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Tariff increases over the electoral cycle: A question of size and salience

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ABSTRACT

Research on the political budget cycle suggests that some budget items are more visible than others. Accordingly, the cycle will exert a varying impact on policy instruments of different salience. Using a panel data set of tariff decisions by Austrian local governments we identify a stable and sizable electoral cycle in water tariffs. Tariff increases are both less frequent and less strong before elections. The cycle effect is, however, not constant: Small increases are not affected by elections or even more likely. This is consistent with advances from prospect theory suggesting that visibility may depend on the size of a policy. Consequently, small tariff changes may not be salient, particularly if they are below inflation as a reference threshold.

1. Introduction

The central result of research on the political budget cycle is that elections increase the probability of higher spending and decrease the probability of higher taxes. In most theoretical work on the cycle, rational voters can only be 'tricked' by politicians because some budget items are more salient than others, leading to a compositional effect. For instance, in the landmark paper (Rogoff, 1990), current expenditure is realized immediately while investment is completed with a lag. This predicts a shift from investment expenditure to current expenditure before elections. On the empirical side, recent evidence on the role of tax framing (see Chetty et al., 2009; Finkelstein, 2009) is largely supportive of the notion that salience matters for consumer choice.

An unexplored issue, however, is the question whether a budget item is salient independently of the size of the adopted policy. While we don't present a direct test of political salience, we address this question by analyzing how politicians dose changes in water tariffs before elections. Empirically, this translates into testing whether the effect of elections is constant over the distribution of observed tariff changes. Hence, going beyond the conditional mean effect of elections is the main contribution of this study.

It is our interpretation that previous research has struggled or ignored this issue mainly because of data limitations. Fiscal data by national or sub-national governments is typically limited to budget items such as expenditures, revenues or debt. While the existence of a cycle may be analyzed with this type of data, it represents an outcome variable that is affected by a multitude of factors and is therefore rather uninformative of actual policy choices.

For this reason, we study the effect of elections on actual fiscal decisions by using a panel data set of water tariffs in Austria. Tariffs reflect real choices by local governments which enable us to address the question at hand directly. Moreover, water tariffs are well

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suited to analyze the issue at hand because at the outset they may not be a particularly salient issue. If the effect of elections really depends on the size of a policy, we should be able to identify this in the observed distribution of tariff decisions.

In terms of empirical strategy, a number of more flexible models will be estimated in addition to the more frequent conditional mean effects models. Thus, we first follow the existing literature by estimating an average election effect that we show to be robust among a number of common specifications. Subsequently, we allow the effect to vary. Initially, we use two-part models to differentiate the decision on whether to change tariffs from the decision on its size. Secondly, we analyze the effect of elections on the whole distribution of tariff changes by using models for distributional effects and quantile regressions.

Our results suggest that on average elections lead to a decrease of tariff changes by roughly 3%. While this effect can be attributed to both the decision to not increase tariffs at all and to smaller average increases, the effect does not appear to be constant. Specifically, small increases are not affected by elections or even more likely. Hence, the cycle is strongly caused by politicians avoiding large increases in tariffs before an election. Such a finding is consistent with insights from behavioral economics, especially prospect theory and mental accounting, suggesting that salience and therefore the election effect may not be independent of the size of a policy.

This article contributes to an emerging literature stressing the importance of tax salience. While previous studies have focused on how salience differs among tax or expenditure types, we add another dimension to the discussion by providing evidence that is consistent with the idea that salience may also depend on the magnitude of a policy. The empirical analysis shows that the average effect of the election cycle conveys an incomplete picture of the actual effect, which is dominated by the two tails of the distribution.

Moreover, while the large part of studies analyzing the political budget cycle focuses on expenditure and debt, this paper adds to the analysis of the revenue side of the budget. Even though (Mikesell, 1978) argued that taxes are a highly visible budget component and tax changes are equally unpopular with the electorate as with the politicians who try to avoid them, there is a wide research gap on the tax side of the political budget cycle. We also highlight that the tax side holds an attractive advantage in that it allows the researcher to analyze actual political decision on budget items instead of noisier outcome variables. Finally, this paper is among a few recent papers like (Streb et al., 2012; Jong-a Pin et al., 2012) that try to address the political budget cycle using additional or more detailed data.

The paper is structured as follows: Section 2 provides a short review of the relevant literature and discusses conceptual issues. Section 3 presents a brief overview of the Austrian institutional background, followed by the empirical analysis in Section 4. Finally, Section 5 discusses the results and Section 6 concludes.

2. Theoretical considerations

Politicians who are running for reelection have an incentive to manipulate fiscal policy prior to elections. Theoretical literature on this issue has identified several potential mechanisms that may drive this behavior. Starting with the ideas of Nordhaus (1975), politicians are assumed to try to use the Phillips–curve relationship to make voters better off and hence gain in popularity. With the advent of rational expectations, and therefore rational voters, these ideas have been largely discarded in favor of models with micro-foundations. Typically, these models focus on the decision process of voters and politicians in games with asymmetric information. Now the theoretical discussion centers around models of adverse selection as in Rogoff (1990) or moral hazard/career concern models as in Persson and Tabellini (2002). More recently, Baleiras and da Silva Costa (2004) as well as Martinez (2009) have shown that even in the absence of informational asymmetries, electoral cycles may arise as a result of uncertainty and effort smoothing behavior, respectively.

Despite some arguments that political cycles may not exist in aggregate macroeconomic outcomes (see Andrikopoulos et al., 2004) or are conditional on the institutional environment,[1] a considerable number of recent studies confirm the existence of these strategic patterns in both tax and expenditure policies (see e.g. Aidt et al., 2010; Foucault et al., 2008; Sakurai and Menezes-Filho, 2010; Schneider, 2010; Gérard et al., 2010).

A recurring theme in this line of research is the visibility or salience of fiscal policy instruments. In this respect, several types of visibility dimensions have been analyzed. Firstly, budget items may be more or less salient depending on how immediate a policy instrument materializes as a signal observable by voters. For instance, on the spending side the theoretical treatment of Rogoff (1990) assumes that current spending is more visible than investment because it is realized immediately. In contrast, capital or investment expenditure is completed with a lag because construction takes time. Thus, the difference in visibility between spending categories is of a temporal nature.

Secondly, fiscal policy instruments may differ in terms of how easily voter groups can be targeted. Such a framework is developed in Drazen and Eslava (2010), where voters reward incumbents for aligning with their preferences. Other than Rogoff (1990), who predicts a shift towards current spending, Drazen and Eslava (2010) consider capital investment and construction projects to be more visible than other types of spending. The argument being that investment generates benefits locally and therefore can be used more easily to target specific groups of voters. Consequently, the model predicts a shift in the budget composition towards investment expenditure.

On the tax side, Katsimi and Sarantides (2012) have shown that elections have a negative effect on direct taxes whereas indirect taxes are not affected or much less. This is consistent with an emerging literature showing that tax salience effectively changes taxpayers' perception of the tax burden (see Gamage and Shanske, 2011 for a review). Importantly, the framing and presentation

[1] For instance Shi and Svensson (2006) and Brender and Drazen (2007) argue that transparency and informational differences may be responsible for observed differences in the size of the political budget cycle between developed and developing countries. Moreover, see de Haan and Klomp (2013) for a current review of studies analyzing conditionalities of the political budget cycle.