The Mechanism of Political Budget Cycles in Greece

George Petrakos, Konstantinos Rontos, Chara Vavoura, and Ioannis Vavouras

Abstract Extended empirical research has established the existence of political budget cycles in Greece but remains agnostic about the mechanism which generates them. In this paper we contribute to the literature by investigating precisely this mechanism of the creation of political budget cycles using data from the Greek economy for the last four decades (1980–2018). We find that it is via the manipulation of public expenditure rather than through the handling of public revenue that opportunistic politico-economic behaviour arises. We go on to build a novel empirical model linking government spending and revenue and estimate that, in years of general elections, public expenditure rises by around 2.2% of GDP. This level is not typical of a developed economy. Still, our finding is robust to various specifications of our model, both linear and non-linear, and hints towards a severe decline in the underlying political culture of the country. We conclude that, in the case of Greece, future fiscal rules aiming to suppress the political budget cycles phenomenon should target the control of pre-election transfer payments instead of resorting to tax increases.

G. Petrakos
Department of Public Administration, Panteion University of Social and Political Sciences, Athens, Greece
e-mail: petrakos@panteion.gr

K. Rontos
Department of Sociology, University of the Aegean, Mytilene, Greece
e-mail: K.Rontos@soc.aegean.gr

C. Vavoura
Department of Economics, University of Athens, Athens, Greece
e-mail: cvavoura@econ.uoa.gr

I. Vavouras (✉)
Panteion University of Social and Political Sciences, Athens, Greece
e-mail: vavouras@panteion.gr

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1 Introduction

This paper identifies the mechanism generating *political budget cycles* (PBCs), a term used to refer to the jump of budget deficits during election years. This phenomenon is generally interpreted as being triggered by the government's pursuit of re-election, and it is played out when incumbents pursue opportunistic fiscal policies before general elections so as to appear competent and offer voters the illusion of economic prosperity (Rogoff, 1990; Rogoff & Sibert, 1988). Specifically, either because they are facing a myopic electorate with a *decaying memory* of past events or taking advantage of *informational asymmetries* that exist between them and rational constituents, politicians may choose to maximise their own *voting function* (Nordhaus, 1975) instead of behaving benevolently by maximising a social welfare function as is commonly assumed by traditional macroeconomic theory (Theil, 1956; Tinbergen, 1975).

There are effectively two possible mechanisms that could generate PBCs, either through excessive public spending or via taxation policies aiming at a suboptimal level of tax revenue (Alesina, 1987, 1988), each with very different social welfare implications. Our paper contributes to the literature by tracing the steps taken in order for PBCs to be created. PBCs on the revenue side take place mainly in the form of a direct and indirect tax rate reduction, whereas PBCs on the expenditure side materialise mostly through an increase in transfer payments. Hence, the former tends to be of practical concern to relatively wealthier and, therefore, less numerous potential voters. As a result, we argue that revenue-side PBCs seem less likely, and for the additional reason that they require a considerably more significant time lag between the reduction in tax rates and the corresponding reduction in tax revenue and timing is of critical importance in increasing the effectiveness of pre-electoral fiscal manipulation.

To test our hypothesis that it is expenditure manipulation that gives rise to PBCs, we propose a novel empirical model to examine how the political cycles affect public spending and public revenue. To confidently construct our model, we look into the connection between elections and the dynamic evolution of the two aforementioned macroeconomic variables. There is an important, although nuanced, relationship between current expenditure, past expenditure and current revenue. How the latter two shape the former has been a matter of an extended debate which is key in the PBCs literature. For example, de Haan and Klomp (2013) consider expenditure to be a function of its lagged values, whereas Shi and Svensson (2006), among others, take the approach that the level of expenditure of a given year is influenced not only by its own past values but also by the level of current revenue.

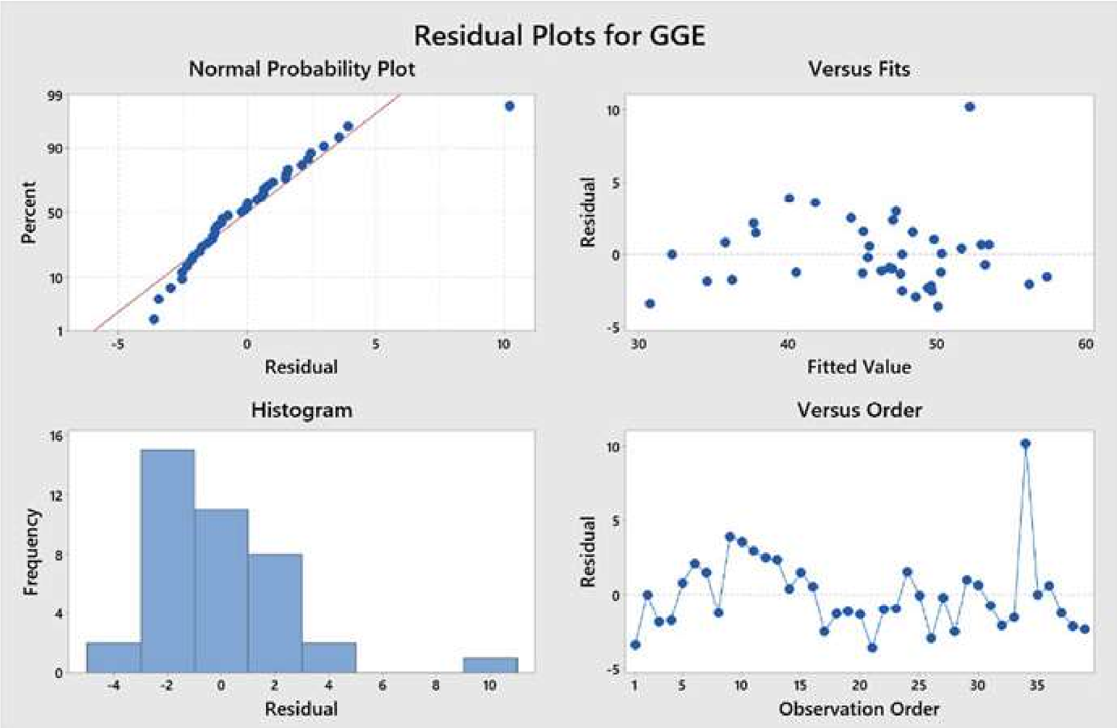

Fig. 4 Diagnostics of Model (4)

$$\frac{\partial \mathrm{GGE}}{\partial \mathrm{GGR}} \cong 4.123 - 0.09\mathrm{GGR} \tag{5}$$

Equation (5) implies that the effect of current revenue on current expenditure changes sign (from positive to negative) at a level of GGR $\cong$ 45.8. This value is similar to the one in Fig. 2 (bearing in mind that Fig. 2 shows the relation between GGR and GGE-1). Finally, it is striking that regardless of the approach (linear vs non-linear) and the variables we include as regressors, the magnitude of PBCs is robust, and it amounts to a 2.2% of GDP increase in public expenditure.

From the analysis presented above, we can conclude that, over the last four decades, the Greek economy has been characterised by severe PBCs of about 2.2% of GDP. These cycles are of alarming magnitude, given that PBCs in developed countries lie between well below 1% of GDP and insignificant (De Haan & Klomp, 2013) and indicate a severe decline in the underlying political culture of the country. These PBCs have largely driven the excessive and persistent public deficits and the resulting debt crisis that devastated the Greek economy for the last 10 years and cost the country more than one-fourth of its GDP per capita (Vavouras, 2019). As a result of the crisis, the European Union implemented strict fiscal rules, mainly in the form of the excessive deficit procedure under the corrective arm of the Stability and Growth Pact. Such fiscal rules have been found to suppress politicians' ability to create PBCs (Bonfatti & Forni, 2019; Gootjes et al., 2019; Vavoura et al., 2019). By highlighting the mechanism that generates PBCs, we add to the literature by deriving economic policy implications useful for the design of effective fiscal rules.

In particular, our results show that, in the case of Greece, fiscal rules aiming to limit the impact of PBCs should target the control of pre-election transfer payments rather than resorting to tax increases.

3 Conclusions

In this paper, we show that PBCs in Greece arise due to a sharp increase of around 2.2% of GDP in the level of public expenditure during election years, and the magnitude of these cycles is robust to different specialisations of the model describing the evolution of public expenditure. As a result, we find that, over the last 40 years, the Greek economy has been characterised by severe PBCs which are not characteristic of a developed but rather a developing economy.

Our contribution is twofold. First, our work adds to the literature on the effect of fiscal rules on limiting PBCs because we can use our findings that PBCs are expenditure-oriented to justify the imposition of fiscal rules aiming at the reduction of transfer payments, rather than the ones focused on increasing tax rates in order to tackle opportunistic budgetary behaviour on the side of the Greek governments. Second, on a technical level, we move away from the linear model, currently the workhorse of the PBCs empirical literature, leveraging on the fact that public revenue and public spending appear to have a non-linear relationship. We end up with a quadratic model linking the two variables which works well for our limited dataset. However, the next task of research within this model would be to explore even more sophisticated relationships between our key macroeconomic variables with the use of larger and richer datasets.

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