A THEORETICAL APPROACH TO THE POLITICAL ECONOMY OF FISCAL CYCLICALITY, FORECASTS AND CONSOLIDATIONS

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Abstract: In this paper we discuss some relevant theoretical issues that help to explain fiscal policy outcomes. We draw our attention to three particular dimensions of fiscal policy – its cyclical behavior; forecast errors; inefficient deficits and the consequent need to carry out fiscal consolidations. Occasionally, we also describe some empirical results on the role played by political and institutional features on fiscal policy performance.

Keywords: Cyclicality, fiscal forecasts, fiscal consolidations, common pool, voracity effect, rent seeking, opportunistic business cycles, partisan business cycles, fiscal illusion.

Resumo: Neste artigo são apresentados alguns contributos teóricos relevantes que contribuem para explicar o desempenho da política orçamental. Focamos a atenção em três dimensões particulares da política orçamental – o seu comportamento cíclico; os erros de previsão; a ineficiência dos défices e a consequente necessidade de levar a cabo consolidações orçamentais. Ocasionalmente, descrevemos também alguns resultados sobre o papel desempenhado pelos factores políticos e institucionais no desempenho da política orçamental.

Palavras-chave: Ciclicidade, previsões orçamentais, consolidações orçamentais, common pool, efeito voracidade, rent seeking, opportunistic business cycles, partisan business cycles, ilusão orçamental.
1. Introduction

Fiscal policy outcomes have long been intimately linked to political and institutional frameworks. Despite the undeniable importance of purely economic variables on the performance of fiscal policy, one should bear in mind the critical influence of political and institutional aspects if a serious analysis is to be undertaken.

From the huge list of different dimensions of fiscal policy which could be analysed, we intend to focus our attention on three of the most important of these dimensions – fiscal cyclicality, fiscal forecasts and fiscal consolidations. Such topics have been intensely studied both theoretically and empirically. As regards fiscal cyclicality, for instance, and according to the Keynesian conventional wisdom, fiscal policy should behave countercyclically. However, theories based on political economy literature which help to explain why fiscal policy sometimes behaves procyclically, are easily found.

As far as the fiscal forecasts are concerned, political and institutional determinants assume increasing importance, particularly in European countries – indeed, the well-known difficulties that some countries have been facing in terms of their public finances, as well as the enormous public visibility and policy relevance of fiscal forecasts, make them more vulnerable to political manipulation. Given the huge budget deficits recorded in some countries, significantly above the 3% of GDP threshold imposed by the Stability and Growth Pact (SGP), the only possible way for those countries is to undertake serious and credible consolidations of their public finances. To the intrinsic difficulty of this task one must add the influence of political considerations. For example, according to the theory of the war of attrition (Alesina and Drazen, 1991), deficits may persist if political actors do not agree on the implementation of fiscal reforms. As becomes clear, political arguments often exert an undesirable influence on fiscal consolidations, which is particularly dangerous in a context of heightened pressures for sizeable reductions of deficits to be carried out.

The goal of this paper is to provide theoretical arguments for the outcomes of fiscal policy in some of its most important dimensions, while some empirical evidence in favour of particular arguments is also presented. In addition, in the face of the several distortions which affect fiscal policies, we will also focus on the role of fiscal rules and institutions on the reductions of these distortions (for instance, in the attempt to handle problems such as the deficit bias or the excessive volatility of fiscal policy).

The structure of this paper is as follows. In sections 2, 3 and 4, we provide an overview of the relevant theories behind the cyclicality of fiscal policy, the forecast errors and the fiscal consolidations, respectively. In section 5 we focus on the role of fiscal rules and institutions, which affect simultaneously all the different dimensions of fiscal policy described above. Finally, section 6 sets out conclusions.
2. The cyclicality of fiscal policy

Researchers have recently been paying greater attention to the behavior of fiscal policy over the business cycle. According to the Keynesian wisdom, fiscal policy should behave countercyclically, with public expenditure and taxes acting in such a way as to stabilise the business cycle. Another well-known theoretical statement related to fiscal cyclicality is the “tax-smoothing” hypothesis, according to which tax rates should be held constant over the business cycle for a given path of public expenditure (Barro, 1979). This would minimise the distortionary effects of tax burden. The neoclassical literature is relatively weak in offering normative conclusions as regards public expenditure, since the typical assumption is that public expenses are exogenously determined (Lucas and Stokey, 1983; Blanchard and Fisher, 1989).

As regards procyclical fiscal policies, one possible explanation for this behaviour is given by Gavin and Perotti (1997). They argue that procyclicality, which is more commonly found in Latin American countries, may have to do with the loss of access to external financing during bad times. Hence, countries are unable to borrow in recessions, which require a contractionary fiscal policy. Lane and Tornell (1998) and Tornell and Lane (1999) give an alternative political explanation for the question as to why many countries follow seemingly procyclical fiscal policies. According to these authors, during booms, the higher availability of resources increase the common pool problem, and the fight over common resources intensifies, leading to budget deficits. This is what they call the “voracity effect”.

Talvi and Végh (2005) argue that procyclicality in developing countries has much more to do with the variability of the tax base in these countries (between two and four times higher than in G-7 countries). The authors develop an optimal fiscal policy model that includes a political distortion according to which there exists an endogenous component of government spending that depends positively on the budget surplus. A government facing strong fluctuations in the tax base will be forced to accept an increase in expenditure in good times, since political pressures become harder to resist. Given this political distortion, the best way to avoid a high growth in expenditure is to lower tax rates. This procyclical behavior is a second-best response to that political distortion. This explanation contrasts with the one given by Gavin and Perotti (1997). In addition, the authors refer to the contribution of Lane (2003), according to whom procyclicality is also present in many OECD countries, for which the lack of access to international credit markets has not been typically an issue.

A different political argument for this procyclical behavior relates to the theory of rent seeking. The concept of rent seeking, referring generally to expen-

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1 The common pool problem occurs when policymakers do not fully internalise the costs of their decisions in terms of public expenditure, leading to higher deficits.
diture of resources to win a contestable prize, was introduced by Tullock (1967), while the term itself was introduced by Krueger (1974). In his paper, Krueger summed up the basic idea (p. 291):

“In many market-oriented economies, government restrictions upon economic activity are pervasive facts of life. These restrictions give rise to rents of a variety of forms, and people often compete for the rents. Sometimes, such competition is perfectly legal. In other instances, rent seeking takes other forms, such as bribery, corruption, smuggling and black markets.”

By focusing on the use of costly resources, the rent seeking literature highlights the socially undesirable consequences of contesting rents. In a recent work, Alesina et al. (2008) have shown that procyclicality in many developing countries occurs because rational voters face corrupt politicians who appropriate part of the revenues for unproductive spending – political rents. When voters realise that a positive income shock has hit the economy, they demand immediate benefits in the form of tax cuts or increases in productive government spending or social transfers. They fear that otherwise the available extra resources would be “wasted” in rents. In the face of such a procyclical demand by voters, governments avoid to accumulate reserves in good times. They prefer to incur large debts, which is considered, from the voter’s point of view, a second best – indeed, if on the one hand they give up on consumption smoothing, on the other hand they avoid leaving excessive rents to corrupt governments.

Finally, Woo (2009), emphasises the role of social polarisation in understanding procyclical fiscal stances often observed in a number of countries. When there is polarisation of social preferences over public choices, the incentives become greater for policymakers to implement their preferred policies. However, this individual rationality may threaten efficiency for the economy. According to the author, such incentives may become particularly strong during boom periods, since increased revenues or new resources make their preferred policies seem easier to implement, thus producing procyclical fiscal policies.

3. Fiscal forecasts – why do governments frequently err?

At least, formally developed, a “theory of fiscal forecasts” seems not to exist (Strauch, et al., 2004). Nevertheless, a number of explanations may fit fiscal forecast errors relatively well. It is the case of the opportunistic business cycle models (Nordhaus, 1975), as well as the partisan business cycle models (Hibbs, 1977; Alesina, 1987), which offer important insights into why governments often perform badly when they project fiscal figures. A key distinction here relates to the main objective of the policymaker when he can influence his chances of
remaining in power. Thus, a policymaker who has objectives which differ from
other potential policymakers is termed partisan, while one whose primary goal is
to remain in office is usually termed opportunistic.

3.1. The opportunistic political business cycle

When it comes to choose policy, a politician’s desire to win the next election
often swamp all other considerations. If, on the one hand, one can view policy
changes induced by elections as a clear demonstration of accountability in demo-
cracies, it is also true, on the other hand, that such policy changes introduce
inefficiencies into policymaking. Thus, a good point to start is the opportunistic
desire to influence election outcomes. Early empirical work has demonstrated
how electoral competition between incumbents and challengers influence aggregate
measures of economic activity. The most well-known study in this respect is the
one carried out by Tufte (1978). The author argues that not only economic con-
ditions ahead of an election strongly affect voters’ choices, but also politicians,
being aware of this fact, try to take advantage of it.

As regards forecasts, opportunistic motivations seem to drive governments to
release too rosy fiscal and macroeconomic figures for the coming years, particularly
if an election is to take place in the near future. By doing so, governments increase
the probability to remain in power.

3.2. Partisan political cycles

The opportunistic models assume that all voters are identical in terms of
their preferences, which is clearly unrealistic. Thus, models whose basic assump-
tion is an incomplete description of reality, do not fit well when it comes to
realistically predicting how political parties will behave immediately before an
election takes place (Drazen, 2000). If one consider that all parties are purely
opportunistic, then it would be obvious that they would converge to the same
policies, those preferred by the median voter. However, one still see significant
differences in terms of policy choices by different parties, which can be seen as
evidence in favour of partisan models. These models assess the role of partisan
differences as a driving force in political business cycles. In the most basic
formulation, the partisan model considers differences in preferred policies as the
only driving force, while more complex models allow for possible interactions of
partisan and opportunistic differences.
3.3. Transparency of the budget

In modern economies, the complexity of the budgets may help hiding the real balance of costs and benefits for taxpayers. Despite being partly unavoidable, this complexity is also partly artificially created, as policymakers have very little incentive to produce transparent budgets (Alesina and Perotti, 1999). On the contrary, politicians often try to emphasise the benefits of current and future spending, hide taxes and government liabilities (higher future taxes). For instance, Alt and Lassen (2006) argue that transparency leads to substantially lower deficits. This is supported by two theoretical arguments. On the one side there is the theory of “fiscal illusion” (Buchanan and Wagner, 1977), according to which voters usually overestimate the benefits of public spending and underestimate the costs of taxation. This apparent myopia caused by the lack of transparency of the budget tends to increase the voters’ confusion, thus reducing the incentive for policymakers to be fiscally responsible.

The second argument, on the other side, assumes that in the face of rational yet not fully informed voters, governments can retain a strategic advantage in introducing a certain degree of ambiguity by making it less clear how policies translate into outcomes (Cuckierman and Meltzer, 1986; Alesina and Cuckierman, 1990).

With the purpose of strategically influence voters, governments may, for instance, overestimate the expected growth of the economy. This leads to an overestimation of tax revenues. Thus, the “unexpected” deficit at the end of the fiscal year may be attributed to unforeseen macroeconomic developments. Governments may also project overly optimistic forecasts of the effect on the budget balance of various adopted policies, as well as keep several items off the budget (creative accounting). An additional way that governments may use to influence voters is the strategic use of multiyear budgeting. For instance, by announcing a four-year adjustment plan with the hardest measures concentrated in the last years (a back loaded consolidation), governments are obviously buying time.

4. Fiscal consolidations

Fiscal consolidations have been undertaken over the last decades in most EU countries as a result of the deficit bias, which becomes apparent when the structure of a government’s budget is such that its promised disbursements exceed the structure of its revenues. In this case the government, even under normal circumstances, will run a budget deficit and accumulate debt. This happened in the aftermath of the two oil shocks, when large fiscal imbalances and unsustainable debt-to-GDP ratios accumulated, which forced European governments to embark on a wave of fiscal adjustment processes. Moreover, the
run-up to euro area membership has proven the major catalyst for undertaking consolidations.

More recently, the large deficits and growing debt-to-GDP ratios recorded in most of the EU countries has heightened the pressure over governments to credibly and seriously tackle their problems of public finances. This trend must continue as ageing population related medium and long-term public finance spending pressures, are expected to increase. This is especially true in Europe, both for demographic reasons and because of the generosity of many public pension schemes. Indeed, not only the number of pensioners is growing rapidly, but they also live longer and are wealthier, bringing additional pressures for social spending. Consequently, it is unsurprising that policy discussions are increasingly focused on the urgent need to reverse those trends.

At least, two important sources of deficit bias in fiscal policy have been identified in the political economy literature: the theory of “fiscal illusion” (Buchanan and Wagner, 1977), already referred to in section 3.3 and the results of the strategic interactions between political actors.

As regards this last issue, researchers have suggested two main ways that strategic interactions can produce inefficient deficits. Firstly, an elected leader may accumulate an inefficient amount of debt to restrain his successor’s spending (Persson and Svensson, 1989; Tabellini and Alesina, 1990). Secondly, disagreement about the best way to divide the burden of reducing the deficit may cause delay in fiscal reform. This might occur because each group tries to force others to bear a disproportionate share of the burden – War of attrition model (Alesina and Drazen, 1991). This model has been used to explain the apparent propensity of coalition governments to run inefficient deficits (empirical evidence can be found, for instance, in Grilli, et al., 1991).

Furthermore, persistent deficits may also be the result of a common pool problem in government spending. In some cases government spending is determined by several players who have particular influence over spending that benefits a specific interest group (for example, the members of his or her legislative district). Each player has to choose how much of the economy’s overall tax base (the common pool) to exploit to finance spending that particularly benefits him or her, which often results in inefficiently high spending. This is clearly the case of the “pork-barrel” programmes, like public works projects benefitting a single legislative district, but paid for by the electorate as a whole. As an example of a static formal model, see for instance, Weingast et al. (1981). For a dynamic formalisation, see Velasco (1999).

5. Fiscal rules and fiscal institutions

A number of theoretical and empirical contributions have been suggesting that fiscal institutions actually play an important role in a country’s fiscal perfor-
nance (for instance, von Hagen, 1992; von Hagen and Harden, 1994). Budget institutions include all the rules (both formal and informal) according to which the budget is prepared, approved in the parliament and carried out. These rules may exert significant effects on the outcomes of budgeting process both by distributing strategic influence among the participants in that budget process and by regulating the flow of information.

Government spending is commonly targeted at specific groups in society, while it is financed from global tax revenues to which all tax-payers contribute. Thus, policymakers tend to engage in excessive levels of spending as they do not fully internalise the total social costs of their spending decisions (common-pool problem). This tendency to overspend increases as more representatives are involved in the spending decisions, that results in a co-ordination failure among the relevant decision makers. Researchers have been arguing that the central key to solving this problem is to create institutional frameworks that make policymakers adopting a more comprehensive view of the budget process and the budget itself. Two basic institutional approaches (or forms of fiscal governance) are shown by Hallerberg and von Hagen (1999) as a means to achieve that goal – the delegation approach and the contract approach. According to the former, significant strategic powers rest on an individual decision-maker – often the finance minister (less vulnerable to interest groups than the other ministers who head spending departments). During the preparation of the budget, the finance minister is given strong powers as regards the setting of spending limits, which are imposed to the other members of the executive. During the approval stage, the delegation approach is meant to protect the finance minister against sizeable and politically relevant parliamentary amendments. Finally, in the implementation stage, the finance minister holds the capacity of strongly monitoring (and correcting any deviations, if necessary) the implementation of the budget.

Contrarily, the contract (or commitment) approach lies on an initial agreement (a commitment) among the parties represented in the parliament on the medium-term budgetary strategy. This strategy may include numerical targets for specific budget items or the budget balance itself. During the planning stage, the finance minister has little power, but actually monitors the fiscal commitment. Contrarily to the case of the delegation approach, the centralisation of the budget process is ensured by the initial bargaining among policymakers. During the approval stage, the parliament assumes increased importance as it has strong powers as regards the vigilance over the executive’s compliance with the budgetary targets previously defined. In the implementation stage, however, the contract and the delegation approaches are rather similar in terms of the powers held by the finance minister to control the budget execution.

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2 Hallerberg et al. (2007).
3 See also Hallerberg (2004).
Some recent empirical studies have been showing the relationship between the forms of fiscal governance and the fiscal policy performance. For instance, Pina and Venes (2007), Annett (2006) or Strauch et al. (2004), find that fiscal governance characterised by commitment or mixed\textsuperscript{4} forms is strongly associated to more prudent budgetary forecasts.

Apart from these procedural rules, another branch of the literature draws attention on the role of numerical rules (which may impose several limits to the budget balance of the general government and the other tiers of government, but they may also set limits to the expenditure and debt growth. In this respect little theoretical work has been developed perhaps due the generality of this topic. The definition of optimal quantitative rules as well as the budgetary stage in which the rules should be adopted depends on the trade-off between the commitment with a certain target and the necessary flexibility to adjust that target. In terms of empirical contributions, Pina and Venes (2007), for instance, resorted to a set of indices described in Debrun et al. (2008), and concluded that stronger expenditure rules are associated to more prudent budget balance forecasts in the EU-15.

6. Conclusions

The effect of institutions and political factors on fiscal policy outcomes has been intensively addressed in the literature. Despite assuming critical importance, purely economic variables are indeed far from providing complete answers in what fiscal policy performance is concerned. Several different dimensions of fiscal policy are identified as being closely related to political and institutional elements. In this work we have focused our attention on three of those dimensions – cyclicality, forecasts and consolidations. We sought to offer comprehensive insights into some of the most important theoretical contributions argued as being on the basis of fiscal policy results. The procyclical behaviour of fiscal policy can be related to the common-pool problem and to the rent-seeking theory. Social polarisation also seems to exert a major role.

As regards fiscal forecasts, we intended to find a “theory of fiscal forecasts” that could help us to explain the reasons why do governments often err in their fiscal projections. Such a theory seems not to exist, despite both the opportunistic and the partisan business cycle models fit forecast errors satisfactorily. Besides, issues related to the transparency (or the lack of it) of the budget can also influence fiscal forecast errors.

\textsuperscript{4} A mixed form of fiscal governance has some elements of delegation in the fiscal decision-making process and some elements of commitment in the “contracts” between the executive and the opposition parties in the parliament. It only exists in countries with minority governments.
Inefficient deficits, and consequently, the need to reverse them through fiscal consolidations, may be explained by the theory of fiscal illusion, but the results of the strategic interactions between political actors as well as the common-pool problem may also contribute to the accumulation of debt and deficits.

Finally, the role played by fiscal rules and institutions in countries' fiscal performances has also been addressed.

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