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Unraveling the political budget cycle nexus in Greece

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ABSTRACT

This paper studies whether the Greek budget deficit is systematically affected by changes of government in the context of two political parties alternating in office. We advance the existing literature by constructing a tax evasion variable specific to the Greek economy and incorporating into our models. Testing the impact of each party upon the budget deficit during election and non-election years in the presence of tax evasion, we find a strong and persistent relationship between them independently of party political ideology. We assert that our finding constitutes a stylized fact of the Greek drama. Our results suggest that tax evasion together with the incident of two political parties alternating in office have tended to exacerbate the Greek government budget deficit accounting for about half the variation in it over the period examined. Moreover, GDP growth is found to exert a mitigating and permanent effect on budget deficit fluctuation.

1. Introduction

After a prolonged period of economic crisis that made the headlines internationally, Greece has found itself at a crossroad, having to choose between its European destiny and some other unknown, largely undesirable by its people, path. In this study we set to investigate the Greek economic drama by focusing on the nexus of budget deficits, political cycles and tax evasion practices. With two political parties alternating in power for the past forty years, substantial tax evasion and persistent budget deficits resulted in a severe erosion of the Greek economy. Shedding light on this situation is of great importance not only because the ongoing financial crisis added to rising government deficits and sovereign debt of the Greek economy, but also because Greece has been under three memoranda over the past six years or so.

Since the seminal works of Nordhaus (1975) and Hibbs (1977) a substantial body of research has been directed at exploring whether the macroeconomic cycle is induced by the political cycle. In general, the study of so-called political cycles has centered around two types of models, "opportunistic" and "partisan". The former assume that politicians, irrespectively of ideology, are only interested in their re-appointment, thus manipulating macroeconomic policy tools and bring about fiscal expansions prior to elections. The latter assume that politicians act in a partisan way, that is, a strong economy helps incumbents to be reelected.

Traditional opportunistic models consider non-rational adaptive expectations and retrospective behavior that create cycles entirely because of the opportunistic behavior of the incumbent, whereas rational opportunistic models (see, for example, Persson and Tabellini, 1990) consider a rationally formed inflation expectations framework and a forward-looking electorate, which generate cycles because of information asymmetries caused by timing assumptions. Similarly, traditional

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partisan models with adaptive inflation expectations imply that expectations take time to adjust and, therefore, yield long cycles.

In contrast, rational partisan models assume forward looking voting behavior, with expectations adjusting immediately thus producing short cycles (Alesina, 1987). Nevertheless, both partisan models generate some form of a cycle, either because of different party preferences or because of the uncertainty in election outcomes. For a two-party system representing the interests of different constituencies, Alesina (1987) has shown that if the two parties are shortsighted, fluctuations in macroeconomic variables connected with the political cycle result in equilibrium, but in the long run adoption of a cooperative common policy rule makes both constituencies better off.

The lack of empirical evidence for induced political cycles in a theoretically rich literature has contributed to a shift in interest toward investigating fiscal expansion in election years, which has come to be known as political budget cycle. Several empirical studies find evidence supporting it (see, for example, Shi and Svensson, 2006; Hanusch and Keefer, 2012). In spite of its remarkable advances and refinements, the theory of political cycles has not yet fully captured the link between political business and budget cycles and tax evasion, except perhaps at the general level of corruption (see for example Kaufmann et al., 1999, 2006, 2009). In the case of Greece, although the relationship between tax evasion and political cycles has been documented, this has only been within the context of the increasing misgovernance that prevails around election times (Skouras and Christodoulakis, 2011) or in relation to debt accumulation (Alogoskoufis, 2013).

However, the magnitude of the informal sector in Greece implies that a connection between tax evasion and the budget deficit is highly likely. Schneider and Williams (2013) estimate the size of the Greek informal sector to be steady at around about 28% since 1999, while Artavanis et al. (2012) approximate the foregone government revenues from tax evasion to be 31% of the Greek budget deficit for 2009. In the same line, the Bank of Greece spotted the gap between what Greek taxpayers owed and what they paid in 2010 and estimated it to be roughly a third of total tax revenue, about the size of the country's budget deficit in that year.[1]

Motivated by these findings and by the fact that there have been no studies linking the setting of two parties alternating in power with the incident of tax evasion and persistently rising budget deficits, we construct a tax evasion variable specific to the Greek economy on the basis of Feige (1989), thus aiming to fill the gap in political cycles research by quantifying the impact of tax evasion upon budget deficit fluctuations in a two-party setting.

The purpose of this paper is threefold. First, to investigate whether the Greek budget deficit is systematically affected by changes of government during the period 1970–2014, with a conservative and a socialist political party alternating in power. Specifically, we ask if political cycles, within the context of alternating political parties in power, go hand in hand with rising deficits. This effect, combined with tax evasion practices, accounts for nearly half (49%) of the observed fluctuation of the budget deficit. In order to test the impact of each of the two parties upon the budget deficit (as a proportion of GDP) during election and non-election years, we employ an unrestricted VAR model. Second, to examine if the size of the deficit is accentuated by tax evasion practices, independently of election or non-election years. And third, to determine whether budget deficits are influenced by the growth rate of GDP. In general, the effect of the growth rate is found to have both mitigating and permanent effects on budget deficit fluctuations.

The rest of the paper is organized as follows: a brief survey of related literature is conducted in Section 2. Section 3 outlines the hypotheses tested in the paper and describes the methodology and data employed. Section 4 contains a detailed discussion of the main and alternative empirical findings, and Section 5 offers some concluding remarks.

2. Literature review

Opportunistic models of political cycles follow the work of Nordhaus (1975), where the incumbent stimulates the economy before the election period so as to get re-elected. In general, opportunistic non-rational expectations models are consistent with economic expansions a year or two before the elections, followed by higher than potential GDP growth and unemployment below its natural rate during the election year. Inflation begins to escalate around election time and thereafter a recession follows with gradual decline in inflation. By and large, there are no differences in policies and outcomes between different political parties in power, with incumbents being re-elected in election years, during which growth is high and unemployment is low. The main criticism against traditional opportunistic models is the assumption of naïve voters, who reward rather than punish an incumbent who engages in pre-electoral manipulation (Drazen, 2000).

This weakness prompted research in the direction of opportunistic models with rational voters. Subsequent work by Cukierman and Meltzer (1986), Rogoff and Sibert (1988), Rogoff (1990), and Persson and Tabellini (1990) sought to incorporate rational expectations into the opportunistic conceptual framework. Such models assume short-run manipulation of policy instruments immediately before elections. Specifically, expansionary policies are followed in the two to three quarters before each election, while tightening of monetary and fiscal policies is pursued after elections. In the context of a rationally formed inflation expectations framework and a forward-looking electorate, cycles are generated because of information asymmetries caused by timing assumptions and incumbents are reappointed when growth is high and unemployment is low in election years.

[1] Reported in *The New Yorker* magazine, July 11, 2011.