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Discretionary Fiscal Policy
and Elections: The
Experience of the Early
Years of EMU

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by
Marco Buti and Paul van den Noord

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ABSTRACT/RÉSUMÉ

Discretionary Fiscal Policy and Elections: The Experience of the Early Years of EMU

An early criticism of the Stability and Growth Pact has pointed to its asymmetric nature and the weak mechanisms to prevent politically-motivated fiscal policies: its constraints would bite in downswings but not in upswings, especially if in the latter the electoral cycle increases the temptation to run expansionary policies. We find that the experience of the initial years of EMU lends support to this criticism. Overall, unlike the experience in the run-up to EMU, fiscal policies had an expansionary bias, and a “genuine” discretionary boost took place in correspondence to political elections. Both sign and composition of such discretionary changes are in line with the predictions of the recent literature on electoral budget cycles. Closer fiscal surveillance may help detect early such behaviour, but it is unlikely to curb the incentives to run politically-motivated fiscal policies when elections approach.

JEL classification: E61, H3, H5, H6.

Keywords: Economic and Monetary Union, Fiscal Policy, Stability and Growth Pact, Political Business Cycle, Elections.

Politique budgétaire discrétionnaire et élections : L'expérience des premières années de l'UEM

D'emblée, le pacte de stabilité et de croissance a été critiqué pour son caractère asymétrique et la faiblesse de ses mécanismes destinés à empêcher les mesures budgétaires à finalité politique : ses contraintes seraient efficaces en période de ralentissement économique, mais pas en période d'accélération, surtout lorsque, dans ce dernier cas, le cycle électoral accroît la tentation d'une politique expansionniste. Notre constat est le suivant : l'expérience des premières années de l'UEM confirme ces critiques. Au total, contrairement à ce qu'on a pu observer durant les années qui ont précédé l'UEM, les politiques budgétaires ont connu un biais expansionniste et il y a eu véritablement expansion budgétaire parallèlement aux élections politiques. Ces changements discrétionnaires sont conformes tant en ce qui concerne leur signe que leur composition à ce que pouvaient laisser prévoir les ouvrages récents consacrés au cycle électoral des budgets. Une surveillance budgétaire plus stricte pourrait permettre de détecter suffisamment tôt ces comportements, mais elle ne freinera probablement pas l'incitation à prendre des mesures budgétaires à finalité politique lorsque des élections approchent.

Classification JEL: E61, H3, H5, H6.

Mots clés : Union économique et monétaire, Politique budgétaire, Pacte de stabilité et de croissance, Cycle politique, Élections

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DISCRETIONARY FISCAL POLICY AND ELECTIONS: THE EXPERIENCE OF THE EARLY YEARS OF EMU

Marco Buti and Paul van den Noord¹

1. Introduction

1. Europe's Economic and Monetary Union (EMU) is based on an original arrangement of public finance relations between member countries: fiscal policy remains decentralised, but is subject to rules which are meant to combine discipline and flexibility. The Stability and Growth Pact (SGP), which complements and tightens the fiscal provisions laid down in the Maastricht Treaty, is the backbone of fiscal discipline in EMU.

2. The SGP is unquestionably the most stringent supranational "commitment technology" ever adopted by sovereign governments on a voluntary basis in the attempt to establish and maintain sound public finances. The SGP, if applied according to its letter and spirit, will have important implications for the behaviour of budgetary authorities in both the short term (cyclical stabilisation, policy co-ordination) and long term (sustainability of public finances).

3. The experience of the early years of EMU has, however been disappointing. While many euro area countries continued the fiscal retrenchment, even moving into surplus, the three largest members — Germany, France and Italy — and Portugal remain trapped in high deficits.

4. This short paper argues that failure to abide by the SGP's "fiscal philosophy" can, at least in part, be traced back to resurrection of incentives — once EMU had been accomplished — to run politically-motivated fiscal policies during important electoral episodes.

5. The paper is organised as follows. Section 2 briefly reviews the budgetary developments in the early years of EMU and discusses the alleged asymmetric working of the Pact in bad times and good times. Section 3 provides a snapshot of the literature on electoral budget cycles. Section 4 presents a new indicator of discretionary fiscal policy. The indicator is then applied in Section 5 to the euro area countries in the years 1999-2002 to gauge the influence of elections on fiscal policy behaviour. The final section draws some policy conclusions.

1. Group of Policy Advisors, European Commission, and OECD, respectively. We would like to thank Andrew Dean, Jonas Fischer, Vincent Koen, Martin Larch, Carlos Mulas-Granados and Alessandro Turrini for useful comments. The views expressed herein are those of the authors and should not be attributed to the European Commission or the OECD.

2. Fiscal polity in EMU's infancy: a longer-than-hoped-for transition

2.1. A disappointing fiscal performance

6. According to the SGP, fiscal discipline would be enforced by establishing the 3 per cent of GDP deficit as a hard ceiling to be exceeded only in exceptional circumstances and maintaining the budget at around balance in normal times and letting automatic stabilisers play freely in downturns and upturns. An upper limit to the actual deficit combined with close-to-balance positions in normal times would ensure the gradual re-absorption of public debt which, in several countries, remains substantially higher than the 60 per cent of GDP reference value of the Treaty.

7. As many countries entered EMU with deficits close to 3 per cent of GDP, a further budgetary adjustment in the early years of EMU was required to move to close-to-balance positions. The determination of countries to continue the fiscal retrenchment in the early years of EMU came to be regarded as a test of whether EMU had brought about a genuine regime change and a political commitment to stability-oriented macroeconomic policy. Clearly, a number of euro area members have not lived up to such commitment.

8. Figure 1 shows the progress — or lack thereof - towards lower public deficits and debts made during the initial years of EMU.² It shows, for each country, on the horizontal axis the difference between the stock of public debt as a share of GDP and the 60 per cent Maastricht reference value, and on the vertical axis the difference between the budget deficit and the 3 per cent deficit ceiling. For both variables, the situation in 1998 and 2002 is pictured. A shift towards a safer territory is represented by a move down and to the left.

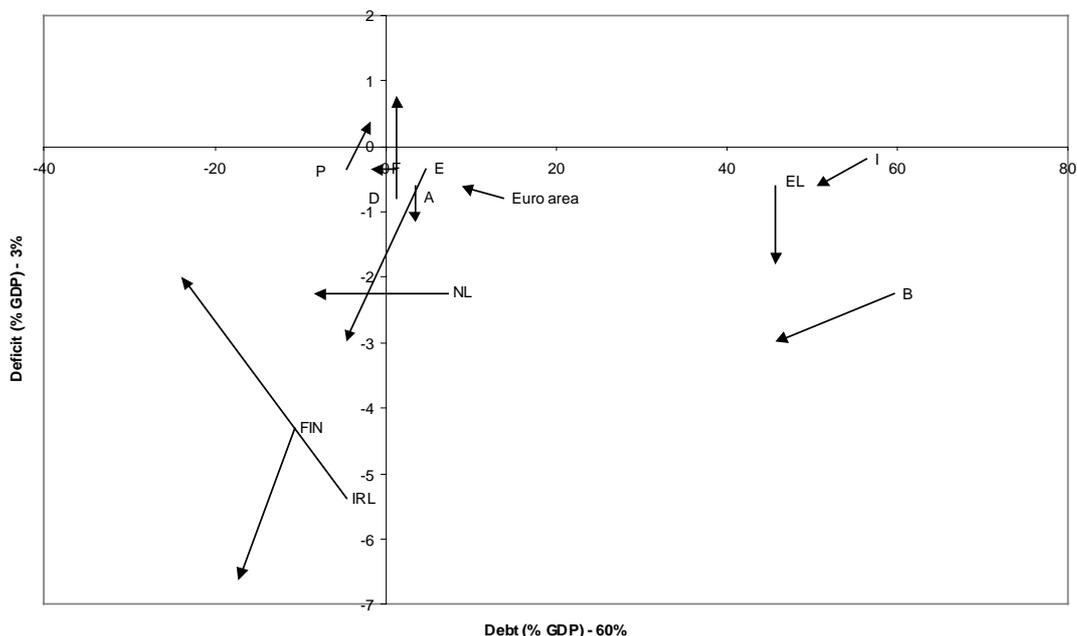
9. Several countries managed to move further away from the deficit threshold between 1998 and 2002 and achieved a reduction in public debt. However, the chart clearly shows that overall little progress has been accomplished on the way to budgetary consolidation, and in structural terms the picture is even bleaker. Indeed, as we show below, if one nets out the automatic effects of growth on the budget, countries in average relaxed their retrenchment efforts in the 1998-2002 period. In particular the three largest countries of the euro area — Germany, France, Italy – as well as Portugal – which has been the first country to have exceeded the 3 per cent of GDP deficit limit in 2001 followed by Germany in 2002 — did not behave according to the spirit (and the letter) of the SGP.

2.2. Fiscal policy incentives under the SGP

10. While the SGP is nominally very strict, it does not tackle a typical failure of fiscal policy behaviour in Europe, namely the tendency to run expansionary pro-cyclical policies in good times (see *e.g.* European Commission, 2000): while an excess over the 3 per cent of GDP deficit ceiling is sanctioned, there is no apparent reward for appropriate budgetary behaviour during cyclical upswings. Hence, the political temptation to 'spend the money when it comes in' may prove irresistible.

2. Due to lack or erratic data hindering the analysis in the next sections, Luxembourg is not considered.

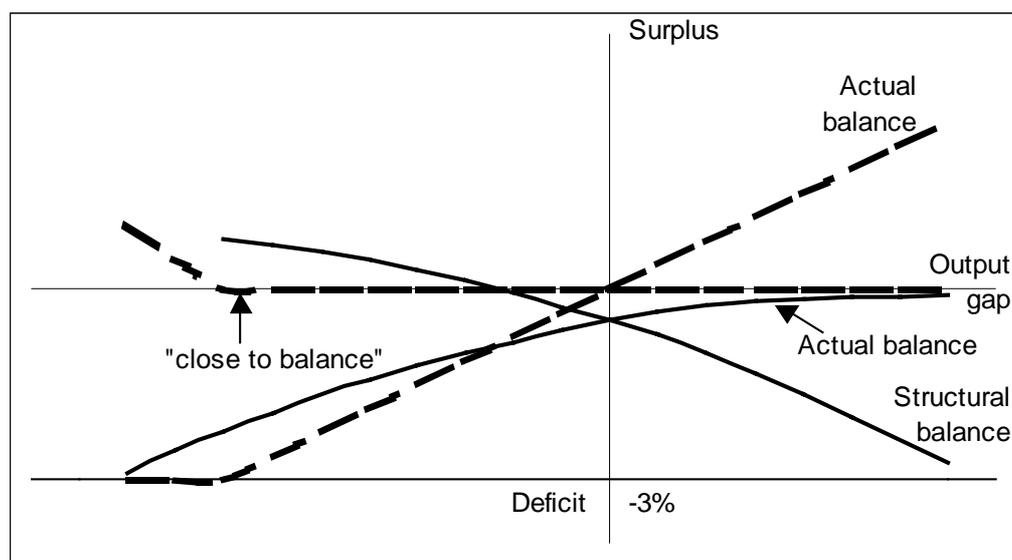
Figure 1. Budgetary room for manoeuvre, 2002-1998



Source: Commission services.

11. The fact that the SGP is “all sticks and no carrots” (Bean, 1998) may entail a pro-cyclical bias in the conduct of budgetary policy. The implicit carrot for well-behaved participants, that they have room for the automatic stabilisers to operate unfettered during downturns without being hit by a stick, is apparently not “tasty” enough. Figure 2, adapted from Buti and Martinot (2000), illustrates this case. It pictures the total and the cyclically adjusted budget balance against the output gap. The dotted lines represent a budgetary behaviour consistent with the SGP philosophy, while the solid lines represent a “surplus-resistant” fiscal behaviour. If governments remain trapped in the budgetary culture of the 1970s and 1980s, they will tend to offset the working of the automatic stabilisers for sufficiently large, positive output gaps. While the actual budget balance would remain broadly stable, the cyclically-adjusted budget balance would worsen adding to the risk of overheating.

12. These wrong structures of incentives may be strengthened in electoral periods. While in the run up to EMU the incentives to stick to the announced consolidation path were evident, at least for traditionally pro-European countries, things may be different once in EMU. Unlike the Maastricht convergence, sticking to the rules of the SGP may not pay politically. As argued by Buti and Giudice (2002), reward for complying with Maastricht public finance requirements and penalty of failing to do so were very clearly laid out. Meeting the convergence criteria would allow budgetary laggards to join the virtuous countries in the new policy regime. Conversely, failure carried the penalty of exclusion from the euro area. This was considered too hard a political sanction especially for countries traditionally at the forefront of the process of European integration. This may have temporarily affected also the political incentives to the extent that fiscal “sacrifices” to join the euro area have a chance of being politically rewarded.

Figure 2. **Budgetary behaviour under the SGP: symmetric and asymmetric behaviour**

Dotted line: SGP-compatible budgetary behaviour: symmetric operation of automatic stabilisers.

Solid line: pro-cyclical fiscal behaviour.

Source: Adapted from Buti and Martinot (2000).

13. Once in EMU, however, the underlying political preferences may pop up again as the carrot of entry has been eaten while the stick of exclusion has been replaced by the threat of uncertain and delayed sanctions. If this is true one should be able to observe a reversal of fiscal behaviour to “old habits” especially in electoral periods. This effect is compounded by a parallel break in some countries of the political consensus around fiscal consolidation between the government and the main opposition parties and the resurgence of ideological disputes. This has increased electoral polarisation and therefore has also increased the incentives that incumbents face to manage the budget electorally.

14. The combination of a cyclical upturn and elections may strengthen the temptation to run pro-cyclical expansionary policies. As pointed out in Buti and Sapir (1998, 2002) and Sapir and Sekkat (2002), the very success of the SGP in reducing the budget deficits would in fact rebuild the capacity of governments to pursue politically-motivated fiscal actions.

3. The literature on electoral budget cycles: a bird’s-eye view

15. The literature on politically-motivate policies is vast. It started off with the seminal contributions by Nordhaus and Hibbs in the mid-1970s on political business cycle and was revived in the early 1990s by Alesina and others in models which incorporated political incentives with rational expectations (for a survey see, Drazen, 2000). A strand of the literature has also analysed electoral budget cycles, with models of opportunistic electoral cycles (Rogoff and Sibert, 1988) and electoral accountability (Ferejohn, 1986). More recently, the new literature on “political economics” has analysed the impact of different features of political systems on the running of fiscal policy (see Persson and Tabellini, 2002a and 2002b). The individual country model of opportunistic or partisan behaviour has been extended by Sapir and Sekkat (1999) to allow for cross-country spillovers.

16. In essence, the predictions of the theoretical literature on fiscal behaviour in relation to elections can be summarised as follow: (1) opportunistic behaviour implies fiscal policy manipulations before the elections; (2) uncertainty about the electoral outcome and the degree of polarisation induce governments to undertake short-sighted policies; (3) most models predict tax cuts before elections while the implications for spending is less clear-cut; (4) electoral rules shape fiscal behaviour, with majoritarian elections leading to larger fiscal activism focussed on targeted programmes aimed at shifting votes in marginal districts, while proportional elections lead to increase of broad-based programmes. Recent empirical work has found support, though not unequivocal, for these predictions (see *i.e.* Persson and Tabellini, 2002a and 2002b, Milesi-Ferretti, Perotti and Rostagno, 2002).³

17. Obviously, only four years into EMU, it is too early to carry out a systematic investigation of electoral manipulation of fiscal policy. Nonetheless, given the relatively large number of electoral episodes in the period 1999-2002 — all countries had either general elections as part of the regular electoral cycle, or early elections prompted by political crises, see Table 1 — we can provide some provisional evidence on incentives for politically motivated fiscal policies.

Table 1. Elections in Euro area countries 1999-2002

	Electoral cycle			
	1999	2000	2001	2002
Austria	General elections	-	-	Early general elections
Belgium	General elections	-	-	Pre-election year
Finland	General elections	-	-	Pre-election year
France	-	-	Pre-election year	General elections
Germany	-	-	Pre-election year	General elections
Greece	Pre-election year	General elections	-	-
Ireland	-	-	Pre-election year	General elections
Italy	-	Pre-election year	General elections	-
Netherlands	-	-	Pre-election year	General elections
Portugal	General elections	-	-	Early general elections
Spain	Pre-election year	General elections	-	-
Number of election years	4	2	1	4
Number of early or pre-election years	2	1	4	4

Source: Updated from Buti and Sapir (2002).

4. Measuring discretionary fiscal policy

18. In order to explore the behaviour of fiscal policy in the early years of EMU we construct an indicator of discretionary fiscal policy — dubbed here DP. The indicator decomposes the primary fiscal balance into two components, a part that is consistent with a neutral stance of fiscal policy and the remainder that is attributable to fiscal stimulus or contraction.

3. Maroto and Mulas-Granados (2002) find election year is an insignificant predictor of the probability of ending a consolidation episode when consolidation is defined as a change in the cyclically adjusted primary balance > 0 per cent < 1 per cent. Only when the definition of consolidation is made stronger (changes > 1 per cent, as in most of the literature), then election year becomes significant, and political variables such as coalition size, cabinet size, and elections become stronger predictors than economic variables regarding the probability of ending the adjustment. These results indicate that governments worry about elections when the required consolidation is important enough to be visible to the electorate.

19. A neutral fiscal stance is defined as a policy in which primary expenditure grows in line with potential GDP plus expected inflation, and tax revenue is a function of actual GDP. If in setting the budget a government adopts such rule, it can be said that it adopts a “neutral” policy. Any deviation from there is considered “discretionary”.

20. Formally, neutral spending is written as follows:

$$(1) \ g^* = \frac{G_{t-1}(1 + y^* \varepsilon_G + \pi^{ECB})}{Y_{t-1}(1 + y + \pi)} = g_{t-1} \frac{1 + y^* \varepsilon_G + \pi^{ECB}}{1 + y + \pi}$$

where G is nominal expenditure, Y is nominal GDP, g is the ratio between the two, π is inflation, y^* is trend growth and π^{ECB} is the inflation target of the ECB. In the case of some countries, Balassa-Samuelson effects can be considered. However, this possibility is ignored in the calculations below. Like Von Hagen (2002), we adopt a unit elasticity for expenditure to potential output, the rationale being that a rise in potential output by x per cent allows to sustain a similar increase in spending. Hence ε_G is set equal to one.

21. Revenue growth is said to be neutral if it is in line with actual GDP, taking into account the elasticity of the various tax components:

$$(2) \ \tau^* = \frac{T_{t-1}[1 + (y + \pi)\varepsilon_T]}{Y_{t-1}(1 + y + \pi)} = \tau_{t-1} \frac{1 + (y + \pi)\varepsilon_T}{1 + y + \pi}$$

where T is revenue and τ its ratio to GDP. The elasticity ε_T is set to the average tax elasticities reported in van den Noord (2002), hence are close to unity.

22. Hence the neutral budget deficit (primary) is $d^* = g^* - \tau^*$ ⁴

23. Actual expenditure can be written as:

$$(3) \ g_t = g_{t-1} \frac{1 + y^e \varepsilon_G + \pi^e + \tilde{g}}{1 + y + \pi}$$

This is a crucial assumption in our approach. We assume that the government sets its spending plans on the basis of expected GDP growth, y^e , and expected inflation, π^e , plus discretionary spending changes, \tilde{g} . The relevance of this assumption on policy behaviour for our results will become clear below.

24. Actual revenue, is written as:

$$(4) \ \tau_t = \tau_{t-1} \frac{1 + (y + \pi)\varepsilon_T + \tilde{\tau}}{1 + y + \pi}$$

The rule for the tax revenue is the same as (2) supplemented by discretionary tax changes, $\tilde{\tau}$. Both spending and revenue are deflated by actual (ex post) nominal GDP growth.

4. Interestingly, Coricelli and Ercolani (2002) posit a similar rule as a possible reform of the Stability and Growth Pact in the context of EU enlargement. Their proposal implies balancing the structural budget and then running a “neutral” policy according to the behavioural rules set out in equations (1) and (2).

25. In the calculations, the expected variables are those in the country's stability programme. For trend growth, the OECD estimates published in the *Economic Outlook 72* that were published late- 2002 have been used. As to π^{ECB} , we used 1½ per cent which is consistent with the implicit inflation target of the ECB considering its "first pillar" strategy.⁵

26. Given that the actual primary deficit is $d=g-\tau$ the indicator of discretionary policy is $DP=d-d^*$. After simple manipulations, DP can be written as follows:

$$(5) \quad DP = \frac{(g_{t-1}\tilde{g} - \tau_{t-1}\tilde{\tau}) + g_{t-1}\varepsilon_G(y^e - y^*) + g_{t-1}(\pi^e - \pi^{ECB})}{1 + y + \pi}$$

27. Hence discretionary fiscal policy can be broken down into three components:

- "Genuine" or overt discretionary policy, that captures the impact of explicit discretionary fiscal policy on the primary balance, *i.e.* the component that is funded directly through debt rather than through the projected growth or inflation "dividend" (see below). This component is then split between discretionary expenditure changes and tax changes.
- A projected "growth dividend" which, if positive ($y^e > y^*$), can be used by the government to fund extra expenditure. This growth dividend is computed by applying the tax and expenditure elasticities with respect to the output gap to the changes in the output gap that are implied by the growth projections underpinning the Stability Programmes.
- A projected "inflation dividend" which is computed by applying the above elasticities to the inflation gap, *i.e.* the difference between the officially projected rate of inflation and the rate of inflation that is consistent with normal capacity utilisation. If $\pi^e > \pi^{ECB}$, the freed resources can be used for expenditure hikes.⁶

In practice, the second and the third components are computed first while the "genuine" component is obtained as a residual. Closer inspection of equation (5) shows that the same three-pronged breakdown can be applied to expenditure. However, this is not the case for revenues for which the growth and inflation dividends are zero by definition. The reason is that we associate "neutral" revenue with the projected actual (as opposed to the structural) evolution of the tax base.

28. This indicator provides a different picture of discretionary policy compared to the change in the cyclically-adjusted primary balance ($\Delta CAPB$). This indicator of the fiscal stance (see, *e.g.* European Commission, 2002a, and Van den Noord, 2002) is usually taken as a gauge of the impact of fiscal policy on economic activity. By contrast, DP aims to capture the discretionary behaviour of the fiscal authorities against a benchmark of "unchanged policy". If nominal GDP growth collapses unexpectedly, the non-discretionary component of the expenditure ratio automatically increases because the allocation of resources is set on the basis of expected GDP growth. This is non-discretionary in DP while it is implicitly

5. The implicit assumption is that governments adopt the ECB target as their benchmark for "equilibrium" rate of inflation, which may or may not be true, but any other assumption risks introducing an arbitrary element. Moreover, the results in this paper are relatively robust with respect to the inflation assumption.

6. Note that the size of the inflation dividend and the total DP depend on the assumed target inflation rate (here 1½ per cent). However, the size of the other two components is invariant with respect to this assumption.

treated as discretionary in the fiscal stance measured ΔCAPB . Moreover, unlike the ΔCAPB , the indicator captures the effect of inflation.⁷

5. Discretionary fiscal policies in EMU: did elections matter?

5.1. A discretionary loosening

29. The results of our calculations for DP are presented in tables 2 to 4 below. A positive (negative) entry indicates a discretionary loosening (tightening). Table 2 shows that, on average for the area as a whole, fiscal policy has become easier over time.⁸ Indeed, whereas in the first two sets of Programmes there was a tightening bias, this turned into an easing bias in the last two vintages.⁹ Interestingly, this is true also for the “genuine” discretionary component (Table 3), suggesting that governments have indeed become less concerned with deficit financing and deliberately relaxed budget discipline in 2001 and 2002 beyond the “unchanged policy” rule. The fiscal loosening started in the year 2000 in a number of countries and notably in Italy and Portugal, two of the countries currently trapped in high deficits.¹⁰ The projected growth dividend is positive in each year, except 2002. The inflation dividend is also positive, but small.

30. Table 4 shows the breakdown of discretionary policy between expenditure and revenue. As the growth and inflation dividends only affect expenditure, they can be subtracted from the total discretionary spending to compute its “genuine” component. The picture that emerges is mixed. The growth and inflation dividends “swell” discretionary spending while genuine spending remained tight. The large loosening in 2001 and 2002 came from the revenue side which reversed a sizeable increase in the previous years.

7. It can easily be shown that $DP = \Delta\text{CAPB}$ if the following conditions hold: $y = y^*$ (actual growth is equal to trend growth), $\pi = \pi^e$ (no inflation expectational error), and $\varepsilon_G = \varepsilon_T = 1$. Note, however, that the CAPB actually assumes that $\varepsilon_G < 0$ to reflect the counter-cyclical behaviour of unemployment-related expenditure.

8. Note that the numbers presented are excluding receipts from UMTS licences, which were substantial in some countries in notably 2000 and 2001. However, the numbers are not corrected for the impact of securitisations which in some countries have been used to mask underlying fiscal easing. As a result, the true easing may have been larger than shown here.

9. The tightening bias in 1999 and 2000 (including in Germany and France) may seem surprising in view of the quite different results reported elsewhere based on the traditional measure of fiscal stance, namely the change in the cyclically-adjusted budget balance (CAPB). However, this different assessment stems from the fact that the DP treats expenditure hikes as “neutral” to the extent these are in line with growth in (nominal) potential GDP whereas the CAPB would treat these largely as “discretionary”; see also footnote 2.

10. Using the change in the CAPB, Buti and Sapir (2002) show that budgetary consolidation in Germany, France and Italy – three of the countries which did not meet the close-to-balance rule of the SGP – was considerably worse than the already timid efforts which were planned in their stability programme. This contrasts sharply with other euro-area members whose budgetary out-turn was better than planned.

Table 2. Indicator of discretionary fiscal policy

	Contribution to primary balance, per cent of GDP											
	Actual primary balance				"Neutral" primary balance				Discretionary policy			
	1999	2000	2001	2002	1999	2000	2001	2002	1999	2000	2001	2002
Austria	0.8	1.3	2.4	0.8	0.0	0.1	0.3	1.3	0.8	1.1	2.1	-0.5
Belgium	6.2	6.6	6.4	5.7	7.0	6.7	6.1	6.4	-0.8	-0.2	0.3	-0.7
Finland	3.5	8.1	5.6	3.9	2.7	5.4	7.8	5.0	0.8	2.7	-2.1	-1.1
France	1.3	1.6	1.4	0.1	0.0	1.1	0.8	0.6	1.4	0.5	0.5	-0.5
Germany	1.6	1.5	0.2	-0.6	0.9	1.5	1.2	-0.2	0.7	0.0	-1.0	-0.4
Greece	5.3	5.2	4.6	4.6	6.3	6.8	6.6	5.7	-1.0	-1.6	-2.1	-1.1
Ireland	3.7	5.5	1.8	-0.9	5.0	4.5	5.4	1.2	-1.4	1.0	-3.6	-2.1
Italy	4.3	4.3	3.6	3.1	4.6	4.9	4.6	3.4	-0.3	-0.6	-1.0	-0.2
Netherlands	4.5	4.8	2.8	1.8	3.6	5.2	5.3	2.6	0.9	-0.5	-2.5	-0.8
Portugal	0.8	-0.1	-1.1	-0.3	1.0	0.9	0.0	-1.5	-0.2	-1.0	-1.0	1.2
Spain	2.2	2.4	2.8	2.9	2.2	3.2	3.2	3.0	0.0	-0.8	-0.4	-0.1
Weighted average	2.6	2.7	2.0	1.2	2.1	2.8	2.6	1.6	0.5	-0.1	-0.6	-0.4
Unweighted average	3.1	3.7	2.8	1.9	3.0	3.7	3.7	2.5	0.1	0.1	-1.0	-0.6

Source: OECD, Economic Outlook 72, authors calculations.

Table 3. Discretionary fiscal policy: breakdown into "genuine" discretionary policy, "growth dividend" and "inflation dividend"

	Contribution to primary balance, per cent of GDP											
	"Genuine" discretionary policy				Projected "growth dividend"				Projected "inflation dividend"			
	1999	2000	2001	2002	1999	2000	2001	2002	1999	2000	2001	2002
Austria	0.8	0.9	2.4	-0.6	-0.2	-0.1	-0.2	0.4	0.2	0.3	-0.1	-0.3
Belgium	-0.8	-0.3	0.2	-0.7	-0.1	-0.1	0.0	0.3	0.0	0.2	0.1	-0.3
Finland	1.2	3.0	-1.9	-2.0	-0.2	-0.3	-0.4	0.7	-0.2	0.0	0.1	0.2
France	1.5	0.8	0.9	-0.2	-0.2	-0.3	-0.5	-0.1	0.1	0.0	0.1	-0.1
Germany	0.7	0.2	-0.5	-0.7	-0.2	-0.4	-0.5	0.3	0.2	0.2	0.0	0.0
Greece	-0.5	-1.1	-1.0	-0.4	-0.2	-0.3	-0.7	-0.2	-0.3	-0.2	-0.3	-0.5
Ireland	-1.4	1.5	-2.6	-2.3	0.4	-0.1	-0.3	0.8	-0.3	-0.4	-0.8	-0.6
Italy	0.2	-0.4	-0.2	0.4	-0.3	-0.1	-0.4	-0.2	-0.2	-0.1	-0.3	-0.4
Netherlands	1.1	-0.4	-1.3	-0.7	0.1	0.3	-0.3	0.5	-0.3	-0.4	-0.8	-0.7
Portugal	0.2	-0.7	-0.2	1.5	0.0	0.1	0.0	0.4	-0.3	-0.3	-0.8	-0.7
Spain	0.5	-0.5	0.1	0.1	-0.3	-0.2	-0.2	0.1	-0.1	-0.2	-0.3	-0.4
Weighted average	0.6	0.1	-0.1	-0.3	-0.2	-0.2	-0.4	0.1	0.0	0.0	-0.1	-0.2
Unweighted average	0.3	0.3	-0.4	-0.5	-0.1	-0.1	-0.3	0.3	-0.1	-0.1	-0.3	-0.3

Source: OECD, Economic Outlook 72, authors calculations.

Table 4. Discretionary fiscal policy: breakdown into expenditure and revenue

	Contribution to primary balance, per cent of GDP											
	"Genuine" discretionary expenditure				Discretionary expenditure				Discretionary revenue			
	1999	2000	2001	2002	1999	2000	2001	2002	1999	2000	2001	2002
Austria	-0.3	-0.6	-0.1	-0.2	-0.3	-0.8	0.2	-0.3	0.5	0.3	2.3	-0.8
Belgium	0.1	0.2	-0.3	-0.1	0.2	0.2	-0.4	-0.1	-0.7	0.0	0.0	-0.8
Finland	-1.3	-1.9	0.1	0.8	-0.9	-1.6	0.4	0.0	-0.1	1.1	-1.8	-1.2
France	-0.3	-0.6	-0.3	-0.1	-0.2	-0.2	0.0	0.2	1.2	0.3	0.5	-0.3
Germany	0.0	-0.5	-0.9	0.2	0.0	-0.4	-0.4	-0.1	0.7	-0.3	-1.4	-0.6
Greece	1.3	2.3	-0.6	0.1	1.8	2.8	0.4	0.8	0.8	1.2	-1.6	-0.3
Ireland	2.1	-1.0	0.8	1.4	2.1	-0.6	1.8	1.2	0.7	0.4	-1.8	-0.8
Italy	0.1	0.0	0.3	-0.5	0.6	0.2	1.0	0.1	0.3	-0.4	0.1	-0.1
Netherlands	0.1	0.5	-0.1	0.7	0.3	0.6	1.1	0.8	1.2	0.1	-1.4	0.0
Portugal	1.3	1.0	0.4	-0.8	1.6	1.3	1.2	-0.5	1.5	0.3	0.2	0.7
Spain	0.2	0.6	0.0	0.1	0.6	1.0	0.4	0.4	0.7	0.1	0.1	0.2
Weighted average	0.0	-0.2	-0.3	0.0	0.2	0.1	0.3	0.1	0.7	0.0	-0.4	-0.3
Unweighted average	0.3	0.0	-0.1	0.1	0.5	0.2	0.5	0.2	0.6	0.3	-0.4	-0.4

Source: OECD, Economic Outlook 72, authors calculations.

5.2. Did elections matter?

31. The interesting question obviously is to what extent this behaviour can be related to the election cycle. Electoral business cycle will work through the three channels of discretionary policy identified above. But their relative importance may change according to the type of electoral calendar. A priori we expect the “genuine” discretionary policy as defined above to be easing in pre-election years (except if the elections are not anticipated) and in election years. The literature surveyed above predicts that tax cuts should be observed in the run up to elections. In principle, one could also expect a positive growth dividend justified by incumbents’ optimism on growth prospects.

32. We have examined this by allocating the discretionary fiscal policy indicator and each of the computed components (*i.e.* expenditure, revenue, “genuine” fiscal policy, “growth dividend” and “inflation dividend”) that are reported in the above tables according to the phase of the political cycle. We distinguish three phases: non-election years, pre- or early election years and full-blown election years. For each of these phases we compute the average and median fiscal stances. There are 22 observations for the non-election years and 11 observations for both the pre- or early elections years and the full-blown election years, respectively.¹¹ The results are shown in Table 5.

33. The prediction in the literature that taxes are cut before elections is confirmed by our results. Indeed, whereas in non-election years there is a small bias towards tax increases, there is a clear tendency towards tax cuts in pre- and early election years. Meanwhile, in full-blown election years there is on average not much activity on the tax front. On average relatively strong discretionary expenditure hikes, in contrast, are observed in election years, but much less so in other years.

34. We find that the average discretionary stance as measured by the overall DP moved from broadly neutral in the non-election years to easing in both the pre/early election years and the election years. A similar shift is observed for the median discretionary stance, indicating that more than half of the observed stances was easing in the pre-, early and full-blown election years whereas in the non-election years this was exactly half. Of course it cannot be excluded that this result may be driven by unusual behaviour of a few countries, and this caveat should definitely be underscored. But what argues in favour of a systematic easing bias is that such behaviour shows up both for the pre/early election years and the election years.

35. Interestingly, the picture becomes even more pronounced when considering the “genuine” discretionary component. We now find that in non-election years the observed “genuine” fiscal policy is distributed around a *negative* mean. This implies that, in line with the SGP’s fiscal philosophy, many countries did continue the fiscal retrenchment to attain safer budgetary positions, sufficiently far from the 3 per cent of GDP deficit ceiling. However, both the mean and median stances move from a tightening of around ¼ per cent of GDP in the non-election years to an easing of around ½ per cent of GDP in the pre- early and full-blown election years. This basically confirms the predicted behaviour: in pre-election years, early election years and full-blown election years there is a bias towards easing “genuine” discretionary fiscal policy.

11. The total number of observations is 44, *i.e.* 11 countries times 4 years. Note that for simplicity we ignore the timing of elections during the year (the most extreme example is that elections in January are treated the same way as elections in December of the same year). However, this choice may also be justified by the annual frequency of budgets.

Table 5. **Discretionary fiscal policy over the election cycle in EMU**

	Non-election years	Pre-/early election years	Full-blown election years
Discretionary expenditure			
Mean	0.22	0.39	0.68
Median	0.26	0.03	0.82
<i>of which:</i>			
"Genuine" discretionary expenditure			
Mean	-0.07	0.06	0.48
Median	0.00	-0.07	0.26
Discretionary revenue			
Mean	0.23	-0.46	0.08
Median	0.24	-0.81	0.01
Total discretionary policy			
Mean	-0.02	0.85	0.59
Median	0.17	0.71	0.81
<i>of which:</i>			
"Genuine" discretionary policy			
Mean	-0.30	0.52	0.39
Median	-0.21	0.49	0.49
"Growth dividend"			
Mean	0.14	0.05	-0.01
Median	0.18	0.25	0.14
"Inflation dividend"			
Mean	0.15	0.28	0.21
Median	0.24	0.27	0.17

Source: OECD, Economic Outlook 72, authors calculations.

36. One way to interpret the results is in terms of the political dynamics. In non-election years governments may want to build up a "war chest" which shows up as tight fiscal policy, and then go into the election year with a subsequent easing of fiscal policy. The problem of course is that not sufficient safety margin has been created in a number of countries, with the result that some of them dangerously approached or exceeded the 3 per cent of GDP deficit ceiling as soon as the economy slowed down.

37. Concerning the frequency distributions for the "expected growth dividend" and the "expected inflation dividend", interestingly, with the onset of elections none of these distributions show a rightward shift according to the mean and median stances reported in Table 5. That suggests that official national forecasters are unbiased with respect to elections.

38. The result for the growth dividend shows that countries have systematically been projecting above-potential growth, but this pattern is uniform irrespective of the electoral cycle, and may be driven by (the perception of) the business cycle rather than anything else. The political cycle does not seem to be of any significance here. Similarly the distribution of the inflation dividend suggests that countries consistently project inflation above the ECB target rate. While this effect is small and again uniform across the electoral cycle, it may suggest that countries have an incentive to keep inflation somewhat above the implicit ECB target in order to capture an “inflation tax” and spend this on expenditure hikes or tax cuts. On the other hand, this conclusion could be contested since the implicit ECB target (if there is one) may simply prove to have been too ambitious and countries' inflation projections may in fact be realistic. So, on balance we are agnostic about this point. At any rate, a link between either the growth dividend or the inflation dividend and the election cycle cannot be demonstrated.

39. In sum, our analysis suggests that the electoral budget cycle is alive and well in EMU. Electoral manipulation of fiscal policy in EU countries – evidence of which in the pre-EMU period is found by Hallerberg and Strauch (2002) – has not been curbed by EMU's fiscal policy rules. Our results are consistent with the findings of von Hagen (2002) who uses a similar indicator of discretionary fiscal policy, but focuses only on pre-elections years and does not distinguish between expenditure and revenue changes. He finds that the expansionary stance in the 1998-2001 period for years preceding the election has been twice as large as that in other years. They are also consistent with Buti (2002) who uses the change in the cyclically adjusted primary balance as a measure of discretionary policy. He compares, for each year since 1999, the target for the cyclically-adjusted budget balance in the national stability programmes submitted two years earlier with the out-turn for the for the same year. His conclusion is that, while most countries missed their targets, deviations from target appear larger and more systematic in elections years.

6. Conclusions

40. EMU's fiscal rules are undergoing their first real stress-test and are currently being refined. Evidence on the fiscal behaviour in the early years of EMU shows that several countries have failed to abide by the spirit of the SGP. We have documented that the discipline requirements of the SGP were insufficient to curb the temptation to run politically-motivated fiscal policies when elections approached. In political economy terms, the short term gains at the national level of higher deficits outweighed the systemic costs involved in violating the rules. This contributed to the erosion in the “political ownership” of the discipline rules after the Maastricht convergence period (Buti and Giudice, 2002).

41. Tackling this double political bias (pro-cyclical loosening in good times and electoral manipulation of fiscal policy) will however be difficult. Suggestions — such as that of introducing “rainy-day” funds by allowing countries to set aside revenue in good times which could then be used in bad times¹² — may be helpful but are unlikely to curb politically-motivated fiscal behaviour. A radical approach would be to harmonise the electoral cycles in EMU: Sapir and Sekkat (1999) show that, if spillovers between countries are positive, adopting a single election day would reduce politically-induced distortions and be welfare-enhancing. But this idea is unlikely to be considered in the foreseeable future.

42. In the end, we are left with the need of stepping up budgetary surveillance, as suggested by the European Commission (2002b), focussing in particular on structural balances and using peer pressure and “early warnings” to curb fiscal misbehaviour. If this succeeds in pushing countries to create sufficient room for manoeuvre in non-election periods, some systematic easing of fiscal policy in electoral periods may have to be accepted.

12. See, Buti, Eijffinger and Franco (2003).

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