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The dynamics of public investment under persistent electoral advantage ☆

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ABSTRACT

This paper studies the effects of asymmetries in re-election probabilities across parties on public policy and their subsequent propagation to the economy. The struggle between groups that disagree on targeted public spending (e.g., pork) results in governments being endogenously short-sighted: Systematic underinvestment in infrastructure and overspending on targeted goods arise, above and beyond what is observed in symmetric environments. Because the party enjoying an electoral advantage is less short-sighted, it devotes a larger proportion of revenues to productive investment. Hence, political turnover induces economic fluctuations in an otherwise deterministic environment. I characterize analytically the long-run distribution of allocations and show that output increases with electoral advantage, despite the fact that governments expand. Volatility is non-monotonic in electoral advantage and is an additional source of inefficiency. Using panel data from US states I confirm these findings.

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1. Introduction

A central issue in dynamic political economy is to understand how political frictions affect fiscal policy and economic performance over time. The political process of fiscal choice determines a game for the allocation of a 'common pool' resource: current and future taxable income (Inman and Fitts, 1990). Legislators demand projects that benefit a particular geographic area or an identifiable group of constituents, the cost of which are borne by the entire population. As a result of the fiscal wedge between social and local marginal costs, overutilization of the public resource and underinvestment in growth-enhancing projects arise.

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The recent literature on pork-barrel politics has focused almost exclusively on characterizing symmetric equilibria in which parties behave identically.[2] A main result is that re-election uncertainty introduces a wedge in intertemporal decisions when governments lack commitment. This wedge distorts economic allocations; thereby reducing long-run output and consumption. This paper contributes to the literature by considering the implications of asymmetries in political turnover between competing parties; that is, in an environment where one of the parties is politically stronger than the other. Additional distortions emerge when incumbents face different re-election prospects, since the politically disadvantaged party leans toward more short-sighted policies than it would if political turnover were symmetric. Even though parties have identical preferences over the size of the government, alternating power induces economic fluctuations via changes in taxation and spending (in an environment that is otherwise deterministic), furthering the inefficiencies. I find that the resulting volatilities are non-monotonic in the size of the political bias.

Persistent partisan advantage in democratic elections has been extensively documented by political scientists, in particular regarding the voting behavior across US states. Using a multi-component index that combines historical results in gubernatorial, House, and Senate elections, individual states are characterized as being under Democratic or Republican control. Brown and Bruce (2002) use a combination of the two most common indices of political competition, the Ranney index and the Holbrook Van Dunk index, to compute trends in political advantage. Their study shows that between 1968 and 2003, Massachusetts, Maryland, and New York exhibit a sizable and uninterrupted Democratic advantage (both at the state and national levels). New Hampshire, Wyoming, and Indiana, on the other hand, have been exclusively under Republican control. Using the results from state legislative elections I document that partisan advantage can be large and persistent at the state level. Evidence of systematic electoral biases in other countries is further illustrated by the recent experiences of Japan and Mexico. Understanding the implications of persistent partisan advantage on long-run outcomes is a main objective of this work.

Building on the work of Alesina and Tabellini (1990) and Besley and Coate (1998), I present a theoretical model in which partisan electoral advantage is explicitly considered. There are two groups of citizens in the economy that would like to target spending to themselves (through the provision of projects that benefit their geographical location) but have common interests regarding the accumulation of public capital, which enhances aggregate output. Groups are represented by parties that alternate in power via a democratic process. A key feature is that a representative of only one of the groups is in power at each point in time (e.g., the party has a majority in Congress) and suffers from limited commitment. I characterize time-consistent policies as Markov-perfect equilibria. Because election outcomes are uncertain, parties are endogenously short-sighted relative to the groups they represent. Thus, despite the fact that financing instruments are non-distortionary (i.e., taxes are lump-sum), an intertemporal wedge arises. As in the symmetric case, policymakers tend to overspend on pork and underinvest in productive public capital, which reduces output and private consumption relative to the efficient allocations.

The asymmetry arises because one of the parties is assumed to enjoy persistent political advantage, which is formalized as a higher probability of winning an election. Because the two decision-makers have different de facto discount factors, interesting strategic interactions arise. In particular, the disadvantaged party is endogenously more short-sighted and thus under-saves (relative to a world in which its rival had the same effective short-sightedness), while the advantaged party is less short-sighted and thus over-saves (relative to a world in which its rival had the same effective short-sightedness). Political uncertainty is propagated throughout the economy via volatility in policies, and economic cycles endogenously arise. This is the case even though there is no source of uncertainty other than the identity of the policymaker. Welfare is lower relative to the first best not only because of a dynamic inefficiency (investment is too low), but also because volatility in macroeconomic variables (output, employment, and consumption) is introduced.

Increases in political advantage widen the gap between the policies chosen by the two parties, as well as their probabilities of being elected. Despite the fact that the size of the government (total expenditures to output) increases with the political bias, long-run average output rises. The reason is that, on average, a larger proportion of revenues is devoted to productive public investment. I find that the size of the cycles induced by changes in political advantage is non-monotonic because it is affected by changes in policy and probabilities in opposite directions. Economies in which the political advantage is low exhibit rapid turnover but small fluctuations in policy, as the difference in investment shares is small. This happens because both parties have similar election prospects and are thus equally short-sighted. At the other extreme, when the biases are large, so are the differences in policy. But the most popular party is in power more often, and hence, fluctuations are small. Volatility is largest for intermediate values of the political bias.

I construct a proxy for partisan advantage for each state during the period 1970–2011 using election data in state legislatures. I document that partisan advantage is generally sizable and persistent within a given state over the sample period. I then test the main predictions of the model combining these series with the state economic and fiscal policy data from the US Census. First, and in line with the theory, I find that targeted spending as a share of total state government expenditure is significantly higher than average when a historically disadvantaged party gains a majority of seats in a state legislature. The share of public investment (total capital outlays) to total state government expenditures, on the other hand, is significantly lower than average when this party is in power. This holds even after state and year fixed effects are controlled for and provides some evidence of the short-sightedness of parties that hold power infrequently. Second,

[2] Recent examples are Amador (2008), Azzimonti (2011), Battaglini (2014), Battaglini and Coate (2007), and Debortoli and Nunes (2010).

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