



# Fiscal imbalances and asymmetric adjustment under Labour and Conservative governments in the UK



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## ARTICLE INFO

### Article history:

Received 16 August 2013

Accepted 4 June 2014

Available online 19 June 2014

### Keywords:

Fiscal policy

UK

VEC models

Government ideology

## ABSTRACT

This paper examines whether the political colour of an incumbent government affects the speed at which fiscal imbalances are corrected in the case of the UK. Using quarterly data, we examine whether Conservative or Labour governments are more prone to operate under a soft budget constraint and vis-à-vis i.e. to adhere to a hard budget strategy. The tests, using quarterly data, cover the period 1961–2011 and the results reported herein reveal differences in the speed at which fiscal imbalances are corrected by Labour and Conservative governments. The former are more inclined to operate under a soft budget constraint whereas the latter under a hard budget constraint.

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## 1. Introduction

In broad terms, it is generally assumed that liberal and left leaning governments will tend to be more inclined to adopt a soft budget strategy and thus step-in to correct deficits only when they exceed a certain threshold, while Conservative governments would tend to exhibit more fiscal prudence and by and large be more deficit averse (Eslava, 2011). This hypothesis is tested in the case of the UK using quarterly data over the period 1961–2011. The use of quarterly data allows for better statistical inferences to be drawn since it offers the opportunity to more accurately depict in the time series the change in office following a general election and hence model and estimate the differences in fiscal behaviour characteristics between Conservative and Labour governments in the UK. We do that by examining particular functional forms of asymmetric adjustment back to equilibrium once fiscal imbalances are observed.

The current environment of acute fiscal imbalances faced by a number of European countries brings to the forefront issues associated not only with the generation of fiscal deficits but also of the correction of such imbalances whenever they arise and the degree of adherence to fiscal rules (Bird and Mandilaras, 2013; Ioannou and Stracca, 2014; Schalck, 2012; Eslava, 2011; Holmes, 2011; Payne, 2003; Thornton, 2009). The dynamics that govern the intertemporal nexus between the two budget aggregates – expenditures and revenues – have been the subject of extensive debate and research (Apergis et al., 2012; Vamvoukas, 2012; van der Ploeg, 2010; Zapf and Payne, 2009; Chang et al., 2002; Ewing et al., 2006; Kollias and Paleologou, 2006; Giavazzi et al., 2000). Payne (2003) comprehensively surveys and reviews the issues and the associated steadily expanding body of literature. In particular, as he notes, two hypotheses describe the relationship in question. The one proposes that tax and spending decisions are made independently of one another. Hence, an empirical investigation

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should not be able to trace any causal ordering. The second hypothesis, postulates some sort of interdependence between the two. This interdependence may be manifested in three different ways: fiscal synchronisation which empirically would yield results pointing to bidirectional causality, or alternatively, unidirectional causality in the form of either spend-and-tax or tax-and-spend (*inter alia*: Payne, 2003; Paleologou, 2013; Owoye and Onafowora, 2011; Vamvoukas, 2012; Kollias and Makrydakis, 2000; Koren and Stiassny, 1998). However, given that the two budget aggregates may have different time profiles, imbalances may very well emerge even under a fiscal synchronization regime. Hence, the way in which such imbalances are corrected by fiscal authorities emerges as an interesting theme to investigate empirically in order to shed light into the adjustment mechanisms that are set into motion in such cases. This adjustment can be achieved either through the expenditure channel or revenues, or both. Furthermore, what is also of interest is the speed at which this adjustment takes place since this can offer evidence on whether a government operates under a hard or a soft budget constraint. In the latter case, fiscal authorities would be inclined to step-in and correct deficits only when they exceed a certain threshold. A number of studies have focused on the issue of the adjustment process of fiscal imbalances which offers insights on the degree of adherence to fiscal rules and whether policy makers and governments operate under a hard or a soft budget constraint (Saunoris and Payne, 2010; Andrikopoulos et al., 2004; Arestis et al., 2004; Bajo-Rubio et al., 2004; Cipollini et al., 2009; Brunila et al., 2003; Cipollini, 2001; Garcia and Henin, 1999; Baghestani and McNown, 1994; de Haan and Sturm, 1994).

As Paleologou (2013) observes, when it comes to fiscal policy behaviour, a soft budget constraint may be driven by the political and ideological underpinnings of the incumbent government or by opportunistic considerations such as to improve popularity and support from the electorate. The median voter model has been extensively used to describe political processes and economic policy platforms and decisions as politicians and parties compete for the median voter's vote (Belke and Potrafke, 2012; Milanovic, 2000; Ahmed and Greene, 2000; Holcombe and Caudill, 1985; Goff and Tollison, 2003). Belke and Potrafke (2012) note that the partisan approach is based on the assumption that politicians provide policies that reflect the preferences of their clienteles. For instance, it has been shown that increases in government spending produce distributional effects in the form of reduced inequality (Ramos and Roca-Sagales, 2008; Milanovic, 2000). Given that parties on the left of the political spectrum invariably exhibit greater sensitivity to issues of equitable income distribution, such an effect may render them more lax in the use of this fiscal instrument vis-à-vis a policy of fiscal vigilance. Similarly, given its economic stimulus potential, governments can yield to the temptation to use public spending as a stabilization and economic revitalization tool to prop-up and spur economic activity and employment possibly at the expense of fiscal judiciousness. A number of papers, using non-linear and asymmetric models, have examined the speed of adjustment when it comes to fiscal imbalances (*inter alia*: Saunoris and Payne, 2010; Legrenzi and Milas, 2012; Paleologou, 2013; Payne and Mohammadi, 2006; Easaw and Garratt, 1999, 2000, 2006; Legrenzi and Milas, 2012; Arestis et al., 2004). Within this strand of the literature, this paper revisits the issue by specifically allowing in the relevant tests for the political colour of the incumbent government in the UK with the introduction of a dummy variable that captures such political differences. Hence, it is hoped that possible differences in the response of Conservative and Labour administrations will be unveiled. In a nutshell, the hypothesis examined is whether imbalances are corrected at a rate that depends on the party's political preferences and ideological affiliation. Or, from a different perspective, the aversion or disposition towards deficits that different parties – Conservative or Labour – in office exhibit is comparatively assessed. Moreover, we examine whether the fiscal instrument (taxes) is flexible enough to adjust symmetrically when above or below its equilibrium level with expenditures given left – (Labour) and right – (Conservative) wing governments. In the section that follows the methodology, data and findings are presented and discussed while section three concludes the paper.

## 2. Data, methodology and findings

As mentioned above, the question at hand is whether the political colour and ideological foundations of the incumbent government affect the speed at which fiscal imbalances are corrected once they appear. The literature postulates that Conservative governments will generally tend to be more fiscally vigilant vis-à-vis administrations that have a more liberal, left tilting political agenda (Eslava, 2011; van der Ploeg, 2010). Hence, the latter will have the propensity to exhibit more fiscal slackness and move to correct deficits at a slower adjustment pace. The data set used in this paper, consisting of government revenues and expenditures expressed as shares of GDP, is drawn from the National Statistics of the UK. It is of quarterly frequency which allows for better statistical inferences to be drawn since the quarterly nature of the time-series allows us to depict in a more accurate and time-wise realistic manner the influence exerted on the fiscal adjustment process by the political colour of the party – Labour or Conservative – in office. The sample period covers the first quarter of 1961 to the second quarter of 2011 which gives a total of 201 observations. During this period, there were a total of thirteen general elections that brought or maintained into power either the Conservative or the Labour party with the exception of the current coalition government if the Lib-Lab pact of the late 1970s is not counted as a formal government coalition. In the estimations that follow, the political dummy variable  $d$  is introduced as follows:

$$d = \begin{cases} 1, & \text{Labour Party in office} \\ 0, & \text{Conservative Party in office} \end{cases}$$

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