $g^*_i$ begin unique maximizer of $f_i$.

We will show that, under the remaining conditions of the proposition, $f_A(g_1)$ has unique global maximum with the claimed properties. Proof for $f_B$ is analogous and omitted in the sake of space. Because $\frac{\theta_{A1} - \theta_{A2}}{\theta_{B2} - \theta_{A2}} \in (0, \psi(\delta, p_A))$ cannot hold when $\theta_{A1} \leq \theta_{A2}$ or when $\theta_{A2} = \theta_{B2}$ when $\psi(\delta, p_A)$ is finite, throughout the proof assume $\theta_{A1} > \theta_{A2}$ and $\theta_{A2} < \theta_{B2}$.
These assumptions imply, denoting $\rho_A = \frac{\theta_{A1} - \theta_{A2}}{\theta_{B2} - \theta_{A2}}$, $\rho_A \in (0, \infty)$.

From the proof of Proposition 4 we know $f_A(g_1)$ is continuous function of $g_1$ on $\mathbb{R}_+$. From the proof of Lemma A5, we know that if $Z = \{0\} \times \mathbb{R}_+$ and $u_{it}(x_t) = -(x_t - \theta_{it})^2$ for all $i \in \{A, B\}$ and all $t$, then $V_A$ is continuously differentiable on $\mathbb{R}_+ \setminus \{2\theta_{A2} - \theta_{B2}, \theta_{A2}, \theta_{B2}, 2\theta_{B2} - \theta_{A2}\}$. Inspection of (A12) in the proof of Lemma A5 shows that $V_A(g_1)$ is increasing in $g_1$ on $[0, \theta_{A2}]$. Because $f_A(g_1) = u_{A1}(g_1) + \delta V_A(g_1)$ and $\theta_{A1} > \theta_{A2}$, $g_A^* > \theta_{A2}$ for any $g_A^* \in \arg \max_{g_1 \in \mathbb{R}_+} f_A(g_1)$. Using the same $Q_k$ intervals as in the proof of Lemma A5, $Q_3 = (\theta_{A2}, \theta_{B2})$, $Q_4 = (\theta_{B2}, 2\theta_{B2} - \theta_{A2})$ $Q_5 = (2\theta_{B2} - \theta_{A2}, \infty)$, this implies $g_A^* \in \{\{\theta_{B2}, 2\theta_{B2} - \theta_{A2}\}\cup(\bigcup_{k \in \{3, 4, 5\}} Q_k)$.

From (A12) and $\theta_{A2} < \theta_{B2}$, we have

$$
\lim_{g_1 \to \theta_{B2}^+} V_A'(g_1) = 0 < \lim_{g_1 \to \theta_{B2}^-} V_A'(g_1) = -p_A u_A'(\theta_{B2})
$$

(A13)

so that $\theta_{B2} \neq g_A^*$ and $f_A'(g_A^*) = 0$, where the latter condition is also sufficient for $g_A^*$ because $f_A$ is piecewise strictly concave by Lemma A5. Solving $f_A'(g_1) = 0$ for different intervals $Q_k$ gives

$$
g_{A,3}^* = \frac{\theta_{A1} + \delta \theta_{A2}}{1 + \delta} \quad g_{A,4}^* = \frac{\theta_{A1} + \delta p_A(2\theta_{B2} - \theta_{A2})}{1 + \delta p_A} \quad g_{A,5}^* = \theta_{A1}
$$

(A14)

where, for $k \in \{3, 4, 5\}$, $g_{A,k}^*$ is local maximum of $f_A$ if $g_{A,k}^* \in Q_k$. $g_{A,k}^* \in Q_k$ rewrites as $\rho_A \in (0, 1 + \delta)$ for $k = 3$, $\rho_A \in (1 - \delta p_A, 2)$ for $k = 4$ and $\rho_A \in (2, \infty)$ for $k = 5$. The remaining possibility, $f_A'(2\theta_{B2} - \theta_{A2}) = 0$, implies $u_A'(2\theta_{B2} - \theta_{A2}) = 0$ and rewrites as $\rho_A = 2$.

This implies that if $\rho_A \geq 2$, $f_A$ has unique global maximum at $g_A^* = \theta_{A1}$. If $\rho_A \in (0, 2)$, $f_A$ has global maximum either at $g_{A,3}^*$ or at $g_{A,4}^*$. Since, $g_{A,3}^* < \theta_{A1}$ if $g_{A,3}^* \in Q_3$ and $g_{A,4}^* > \theta_{A1}$ if $g_{A,4}^* \in Q_k$, we need to show that the condition ensuring that $g_{A,3}^*$ is unique global maximum of $f_A$ is $\rho_A \in (0, \psi(\delta, p_A))$. Direct evaluation, $g_{A,3}^* \in [\theta_{A2}, \theta_{B2}]$ with Proposition 4 part 2 and some algebra give

$$
f_A(g_{A,3}^*) = -\frac{\delta}{1 + \delta}(\theta_{A1} - \theta_{A2})^2
$$

$$
f_A(g_{A,4}^*) = -\frac{\delta p_A}{1 + \delta p_A}(2\theta_{B2} - \theta_{A2}) - (\theta_{A1} - \theta_{A2})^2
$$

(A15)

$$
- \delta(1 - p_A)(\theta_{B2} - \theta_{A2})^2.
$$
Further algebra shows that \( f_A(g_{A,3}^*) > f_A(g_{A,4}^*) \) implies \( \rho_A < \psi(\delta, p_A) \), where

\[
\psi(\delta, p) = (1 + \delta) \left[ 1 + \frac{1+p}{1-p} \left( \frac{1+\delta p}{1+\delta} - 1 \right) \right]. \tag{A16}
\]

What remains is to show \( \psi(\delta, p) \in (1, 1+\delta) \) (and hence \( \psi(\delta, p) > 1 \)), \( \frac{\partial \psi(\delta, p)}{\partial \delta} > 0 \), \( \frac{\partial \psi(\delta, p)}{\partial p} < 0 \) for any \( (\delta, p) \in (0, 1] \times (0, 1) \). \( \psi(\delta, p) < 1 + \delta \) is immediate as \( \frac{1+\delta p}{1+\delta} < 1 \) for any \( (\delta, p) \in (0, 1] \times (0, 1) \). \( \psi(\delta, p) > 1 \) for any \( (\delta, p) \in (0, 1] \times (0, 1) \) follows from \( \lim_{\delta \to 0^+} \psi(\delta, p) = 1 \) for any \( p \in (0, 1) \), obtained by direct evaluation, and \( \lim_{p \to 1^-} \psi(\delta, p) = 1 \) for any \( \delta \in (0, 1] \), obtained by application of L’Hopital’s rule, if we prove \( \frac{\partial \psi(\delta, p)}{\partial \delta} > 0 \) and \( \frac{\partial \psi(\delta, p)}{\partial p} < 0 \) for any \( (\delta, p) \in (0, 1] \times (0, 1) \).

The partial derivatives are

\[
\frac{\partial \psi(\delta, p)}{\partial \delta} = \frac{(1+p)[(1-p)+2p(1+\delta)]-4p(1+\delta)\sqrt{1+\delta p}}{2(1-p)(1+\delta)\sqrt{1+\delta p}}, \\
\frac{\partial \psi(\delta, p)}{\partial p} = \frac{4(1+\delta p)+\delta((1-p)(1+\delta))-4(1+\delta)\sqrt{1+\delta p}}{2(1-p)^2\sqrt{1+\delta p}}. \tag{A17}
\]

The denominator in each expression is strictly positive for any \( (\delta, p) \in (0, 1] \times (0, 1) \). Conditions for the numerators to have the claimed signs are

\[
(1-p)^2[(1+p)^2+4p(1+\delta)(1+\delta p)] > 0 \\
\delta(1-p)^2[8(1+\delta p) - \delta(1+p)^2] > 0 \tag{A18}
\]

and clearly hold for any \( (\delta, p) \in (0, 1] \times (0, 1) \).

\section*{A3.4 Efficiency with mandatory spending only}

\textbf{Proposition 11.} Under a budgetary institution that allows only mandatory spending programs, any equilibrium \( \sigma^* \) is dynamically Pareto efficient for any initial status quo \( g_0 \in \mathbb{R}_+ \), if any of the following conditions hold:

1. \( \theta_{A2} = \theta_{B2} \).

2. utilities are regular and \( \theta_{i1} = \theta_{i2} \) for all \( i \in \{A, B\} \).

We first prove part 1. When \( \theta_{A2} = \theta_{B2} \) by Proposition 4 part 1 part 1 \( \kappa_{i2}^*(g_1) + \gamma_{i2}^*(g_1) = \theta_{A2} \) for all \( i \in \{A, B\} \) and all \( g_1 \in \mathbb{R}_+ \). The continuation value of each party \( i \in \{A, B\} \) is thus \( V_i(g_1) = u_{i2}(\theta_{A2}) \) for all \( g_1 \in \mathbb{R}_+ \). Proposing party \( i \in \{A, B\} \) in the first period under
initial status quo $g_0$ thus makes a proposal that solves $\max_{(0,g_0) \in Z} u_i(g_1) + \delta u_j(\theta_{A2})$ subject to acceptance constraint by the responder $j \neq i$, $u_j^i(g_1) + \delta u_j(\theta_{A2}) \geq u_j^i(g_0) + \delta u_j(\theta_{A2})$. This problem is identical, safe for the constants, to $(SSP)$. $\kappa_{i1}^*(g_0) + \gamma_{i1}^*(g_0)$ for any $g_0 \in \mathbb{R}_+$ is thus statically Pareto efficient allocation in period 1. Because $\theta_{A2}$ is statically Pareto efficient allocation in period 2, by Lemma A3, $\{x_t^\sigma(g_0), x_{t2}^\sigma(g_0)\}$ with $x_t^\sigma(g_0) = \kappa_{i1}^*(g_0) + \gamma_{i1}^*(g_0)$ for any $i \in \{A, B\}$ and $x_{t2}^\sigma(g_0) = \theta_{A2}$ is statically Pareto efficient allocation in period $t$ for all $t$ and hence is dynamically Pareto efficient. Hence equilibrium $\sigma^*$ is dynamically Pareto efficient for any initial status quo $g_0 \in \mathbb{R}_+$.

We begin the proof of part 2 with the following lemma.

**Lemma A6.** Suppose utilities are regular and $\theta_{it}$ is constant in $t$ for all $i \in \{A, B\}$. Then an allocation $x$ is dynamically Pareto efficient if and only if $x = \{\bar{x}\}_{t=1}^T$ and $\bar{x} \in [\theta_{A1}, \theta_{B1}]$.

**Proof.** We first prove the only if part of the lemma: if $u_{it}(x_i) = u_i(x_i, \theta_{it})$ and $\theta_{it}$ is constant in $t$ for all $i \in \{A, B\}$, then any dynamically Pareto efficient allocation $x^*$ satisfies $x^* = \{\bar{x}\}_{t=1}^T$ with $\bar{x} \in [\theta_{A1}, \theta_{B1}]$.

If $x^* = \theta_A$, or $x^* = \theta_B$, then the result follows immediately. Until we prove the only if part, suppose $x^* \neq \theta_A$ and $x^* \neq \theta_B$.

Suppose $\theta_{A1} = \theta_{B1}$. By Proposition 2 part 1, $x_t^* = \theta_{it}$. If $\theta_{it}$ is constant in $t$ for all $i \in \{A, B\}$, then $\theta_{At} = \theta_{Bt}$ for any $t'$ $\neq t$ and by Proposition 2 part 1, $x_{t'}^* = \theta_{it'}$, which in turn implies that $x_{t'}^* = x_t^*$.

Suppose that $\theta_{A1} \neq \theta_{B1}$, then by Proposition 2 part 2 we have, for any $t$ and $t'$ $\neq t$, $\frac{u'_{At}(x^*_t)}{u'_{Bt}(x^*_t)} = \frac{u'_{At'}(x^*_t)}{u'_{Bt'}(x^*_t)}$.

Since $u_{it}(x_i) = u_i(x_i, \theta_{it})$, this implies that

$$\frac{\partial u_A(x_t^*, \theta_{At})/\partial x}{\partial u_B(x_t^*, \theta_{Bt})/\partial x} = \frac{\partial u_A(x_{t'}^*, \theta_{At'})/\partial x}{\partial u_B(x_{t'}^*, \theta_{Bt'})/\partial x}.$$  

As shown in the proof of Lemma 1, the solution to $-\frac{u'_{At}(x)}{u'_{Bt}(x)} = \lambda^*$ is unique for any $\lambda^* > 0$ and $t$. Therefore the solution to $-\frac{\partial u_A(x, \theta_{At})/\partial x}{\partial u_B(x, \theta_{Bt})/\partial x} = \lambda^*$ is unique for any pair of $(\theta_{At}, \theta_{Bt})$. Since $\theta_{it} = \theta_{it'}$ for all $i \in \{A, B\}$, it follows that we have $x_{t'}^* = x_t^*$.

We now prove the if part of the lemma: if $u_{it}(x_i) = u_i(x_i, \theta_{it})$ and $\theta_{it}$ is constant in $t$
for all \( i \in \{A, B\} \), then any \( x = \{\tilde{x}\}_{t=1}^T \) with \( \tilde{x} \in [\theta_{A1}, \theta_{B1}] \) is dynamically Pareto efficient allocation.

If \( \theta_{it} \) is constant in \( t \) for all \( i \in \{A, B\} \), then from the previous part \( x^* = \{\tilde{x}\}_{t=1}^T \) for some \( \tilde{x} \). We can thus rewrite (DSP) as \( \max_{\tilde{x} \in R_+} u_i(\tilde{x}; \theta_{i1}) \sum_{t=1}^T \delta^{t-1} \) subject to \( u_j(\tilde{x}; \theta_{j1}) \sum_{t=1}^T \delta^{t-1} \geq U \), which is equivalent to (SSP). By Proposition 4 if \( \tilde{x} \in [\theta_{A1}, \theta_{B1}] \), then \( \tilde{x} \) solves (SSP). 

Take any equilibrium \( \sigma^* \). We show that the equilibrium allocation \( x^\sigma(g_0) \) satisfies \( x^\sigma_1(g_0) = x^\sigma_2(g_0) \in [\theta_{A1}, \theta_{B1}] \) for any \( g_0 \in \mathbb{R}_+ \), which, by Lemma A6, implies that \( \sigma^* \) is dynamically Pareto efficient for any \( g_0 \in \mathbb{R}_+ \). To prove that \( x^\sigma_1(g_0) = x^\sigma_2(g_0) \in [\theta_{A1}, \theta_{B1}] \) for any \( g_0 \in \mathbb{R}_+ \), it suffices to show that \( \gamma^*_{i1}(g_0) \in [\theta_{A1}, \theta_{B1}] \) for any \( g_0 \in \mathbb{R}_+ \) and any \( i \in \{A, B\} \). When only mandatory spending programs are allowed, \( \kappa^*_{i1}(g_{i-1}) = 0 \) for any \( i \in \{A, B\} \) and any \( t \), so that \( x^\sigma_1(g_0) = \gamma^*_{i1}(g_0) \) and \( x^\sigma_2(g_0) = \gamma^*_{j2}(\gamma^*_{i1}(g_0)) \) for some \( i, j \in \{A, B\} \). When \( \theta_{A2} = \theta_{B2} \) (so that \( \theta_{A1} = \theta_{B1} \)), \( \gamma^*_{i1}(g_0) \in [\theta_{A1}, \theta_{B1}] \) rewrites as \( \gamma^*_{i1}(g_0) = \theta_{A1} \) and, by Proposition 4 part 1 \( \gamma^*_{j2}(\gamma^*_{i1}(g_0)) = \theta_{A2} \). When \( \theta_{A2} \neq \theta_{B2} \), \( \gamma^*_{i1}(g_0) \in [\theta_{A1}, \theta_{B1}] \) implies, by Proposition 4 part 2 \( \gamma^*_{j2}(\gamma^*_{i1}(g_0)) = \gamma^*_{i1}(g_0) \).

We now show that \( \gamma^*_{i1}(g_0) \in [\theta_{A1}, \theta_{B1}] \) for any \( g_0 \in \mathbb{R}_+ \) and any \( i \in \{A, B\} \). Suppose there exists \( i \in \{A, B\} \) and \( g_0 \in \mathbb{R}_+ \) such that \( \gamma^*_{i1}(g_0) \notin [\theta_{A1}, \theta_{B1}] \). We claim that this contradicts \( \gamma^*_{i1} \) being part of equilibrium \( \sigma^* \). The desired contradiction follows from the fact that if \( \theta_{A1} = \theta_{A2}, \theta_{B1} = \theta_{B2} \) and \( u_{it}(x_t) = u_t(x_t, \theta_{it}) \), then for any \( g_1 \in \mathbb{R}_+ \setminus [\theta_{A2}, \theta_{B2}] \), there exists \( \tilde{g}(g_1) \in [\theta_{A2}, \theta_{B2}] \) such that \( f_A(g_1) < f_A(\tilde{g}(g_1)) \) and \( f_B(g_1) < f_B(\tilde{g}(g_1)) \).

To see that \( \tilde{g}(g_1) \) exists for any \( g_1 \in \mathbb{R}_+ \setminus [\theta_{A2}, \theta_{B2}] \) and has the claimed properties, let \( \tilde{g}(g_1) = p_A(\kappa^*_{A2}(g_1) + \gamma^*_{A2}(g_1)) + p_B(\kappa^*_{B2}(g_1) + \gamma^*_{B2}(g_1)) \). When \( \theta_{A2} = \theta_{B2} \), \( \tilde{g}(g_0) = \theta_{A2} \) by Proposition 4 part 1 and \( f_A(g_1) < f_A(\tilde{g}(g_1)) \) and \( f_B(g_1) < f_B(\tilde{g}(g_1)) \) for any \( g_1 \in \mathbb{R}_+ \setminus \{\theta_{A2}\} \) are immediate. When \( \theta_{A2} \neq \theta_{B2} \), we consider the case when \( g_1 < \theta_{A2} \). When \( g_1 > \theta_{B2} \) the argument is similar and omitted. From the proof of Proposition 4 we know that if \( g_1 < \theta_{A2} \), then \( \kappa^*_{A2}(g_1) + \gamma^*_{A2}(g_1) = \theta_{A2} \) and \( \kappa^*_{B2}(g_1) + \gamma^*_{B2}(g_1) > \theta_{A2} \). Because of the restriction to mandatory spending only, this rewrites as \( \gamma^*_{A2}(g_1) = \theta_{A2} \) and \( \gamma^*_{B2}(g_1) > \theta_{A2} \). We also have \( \gamma^*_{B2}(g_1) \leq \theta_{B2} \) by Proposition 4 part 1. From \( \gamma^*_{A2}(g_1) = \theta_{A2} < \gamma^*_{B2}(g_1) \in (\theta_{A2}, \theta_{B2}] \) for any \( g_1 < \theta_{A2}, \tilde{g}(g_1) \in (\theta_{A2}, \gamma^*_{B2}(g_1)) \subseteq [\theta_{A2}, \theta_{B2}] \) for any \( g_1 < \theta_{A2} \). This implies, for any \( g_1 < \theta_{A2} \),
The inequality rewrites as
\[ x \leq u_{A2}(\gamma_{B2}^*(g_1)) < u_{A2}(\bar{g}(g_1)) \],
where the weak inequality follows from A’s acceptance of \( \gamma_{B2}^*(g_1) \) under status quo \( g_1 \) and the remaining inequalities follow from \( \bar{g}(g_1) \in (\theta_{A2}, \gamma_{B2}^*(g_1)) \). Since \( u_{it}(x_i) = u_i(x_i, \theta_{it}) \) and \( \theta_{i1} = \theta_{i2} \) for all \( i \in \{A, B\} \), \( u_{i1}(g_1) < u_{i1}(\bar{g}(g_1)) \) for any \( i \in \{A, B\} \) and any \( g_1 < \theta_{A2} \).

What remains is to show that \( V_i(g_1) < V_i(\bar{g}(g_1)) \) for any \( i \in \{A, B\} \) and any \( g_1 < \theta_{A2} \). The inequality rewrites as
\[
p_A u_{i2}(\theta_{A2}) + p_B u_{i2}(\gamma_{B2}^*(g_1)) < u_{i2}(\bar{g}(g_1)) = u_{i2}(p_A \theta_{A2} + p_B \gamma_{B2}^*(g_1)).
\] (A19)
The left hand side simply substitutes into definition of \( V_i \). The right hand side follows from Proposition 4 part 2 and \( \bar{g}(g_1) \in [\theta_{A2}, \theta_{B2}] \). Note that the left hand side is expected utility of a lottery over spending levels \( \theta_{A2} \) and \( \gamma_{B2}^*(g_1) \), while the right hand side is utility of expected spending under the same lottery. By strict concavity of \( u_{i2} \) for \( i \in \{A, B\} \), the inequality holds and hence \( V_i(g_1) < V_i(\bar{g}(g_1)) \) for any \( g_1 < \theta_{A2} \).

\[ \Box \]

A4 State-contingent mandatory spending

A4.1 Proof of Proposition 9

We prove part 1 by contradiction. Suppose \( x_i^t \neq x_i^{t'} \) for some \( t \neq t' \). Then there exists \( s \in S \) such that \( x_i^s(s) \neq x_i^{s'}(s) \). Without loss of generality, assume \( x_i^s(s) < x_i^{s'}(s) \).

From strict concavity of \( u_i \), we have \( \alpha u_i(x_i^t(s), s) + (1 - \alpha) u_i(x_i^{s'}(s), s) < u_i(\alpha x_i^t(s) + (1 - \alpha) x_i^{s'}(s), s) \) for any \( \alpha \in (0, 1) \). Let \( \alpha = \frac{\delta^{t-1}}{\delta^{t-1} + \delta^{t'-1}} \in (0, 1) \) and \( x' = \alpha x_i^t(s) + (1 - \alpha) x_i^{s'}(s) \), we have
\[
\delta^{t-1} u_i(x_i^s(s), s) + \delta^{t'-1} u_i(x_i^{s'}(s), s) < (\delta^{t-1} + \delta^{t'-1}) u_i(x', s),
\] (A20)
which contradicts that \( x^* \) is a solution to \( \text{DSP-S} \).

Next we prove part 2. Fix \( i, j \in \{A, B\} \) with \( i \neq j \). For any \( U > \sum_{t=1}^T \delta^{t-1} E_s[u_j(\theta_{js}, s)] \), \( \text{DSP-S} \) has no solution, so assume \( U \leq \sum_{t=1}^T \delta^{t-1} E_s[u_j(\theta_{js}, s)] \).

For \( U = \sum_{t=1}^T \delta^{t-1} E_s[u_j(\theta_{js}, s)] \), the solution to \( \text{DSP-S} \) is \( x_j^s(s) = \theta_{js} \) for all \( t \) and \( s \in S \) and for any \( U \leq \sum_{t=1}^T \delta^{t-1} E_s[u_j(\theta_{is}, s)] \), the solution to \( \text{DSP-S} \) is \( x_j^s(s) = \theta_{is} \) for all \( t \) and \( s \in S \). What remains is the case when \( U \in (\sum_{t=1}^T \delta^{t-1} E_s[u_j(\theta_{js}, s)]; \sum_{t=1}^T \delta^{t-1} E_s[u_j(\theta_{js}, s)]) \).
From the Lagrangian for (DSP-S), the first order necessary condition with respect to \( x_t(s) \) for any \( t \) and \( s \in S \) is
\[
\delta^{t-1}u_i'(x_t^{*}(s),s) + \lambda^* \delta^{t-1}u_j'(x_t^{*}(s),s) = 0
\]
for some \( \lambda^* \in (0, \infty) \), which simplifies to
\[
\frac{u_i'(x_t^{*}(s),s)}{u_j'(x_t^{*}(s),s)} = \lambda^*.
\]

**A4.2 Proof of Proposition 10**

Suppose the state in period 1 is \( s_1 \). Consider the following problem:

\[
\max_{\{x_t : S \to \mathbb{R}_+\}^T_{t=1}} u_i(x_1(s_1), s_1) + \sum_{t=2}^{T} \delta^{t-1}E_s[u_i(x_t(s), s)]
\]

s.t. \( u_j(x_1(s_1), s_1) + \sum_{t=2}^{T} \delta^{t-1}E_s[u_j(x_t(s), s)] \geq U' \).

Also, analogous to the proof of Proposition 7, consider the following alternative way of writing the social planner’s problem:

\[
\max_{\{x_t^A, x_t^B : S \to \mathbb{R}_+\}^T_{t=1}} u_i(x_1^{A}(s_1), s_1) + \sum_{t=2}^{T} \delta^{t-1}E_s[p_Au_i(x_t^{A}(s), s) + p_Bu_i(x_t^{B}(s), s)]
\]

s.t. \( u_j(x_1^{A}(s_1), s_1) + \sum_{t=2}^{T} \delta^{t-1}E_s[p_Au_j(x_t^{A}(s), s) + p_Bu_j(x_t^{B}(s), s)] \geq U' \).

Since \( u_A \) and \( u_B \) are strictly concave in \( x \) for all \( s \), clearly any solution to (DSP-\( S'' \)) satisfies \( x_t^{A}(s) = x_t^{B}(s) \) for all \( t \) and \( s \). So we can just consider (DSP-\( S' \)).

**Lemma A7.** If \( x \) is a solution to (DSP-\( S \)), then or any \( t, t' \geq 2 \), \( x_t = x_{t'} \). Moreover, \( x_1(s_1) = x_t(s_1) \) for \( t \geq 2 \).

The proof of Lemma A7 is immediate from the proof of Proposition 9. We then have the following result.

**Lemma A8.** If \( x \) is a solution to (DSP-\( S \)) for some \( U \), then it is a solution to (DSP-\( S' \)) for some \( U' \). If \( x \) is a solution to (DSP-\( S' \)) for some \( U' \) and it satisfies that \( x_1(s) = x_t(s) \) for \( t \geq 2 \) and for all \( s \), then \( x \) is a solution to (DSP-\( S \)) for some \( U \).

**Proof.** Fix \( i, j \in \{A, B\} \) with \( i \neq j \) and \( s_1 \in S \). Note that (DSP-\( S \)) with \( x_1(s) \) for \( s \in S \setminus \{s_1\} \) held constant is equivalent to (DSP-\( S' \)) and that \( x_1(s) \) for \( s \in S \setminus \{s_1\} \) do not enter either
the objective function or the constraint in (DSP-S'). Hence if \( x \) is a solution to (DSP-S) with \( U, (x_1(s_1), \{x_t : S \to \mathbb{R}_+\}_{t=2}) \) is a solution to (DSP-S) with \( x_1(s) \) for \( s \in S \setminus \{s_1\} \) held constant and hence \( x \) is a solution to (DSP-S') with \( U' = U - \mathbb{E}_{s \in S \setminus \{s_1\}}[u_j(x_1(s), s)] \). Similarly, if \( x \) with \( x_1(s) = x_i(s) \) for \( t \geq 2 \) and for all \( s \in X \) solves (DSP-S) with \( U' \), \( (x_1(s_1), \{x_t : S \to \mathbb{R}_+\}_{t=2}) \) is a solution to (DSP-S) with \( x_1(s) \) for \( s \in S \setminus \{s_1\} \) held constant and hence \( x \) is a solution to (DSP-S) with \( U = U' + \mathbb{E}_{s \in S \setminus \{s_1\}}[u_j(x_1(s), s)] \).

We prove Proposition 10 by establishing Lemmas A9 and A10 below. With slight abuse of terminology, we call a spending rule \( g \in \mathcal{M} \) dynamically Pareto efficient if \( \{g_t\}_{t=1}^T \) with \( g_t = g \) for all \( t \) is a dynamically Pareto efficient allocation rule.

**Lemma A9.** For any \( t \), if the status quo \( g_{t-1} \) is dynamically Pareto efficient, then \( \gamma_{it}(g_{t-1}, s_t) = g_{t-1} \) for all \( s_t \in S \) and all \( i \in \{A, B\} \).

**Proof.** Suppose the state in period \( t \) is \( s_t \). For any status quo \( g_{t-1} \) in period \( t \), the proposer \( i \)'s equilibrium continuation payoffs are weakly higher than \( u_i(g_{t-1}(s_t), s_t) + \sum_{t'=t+1}^T \delta^{t'-t} \mathbb{E}_s[u_i(g_{t-1}(s), s)] \) and the responder \( j \)'s equilibrium continuation payoffs are weakly higher than \( u_j(g_{t-1}(s_t), s_t) + \sum_{t'=t+1}^T \delta^{t'-t} \mathbb{E}_s[u_j(g_{t-1}(s), s)] \). To see this, note that for any status quo in any period, a responder accepts a proposal if the same as the status quo, so a proposer can maintain the status quo by proposing it. Hence, proposer \( i \) can achieve the payoff above by proposing to maintain the status quo in period \( t \) and in future periods continue to propose to maintain the status quo if it is the proposer and rejects any proposal other than the status quo if it is the responder. Similarly, responder \( j \) can achieve the payoff above by rejecting any proposal other than the status quo in period \( t \) and in future periods continue to reject any proposal other than the status quo if it is the responder and propose to maintain the status quo if it is the proposer.

Consider proposer \( i \)'s problem in period \( t \)

\[
\max_{g_t \in \mathcal{M}} \quad u_i(g_t(s_t), s_t) + \delta V_{it}(g_t; \sigma^*)
\]

subject to

\[
u_j(g_t(s_t), s_t) + \delta V_{jt}(g_t; \sigma^*) \geq u_j(g_{t-1}(s_t), s_t) + \delta V_{jt}(g_{t-1}; \sigma^*),
\]

where \( V_{it}(g; \sigma^*) \) is the expected discounted utility of party \( i \in \{A, B\} \) in period \( t \) generated by
strategies $\sigma^*$ when the status quo is $g$. As shown in the previous paragraph, $u_j(g_{t-1}(s_t), s_t) + \delta V_{jt}(g_{t-1}, \sigma^*) \geq u_j(g_{t-1}(s_t), s_t) + \sum_{t'=t+1}^{T} \delta^{t'-t}E_s[u_j(g_{t-1}(s), s)]$.

Suppose the solution to the proposer’s problem in period $t$ is $g_{t}^* \neq g_{t-1}$. Then there exist an allocation with $x_t = g_t^*$ and future allocations induced by status quo $g_t^*$ and $\sigma^*$ such that party $i$’s dynamic payoff is higher than $u_i(g_{t-1}(s_t), s_t) + \sum_{t'=t+1}^{T} \delta^{t'-t}E_s[u_i(g_{t-1}(s), s)]$ and party $j$’s dynamic payoff is higher than $u_j(g_{t-1}(s_t), s_t) + \sum_{t'=t+1}^{T} \delta^{t'-t}E_s[u_j(g_{t-1}(s), s)]$. But if $g_{t-1}$ is dynamically Pareto efficient, then having allocation in all periods $t' \geq t$ equal to $g_{t-1}$ is a solution to $(DSP-S)$ with $U = u_j(g_{t-1}(s_t), s_t) + \sum_{t'=t+1}^{T} \delta^{t'-t}E_s[u_j(g_{t-1}(s), s)]$, a contradiction.

Lemma A10. For any initial status quo $g_0$ and any $s_1 \in S$, the proposer makes a proposal in period 1 that is dynamically Pareto efficient, that is, $\gamma_{i1}(g_0, s_1)$ is dynamically Pareto efficient for all $i \in \{A, B\}$.

Proof. Fix $g_0$ and $s_1$. Let $f_j(g_0, s_1)$ be the responder $j$’s status quo payoff. That is,

$$f_j(g_0, s_1) = u_j(g_0(s_1), s_1) + \delta V_{j1}(g_0; \sigma^*)$$

Let $U' = f_j(g_0, s_1)$ and denote the solution to $(DSP-S)$ by $x(U') = (x_1(U'), ..., x_T(U'))$. By Lemma A7, $x_t(U') = x_t'(U')$ for any $t, t' \geq 2$. Without loss of generality, suppose $x(U')$ satisfies $x_1(U') = x_t(U')$ for $t \geq 2$. Note that $x_1(U')$ is a dynamically Pareto efficient allocation.

We next show that $\gamma_{i1}^*(g_0, s_1) = x_1(U')$. First note that if $\gamma_{i1}^*(g_0, s_1) = x_1(U')$, then, since $x_1(U')$ is dynamically Pareto efficient, by Lemma A9, the induced equilibrium allocation is $x(U')$. We show by contradiction that $\gamma_{i1}^*(g_0, s_1) = x_1(U')$ is the solution to the proposer’s problem. Suppose not. Then proposing $\gamma_{i1}^*(g_0, s_1)$ is strictly better than proposing $x_1(U')$, that is, proposing $\gamma_{i1}^*(g_0, s_1)$ gives $i$ a strictly higher dynamic payoff while giving $j$ a dynamic payoff at least as high as $f_j(g_0, s_1)$. But since $x(U')$ is a solution to $(DSP-S)$ and hence a solution to $(DSP-S')$, this is a contradiction.