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## Electoral cycle and tax policy – determination of income tax variables: case of the Czech Republic

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### Abstract

The paper deals with the issue of the relationship between results of examination of the influence of political business cycle on the basis of the choice of input variables. There were used nominal and effective tax rates, total tax liability, total tax collection in case of individual income tax setting in the Czech Republic in the time period 1993–2014. The results of analysis of the effects the electoral cycle on the tax policy determination may differ in relation to the specification of input data and the choice of dependent variables.

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### 1. Introduction

Provided that the fiscal policy should be a supportive element of economic growth then the fiscal policy determination must correspond with the development of economic indicators and with the impulses creating the conditions for it. The fact, that the fiscal policy determination in field of tax policy can be determined by other than economic matters, is worrying. On the basis of that, it can mean that its development do not have to be consistent with the parameters of the pro-growth policy. It is necessary to distinguish between unintentional deflection of pro-growth policy because of the existence elements of market failure and intentional deflection of pro-growth policy.

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This paper is focused on the issue of determination of the tax policy by others than economic aspects. The representatives of legislative power are responsible for the implementation of tax policy. Therefore, their behaviour and activities can be focused on implementation such measurements that may increase their popularity among voters in order to get a higher chances of their re-election in a democratic electoral system. In this context we respect the statement of Sjahrir, Kis-Katos, & Schulze (2013) who add that the existence of political business cycle can arise only in the systems of direct elections. The results of realized examination of the influence of political business cycle on economic indicators or in more detail on tax policy setting show considerable differences. The question is whether they are caused by geographical or time distinction, or by the choice of input variables. The elementary task should be the identification of possible input variables which can be used for the examination a relationship between electoral cycle and tax policy setting.

Our effort and objective of this paper is to find differences or to confirm compliances of the results in examination of a relationship between electoral cycle and tax policy setting in case of using different input variables focusing on the Czech Republic in timeline 1993–2015.

## **2. The theory of political business cycle**

The Nordhaus's (1975) assumption of irrational voters became the object of critique. Therefore Rogoff & Sibert (1988) introduced the model political business cycle which is based on the temporary information asymmetries between voters and political representatives. It is clear that the governments receive information about its competency more quickly than the voters can. Therefore the public sees the government's competency with a lag. As a consequence of that fact it is obvious that the incumbent party can have an incentive to lower taxes in election years to show their competency (Rogoff & Sibert, 1988). Another significant difference between Nordhaus's model and Rogoff's model is the fact that Rogoff's model is more focused on main budgetary components such as spending, revenues, deficits and taxes rather than only on macroeconomics indicators.

There are some studies which dealt with the impact of political business cycle on fiscal policy setting, for example Shi & Svensson (2006), Doležalová (2013), Štiková (2007), Brender & Drazen (2005), or Andrikopoulos (2004). The researches of mentioned authors are oriented especially on macroeconomics indicators (as Nordhaus, 1975). Mainly, they use indicators as GDP, the inflation rate or the unemployment rate.

The realization of tax policy depending on political business cycle has been examined by many researches, for example by Foremmy & Riedel (2014), Ehrhart (2013), Mikesell (1978), Petterson-Lidbom (2003), Morozumi, Veiga, & Veiga (2014), Andrikopoulos, Loizides, & Prodromidis (2006) or Formanová, David, & Křápek (2015). Within their analysis they used different indicators which are classified in the following part.

## **3. The approaches for identification the relationship between electoral cycle and tax policy setting**

There are several elementary approaches for identification the effects of electoral cycle on the tax policy setting. These approaches differ not only in results, but mainly in the choice of input data especially in case of explanatory and explained variables.

Basically, the possible approaches can be divided into 2 groups. The first one includes the legal tools for tax policy determination, such as nominal and effective tax rates, the second one then involves the results of its determination and includes total tax collection or total tax liability. The variables which represent the results of tax policy determination can be significantly determined by other factors. To eliminate them it is used the participation of mentioned indicators on gross domestic product.

### *3.1. Total tax collection*

For the purpose of examination a relationship between electoral cycle and tax policy it can be primarily used the indicator of share of selected tax collection as a percentage of GDP or as a percentage of total tax collection. The objective of Ehrhart (2013) was to analyse the impact of the electoral cycle calendar on the composition of tax revenue (direct versus indirect taxes). For testing she used the indicator of total tax collection. She analysed data of 56 developing countries over 1980–2006 time periods. Formanová & Křápek (2015) focused on tax collection of

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