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Now or later? The political economy of public investment in democracies☆

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ABSTRACT

This paper explores the impact of elections on public investment. Working with a sample of 67 presidential and parliamentary democracies between 1975 and 2012, we find that the growth rate of nominal public investment is higher at the beginning of electoral cycles and decelerates thereafter. The peak in public investment growth occurs 28 months before elections, and each month closer to the next election the growth rate of public investment declines by 0.7 percentage points. Other political variables, such as cabinet ideology and government fragmentation have less influence on short-term public investment dynamics. Fiscal rules and stronger institutions seem to attenuate the impact of elections on investment, but available information is insufficient to draw definitive conclusions. These results are robust to a number of controls, including for fixed elections.

1. Introduction

Public investment is often touted as a way to raise output, both in the short term by promoting aggregate demand and in the long term through enhanced supply potential of the economy (IMF, 2014a; Felice, 2016). However, even when shovel-ready projects are available and budget processes are sufficiently strong for implementing investment programs, public investment may not occur. This may be because public investment is less noticeable (Rogoff, 1990) or may have a lower short-term economic multiplier than certain other types of public spending, including public consumption. When elections approach, policymakers may seek to increase public consumption at the expense of public investment to accelerate the economy faster and increase their probabilities of reelection.

In this paper, we explore the potential relationship between public investment and electoral cycles. In particular, we seek to answer the following question: does the proximity of elections affect the growth rate of public investment? Our empirical approach relies on a unique database covering 67 advanced, emerging and low-income economies with presidential and parliamentary democracies. Using this data, we try to answer to what extent the growth rate of public investment can be explained by the proximity of elections, after controlling for relevant considerations.

In contrast to previous studies that relied on a linear relationship or binary association, we show that the relationship between the growth rate of public investment and the electoral cycle follows an inverted U-shape. Our results show that the growth rate of public investment is larger at the beginning of the mandate, peaks about 28 months before elections, and then declines fast as

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elections approach.[1] One month closer to the next election the growth rate of public investment declines about 0.7 percentage points. Other political and institutional variables are less important. Our results are robust to a number of tests, in particular to the potential endogeneity of election dates.

The paper is organized as follows. Section 2 reviews the relevant literature. Section 3 presents the data and some stylized facts. Section 4 reports the results of the regression analysis on the baseline model. Section 5 performs various robustness tests. And Section 6 summarizes the main findings and concludes.

2. Literature review

Since the concept of political business cycles (PBC) was first proposed by Nordhaus (1975), the literature on the political economy of fiscal policy has mainly focused on the political and institutional factors behind budget deficits. Only few papers have dealt with the political economy of public investment and capital accumulation.[2] The literature can be grouped into three approaches (Eslava, 2006). The first would be the *opportunistic* approach, according to which electoral incentives influence the government's budget balance. The second could be labeled as *ideological*, and would include all the papers that see fiscal deficits as arising from conflicts of interest among different political parties with heterogeneous preferences. The third approach—which focuses on *rules and institutions*—highlights their importance behind fragmentation in the decision-making process, thereby affecting budget composition and damaging public investment. The literature on the political economy of public investment can be grouped along the same lines.

The *opportunistic* or *electoral approach* is summarized by Rogoff (1990) who provided a firm theoretical foundation for electoral shifts leading to changes in the composition of public spending. He showed that electoral incentives may induce the incumbent to shift public spending towards more "visible" government consumption and away from public investment. Government consumption expenditures are more "visible" before elections, while capital expenditures (e.g., infrastructure) are mostly long-term projects that increase voters' utility upon completion. Drazen and Eslava (2010) developed this idea further and predicted that changes in composition of public spending during election periods were the result of incumbents attempting to signal that their preferences were closer to those of voters. Empirical evidence in this regard is mixed.[3] Most multicountry studies at the general government level show that elections tend to shift public spending in favor of current spending and away from public investment (Schuknecht, 2000; Block, 2002; Vergne 2009; Katsimi and Sarantides, 2012).[4] However, the evidence from single country studies (e.g., Canada, Colombia, Portugal, and Norway) suggests that at the local government level opposite forces are at play. Local elections are correlated with a shift toward "visible" investment (which at the subnational level takes the form of local infrastructure) together with targeted public transfer programs (Blais and Nadeau, 1992; Kneebone and McKenzie, 2001; Veiga and Veiga, 2007; Alesina and Paradisi, 2014; Halse, 2016).

The *ideological* or *partisan approach* tries to link the size and the composition of the budget with the sign of partisan preferences. In partisan models, parties of the left are expected to favor a larger government and have less aversion to public deficits than parties of the right (Tufte, 1978; Alesina and Tabellini, 1990; Alt and Lassen, 2006). The greater preference for redistribution of left-wing parties would imply more spending on social transfers. In addition, their preference for a more activist role of the state in the provision of public physical and human capital would imply higher public investment on infrastructures, health and education. Empirical findings support the effect of partisanship on the composition of public spending (Boix, 1997; Francese, 2002; Brauninger, 2005; Potrafke, 2010; Angelopolous and others, 2012) and during fiscal adjustments, with left-wing parties opting for revenue-based adjustments and right-wing parties opting for expenditure-based ones (Perotti, 1998; Mulas-Granados, 2003, 2006; Mierau et al., 2007).[5] But there can be exceptions to partisanship. Given that politicians need to be opportunistic to win elections, rational politicians may go against their ideological policy preferences (Persson and Svensson, 1989; Pettersson-Lidbom, 2001).

The *rules* or *institutional* approach encompasses a great variety of issues, such as the role that rules and institutions play in constraining or facilitating public investment decisions. In certain cases, the focus is on the way they shape the political and economic context in which governments operate. These contributions can be grouped in three broad areas:

First, the role of electoral rules and political traditions in generating fragmented party systems and weak governments. Minority governments, divided legislatures, coalitions and multiparty cabinets, with a large number of ministers, and with a weak coordinating role for the Ministry of Finance, are all associated with fiscal profligacy and low productive investment (Hallerberg and Von Hagen, 1997; Von Hagen et al., 2001; Perotti and Kontopoulus, 2002; Hallerberg et al., 2007). Institutional frameworks that reinforce and centralize budget commitments help eliminate electoral manipulation of budget cycles (Saporiti and Streb, 2008), and frequent changes in government are associated with lower average public investment (De Haan and Sturm, 1997).

[1] Note also that public investment deceleration is accompanied by an acceleration of current spending. Our results confirm at an aggregate multi-country level what other studies suggested at the single-country level. For example, Klein (2004) examined the political cycles in Israel, and found that in the 1980s and 1990s (a period that includes six general elections) in the period before an election public investment declined and civilian consumption rose significantly. Fiva and Navik (2013) also explored these issues at the municipal level in Norway.

[2] Early references in this field are: Sturm and De Haan (1998), De Haan, Sturm and Sikken (1996), De Haan and Sturm (1994), and Sturm (2001)

[3] It should be stressed that PBC models are all based on the assumption of competitive elections, which is more applicable to developed established democracies, rather than to emerging and low-income countries, many of which are "new" democracies.

[4] Drazen and Eslava (2010) and Aidt et al. (2011) show instead that public investment grows during electoral years.

[5] For further evidence on the existence of partisan effects in public spending and tax policies and on the impact of partisanship on specific categories of public spending, such as social and welfare policies, see Cusack (1997). Regarding the impact of ideology on the composition of fiscal revenues, see Hallerberg and Basinger (1998) and Belke et al. (2007).