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# Business taxes and the electoral cycle

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ABSTRACT

The purpose of this paper is to assess whether the timing of elections affects tax policy choices. To do so, we exploit information on the German local business tax which is set autonomously by German municipalities. As the dates for local council elections vary across German states, the data allows us to disentangle effects related to the timing of elections from common trends. The findings support the notion of a political cycle in tax setting as the growth in local business tax rates is significantly reduced in the election year and the year prior to the election, while it significantly increases in the year after the election. This pattern turns out to be robust against a number of sensitivity checks.

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## 1. Introduction

The last decades have seen a strong and rising interest in identifying the determinants of corporate tax setting behavior. Recent theoretical and empirical papers stress that corporate tax rate choices are influenced by the size and structure of the economy, the government's budgetary situation and tax competition (see e.g. Bucovetscy, 1991; Wilson, 1999; Buettner, 2003; Devereux et al., 2008). One aspect that has been rather neglected though is the impact of political economy determinants on corporate tax rate choices. One key question in this area is whether politicians engage in opportunistic behavior and deliberately manipulate government policies over the course of the electoral cycle in order to increase their reelection prospects.

Traditional papers in this area suggest that, in a world with asymmetric information, incumbent politicians have an incentive to signal their competency by increasing public spending prior to elections in order to boost the economy (see e.g. Nordhaus, 1975). Empirical evidence for this type of spending-induced economic cycles has been rather mixed though (see e.g. Alesina et al. (1997) and Drazen (2000) for an overview). A more recent strand of the theoretical literature has suggested that politicians may use adjustments of short-run policy instruments, like tax policy choices, to demonstrate their competency to the electorate rather than through spending-induced changes of the economic conditions (see e.g. Persson and Tabellini, 2001). This predicts a political business cycle in tax rates in the sense that tax increases tend to be delayed until after the election, while the probability for tax decreases is increased in the election year and the year prior to the election. While political budget cycles in key budgetary elements such as spending and deficits are frequently found in European data, empirical evidence for this type of systematic tax rate manipulation is scarce at best.

The present paper contributes to this literature and tests for political cycles in tax rate adjustments. Our empirical analysis uses the German local business tax as a testing ground which is set autonomously by German municipalities. The analysis is based on a unique and rich panel data base of around 8000 German municipalities and their political, social and budgetary situation for the time period between 2000 and 2008. As the dates for local council elections vary across German states, the data allow us to disentangle effects related to the timing of elections from common trends.

Descriptively, our data suggest a strong trend to increase the local business tax rate during the covered time period. While more than half of the communities in our sample raise their local business tax rate once or more during our sample period, only a small fraction of around 5% of the communities enacted a tax decrease. This pattern largely reflects a number of expenditure shocks at the local level within our sample period driven by rising costs for the provision of social services and a number of reforms that shifted public responsibilities to the local level. In

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consequence, communities were forced to adjust their local business tax rates as the major revenue instrument at their own discretion.

The purpose of this paper is to assess the timing of these local business tax rate changes and to test whether it follows a systematic pattern induced by the electoral cycle. To do so, we estimate panel models which determine the effect of elections on the annual growth rate of local business taxes. In robustness checks, we also use logistic models to determine the impact on the probability that a municipality increases or decreases its local business tax rate. Our results provide strong evidence in favor of an electoral cycle. Specifically, we find that tax rate growth and the probability to observe an increase in the local business tax rate are significantly lower in election and pre-election years, while they jump up in the post election years. The effects are quantitatively important. Our preferred estimates suggest that, relative to other years, the growth rate of local business tax rates is, evaluated at the sample mean, reduced by more than 40% in election years and increased by around the same amount in post-election years. This result is robust to controlling for a large number of economic, social and budgetary characteristics as well as municipality fixed effects.

As indicated above, our paper relates to the empirical literature on political budget cycles. The majority of studies in this literature tests for electoral cycles in government spending (see Alesina et al., 1997). Our paper is closely related to work on the effect of election timing on governments' tax revenues (e.g. Block, 2002; Schuknecht, 2000; Andrikopoulos et al., 2004; Rose, 2006; Veiga and Veiga, 2007; Katsimi and Sarantides, 2012; Ehrhart, 2013). We extend this literature by testing for electoral cycles in a statutory tax instrument. This is conceptually superior as it is not clear from a theoretical perspective that low tax revenues are a signal of competence to voters. Low revenues at a given tax rate might be seen as exactly the opposite, the government's inability to administer the tax collection. As stressed by Pettersson-Lidbom (2003), testing for electoral cycles in tax rates rather than total tax receipts has the general advantage of "more closely reflecting […] [the] elected governments' intentions".

We are aware of only four earlier papers that assess political cycles in tax rates. Mikesell (1978) and Nelson (2000) analyze the effect of elections on the adjustment of US state taxes in the post-war period. Pettersson-Lidbom (2003) tests for changes in the personal income tax rate set by Swedish municipalities in response to election dates. While all three papers present evidence in line with the notion of political tax cycles, the proposed empirical strategies rely on strong identification assumptions. The approach of Mikesell (1978) and Nelson (2000) is purely descriptive and does not account for any type of heterogeneity between US states. Thus, their qualitative and quantitative results may suffer from problems related to omitted variables. Pettersson-Lidbom (2003) proposes a more rigorous identification strategy but still lacks variation in election dates across his sample jurisdictions and is thus unable to disentangle effects related to the electoral cycle from common time trends.

A recent paper by Dahlberg and Mörk (2011) tries to account for that by testing for electoral cycles in tax rates by combining Swedish and Finnish data on local governments. Local election dates vary between the two groups of Swedish and Finnish municipalities and thus allow for a separation of electoral cycle effects and common shocks. The two groups of municipalities, however, differ in their institutional characteristics and may thus be subject to heterogeneous shocks, which may invalidate the common trend assumption. Our estimation approach tackles these problems by exploiting variation in election timing across federal states within the same country and by controlling for both, time-constant and time-varying heterogeneity in the social, political, and budgetary situation of municipalities.[1]

[1] Ashworth et al. (2006) furthermore estimate a hazard model which assesses whether the hazard of introducing an environmental tax is affected by election timing. The authors' data again does not allow to disentangle electoral cycle effects from common trends in tax choices though.

The remainder of the paper is structured as follows: Section 2 provides a brief theoretical motivation for our analysis, Section 3 presents our data set and gives a brief overview over the institutional background for the German local business tax. Our estimation strategy is described in Section 4. Section 5 presents the results and Section 6 concludes.

## 2. Theory and related literature

One of the main elements of fiscal policy is politics. The main reasoning is, as Tufte (1978) summarizes, that "as goes politics, so goes economic policy and performance. This is the case because, as goes economic performance, so goes the election." This relationship has been studied extensively by the theoretical and empirical literature on political business cycles and political budget cycles. The central idea of a political business cycle is that politicians have an incentive to implement demand-increasing policy measures prior to elections in order to boost the economy which then affects key macroeconomic variables, such as unemployment, output, and inflation (Nordhaus, 1975; Lindbeck, 1976). The empirical evidence for such a political cycle in macroeconomic performance is, however, rather mixed (see Alesina et al. (1997) and Drazen (2000) for an overview). On theoretical grounds these models were criticized for their assumption of non-rational and myopic voters, which are easy to fool by such means.

Subsequent papers drop the irrationality assumption and focus on information asymmetries between voters and politicians. Rogoff and Sibert (1988) and Rogoff (1990) investigate fiscal choices in a game where politicians signal their level of competence. As a result, fiscal policies are distorted in election years. An important difference to the earlier papers is that these models predict distortions in main budgetary concepts, such as spending, revenues, deficits, and taxes rather than in macroeconomic indicators. It has been argued that politicians may want to implement expansionary politics in election and pre-election periods to signal their competency to the electorate by a higher level of public good supply at constant levels of taxation or by implementing low-tax policies for a given public goods provision. Beyond these signaling considerations, incumbents may want to implement political actions in pre-election and election years that are, in a very general sense, likely to be appreciated by the electorate and which might thus increase their reelection probability. Analogously, as voters face high costs of ousting unpopular politicians from office in non-election years and "unpopular actions in none-election years may be heavily discounted by election time" (Nelson, 2000, p. 544) if voters have short memories, politicians have an incentive to implement unpopular decisions at the beginning of the election period when the time span to the next election is as large as possible.

Following most of the empirical literature, we do not aim at providing an explicit test of political budget cycle models. As noted by Kneebone and McKenzie (2001), doing so is difficult since a measure for government competency is needed. Instead, we test a reduced form of political budget cycle models by investigating whether tax rate choices are determined by election dates. There is a large and still growing literature testing for election effects in public policy. Most of this literature finds evidence in favor of political budget cycles across European and OECD countries. Alesina et al. (1997) provide an exhaustive overview. Recent work of Schuknecht (2000), Persson and Tabellini (2003a,b) and Shi and Svensson (2006) report results which are in line with political spending cycles at the national level.[2] Hallerberg et al. (2007) show that the public debt of European Union countries tends to increase more in election years. In particular after the set-up of the

[2] Persson and Tabellini (2003a) moreover suggest that electoral cycles differ across political systems. Their evidence suggests that, while pre-election tax cuts are a universal phenomenon, post-election fiscal adjustments (spending cuts, tax hikes and rises in surplus) tend to be present in presidential democracies. Majoritarian electoral rules are associated with pre-electoral spending cuts, while proportional electoral rules are associated with expansions of welfare spending both before and after elections.

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