



EXCERPT

FISCAL POLITICS

EDITORS

VITOR GASPAR • SANJEEV GUPTA
CARLOS MULAS-GRANADOS

INTERNATIONAL MONETARY FUND

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Note to Readers

This is an excerpt from *Fiscal Politics*, edited by Vitor Gaspar, Sanjeev Gupta, and Carlos Mulas-Granados.

Economics and politics are closely intertwined. Do elections influence budgetary policies? Is political fragmentation associated with the degree of fiscal discipline? What is the role of political ideology? If politics affects fiscal outcomes, can fiscal rules and institutions make a difference?

This volume looks at how politics affects fiscal policies. Two main themes stand out: (1) politics can distort fiscal policy through elections and political divisions, and (2) rules and institutions can keep this dynamic under control. The book presents empirical evidence from advanced and emerging market economies and developing countries. It also examines the relevance of deeper political, historical, and institutional forces that influence the budget at the national and international levels. The book includes chapters by IMF staff members, academics, policymakers, and researchers focusing on this complex subject. Their contributions help improve our understanding by offering new perspectives and looking at past findings.

This excerpt is taken from *uncorrected* page proofs. Please check quotations and attributions against the published volume.

Fiscal Politics

Edited by Vitor Gaspar, Sanjeev Gupta, and Carlos Mulas-Granados

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Foreword

Politics lie at the heart of the role that the state plays in the economy. Decisions to allocate resources, redistribute income, or stabilize the economy have a strong political component. Political developments can therefore have a powerful impact on economic outcomes.

For example, sudden policy shifts, uncertainty from political gridlock, or stalled budget negotiations can lead to market volatility and bad economic outcomes.

For this reason, analyzing the influence of political economy on policy outcomes is essential for the IMF's macroeconomic surveillance and policy analysis.

A deeper understanding of domestic and international constraints faced by policymakers facilitates our interactions with country authorities. By incorporating the understanding of a political dimension in its analysis, the IMF can also tailor its policy recommendations more closely to its mission of serving our member countries.

In particular, I believe that a better understanding of fiscal policy decisions can help us come up with more inclusive—and therefore more sustainable—macroeconomic policies.

I welcome the work done in the Fiscal Affairs Department in this area. It examines rigorously the impact of politics on fiscal decisions and presents compelling evidence that strong institutions and smart rules can have a positive effect on macroeconomic outcomes.

This book is a first step to further integrate political economy issues into the IMF's policy analysis. I hope it will also spark further debate and research on this topic, both inside and outside the IMF.

Christine Lagarde
Managing Director
International Monetary Fund

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Fiscal Politics

VITOR GASPAR, SANJEEV GUPTA, AND
CARLOS MULAS-GRANADOS

INTRODUCTION

Fiscal Politics seeks to capture the politics of fiscal policymaking, and thus revives a tradition in political economy that gradually left the mainstream. This tradition takes economic, social, and political processes as co-determined and co-evolutionary.¹ The inspiration for the book's title comes from the work of the Austrian economist Joseph Schumpeter, drawing on his two seminal contributions: a theory of democracy and the concept of the tax state.

In *Capitalism, Socialism and Democracy*, Schumpeter (1942) defines democratic regimes as a set of institutions leading to a struggle for political power—a competition to win the people's vote and gain the right to exercise that power. This view influenced the work of subsequent political economists, most notably Downs (1957), who portrayed electoral politics as a fight for the median voter.

A second fundamental source of inspiration for the book is Schumpeter's concept of the modern tax state, which reflects an underlying tension between two forces.² On the one hand, the modern state is intertwined with social and political dynamics; on the other, it requires that private and civil spheres be allowed to develop separately from it. In Schumpeter's view, public finances go beyond economics narrowly defined, as captured in his statement, "The spirit of a people, its cultural level, its social structure, the deeds its policy may prepare—all this and more is written in its fiscal history" (Schumpeter 1991, 101).

Several authors have since given political and institutional factors a key role in the analysis of state building, taxation, and economic development. Most notably, Besley and Persson (2011, 2013, 2014a, 2014b) expand the concept of minimal state capacity originally developed by Adam Smith and add a Schumpeterian flavor to the range of capabilities that any modern state needs to function effectively.³

¹For further details on this concept, see Hayek (1978, 1988).

²In 1918, Joseph Schumpeter wrote *The Crisis of the Tax State* (Schumpeter 1991), where he affirmed that the expression "tax state" could be considered a pleonasm.

³"Smith listed 'peace, easy taxes, and a tolerable administration of justice' as sufficient conditions for prosperity. His three pillars of prosperity are broadly the same as ours although with a somewhat different emphasis" (Besley and Persson 2011, 10). In Besley and Persson's view, peace refers to the

In the contributions of these authors, the capacities that define modern states are both economic and political in nature.

In a similar vein, this book is based on the premise that economics and politics are profoundly intertwined. For example, when the economy performs poorly, incumbent governments find it difficult to implement their policy agendas and are likely to lose power in the next elections. The opposite tends to be true during good times. When political uncertainty increases, investment decisions are postponed and markets can become volatile (Alesina and Perotti 1996b; Brandon and Yook 2012; Pastor and Veronesi 2013; Chang and others 2013). When combined with low growth and rising inequality, which fuel populism and protectionism, political uncertainty can become a serious threat to economic prosperity (Alesina and others 1996; IMF 2016).

Even during times of political stability, electoral outcomes and political polarization can affect economic policies and the state of the economy (Alesina and Rosenthal 1995; Acemoglu and Robinson 2013). Different political parties running for office target different economic outcomes of output growth and income equality. These distinctive objectives, coupled with uncertainty about the election results, make macroeconomic outcomes unpredictable and could generate unexpected recessions or expansions. Politics influences economic outcomes through various channels, including structural reforms and monetary and fiscal policies.

This book is about how politics affects policies on the fiscal front. Do elections affect budgetary policies? Is political fragmentation associated with the degree of fiscal discipline? What is the role of political ideology? If politics affects fiscal outcomes, can fiscal rules and institutions make a difference?

To address these questions, the chapter authors rely on past findings and offer new perspectives. Although the details vary and depend on country-specific circumstances, scholars have identified specific political patterns that have improved our understanding of fiscal outcomes.⁴ The main lesson is that politics, whether at the national or supranational level, matters for fiscal policymaking. Unfortunately, this topic was neglected during the years of prosperity before the global crisis and, in light of the ongoing difficulties in implementing growth-friendly fiscal policies in the aftermath of the financial meltdown, further work is needed in this area. Minimizing political distortions to fiscal policy requires a sound understanding of the mechanisms through which political activity affects the budget. This book makes a contribution to this effect, motivated by the need to adapt fiscal policy advice to evolving political and economic circumstances.

absence of internal conflict and political repression; easy taxes means taxes that are easily extracted and broad based; and justice means finding ways of ensuring that the state supports contracts, enforces property rights, and limits (public or private) predation. These authors consider that modern state capacity involves three key dimensions: (1) fiscal capacity for tax collection; (2) legal capacity to secure market functioning, enforce contracts, and protect property rights; and (3) collective capacity to supply public goods.

⁴For recent literature reviews on the political economy of fiscal policy, see Katsimi and Sarantides (2012); Klomp and de Haan (2013a, 2013b); and Alesina and Passalacqua (2015).

Although the book's coverage of topics is comprehensive, it does not delve into issues such as the electoral consequences of fiscal adjustments, the impact of budget cuts on inequality, or the relationship between austerity and the recent wave of populist politics.

The book makes four contributions. First, in contrast to most of the existing literature on the political economy of fiscal policy that focuses on developed economies, this book also presents empirical evidence from advanced, emerging, and developing countries. Second, it goes beyond the typical concentration on electoral politics and uses a combination of electoral calendar variables, measures of political fragmentation, and indicators of ideological polarization to explain how political factors affect fiscal outcomes. Third, it examines the relevance of deeper political, historical, and institutional forces that influence the budget at the national and international levels. Finally, this volume not only describes the political bias embedded in fiscal policy decisions, but also proposes smart rules and strong fiscal institutions to bring fiscal outcomes closer to their optimum.

HOW POLITICS AFFECTS FISCAL POLICY

Fiscal policy, which was once defined as “the matter of who gets what, when, and how” (Laswell 1936, 19), is heavily influenced by political factors. A typical government performs three core functions: allocation, distribution, and stabilization (Musgrave 1959).⁵ All of these functions are intrinsically political. Politics has a direct impact on the provision of public goods and is of particular relevance with regard to stabilization and redistributive policies. For example, when the executive branch of government runs a fiscal deficit to stabilize the economy, a political decision with intergenerational implications is involved. Similarly, subsequent discussions in the parliament about the composition of revenues and expenditures are the result of bargaining in the political process that has an impact on income distribution and can generate unintended economic outcomes.

The literature on the political economy of fiscal policy dates back to the nineteenth century when the Italian and Swedish schools of public finance began to analyze how governments choose policies (Alesina and Tabellini 1990). During the twentieth century, the Public Choice school continued this work and focused on the political incentives and constraints in policy formulation. For example, the work of Buchanan (1960) and Buchanan and Wagner (1976) stressed the inability of voters to understand the intricacies of fiscal policy and the government's tendency to deviate from the optimal path. This discussion revived the interest of scholars in the political determinants of fiscal policy. Initially, the new political economy models sought to explain deviations from the tax-smoothing framework (Barro 1979), under which public debt was the result of an optimal fiscal

⁵The stabilization function works to ensure the achievement of high employment and price stability; the redistribution function aims to achieve an equitable distribution of income; and the allocation function sees that resources are used efficiently.

policy aimed at smoothing tax rates over time. These political economy models aimed to explain observed fluctuations in deficits and public debt arising from institutional factors mediated by electoral constraints. These new models varied substantially in the type of electoral system,⁶ the degree of fiscal centralization,⁷ and the budgetary laws⁸ under which fiscal policy decisions were made. But in general, their most important contribution was to develop a framework by which the effect of political factors on fiscal economic decisions could be empirically tested.⁹ Since then, three sets of factors have systematically been shown to influence fiscal policies: (1) the date of elections when voters have the opportunity to reward or punish the government for its economic policies; (2) the ideology of the party in government with respect to the size and role of the state in the economy; and (3) the degree of political fragmentation, which determines how many actors participate in fiscal policy decisions.

Proximity of Elections

Elections mainly affect the stabilization and redistribution functions of the government. Proximity of elections can influence the government's budget decisions in various ways.

First, if the government believes that its prospects of getting reelected will be better when the economy is growing, it may consider launching a fiscal expansion before the elections. Such behavior would generate political budget cycles.¹⁰ Moreover, if this action is not fully compensated for during the incumbent's tenure, it will lead to debt accumulation from one political cycle to the next. This bias requires two assumptions: fiscal illusion among voters, according to which they overestimate the benefits of current expenditures and underestimate the future tax burden that will be needed to finance current expenditure;¹¹ and voter ignorance, implying that voters find it difficult to fully understand the details of the budget's composition and its long-term impact.

The second type of electoral effect on fiscal policies is related to the first and has to do with the strategic use of debt by the incumbent government. For example, a conservative government that dislikes the provision of public goods, and is certain that it is going to be followed by a leftist government that is in favor of expanding the provision of such goods, may strategically leave less funds for

⁶ For the effects of electoral systems on fiscal policy, see Grilli, Masciandaro, and Tabellini (1991); Hallerberg and von Hagen (1997); and Milesi-Ferretti, Perotti, and Rostagno (2002).

⁷ For a review of theories of fiscal federalism, see Ter-Minassian (1997), and for a political economy perspective on fiscal decentralization, see Lockwood (2005).

⁸ For the effects of different budgetary rules related to spending limits, see Hallerberg and von Hagen (1997) and Perotti (1998).

⁹ For a literature review on the political economy of budget deficits and debt, see Alesina and Perotti (1995); de Wolff (1998); Persson and Tabellini (2002); Franzese (2002); Mulas-Granados (2006); and Alesina and Passalacqua (2015).

¹⁰ See Nordhaus (1975) and Alesina, Roubini, and Cohen (1997).

¹¹ See Buchanan and Wagner (1976) for fiscal illusion.

the incoming government. By leaving a sizable debt for the successor government, the conservative government would tie the hands of the leftist government and oblige it to raise new taxes (which is unpopular), not comply with its electoral program of expansion of public services (which will cause strong disappointment among its supporters), or both. With this strategic use of the debt, the incumbent conservative government would dramatically increase its chances of defeating the new government in the next elections.¹²

We find support for this type of fiscal behavior in chapters included in this volume. As other scholars have noted, the intensity of political budget cycles is higher in younger democracies and in less transparent systems (Klomp and de Haan 2013a, 2013b), and is behind the delay in implementing necessary fiscal adjustments (Mierau, Jong-A-Pin, and de Haan 2007).¹³

In addition to proximity of elections, deviations from optimal behavior are explained by other political variables, such as the cabinet's ideology and, most important, by political fragmentation.

Ideology of the Cabinet

Parties in government are motivated by the objective of remaining in office and by their specific policy agenda following (in part) from their political ideology (Muller and Strom 1999).¹⁴ Ideology of the party in government tends to surface in tax-and-spend policies linked to the government's redistribution function, but it can also influence fiscal policy decisions about macroeconomic stabilization.

The first contributions to the literature on stabilization policies date back to the 1970s, when Hibbs (1977, 1987) supported the thesis that left-wing governments fought unemployment while right-wing governments were especially worried about inflation. Subsequent studies provided empirical evidence that left-wing

¹² See Persson and Svensson (1989) for a concrete example. For a more general overview of the models that analyze the strategic use of debt, see de Wolff (1998) and Franzese (2002).

¹³ Broad empirical evidence on the existence of political budget cycles can be found in Persson and Tabellini (2002); Drazen and Eslava (2010); or Alesina and Paradisi (2015). Klomp and de Haan (2013b) introduce some nuances and show that the size of political budget cycles is higher in developing countries than in advanced economies. Similarly, other papers report evidence suggesting that the occurrence and strength of manipulation of fiscal policy for electoral purposes depend on a variety of accompanying factors, such as the level of development and institutional quality (Shi and Svensson 2006), the maturity and age of democracy (Brender and Drazen 2005), constitutional provisions determining electoral rules and form of government (Persson and Tabellini 2002, 2003), transparency of the political process (Alt and Lassen 2006a, 2006b), the presence of checks and balances (Streb and Torrens 2013), or credible fiscal rules (Rose 2006; Alt and Rose 2009).

¹⁴ We depart from Downs' statement that political parties "formulate policies in order to win elections, rather than win elections in order to formulate policies" (Downs 1957, 28). The chapters in the present volume assume that political parties are guided by two objectives at the same time: the pursuit of policy and the pursuit of office. This approach contrasts with pure policy seekers and pure office seekers (Muller and Strom 1999). The collective view underlying the different contributions in this book is that parties in government seek to maximize both objectives simultaneously, because staying in office guarantees further influence on the policy agenda, and delivering on the policies preferred by citizens typically increases the chances of remaining in office.

cabinets favored expansionary fiscal policies to accelerate aggregate demand as a means of reaching full employment, while right-wing cabinets maintained small and balanced budgets favoring market-led full employment equilibrium (Alesina and Rosenthal 1995; Boix 1997). In parallel, evidence showed that fiscal policies on the demand side had only temporary effects (Alesina 1989; Alesina and Roubini 1992), were inflationary (Álvarez, Garrett, and Lange 1991), and were difficult to implement in open economies (Alt 1985; Alesina and Summers 1993; Frieden and Rogowski 1996; Hall 1986; Garrett 1998).¹⁵ Thus, political parties were only left with the possibility to affect economic policies on the supply side. Here again, some partisan differences in macroeconomic policies were found, indicating that left-wing governments were likely to implement interventionist supply-side policies, through the public provision of human and physical capital, to increase growth and the competitiveness of the economy (Boix 2000; Franzese 2002; Notermans 2000; Mulas-Granados 2006). This book presents some evidence that left-wing governments are associated with higher rates of growth in public investment.

Ideology heavily influences fiscal policies that pertain to redistribution. Left-wing parties draw their support from workers and the middle- and low-income segments of the population. Thus, they pay particular attention to income inequality, redistribution, social benefits, and interventionist supply-side policies in the form of public provision of human and physical capital. One would expect left-wing governments to be associated with higher public expenditures on welfare policies and a sizable public administration. To finance these expenditures, these governments would be expected to tax more and to tax more progressively (Angelopoulos, Economides, and Kammass 2012).¹⁶ The book shows that after banking crises and during fiscal adjustment episodes, left-wing governments are associated with different revenue-raising measures than right-leaning governments.

In contrast, right-wing governments would prefer a less activist role for the government and would favor a stronger role for the private sector. Right-wing parties obtain their votes mostly from the economically stronger segments of the population (or at least with average income above the median voter's income). These voters have more private resources to smooth their personal consumption in periods of economic downturn; they are more concerned about inflation; and as potential private investors, they suffer most from the crowding-out effect of public intervention in the economy. Thus, right-wing governments would prefer to run balanced and small budgets. Lower levels of public spending would require lower levels of public revenue, meaning less distortionary taxes on market

¹⁵ For a longer review of the initial literature on partisan economic policy management, see Boix (1997).

¹⁶ Higher public expenditures financed by higher public revenues do not mean that left-wing governments run deficits more often than right-wing governments (Boix 1997; Franzese 2002; Notermans 2000). According to these authors, to intervene on the supply side of the economy through public investment, left-wing governments would prefer surplus or close to balanced budgets.

activities. The implication is that right-wing governments would tax and spend less than left-wing governments (Volverink and de Haan 2001).

Although the cabinet's ideology is an important predictor of fiscal policy, it does not always play the same role, especially when the government's credibility is at stake and they need to reassure financial markets. In this context, Tavares (2004) and Kraft (2016) show that cabinets signal commitment and gain credibility by pursuing fiscal adjustments in ways not favored by their constituents (that is, the left cuts expenditures and the right increases taxes). According to Starke, Kaasch, and van Hooren (2014), partisanship may play a different role than expected depending on the degree of development of the underlying welfare state (that is, in more developed welfare states, ideology is a weaker predictor of government's likely actions).

Political Fragmentation

Most studies focusing on the political economy of fiscal deficit and public debt find that fragmentation in decision making is damaging for expenditure control and eventually for fiscal discipline. Political fragmentation affects the three government functions—the provision of public goods, stabilization, and income redistribution. In the presence of multiple parties with different ideologies, achieving consensus on balanced budgets is difficult because every party will have its favorite spending program, but it will only internalize a part of the costs and distortions of the associated increase in revenues needed to finance spending. This is the “common pool problem” put forward by Weingast, Shepsle, and Johnsen (1981).¹⁷

The larger the number of actors with a voice in the fiscal decision-making process, the stronger the pressure for more expenditures, and thus the greater the deviation from optimal fiscal policy. Political fragmentation affects the stabilization function of the government because the pace and size of fiscal consolidations can be contentious. For example, coalition governments or big cabinets (with many spending ministries) would be less likely to undertake a fiscal adjustment. Alesina and Drazen (1991) show how the distributional struggle among different interest groups delays the adoption of the efficient policy of balancing the budget. They further show that the more polarized the groups are in a country, the longer stabilization is delayed. The predictions arising from this theoretical work have been confirmed by empirical studies. For example, Roubini and Sachs (1989); Grilli, Masciandaro, and Tabellini (1991); and Volverink and de Haan (2001) find that fragmented governments tend to be associated with larger public deficits. Perotti and Kontopoulos (2002) and Illera and Mulas-Granados (2008) show that the size and duration of fiscal consolidations is negatively affected by political fragmentation. In general,

¹⁷ The origin of this idea can be traced to Hardin (1968). In addition, note that many studies link the electoral system (majoritarian, proportional, and so on) with the subsequent degree of political fragmentation. See Persson and Tabellini (2002) and Golosov (2015) for an overview of this literature.

minority governments, divided legislatures, coalitions, and multiparty cabinets, along with a weak coordinating role for the ministry of finance, are associated with fiscal profligacy and low productive investment (Hallerberg and von Hagen 1997; von Hagen, Hallett, and Strauch 2001; Hallerberg, Strauch, and von Hagen 2007).

The number and strength of political and institutional veto players helps explain why spending cuts are so difficult to implement. A government system with a large number of veto players (Tsebelis 1995, 2000, 2002) tends to preserve the status quo. Changes only materialize when a certain number of institutional or partisan actors agree. As the number of veto players increases, spending cuts and fiscal adjustment become slower, leading to suboptimal public debt accumulation (Spolaore 2004). Similarly, as the ideological distance between the government players increases, the likelihood of any policy change from the status quo decreases (Franzese 2007; Tsebelis and Chang 2004). The presence of a large number of veto players and sharp ideological polarization reduces the chances of agreeing on policy changes and stabilizing the magnitude of excessive public debt (Cox and McCubbins 2001; MacIntyre 2001; Mian, Sufi, and Trebbi 2014).

This book examines the role of political constraints and finds that strong parliamentary opposition weakens the capacity of governments to implement fiscal policies during recessions, confirming previous findings that decisive countercyclical action happens under unified governments (Armingeon 2012). It shows that political fragmentation (measured by both “common pool” and “veto players” indicators) is associated with higher public debt accumulation.

WHAT CAN BE DONE ABOUT THE INFLUENCE OF POLITICS ON FISCAL POLICY?

To date, the main response intended to reduce the influence of political factors on fiscal policymaking has been the introduction of fiscal rules and frameworks to restrain the budgetary discretion of politicians. The book presents mixed evidence on the role of these institutions.

Fiscal rules to constrain political distortions in the budget were introduced in many countries from the 1990s onward (IMF 2009). According to Solow (2004, 30–31), the main reason for imposing rules is, “Whenever discretionary fiscal policy rises to the top of the political agenda, special interests come out of the woodwork. Every tax change, every increase or decrease in public spending is caught over by the potential winners and losers, their lobbyists and elected representatives. The final outcome may often be distributionally and allocationally, and even macroeconomically, perverse. . . . Note that this is not some kind of minor flaw in the system; it *is* the system.”

Those who argue in favor of rules-based fiscal policy also support reliance on automatic stabilizers to smooth macroeconomic shocks (Buti and van den Noord 2004). Because political factors could always force sovereign governments

to violate fiscal rules, such rules should be well-designed (clearly defined, simple, transparent, consistent, and flexible), allow effective implementation (by entailing *ex ante* and *ex post* compliance and efficient monitoring), and be enforceable (in terms of decision making, amendment, and sanctions).¹⁸

The use of fiscal rules is, on average, associated with improved fiscal performance (IMF 2009; Schaechter and others 2015). If rules are designed to prevent conflicts with the stabilization function of fiscal policy, they are indeed associated with less procyclical policies (Debrun and others 2008). But fiscal rules are often introduced to lock in earlier consolidation efforts rather than being implemented at the beginning of the fiscal adjustment. The positive association between fiscal rules and fiscal performance may generally reflect changes in countries' attitudes toward fiscal rectitude—determining both the improved fiscal performance and the introduction of rules.

Fiscal institutions are crucial for fiscal policy (Alesina and Perotti 1996a), especially in the presence of ideological fragmentation (de Haan, Jong-A-Pin, and Mierau 2013).¹⁹ Fiscal frameworks not involving formal rules but focused on transparent and credible strategies backed by proper fiscal institutions can also provide a viable approach to supporting fiscal discipline. Recent evidence has shown that countries with stronger budget institutions have more sustainable public finances (Dabla-Norris and others 2010; IMF 2014). Specifically, countries with comprehensive fiscal reporting, forecasting, and risk disclosure seem to be less vulnerable to political biases in fiscal policy. Those with more credible medium-term frameworks, performance budgeting systems, and intergovernmental fiscal arrangements are quicker to announce adjustment plans and better at protecting public investment. And countries with more unified and disciplined budget processes are more effective in implementing budget plans. This book shows that in developing countries, strengthening fiscal institutions such as public financial management systems or linking annual budgets to medium-term budget frameworks could mitigate the political pressures to overspend. This is particularly important in countries that are highly dependent on natural resource revenues.

Finally, independent fiscal councils have been introduced to provide independent information and analysis and to monitor compliance with government's own commitments and legislated fiscal rules. The IMF (2013) asserted that, all else equal, well-designed fiscal councils can promote stronger fiscal discipline.²⁰ Different analyses point to a number of key features of effective fiscal councils (Debrun and Kinda 2014): strict operational independence from politics, the provision of public assessment of budgetary forecasts, strong presence in the public debate (notably through an effective communication strategy), and an explicit role in monitoring fiscal policy rules. The book provides additional evidence

¹⁸ For a discussion of how fiscal rules should be designed, see Kopits and Symansky (1998).

¹⁹ These authors find that strong budgetary institutions, whether they are based on delegation to a strong minister of finance or on fiscal contracts, reduce the deficit bias in European Union countries, especially in the presence of strong ideological fragmentation.

²⁰ In the context of the European Union's fiscal rules, Larch and Braendle (2016) advocate transferring the stabilization function from national governments to independent fiscal councils.

on the positive impact of fiscal councils in further constraining the influence of politics on fiscal policy.

ORGANIZATION AND MAIN FINDINGS OF THIS BOOK

This book consists of three parts: Part I explores how domestic political factors affect fiscal policy outcomes. It focuses on the impact that elections, ideology, and fragmentation of decision making have on fiscal policy variables such as the public deficit, debt, revenues, or expenditures. Part II examines how institutions, fiscal rules, and fiscal councils can reduce the impact of politics on fiscal policy and improve fiscal results. Part III analyzes the interaction between political factors and institutions in supranational governance frameworks, such as those involving the European Union and the IMF.

Three principal messages can be gleaned from the book: First, politics has a decisive influence on fiscal policy formulation and performance because fiscal policy is itself intrinsically political. Second, fiscal rules and budget institutions help attenuate the effect of politics on fiscal policy but are ineffective at forcing political actors to act against their own will. Third, while supranational rules and institutions exert influence on domestic fiscal policymaking, long-lasting good fiscal behavior requires ownership on the part of national political systems.

The book starts by looking at whether governments stick to their own fiscal policy plans. In Chapter 2, Sanjeev Gupta, João Tovar Jalles, Carlos Mulas-Granados, and Michela Schena analyze the political causes and consequences of fiscal consolidation promise gaps, defined as the distance between planned fiscal adjustments and actual consolidations. The consolidation promise gaps can be sizable (about 0.3 percent of GDP per year, or 1.1 percent of GDP during an average three-year adjustment episode). Three political factors explain these consolidation gaps: First, proximity to elections reduces the promise gap as policymakers seek to show voters that they are capable of delivering on their announced plans. Second, greater political strength—the government’s control of parliament and weakness of the opposition—is associated with smaller promise gaps. At the same time, democratic accountability is important for the reduction of promise gaps. The authors find that governments that delivered on their promised fiscal consolidation plans were rewarded by financial markets and not penalized by voters.

Chapter 3, by Christian Ebeke and Dilan Ölçer, analyzes the impact of elections on fiscal policy and offers evidence on the potential role of fiscal rules in reducing electoral budget cycles. Focusing on low-income countries, the authors investigate the behavior of fiscal variables during and after elections. The results indicate that during election years, government consumption significantly increases and leads to larger budget deficits. During the two years following elections, the fiscal adjustment is carried out through increases in trade taxes and cuts to government investment, with no significant reductions in government consumption. The authors find evidence that the presence of both fiscal rules

and IMF programs helps dampen the magnitude of the political budget cycle in low-income countries.

In addition to the role of elections and fragmentation, Chapter 4 introduces another political factor—ideology—that influences fiscal policymaking. Mark Hallerberg and Jürgen von Hagen discuss how partisanship can affect tax policy decisions, both during fiscal consolidations and in normal times in advanced economies. They find that economic factors (such as banking crises) affect tax rates, but there is a political dimension to these tax changes: left-wing governments are less likely than right-wing governments to increase the value-added tax rate and more likely to increase the top personal income tax rate as part of a pronounced fiscal consolidation, but there seem to be no partisan effects on tax policy during normal times. The effect of elections on tax policy is negligible, with only a corporate income tax rate increase more likely the year after an election.

The next three chapters explore the effects of politics on different components of public expenditures. In Chapter 5, Sanjeev Gupta, Estelle X. Liu, and Carlos Mulas-Granados provide empirical evidence of the impact of elections on public investment. Looking at a large sample of presidential and parliamentary democracies across developed and developing countries, they find that the growth rate of public investment is higher at the beginning of electoral cycles and decelerates thereafter. This happens because government consumption expenditure is more visible than capital expenditure before elections. The peak in public investment growth occurs 28 months before elections, and each month closer to the next election, the growth rate of public investment declines by 0.7 percentage point. Other political variables, such as cabinet ideology and government fragmentation, have less influence on short-term public investment dynamics but are more relevant in the medium term.²¹

Chapter 6, by Yehnew Endegnew, Mauricio Soto, and Geneviève Verdier, examines the impact of elections on the government wage bill. By taking advantage of a newly assembled database comprising advanced, emerging, and low-income countries, they find that elections increase the share of the government wage bill to GDP, particularly in nonadvanced economies: at current levels of the wage bill, elections result in an increase of about 0.2 percent of GDP in emerging market economies and low-income developing countries. In advanced economies, changes in both pay and employment are modest and vary little with the election cycle. In both emerging and developing economies, the election year's wage bill increase is more closely associated with pay raises than with increases in public employment.

The role of political fragility and the interaction between social spending and energy subsidies is discussed by Christian Ebeke and Constant Lonkeng Nguouana in Chapter 7. They present a model in which high energy subsidies and low

²¹In addition to the short-term evidence on electoral investment cycles shown in Chapter 5, Gupta, Liu, and Mulas-Granados (2015) report results on the impact of political fragmentation and cabinet ideology for medium-term public investment booms that span several election cycles.

public social spending can emerge as an equilibrium outcome of a political game between the elite and the middle class when the delivery of the public good is subject to weak domestic institutions. They find that public spending on education and health was, on average, two-thirds percentage point of GDP lower in countries where energy subsidies were 1 percentage point of GDP higher than the average. Moreover, this trade-off is larger in a context of political ineffectiveness, measured by an index of fragmentation and political fragility.

In Chapter 8, Fabian Gunzinger and Jan-Egbert Sturm provide additional evidence that political fragmentation can generate suboptimal fiscal policy outcomes. They quantify the effect of the fragmentation of power on the size of fiscal stimulus packages put in place in response to the Great Recession. On average, more political fragmentation (measured by the degree of legislative control that parliaments exert over governments) reduced the size of a country's fiscal stimulus package by between 1.0 and 2.7 percentage points of GDP. In contrast, in contexts with lower or no fragmentation, government stimulus packages were sizable. Among all the political variables tested in the model, the presence of political fragmentation and constraints (for example, strong parliamentary opposition) was by far the most robust political factor explaining the differences observed in countercyclical fiscal policies to stimulate the economy after deep recessions.

In the final chapter of the first part of the book (Chapter 9), Ernesto Crivelli, Sanjeev Gupta, Carlos Mulas-Granados, and Carolina Correa-Caro study the impact of fragmented politics on public debt. The chapter shows a strong positive association between political fragmentation and public debt changes between two consecutive legislative elections. This effect holds true for all indicators associated with "common pool" and "veto player" theories. Common pool indicators are those that capture the political pressures for additional spending, whereas the veto player indicators help identify the political sources of resistance to reform. This chapter shows that corruption magnifies the negative effects of political fragmentation on public debt accumulation. For example, in countries with high corruption, high political fragmentation (measured by weak majorities in the parliament or a large number of ministries) multiplies the increase in public debt. Finally, the introduction of fiscal councils helps attenuate the negative impact of political fragmentation on public debt dynamics.

Part II of the book focuses on how institutions, fiscal rules, and fiscal councils can reshape politics and have positive effects on fiscal policy outcomes. In Chapter 10, Vitor Gaspar, Laura Jaramillo, and Philippe Wingender illustrate via case studies the nature of the political conditions and institutions that characterized countries as they crossed a specific tax-to-GDP-growth tipping point. The existence of such a tipping point is interpreted as likely to come from the strong association between tax, legal, and administrative capacities.²² The chapter

²² Gaspar, Jaramillo, and Wingender (2016) show this relationship statistically in an empirical paper using a contemporary database covering 139 countries from 1965 to 2011 and a historical database for 30 advanced economies from 1800 to 1980.

highlights three key political factors that go together with enhanced tax capacity: constitutive institutions (for example, social pacts between the elite and citizens to develop welfare state policies), inclusive politics (for example, participation of all relevant actors in collective decision making), and credible leadership. The role of constitutive institutions was evident in Spain and Colombia, as an explicit political settlement between political elites and citizens preceded tax capacity building. Both countries recognized that greater levels of taxation were essential to meet the emerging spending pressures associated with the economic, social, and institutional demands prompted by those countries' new constitutions. Inclusive politics facilitated new center-periphery agreements crucial to building new tax collection schemes, as in China and Lagos State of Nigeria. And credible leadership was clearly present across the four case studies, resulting from deliberate decisions by policymakers to implement a shift in the economic model, taking advantage of opportunities offered by economic or political crises.

Together with domestic institutions, strong external commitments can have a positive effect on fiscal discipline. In Chapter 11, João Tovar Jalles, Carlos Mulas-Granados, and José Tavares discuss how exchange rate regimes affect fiscal discipline, taking into account the effect of underlying political conditions. They present a model in which the disciplining effect of the exchange rate regime on fiscal outcomes could be affected by weak politics (defined as policymakers facing a short political horizon and fragile cohesion). Contrary to common perception but in line with similar studies, their results show that being at (or moving toward) fixed exchange rates is harmful for fiscal discipline. This outcome occurs because under fixed exchange rates, the economic cost of fiscal indiscipline and default takes longer to be felt than under alternative regimes, thus allowing policymakers to overspend. Strong politics (with distant elections and lack of fragmentation) helps induce fiscal discipline but is not enough to counter the negative impact of fixed exchange rate regimes. The authors use a synthetic control method to illustrate how the transition from flexible to fully fixed exchange rates under the euro negatively affected fiscal discipline in European countries.

The subsequent three chapters of Part II discuss how fiscal rules can help attenuate the distorting effect of political factors on fiscal policy. Chapter 12, by Till Cordes, Tidiane Kinda, Priscilla Muthoora, and Anke Weber, presents evidence suggesting that expenditure rules are associated with spending control, countercyclical fiscal policy, and improved fiscal discipline. This appears to be related to the properties of expenditure rules given that compliance rates are generally higher than with other types of rules (concerning the budget balance or debt, for example). In particular, compliance with expenditure rules is higher if the expenditure target is directly under the control of the government and if the rule is not a mere political commitment but enshrined in law or in a coalition agreement.

Chapter 13, by Andrea Bonfatti and Lorenzo Forni, demonstrates that sub-national governments are able to tame the political budget cycle by using fiscal rules. The authors find that Italian municipalities subject to fiscal rules face more limited political budget cycles than municipalities not subject to rules. They find

that the political budget cycle increases real capital spending by about 35 percent, on average, in the years before municipal elections, while subnational fiscal rules manage to reduce this spending by about 66 percent in municipalities where such a rule is applicable.

In Chapter 14, Mar Delgado-Téllez, Victor D. Lledó, and Javier J. Pérez propose a framework with which to study noncompliance with centrally mandated fiscal targets in Spanish regions. Their framework shows that regional fiscal noncompliance increases with the size of growth forecast errors and fiscal adjustment needs, factors not fully under the control of regional governments. But fiscal noncompliance tends to increase during election years. The chapter shows that fiscal rules have a positive impact but are not sufficient to guarantee compliance with fiscal targets at the subnational level. Enhancing fiscal compliance in countries with multilevel governance systems requires a comprehensive assessment of intergovernmental fiscal arrangements that goes beyond strengthening the rules-based framework.

The remaining two chapters of the second part of the book present evidence suggesting that strong budget processes and institutions are crucial for good fiscal performance. In Chapter 15, Sanjeev Gupta, Sami Yläoutinen, Brian Olden, Holger van Eden, Teresa Curristine, Tom Josephs, Eliko Pedastsaar, and Johann Seiwald discuss budget institutions that can support planning and delivery of credible fiscal strategies in the fiscal policymaking process. These institutions are grouped in three categories: institutions that help provide an understanding of the fiscal outlook and future challenges; institutions that are crucial to formulating a credible fiscal strategy; and finally, a third group of institutions that secure the efficient implementation of any fiscal strategy. The resulting framework is applied to low-income countries and the status of their budget institutions is compared with that prevailing in Group of 20 advanced and emerging market economies. The chapter ends with a recommendation to prioritize and sequence reform efforts regardless of surrounding political conditions.

Chapter 16, by Xavier Debrun, Marc Gérard, and Jason Harris, revisits the potential contribution of politically independent fiscal councils to improve fiscal performance. Using a simple theoretical model, these authors illustrate that fiscal councils cannot credibly exert a direct constraint on day-to-day policy choices, but they can exert an indirect influence. By contributing to the broader public debate on fiscal policy—through the provision of unbiased quantitative and qualitative analysis, forecasts, and possibly recommendations—these institutions can reduce informational asymmetries hindering voters' ability to reward good policies and penalize bad ones. The authors explore the empirical relevance of this argument by looking at the media impact of fiscal councils in relation to “real-time” fiscal developments. Evidence shows that fiscal councils' activity and media impact increase in times of budget slippages or relative fiscal activism; unfortunately, however, media impact is only weakly correlated with subsequent policy changes.

Part III of the book revisits how some of the political and institutional factors discussed in Part I and Part II affect fiscal policy in a supranational policy setting. In Chapter 17, Vitor Gaspar compares the early American experience

to the ongoing European struggle to a complete Economic and Monetary Union. Following Sargent (2012), the starting point of his chapter is that the United States had to undergo a political transformation between 1789 and 1795 to make it possible to ground public finances in solid fundamentals. Because changing policy outcomes systematically requires changing the rules and incentives of politics, the U.S. experience can be useful for today's Europe in helping align political incentives with macrofiscal stability and financial integration. U.S. history shows that there is a close relationship between the different layers of fiscal policy, finance, and politics. For a program to be successful in Europe, it needs to be viable in all of these layers at the same time. One crucial element of Alexander Hamilton's program was the establishment of U.S. federal bonds as the ultimate safe asset. Similar issues are now being debated in Europe around the concept of European Safe Bonds.²³

In Chapter 18, Luc Eyraud, Vitor Gaspar, and Tigran Poghosyan continue to explore the political sources of fiscal policy outcomes in today's Europe. This chapter provides evidence of how political factors have been associated with fiscal procyclicality, excessive deficits, distorted budget composition, and poor compliance with fiscal rules in the euro area since its creation. From a conceptual point of view, the chapter extends the analysis of political economy factors and policy distortions to the supranational level; from an empirical point of view, the chapter reviews a series of policy biases, including the relationship between country size and budget execution; and from a normative point of view, the chapter brings a novel perspective on supranational fiscal governance reforms by focusing on how to correct political incentives at the national level instead of insisting on ever more complicated rules and illusive application of rigid sanctions. A crucial factor is to ensure that the existence of supranational rules is not used to dilute the ultimate national responsibility for fiscal policy.

The final chapter of the book explores how supranational institutions such as the IMF can exert influence on national fiscal policies. Chapter 19, by Ernesto Crivelli and Sanjeev Gupta, studies whether revenue conditionality in IMF programs helped overcome domestic political barriers in implementing revenue reforms in a large number of low- and middle-income countries. Their results indicate that such conditionality had a positive impact on tax revenue, with the strongest improvement felt in taxes on goods and services, including the value-added tax. Revenue conditionality matters more for low-income countries, particularly those where revenue ratios are below the group's average. Moreover, the IMF's revenue conditionality was more effective when targeted to a specific tax because a narrow focus for tax reform helps avoid political reaction against widespread tax hikes.

²³ For further explanation and references, see Brunnermeier, James, and Landau (2016).

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FISCAL POLITICS

The essays in *Fiscal Politics* are gold mines of description and explanation of the sources of tension between optimal and equilibrium fiscal policies. The book presents a fascinating array of evidence about the purposes served by alternative rules, when they have worked, when they have broken down, and how they can be improved.

—**Thomas J. Sargent**, Professor, New York University, and Nobel Laureate in Economics

It is now widely accepted that understanding fiscal policy requires understanding economics and politics. This valuable volume is rooted in political economy and covers a range of first-order issues which will be of interest to both researchers and policymakers.

—**Timothy J. Besley**, Professor, London School of Economics

You can't understand fiscal policy if you don't consider the politics behind it. This book will greatly help you to navigate this complex territory. A splendid and broad-ranging contribution.

—**Alberto Alesina**, Professor, Harvard University

Fiscal Politics keeps with a long IMF tradition to offer lucid, commonsensical empirical analyses of policy-making, but breaks with a long IMF tradition to stay clear of politics. Instead, the authors in this collection of essays on fiscal policy pay close attention to the constraints and motives embedded in political institutions. They uncover new answers to a range of interesting questions on how fiscal policy reflects domestic political drivers—like elections, party fragmentation, and investments in state building— as well as interactions with domestic and supranational institutions—like fiscal rules and watchdogs, the EU, and the IMF itself.

—**Torsten Persson**, Professor, Swedish Research Council and University of Stockholm

The current President of the European Commission, Jean-Claude Juncker, famously remarked, “We all know what are the policies which we should follow, but we do not know how to do them and then be re-elected.” An obvious application of this statement regards fiscally prudent policies. An idea vastly held as obvious is that voters always punish incumbents who raise taxes or cut spending to reduce deficits. The first part of this book provides a new, thorough, and welcome analysis of the issues related to fiscal politics. Parts II and III are an instruction manual on how to design institutions that help control a country's debt at the national and supranational levels. Governments and legislatures throughout the world will find this manual particularly valuable. This is a book that should be on the shelf of any policymaker with an interest in fiscal policy and on the reading list of any macro course that aims to address relevant issues

—**Francesco Giavazzi**, Professor, Bocconi University

EXCERPT:
FISCAL POLITICS