Politics of Fiscal Policy: What do we know

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Drawn From a Recent Book Published by the IMF Last Year
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
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).

Source: Gupta and others (2016)
II. Impact of Elections

On budget’s composition: public wages grow before elections

Source: Own elaboration (Data: Fiscal Politics, Chapter 6)
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

Source: Gupta, Liu and Mulas-Granados (2016)
II. Impact of Elections

The tax side also affected as probability of tax reform in Latin America declines as elections approach.
II. Impact of Political Divisions

Political divisions are associated with large deviations between promised adjustment in fiscal deficit and actual outcome.
Weaker majorities are associated with larger debt accumulation in AEs and with smaller debt reduction in EME/LIDCs, during the electoral cycle.

Source: Fiscal Politics, Chapter 9
II. Impact of Political Divisions

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

Source: Fiscal Politics, Chapter 9

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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](chart.png)
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

- Expenditure (left axis)
- Volatility (right axis)

Source: Fiscal Politics (Chapter 12)
FISCAL COUNCILS can improve fiscal performance
IV. Supranational Fiscal Politics

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

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

Source: Fiscal Politics (Chapter 18)
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.

Source: Fiscal Politics, Chapter 19
• 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