

POLITICAL BUDGET CYCLES IN THE EUROPEAN UNION – POST-COMMUNIST HERITAGE

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ABSTRACT

We test the hypothesis that post-communist history affect election cycles in the European Union countries. We show that pre-election fiscal manipulation increase total public spending per capita by 1.9% and three specific spending categories, i.e. general public services, public order and safety, and economic affairs in Central and Eastern Europe democracies with post-communist roots. At the same time we observe no significant spending deviations in remaining EU Member States, except expenditure linked to environmental protection. Our results indicate cross-country heterogeneity of political budget cycles (PBCs) in the EU, conditional on political system history.

Key words: political budget cycle (PBC), election cycle, general government expenditure, fiscal manipulation, European Union, EU post-communist countries

INTRODUCTION

The public finance sector remains the responsibility of politicians, not economists. Thus, economic and political scientists have been intrigued by the coincidence of economic policies and election timing [Rogoff 1990]. Elections play a crucial role in functioning of any democracy. Elections create incentives for the incumbent to put to use policy instruments to be re-elected [De Haan 2014]. The state of an economy affects voting [Nannestad and Paldman 1994]. Political budget cycle can be described as a cyclical fluctuation in fiscal policy, induced by electoral cyclicity [Shi and Svensson 2003].

There are numerous theoretical and empirical studies on political budget cycles. They date back to Nordhaus' [1975] opportunistic political business cycle which indicates that incumbents have strong incentives to use fiscal policy for re-election purposes. Fiscal policy opportunistic manipu-

lation for electoral gains has been criticized by numerous evidence suggesting that voters are fiscal conservatives and punish politicians who increase pre-election expenditure [Peltzman 1992, Brender 2003, Brender and Drazen 2008, Arvate et al. 2009, Drazen and Eslava 2010, Garmann 2017]. However, Akhmedov and Zhuravskaya [2004], Sakurai and Menezes-Filho [2008], Aidt et al. [2011], and Klomp and De Haan [2013a] find voters as fiscal liberal who appreciate and reward pre-election extra public spending.

Pure PBC models predict increase in aggregate spending but pre-election incumbent's manipulation may occur as a form of targeting expenditure. Rogoff [1990] shows that PBCs arise due to information asymmetries about government's competence, thus during pre-election period incumbent prefers shifting expenditure towards easily observed consumption expenditures, and away from others. Using multi-country panel data, Vergne [2009] and Block [2002] observe an

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increase in more visible current expenditure and a decline in capital spending in election period. In contrast, capital expenditures [Schuknecht 2000] and infrastructural spending [Aidt et al. 2011] have been shown to increase around elections. Larger expenditure composition changes in election years are related to established democratic economies [Katsimi and Sarantides 2012], not new ones [Brender and Drazen 2013].

Recent empirical studies focus on the cross-country heterogeneity and investigate the drivers and mechanisms of PBCs existence [De Haan and Klomp 2013, Dubois 2016]. Electoral spending expansions have initially been assumed to be characteristic for new democracies and less developed countries [Schuknecht 2000, Block 2002, Shi and Svensson 2002, 2006, Brender and Drazen 2005]. However, recent numerous evidence [Buti and Van den Noord 2004, Mink and De Haan 2006, Tujula and Wolswijk 2007, Efthyvoulou 2012] find support for PBCs evidence in developed countries, i.e. OECD and EU Member States.

Stanova [2012] observes PBCs in Central and Eastern Europe new democracies and finds them to recede over time with increasing number of parliamentary elections conducted. Enkelmann and Leibrecht [2013] based on 1990–2010 data on OECD countries, find PBCs occurrence in total expenditures as well as in specific spending categories mainly in newly democratized Eastern European countries. They also find that election-year expenditure shift towards administrative spending. Dolezalova [2013] report PBCs presence throughout EU Member States but find that the factor of length of democracy has a small impact on the results. Ademmer and Dreher [2016] using data from 1996–2012 for 25 EU countries, show that governments frequently fiscally stimulate the economy in pre-election period, regardless the political system history.

Despite empirical PBCs evidence in the European Union countries in spending on aggregated and disaggregated level, we observe the lack of deeper investigation on PBCs drivers.

The aim of the article is to test the hypothesis that post-communist history affect election cycles in the European Union countries.

Our contribution is that using panel data on all 28 current EU Member States from 1995 to 2015, we find pre-election fiscal manipulation in post-commu-

nist countries. We report increased general government spending in total by almost 2% in these countries. We observe also larger spending on three specific categories by economic function, i.e. general public services, public order and safety, and economic affairs in group of eleven EU countries with post-communist heritage. At the same time, we observe almost no significant pre-election fiscal manipulation (except spending on environment) in case of remaining 17 EU Member States.

The agenda of the paper is as follows. The next section gives a description of the data and research methods used. Posterior section presents the empirical findings and the final section concludes.

MATERIAL AND RESEARCH METHODS

We use an annual panel dataset of all 28 European Union countries over the period 1995–2015. The spending data are taken from Eurostat, while data on control variables come from the annual macro-economic database (AMECO) collected by the European Commission. The election data are taken from the Database of Political Institutions reported by the World Bank. Data on regular elections are collected from the Database of Political Institutions reported by the World Bank. We apply the following empirical model:

$$\ln exp_{it} = \alpha_i + \ln exp_{it-1} + \beta X_{it-1} + \gamma elec_{it} + \lambda(elec_{it} \cdot post_comunist_i) + \varepsilon_{it} \quad (1)$$

The variable exp_{it} is the amount of general government expenditure per capita (in natural logarithms) and refers either to the total expenditure or one of ten spending categories by government functions. The Classification of the functions of government was developed by the Organisation for Economic Co-operation and Development and introduced by the United Nations Statistical Division as a standard classifying the purposes of general government activities. The considered ten spending categories are: general public services, defence, public order and safety, economic affairs, environmental protection, housing and community amenities, health, recreation, culture and religion, education, and social protection. The value of

general government expenditure is converted into constant 2010 euro prices in order to make it comparable over time in the analysed period.

The figure displays public spending composition in two European Union country-groups (post-communist and elder democracies) to present the differences in general government expenditure policy between these two groups.

Central and Eastern Europe new democracies spend relatively more on economic affairs and safety, while in remaining EU Member States expenditure on social protection, health, and public services represent larger GDP share. In order to make the value of public spending comparable over time, we have converted them into constant 2010 euro prices. To control for autoregressive tendencies and policy smoothing, we include the lagged dependent variable. By using intercept α_p , we control for time-invariant unobserved and observed characteristics. We include the lagged dependent variable $\ln exp_{it-1}$ since fiscal indicators display a great deal of persistence.

Measure $X_{i,t-1}$ is the vector of socio-economic control variables following previous studies by Shi and Svensson [2006], and Klomp and De Haan [2013a, b, c]. The controls are taken up in the analysis as one-year lagged variables. We include real GDP per capita (in natural logarithms) to control country development

level. GDP growth rate capture fiscal policy fluctuations induced by the domestic business cycle. Deficit rule refers the dummy variable that is set to one when we observe an excessive budget deficit (greater than 3% of GDP) in country i . Stability and growth pact requirements allow for a launch of an excessive deficit procedure by the European Commission against any EU Member State that exceeds the imposed budgetary deficit ceiling. The procedure enforces the fiscal consolidation to gets EU Member State budget deficit under control. Openness variable is included to present the size of international trade as economic openness indicator. It is calculated as a sum of export and import per capita taken in natural logarithms (in constant 2010 euro prices). Change in CPI represents the level of inflation rate. Overall effect of inflation is not clear *a priori*. On the one hand it affects government spending through nominal progression in tax rates and tax brackets, while on the other hand inflation erodes the real value of nominal debt [Tujula and Wolswijk 2004, Mink and De Haan 2007]. Total dependency ratio measures the age structure of population. It is a sum of two generally inactive groups (i.e. under 15 years of age and aged 65 and over), compared to the number of people of working age (i.e. 15–64 years old). Higher dependency ratio may reduce government revenue and induce increased public spending, particularly social

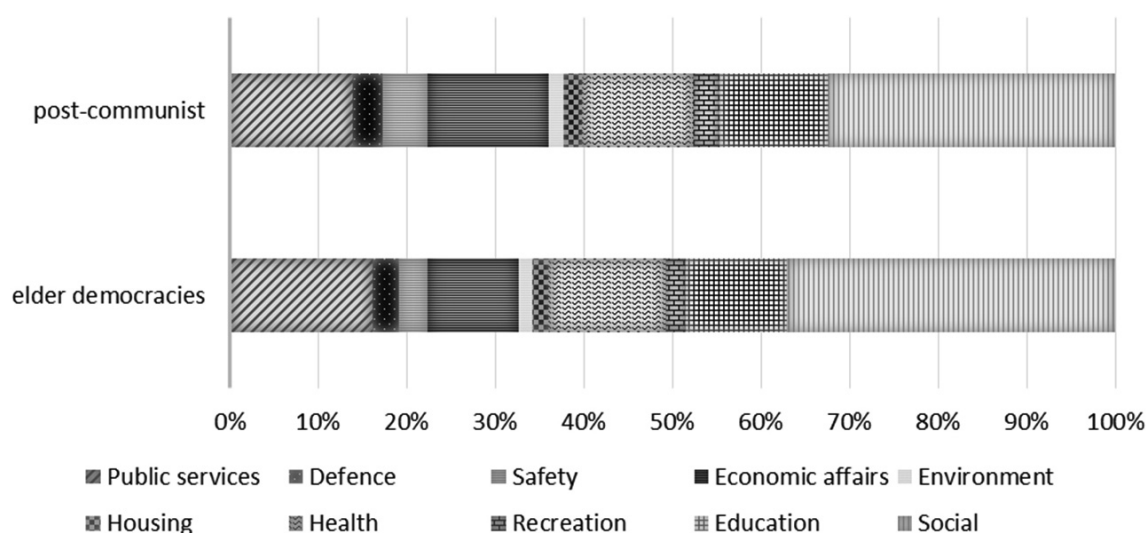


Fig. General government expenditure composition in the European Union

Source: Own elaboration using MS Excel based on Eurostat data.

Table 1. Estimation results for political budget cycles in the European Union

Specification	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
	Total spending	Public services	Defence	Order, Safety	Economic affairs	Environment protection	Housing	Health	Recreation	Education	Social protection
Lagged dep. variable	0.599*** (9.84)	0.582*** (5.70)	0.692*** (19.75)	0.649*** (4.87)	0.359*** (4.42)	0.676*** (7.86)	0.534*** (4.20)	0.716*** (14.04)	0.728*** (11.51)	0.626*** (9.55)	0.792*** (22.84)
Real GDP pc	0.280*** (4.39)	0.382** (2.25)	0.466*** (2.96)	0.043 (0.56)	0.608** (2.28)	0.522** (2.47)	0.378 (1.46)	0.181 (1.68)	0.175 (0.95)	0.229*** (3.08)	0.068 (1.21)
GDP growth	-0.000*** (-3.00)	0.000*** (2.89)	0.000*** (3.48)	-0.000* (-1.88)	-0.000 (-0.51)	0.000 (0.95)	-0.000*** (-3.89)	-0.000*** (-3.51)	0.000 (0.13)	0.000 (0.47)	0.000 (1.45)
Deficit rule	0.005 (0.75)	0.010 (0.75)	-0.018 (-1.68)	-0.009 (-0.86)	0.029 (1.47)	-0.033 (-1.06)	0.006 (0.25)	0.004 (0.61)	-0.026** (-2.41)	-0.013* (-2.04)	0.008 (1.66)
Openness	0.029* (2.01)	-0.081 (-1.57)	-0.148*** (-2.95)	0.074 (1.40)	0.009 (0.10)	-0.101 (-1.45)	-0.135 (-1.46)	0.044 (1.38)	0.021 (0.50)	0.046 (1.66)	0.053*** (3.32)
CPI	-0.000* (-1.91)	0.002* (1.99)	-0.006*** (-11.93)	-0.004*** (-2.82)	-0.003*** (-2.90)	-0.014*** (-6.84)	-0.002* (-1.72)	0.000 (0.53)	-0.001 (-0.80)	-0.000 (-0.03)	0.000 (0.68)
Dependency ratio	0.000 (0.14)	0.005 (1.07)	-0.000 (-0.00)	-0.000 (-0.09)	0.000 (0.05)	-0.000 (-0.05)	-0.009 (-1.19)	0.001 (0.53)	0.003 (0.67)	-0.005** (-2.51)	-0.000 (-0.12)
Unemployment rate	-0.001 (-0.55)	0.004 (1.31)	-0.005*** (-2.88)	-0.004 (-1.68)	-0.001 (-0.19)	-0.002 (-0.25)	-0.010* (-1.84)	-0.004* (-1.94)	-0.004 (-1.52)	-0.001 (-0.49)	-0.003 (-1.60)
EU membership	-0.000 (-0.03)	0.091*** (2.91)	-0.058 (-1.52)	-0.043** (-2.14)	-0.044 (-0.92)	0.059 (0.79)	0.076 (1.28)	0.001 (0.07)	0.047** (2.26)	-0.030** (-2.54)	-0.005 (-0.47)
Regular elections	0.007 (1.42)	0.029* (1.72)	0.007 (0.44)	0.022** (2.70)	0.010 (0.60)	0.007 (0.27)	0.022 (1.11)	-0.005 (-0.40)	0.010 (0.74)	0.010* (1.87)	0.006 (1.38)
N	526	526	526	526	526	523	526	526	526	526	526

Note: Estimates of Equation (1); *t*-values are shown in parentheses; * $P < 0.1$, ** $P < 0.05$, *** $P < 0.01$.

Source: Own calculations using STATA based on: AMECO database, Eurostat, World Bank, and Database of Political Institutions.

Table 2. Estimation results for political budget cycles in the European Union: conditional on post-communist legacy

Specification	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
	Total spending	Public services	Defence	Order, Safety	Economic affairs	Environment protection	Housing	Health	Recreation	Education	Social protection
Lagged dep. variable	0.595*** (9.86)	0.585*** (5.85)	0.692*** (19.94)	0.644*** (4.83)	0.356*** (4.42)	0.677*** (7.88)	0.533*** (4.19)	0.719*** (13.96)	0.728*** (11.46)	0.626*** (9.53)	0.792*** (22.85)
Real GDP pc	0.283*** (4.44)	0.378** (2.25)	0.466*** (2.95)	0.043 (0.55)	0.608** (2.27)	0.517** (2.46)	0.379 (1.47)	0.178 (1.66)	0.175 (0.95)	0.230*** (3.07)	0.0678 (1.21)
GDP growth	-0.000*** (-3.08)	0.000*** (2.85)	0.000*** (3.46)	-0.000* (-2.03)	-0.000 (-0.56)	0.000 (0.86)	-0.000*** (-3.88)	-0.000*** (-3.40)	0.000 (0.15)	0.000 (0.47)	0.000 (1.43)
Deficit rule	0.005 (0.82)	0.010 (0.78)	-0.018 (-1.68)	-0.009 (-0.79)	0.030 (1.50)	-0.032 (-1.04)	0.006 (0.24)	0.004 (0.56)	-0.027** (-2.42)	-0.013* (-2.03)	0.008 (1.68)
Openness	0.030* (1.99)	-0.080 (-1.54)	-0.148*** (-2.94)	0.075 (1.39)	0.009 (0.11)	-0.100 (-1.46)	-0.136 (-1.46)	0.043 (1.37)	0.021 (0.49)	0.046 (1.66)	0.053*** (3.32)
GPI	-0.001* (-1.93)	0.002** (2.06)	-0.006*** (-11.80)	-0.004*** (-2.84)	-0.002*** (-2.82)	-0.014*** (-6.86)	-0.002* (-1.74)	0.000 (0.52)	-0.001 (-0.81)	-0.000 (-0.03)	0.000 (0.69)
Dependency ratio	0.000 (0.17)	0.005 (1.12)	-0.000 (-0.01)	-0.000 (-0.02)	0.001 (0.07)	-0.000 (-0.03)	-0.009 (-1.19)	0.001 (0.50)	0.003 (0.66)	-0.005** (-2.50)	-0.000 (-0.11)
Unemployment rate	-0.001 (-0.57)	0.004 (1.26)	-0.005*** (-2.86)	-0.004* (-1.73)	-0.001 (-0.23)	-0.002 (-0.28)	-0.010* (-1.84)	-0.004* (-1.95)	-0.004 (-1.52)	-0.001 (-0.49)	-0.003 (-1.61)
EU membership	0.000 (0.01)	0.093*** (3.10)	-0.058 (-1.52)	-0.042** (-2.11)	-0.043 (-0.89)	0.062 (0.83)	0.076 (1.28)	0.001 (0.06)	0.047** (2.23)	-0.029** (-2.51)	-0.004 (-0.46)
Regular elections	-0.002 (-0.29)	0.001 (0.09)	0.010 (0.41)	-0.006 (-0.71)	-0.018 (-0.78)	-0.028* (-1.72)	0.029 (1.17)	0.003 (0.43)	0.016 (1.33)	0.010 (1.48)	0.003 (0.89)
Electrons × Post_communist	0.019* (1.94)	0.064* (1.72)	-0.005 (-0.13)	0.062*** (3.51)	0.064* (1.94)	0.079 (1.56)	-0.017 (-0.45)	-0.018 (-0.68)	-0.013 (-0.43)	0.001 (0.12)	0.007 (0.73)
<i>N</i>	526	526	526	526	526	523	526	526	526	526	526

Note: Estimates of Equation (1); *t*-values are shown in parentheses; * $P < 0.1$, ** $P < 0.05$, *** $P < 0.01$.

Source: Own calculations using STATA based on: AMECO database, Eurostat, World Bank, and Database of Political Institutions.

expenditure. Variable unemployment rate explain the labour force impact on public finance. Higher level of unemployment should be positively correlated with increased spending.

The variable $elec_{it}$ is an election variable suggested by Franzese [2000]. It is calculated as $m / 12$ in election year and $(12 - m) / 12$ in pre-election year, where m is a month when election is held. In all other years the value of $elec_{it}$ is set to zero. We consider only parliamentary elections which are held on the fixed date, required by the law. Snap elections (earlier than expected) which are the consequence of cabinet fall are not taken up in the analysis. More detail, early elections make incumbent's pre-election fiscal manipulation harder to enforce, due to the time and capacity constraints in engaging additional resources.

To investigate the PBC heterogeneity we include also the dummy variable *post-communist* describing whether any analysed current EU Member State has post-communist roots. It is set to one when EU Member State has post-soviet, post-yugoslav, or Soviet satellite heritage. The parameter ε_{it} refers to an error term.

Finally, the model (1) is estimated using the ordinary least square fixed effects (OLS-FE).

RESULTS

Estimation results presented in Table 1 indicate the election cycle in total general government expenditure (column 1) and ten specific spending categories by government function (columns 2–11) in 28 current European Union countries regardless political system history.

The results are based on regular parliamentary elections. Findings in column 1 show that there is no significant election effect in total expenditure in the EU on average. This indicates no pure PBCs existence in the EU in analysed period. Despite no aggregate spending effect findings from columns 2–11 show that some targeting within specific expenditure categories is observed. We report a pre-election increase in spending on public services (2.9%), order and safety (2.2%), and education (1.0%). At the same time, we do not observe that electoral manipulation negatively affect any specific expending category by government function. Our findings differ from previous studies by Buti

and Van den Noord [2004], Mink and de Haan [2006], Tujula and Wolswijk [2007], Efthyvoulou [2012]. The reason for this distinction might be rooted in different time-period and elections classification used.

Estimation results displayed in Table 2 present a more nuanced picture of PBCs existence in European Union countries, conditional on post-communist political history. Findings in column 1 report an increase in total expenditure per capita by 1.9% in post-communist EU countries. The results confirm PBCs existence in these countries and are in line with Stanova [2012], Enkelmann and Leibrecht [2013], and Ademmer and Dreher [2016]. At the same time, we do not observe fiscal manipulation resulting in significant total spending deviation in election period in case of other EU countries. It suggests that, taking into account only regular parliamentary elections, pure opportunistic political budget cycles exist only in new EU democracies but not in elder ones.

Splitting the total government expenditure into 10 specific categories by economic function, we report existence of some targeting spending in post-communist EU Member States. Government spending on public services, order and safety, and economic affairs are increased by more than 6% in pre-election period in these countries. At the same time, we do not observe any significant negative election effect on analysed spending categories in this group of EU Member States. Our findings are partly in common with Enkelmann and Leibrecht [2013]. Splitting panel data on 32 OECD countries into small panel on 10 Eastern EU countries including only 120 observations, they find significant increased spending on administration, economic affairs, environment and social protection. Taking into account results for remaining countries (Table 2, row: regular elections), we report only decreased pre-election spending on environmental protection. Reflecting fact is that estimation variations within spending categories for elder EU democracies turn out to be statistically insignificant.

CONCLUSIONS

The paper explains one of the drivers of country-group specific PBCs in the European Union. Our paper prove political budget cycles existence in post-com-

munist European Union Member States and show that political history play a role in shaping fiscal policy in election time. Our findings confirm results of previous studies underlining the impact of democracy maturity as PBC driver. Taking into account regular parliamentary elections we show that pre-election fiscal manipulation increase total general government expenditure per capita by 1.9% and three specific spending categories by function, i.e. general public services, public order and safety, and economic affairs in post-communist EU Member States. At the same time we observe no significant spending deviations in remaining EU Member States, except pre-election negative effect on expenditure linked to environmental protection. Despite division of total public spending into 10 specific categories, dipper disaggregation is needed for complete estimation results interpretation. We consider this fact as a challenge for the future research.

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ZJAWISKO POLITYCZNEGO CYKLU BUDŻETOWEGO W UNII EUROPEJSKIEJ – POSTKOMUNISTYCZNA SPUŚCIZNA

STRESZCZENIE

Celem artykułu jest weryfikacja hipotezy traktującej o wpływie postkomunistycznej spuścizny na występowanie zjawiska politycznego cyklu budżetowego w państwach członkowskich Unii Europejskiej. Wykazano, że w państwach Europy Środkowo-Wschodniej, w których panował ustrój komunistyczny po II wojnie światowej, przedwyborcza manipulacja fiskalna prowadziła do wzrostu wydatków sektora instytucji rządowych i samorządowych ogółem per capita o 1,9%. Ponadto w tej grupie państw UE stwierdzono występowanie istotnego wzrostu wydatków publicznych związanych z działalnością ogólnopaństwową, bezpieczeństwem i porządkiem publicznym oraz sprawami gospodarczymi. W pozostałych państwach członkowskich UE nie stwierdzono zaś istotnych zmian poziomu wydatków publicznych ogółem oraz poszczególnych kategorii wydatków sektora instytucji rządowych i samorządowych w okresie przedwyborczym, z wyjątkiem związanych z ochroną środowiska. Wyniki wskazały na występowanie heterogeniczności politycznych cykli budżetowych w UE w zależności od historii ustroju politycznego.

Słowa kluczowe: polityczny cykl budżetowy (PBC), cykl wyborczy, wydatki sektora instytucji rządowych i samorządowych, manipulacja fiskalna, Unia Europejska, państwa postkomunistyczne UE