

Electoral cycle runs economy again

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Private sector borrowing, Government largesse and SSIA money pose a threat to our economy, writes Marc Coleman, Economics Editor.

You can fool all of the people some of the time or some of the people all of the time. But can you fool enough of the people enough of the time to get re-elected? Thirty years ago, an economist by the name of William Nordhaus wrote a paper on what he called "The Political Business Cycle", starting a whole branch of economics centred on one simple idea: that the short-term performance of an economy can greatly depend upon the closeness of an election. The reason, he suggested, is that governments deliberately manipulate the economy to make it look better than it really is.

The present perception of strong economic growth and a buoyant property market has created a feel-good factor from which the Government arguably deserves to benefit come election time. But what if that growth isn't real, or isn't as real as it looks? What if the Government is merely massaging the economy in order to win a third term in office? Last Friday, the Central Bank complained of the Government's so-called "pro-cyclical" fiscal policy. Specifically, it was referring to the fact that the present Government has tended to increase public spending at a time when the economy is already growing, namely now.

As we approach the next election, the feel-good factor is turning into feel-great factor. In 2006 the Budget will add a further €4 billion in spending as well as €0.75 billion in tax cuts to the economy, adding to another €14 billion of SSIA money due for release into the economy before election day. Last week the Central Bank pointed out that the economy doesn't need such fiscal stimulus right now. And in its latest commentary on the economy the Economic and Social Research Institute (ESRI) yesterday argued that the Government ought to have run a fiscal surplus.

Although the ESRI refrained from commenting on the influence of the coming election on present budgetary policy, these links are well known to academic economists. In fact the theory of "political business cycles" has gained a respected perch in economic studies.

The simplest version of the theory begins by assuming that there are two sorts of voters. Ideological voters tend to support a party for reasons other than their personal economic self-interest. That might be because they like the party's philosophy or its leader. Swing voters are in the "what's in it for me?" camp. According to the theory, they tend to be part of well-organised lobbies and are only interested in how the government's policies affect their well-being. As all voters are assumed to have short memories, the government maximises its vote by raising spending or cutting taxes close to the election and in a way that appeals to swing voters.

The electoral cycle phenomenon has been proven to exist. It is a malignant disease in two respects. It causes governments to divert resources towards spending favoured by organised lobbies at the expense of more deserving but less politically advantageous causes. But it also damages the economy by concentrating spending in one year. This can lead to a so-called pro-cyclical budgetary policy of raising spending at a time when the economy is already growing. As well as risking inflation, this causes an additional risk: if the economy performs poorly immediately after the election, this usually causes tax revenues to decline. The government is then forced to balance its books and does so by cutting spending, usually capital infrastructure, or by raising stealth taxes.

During the early 1990s, the electoral cycle phenomenon was thought to have disappeared as most western governments trimmed fiscal deficits and reduced the size of the state sector. In Ireland the phenomenon has returned with a vengeance during the present decade. Between 1998 and 2002 public spending rose on average by 11 per cent per annum. But in the pre-election year of 2001 it rose by 16 per cent. As the economy slowed in 2002, the Government responded to disappointing tax revenues by cutting capital spending and increasing indirect taxation - exactly as predicted by the theory.

There is much to suggest that we are in for a repeat performance. Between 2003 and 2005 public spending growth averaged 9 per cent per annum. Public sector pay commitments are likely to push this year's figure to 14 per cent.

SSIAs - ostensibly designed to encourage a savings habit and dampen consumption during an inflationary time - are being released in the period leading up to the election. But with growth forecast to reach 6 per cent this year and inflation forecast to accelerate, the €14 billion injection is unhelpful to say the least.

Government policy on income tax is also suspect. In the years following the 2002 election, the tax thresholds for the higher rate of tax were kept constant. The share of taxpayers paying the rate rose from 26 per cent to 32 per cent over just two years. The last Budget increased the bands significantly, but not enough to make up for the drift since 2002. It's a good bet that the next budget will make up most of the difference.

Last but not least, there is the recent appointment of the benchmarking body. It is to study pay levels in the public sector, with a view to keeping them in line with the private sector. But it will not report its findings until after the next election. This gives public sector workers an incentive to vote for the Government. But it does not make commitments that might alienate taxpayers.

There is less evidence of an electoral impact on policy between 1994 and 1997. But this may be no credit to the Rainbow coalition. In a paper published three years ago, three prominent fiscal economists - Strauch, Hallerberg and von Hagen - found that the race to join EMU caused EU governments to behave like fat men on a beach when a blonde walks by.

In the mid-1990s they "pulled in their stomachs", reducing deficits through using a range of accounting tricks. Once let into EMU, fiscal stomachs were let back out, leading, incidentally, to the pact's breach in 2002. But for the constraints of EMU, the Rainbow coalition of the time might have behaved in much the same way as this Government.

If the Government is manipulating the economy it is playing with fire. A cocktail of private sector borrowing, Government largesse and SSIAs is

threatening the economy with more demand than it can handle. Inflation - already forecast to rise this year - could rise by one or two percentage points. It will also drive revenue growth to rates that will be hard to repeat once high borrowing rates and SSIA's have subsided. At a time when the economy may be turning down, spending commitments will have been raised to new heights.

Nothing is inevitable. Next week's Finance Bill will give the Government an opportunity to implement last week's recommendations from the Pensions Board to incentivise SSIA account holders to put their savings back into private pensions, instead of spending them. And in the partnership talks, the Government can work to constrain growth in public spending this year.

The Government can use these instruments, as well as next year's budget, to prevent overheating in the economy.

But perhaps it calculates that Irish voters do not reward responsible government, but only reward short-termism. And perhaps it is right. If it is, it may find itself cleaning up an economic mess.

That clean-up will embarrass the Government, but will come at taxpayers' expense. Ultimately, we get the government we deserve.

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