

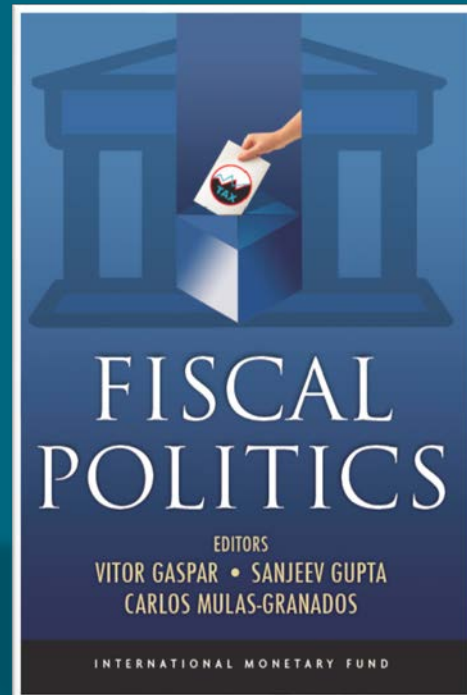
Politics of Fiscal Policy: What do we know

Sanjeev Gupta

XXX REGIONAL FISCAL POLICY SEMINAR

Santiago 26-28 March 2018

Drawn From a Recent Book Published by the IMF Last Year



Outline

- I. Why Focus on Political Economy of Fiscal Policy
- II. Nexus Between Politics and Fiscal Policy: Elections, Divisions and Ideology
- III. Fiscal Rules and Fiscal Institutions
- IV. Supranational Fiscal Politics
- V. Main Policy Messages

I. Rationale

- Economics and politics are co-determined, especially with regard to fiscal policy.
- The government's three core functions are inherently political in nature:
 - Allocation
 - Stabilization
 - Redistribution

I. Rationale

- What is different in the results?
 - Unlike previous studies which focused mainly on advanced economies, the sample also contains emerging and developing countries
 - The results go beyond electoral politics and use various electoral calendar variables, measures of political fragmentation, and indicators of ideological polarization to explain how political factors affect fiscal outcomes
 - The results further look at the role that fiscal institutions can play in bringing fiscal outcomes closer to their optimum

II. Politics and Fiscal Policy

Fiscal Outcomes



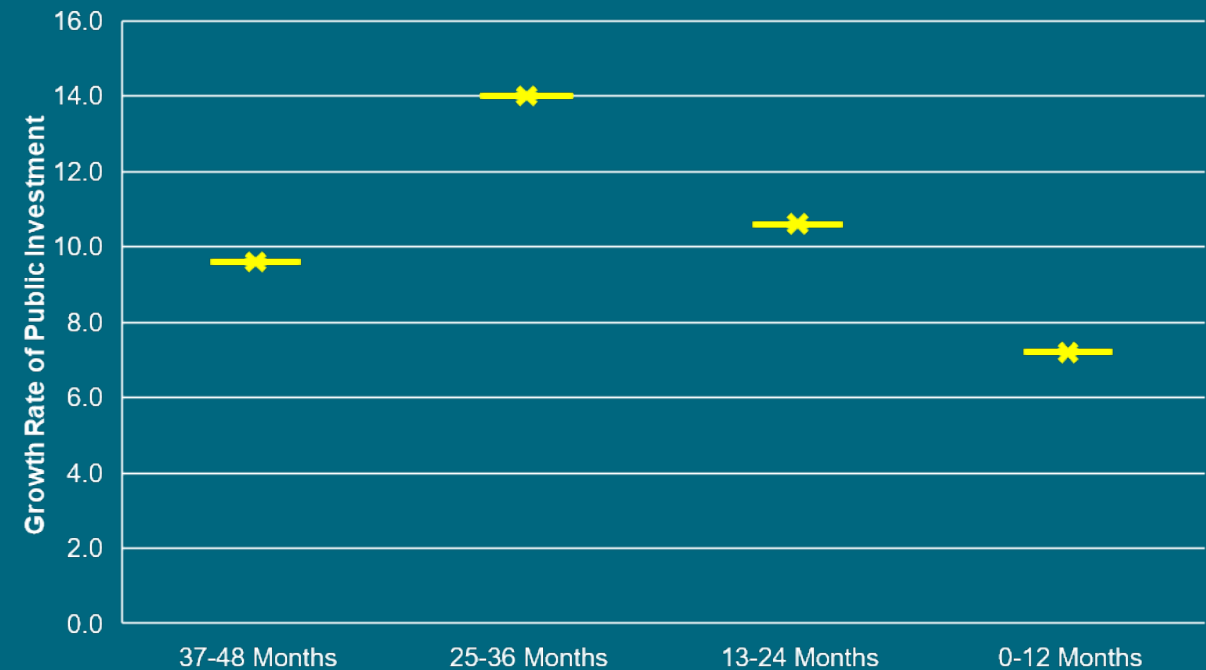
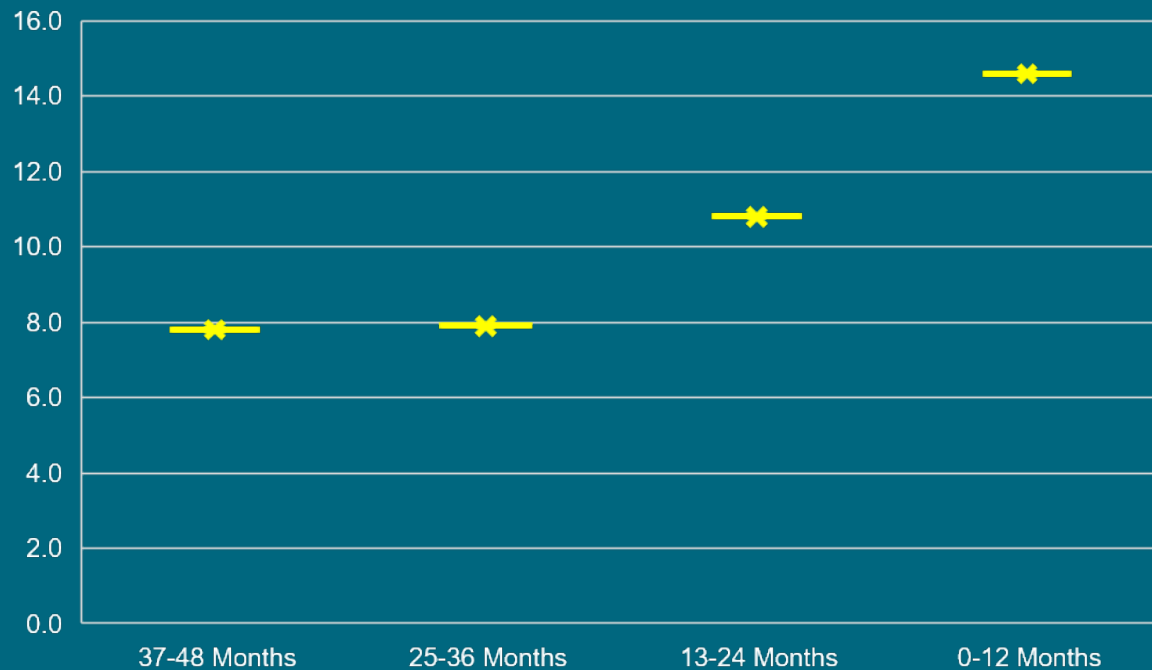
Political Factors

- *Elections*
- *Political Divisions*
- *Ideology*

II. Impact of Elections

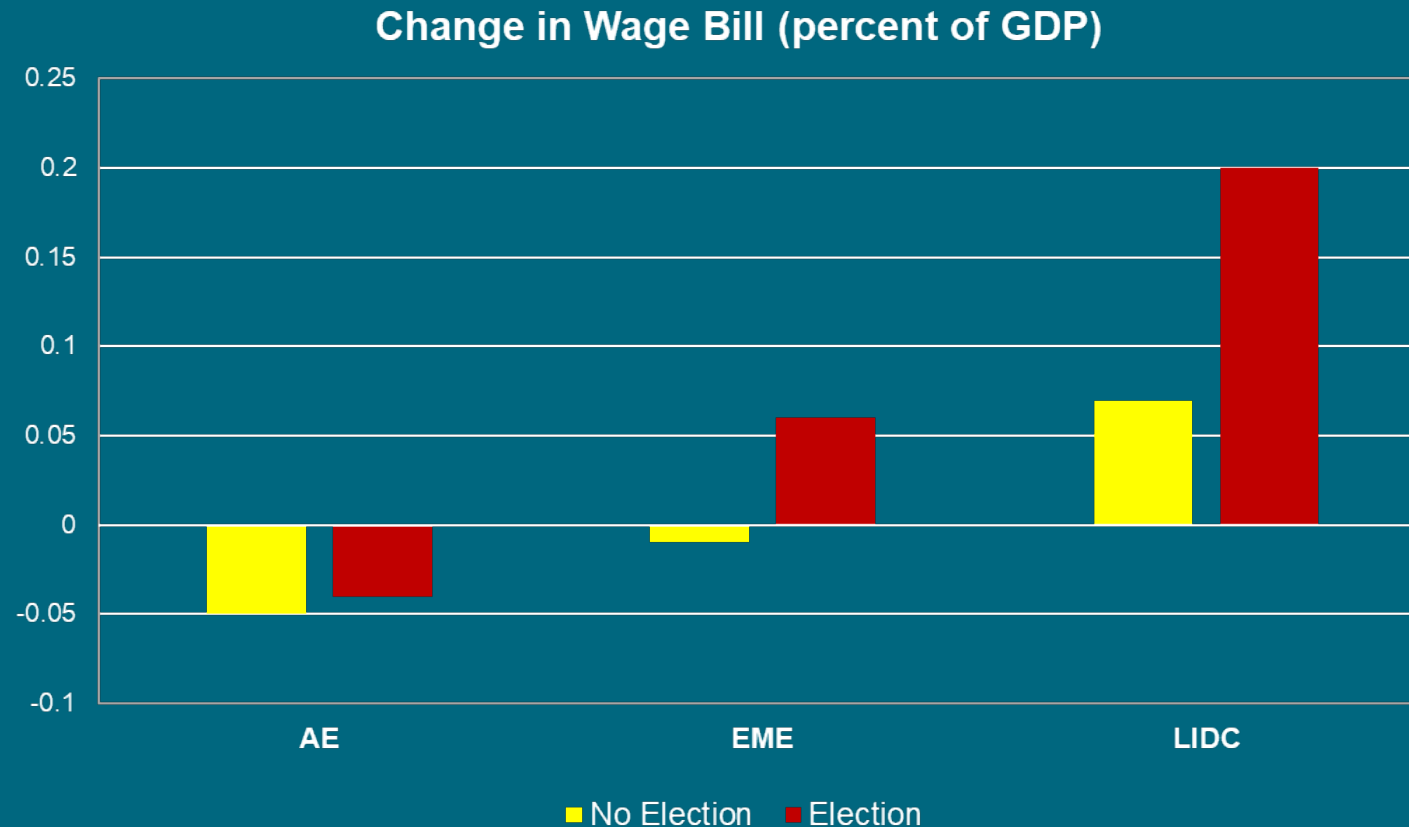
On fiscal deficits: up to 1% of GDP higher deficits during election years, with pressure coming from the wage side, particularly in emerging and developing countries

On budget's composition: growth rate of public consumption grows and that of public investment declines as elections approach (Rogoff, 1990)

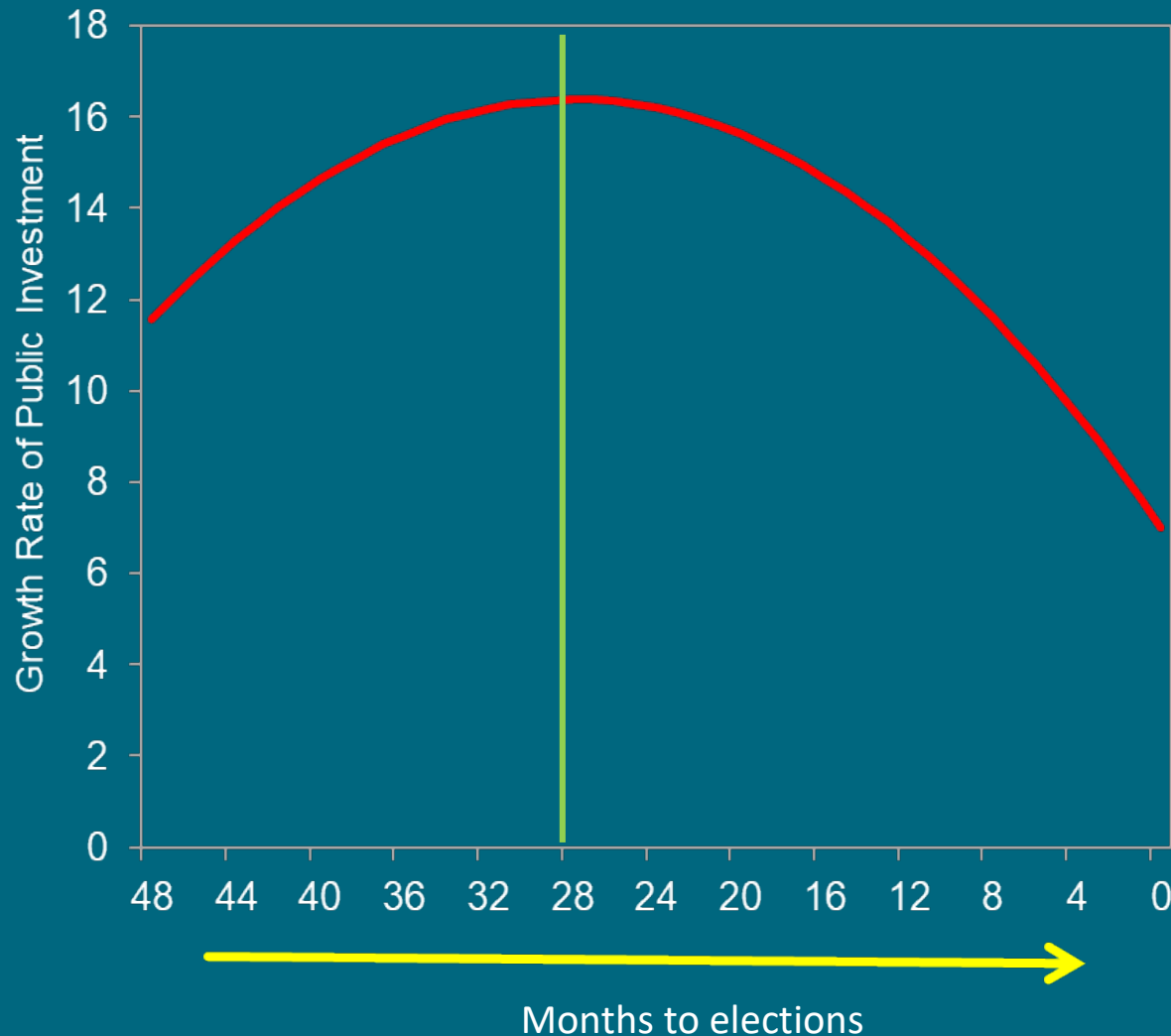


II. Impact of Elections

On budget's composition: public wages grow before elections



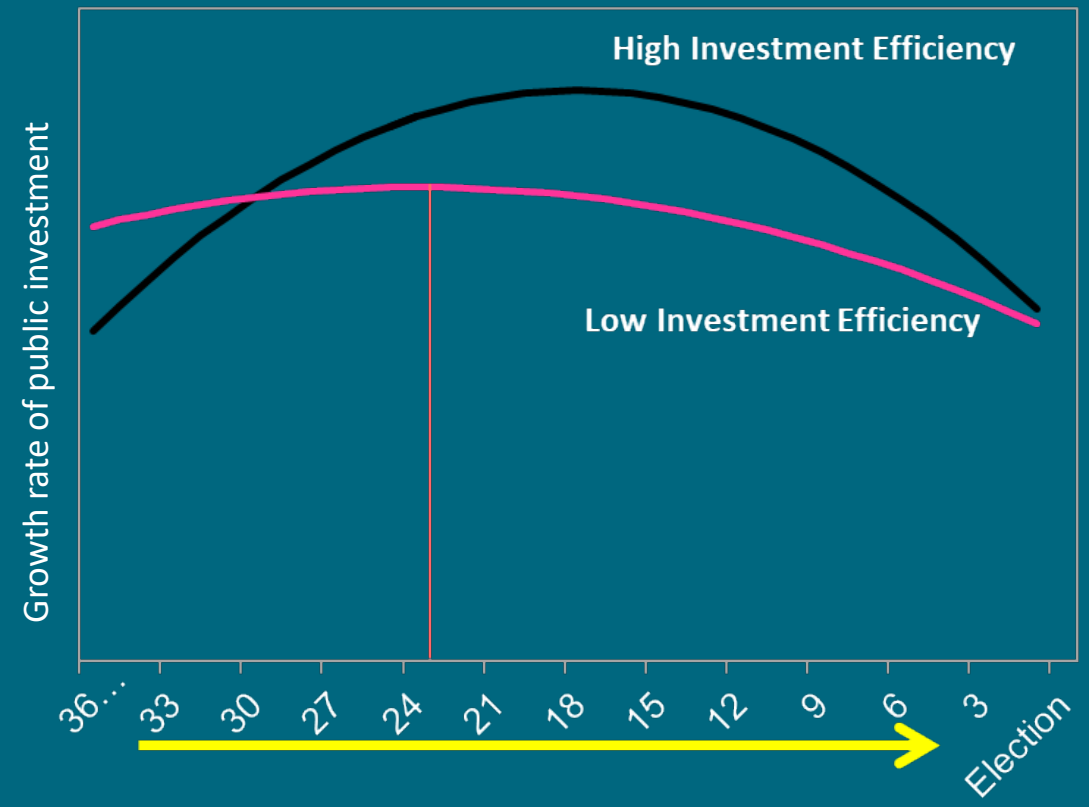
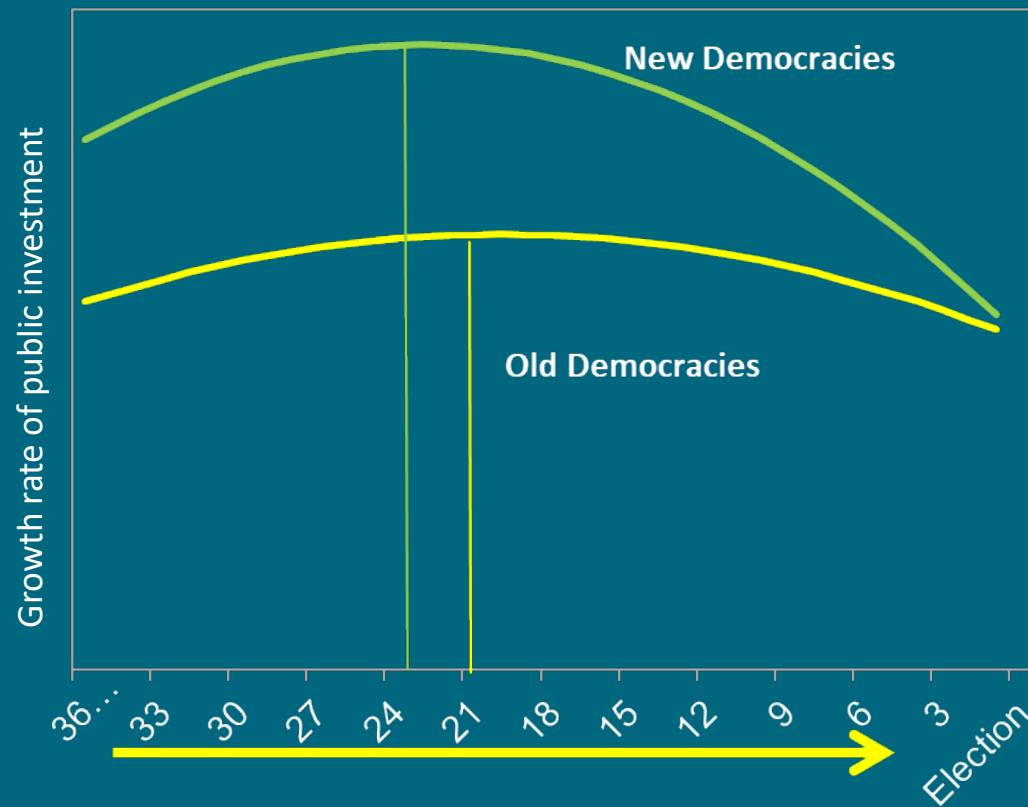
II. Impact of Elections



The second way spending composition is affected by electoral investment cycles: the growth rate of public investment peaks about 28 months before elections.

II. Impact of Elections

Electoral investment cycles (cont'd): Institutions and governance matter



II. Impact of Elections

The tax side also affected as probability of tax reform in Latin America declines as elections approach

Figure 3. Marginal Effect of Crises on the Probability of Increasing Taxes According to the Electoral Calendar

Figure 3a. VAT Taxes

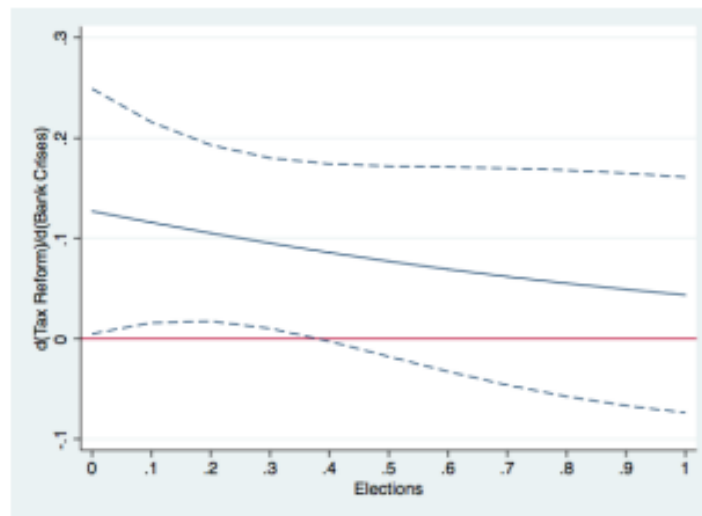
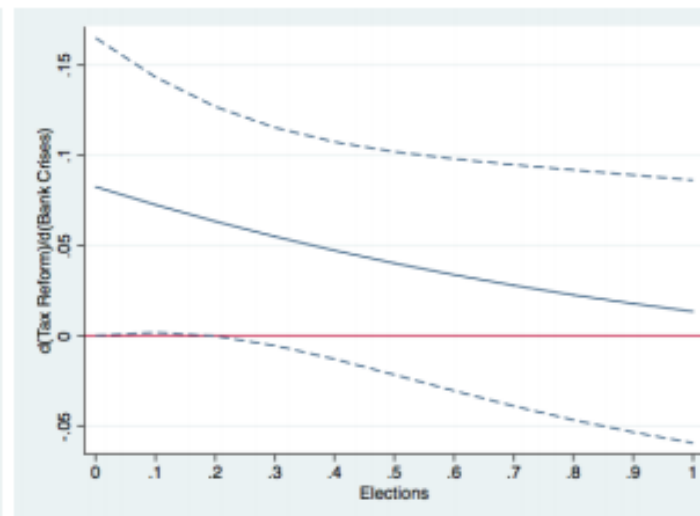


Figure 3b. Personal Income Taxes

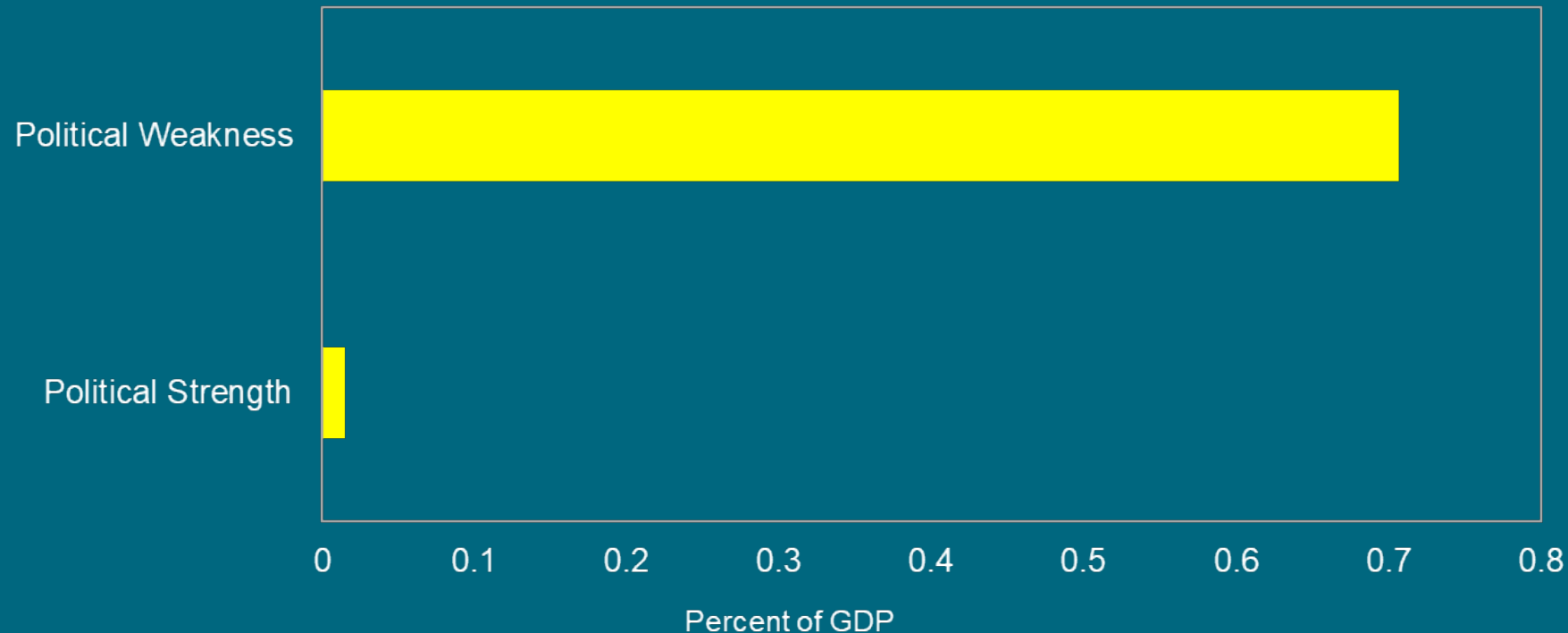


Source: Authors' calculations based on data from Focanti, Hallerberg and Scartascini (2016).

II. Impact of Political Divisions

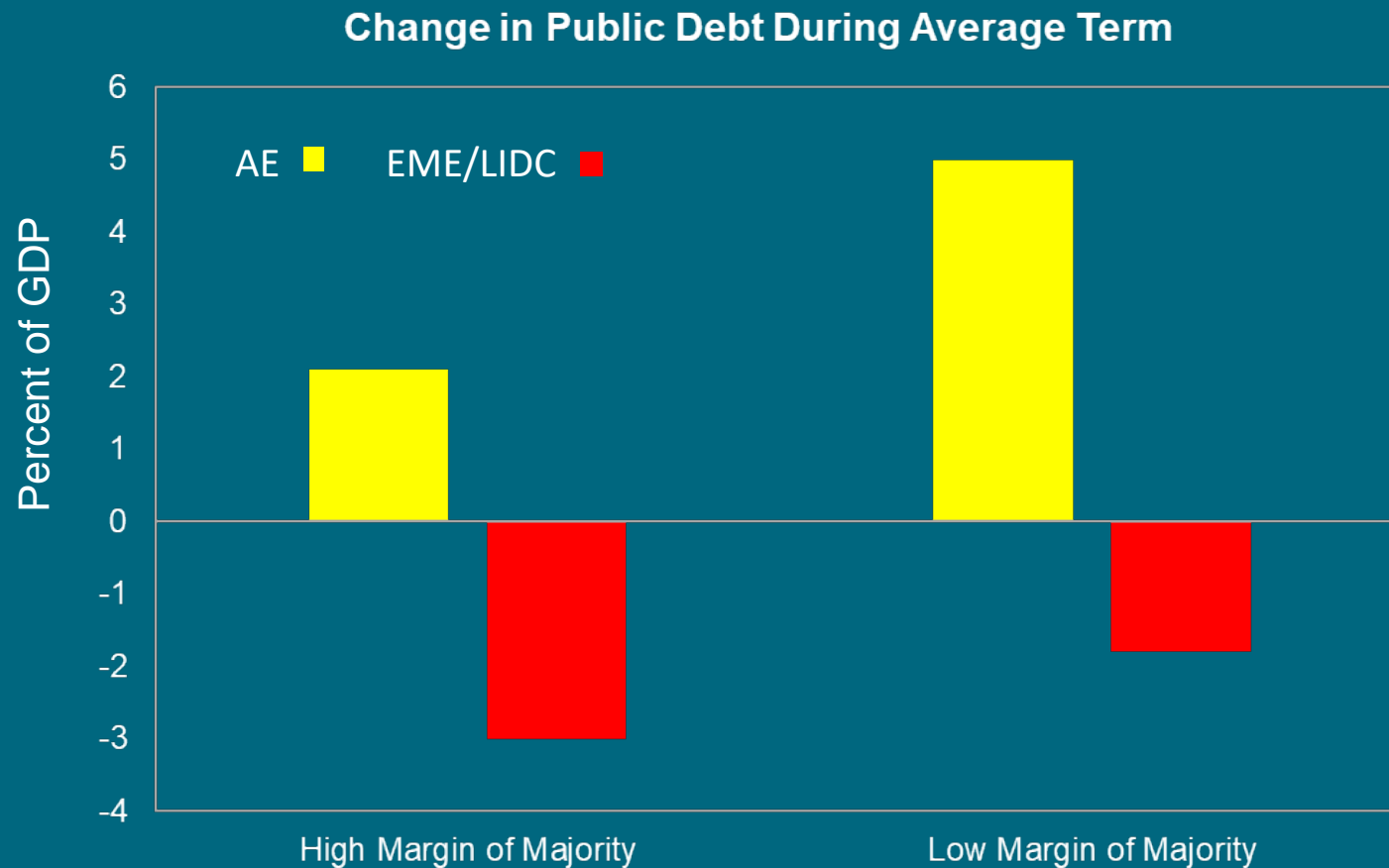
Political divisions are associated with large deviations between promised adjustment in fiscal deficit and actual outcome.

Size of Fiscal Consolidation Promise Gap



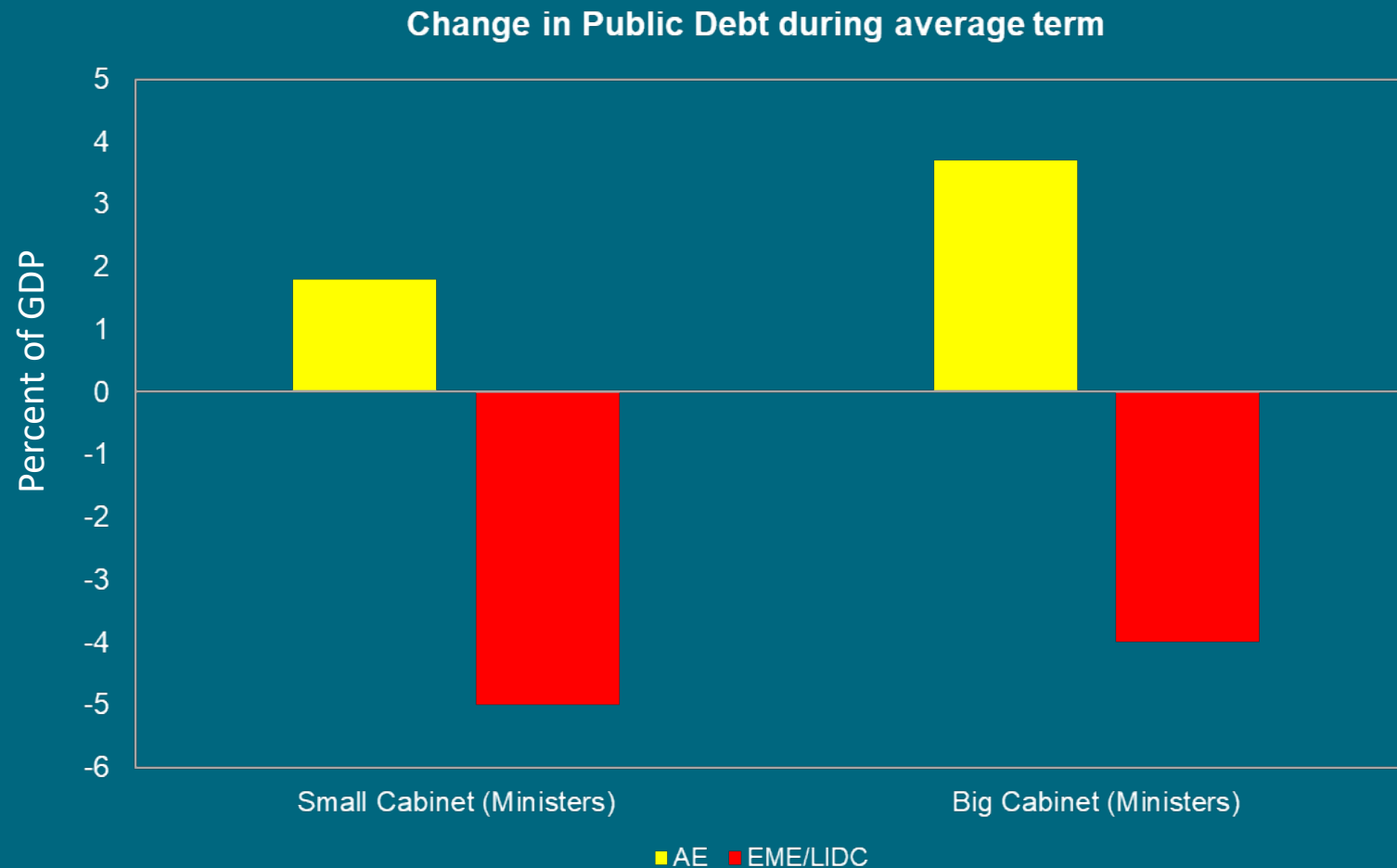
II. Impact of Political Divisions

Weaker majorities are associated with larger debt accumulation in AEs and with smaller debt reduction in EME/LIDCs, during the electoral cycle.



II. Impact of Political Divisions

Big cabinets (with many ministers) accumulate much more public debt than small cabinets



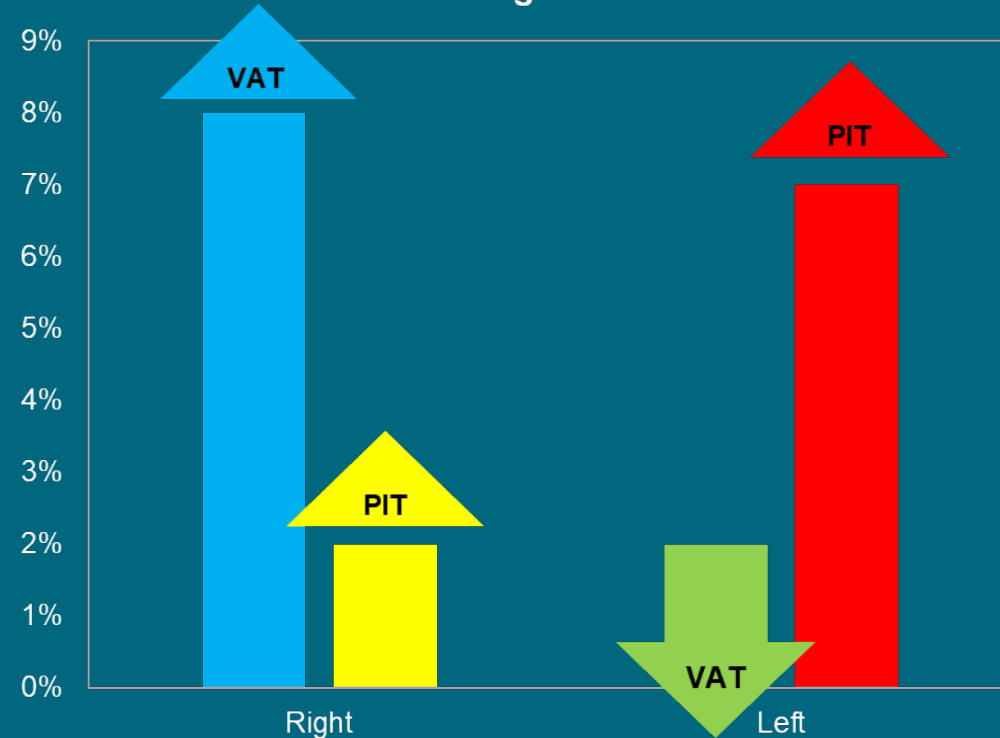
II. Impact of Ideology

IDEOLOGY AND TAXES:

Right wing governments are more likely to increase the VAT rates during crises, while left governments prefer to increase top-personal income taxes.



Probability of Raising/Cutting Taxes during Banking Crises

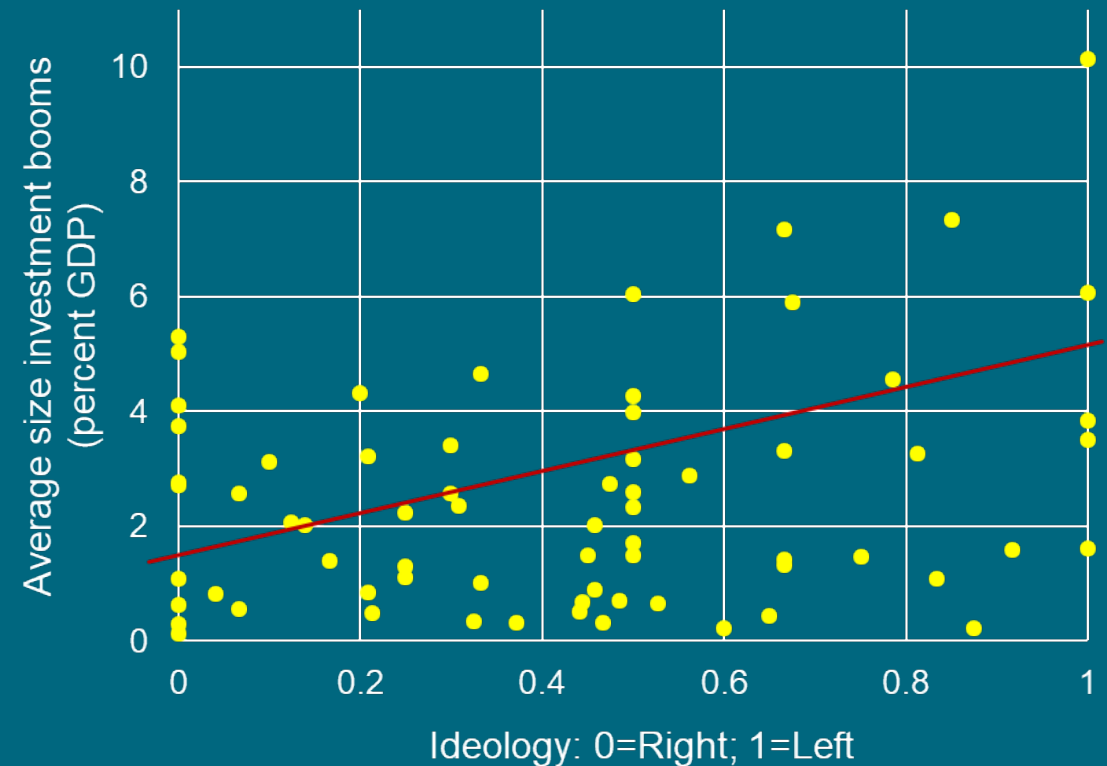


II. Finally the Impact of Ideology

IDEOLOGY AND SPENDING:



Left-wing governments are associated with larger public investment booms

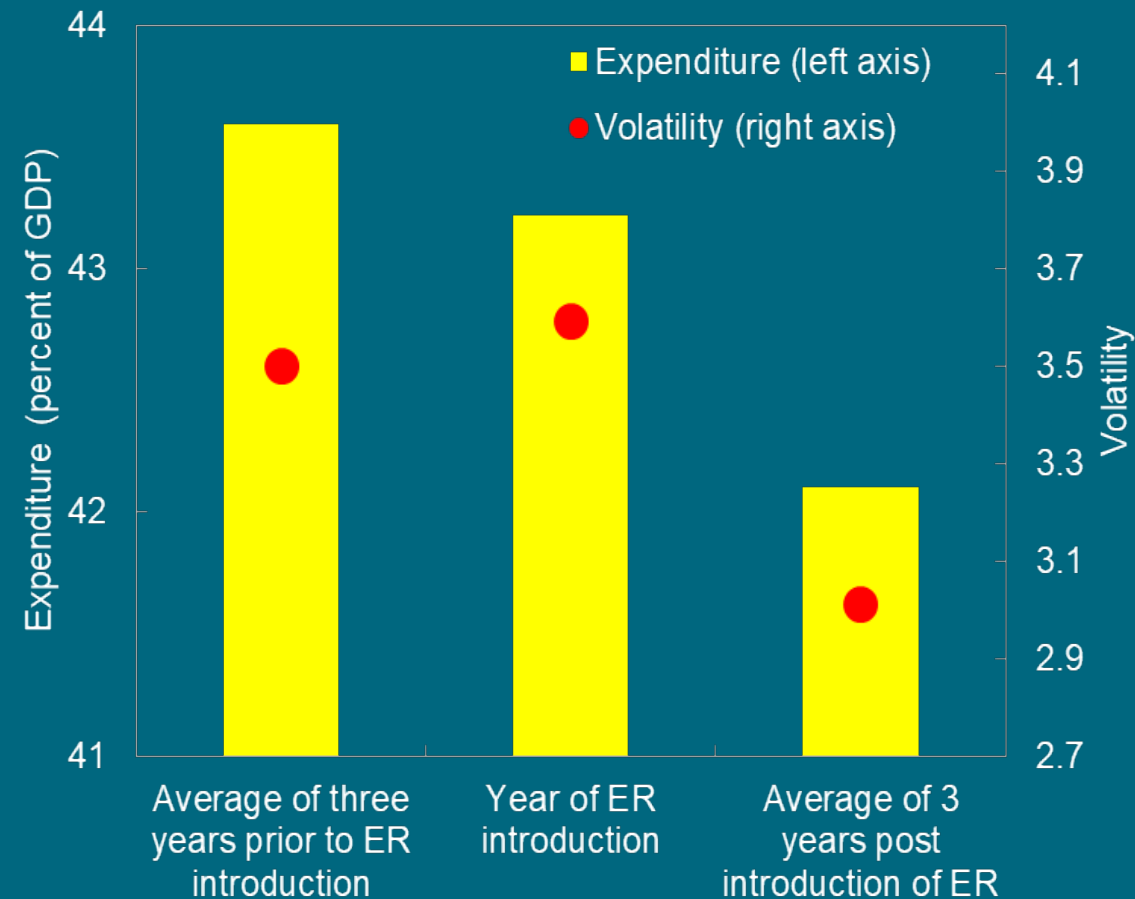


Source: Gupta and others (2015)
Now or Later? The Political Economy of Public Investment in Democracies, IMF Working Paper No.15/175

III. Can Fiscal Rules and Institutions be Helpful?

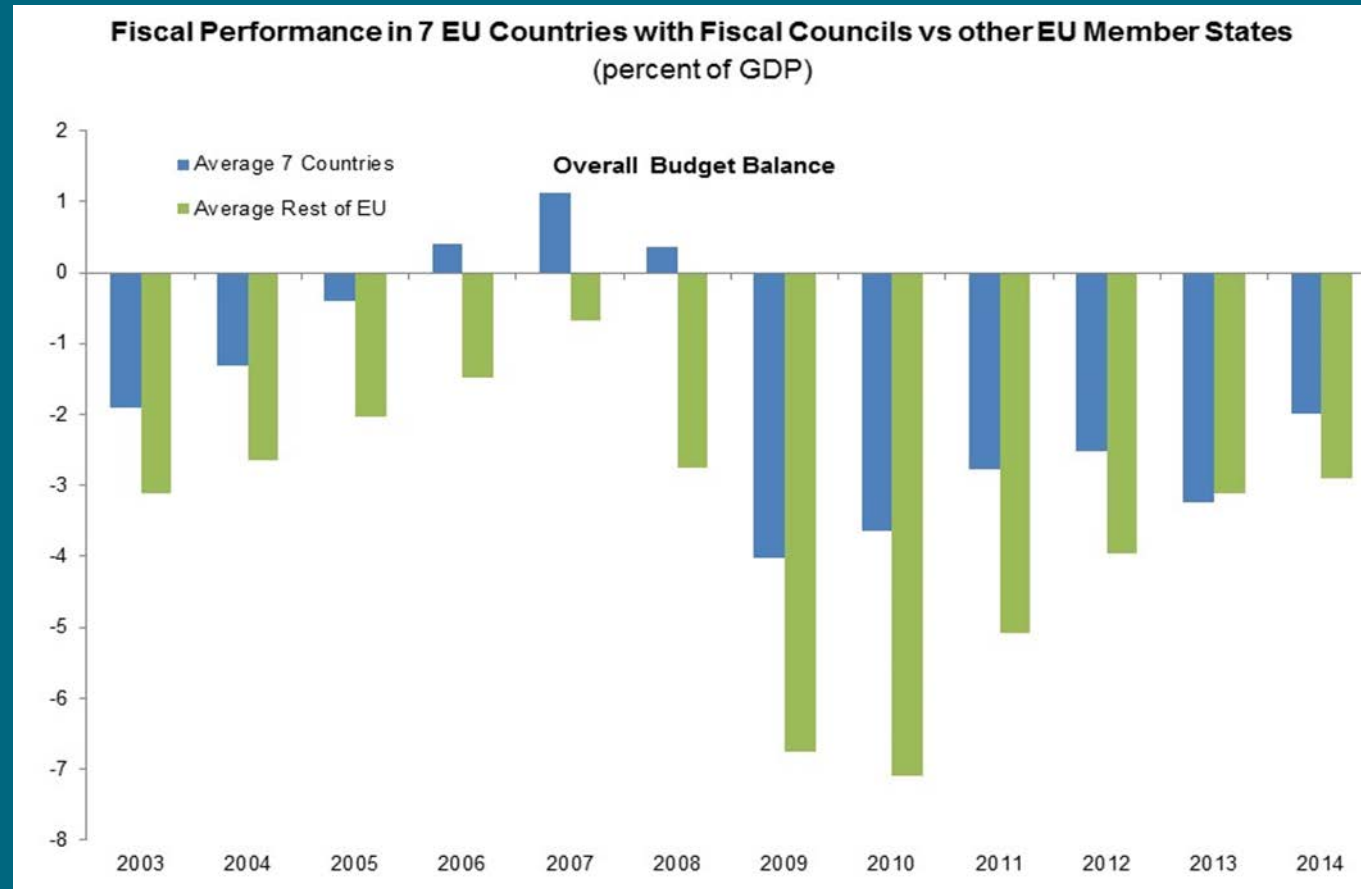
FISCAL RULES help reduce the electoral fiscal cycle

Government Size and Spending Volatility



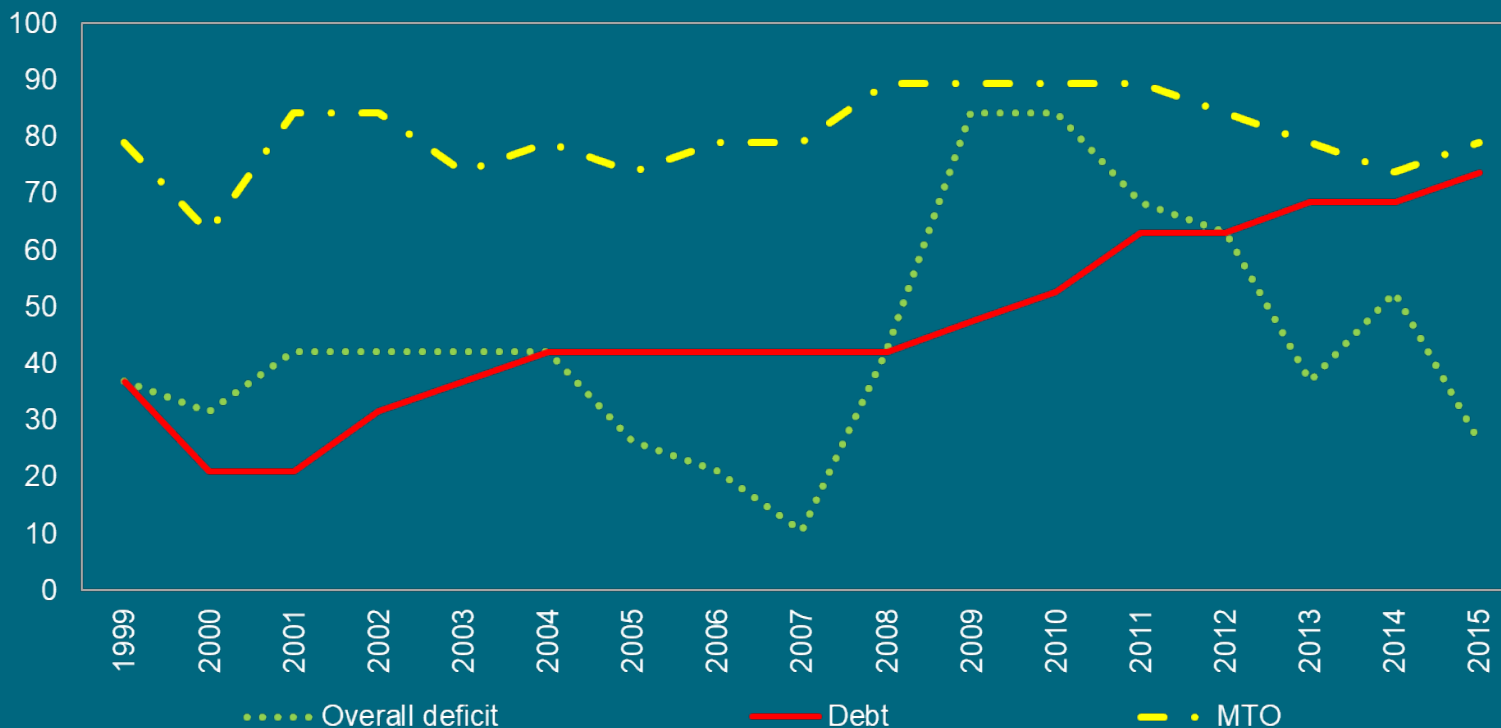
III. Can Fiscal Rules and Institutions be Helpful?

FISCAL COUNCILS can improve fiscal performance



IV. Supranational Fiscal Politics

Euro Area: Share of Non-Compliers (1999=2015, EA-19)



- Supranational rules: effective when owned by country authorities
- Lack of ownership explains weak compliance in Euro Area

IV. Supranational Fiscal Politics

IMF programs have shown a high degree of ownership reflecting a growing reliance on IMF TA. Countries with a program conditionality in the revenue area were successful in increasing public revenues



V. Policy Messages

- Politics has a decisive influence on fiscal policy formulation and performance
- The impact of elections and political divisions is particularly significant
- It seems that ideology has less of an impact
- Budget institutions help soften the effect of politics on fiscal policy
- External constraints work if owned by country authorities