It’s Politics, Stupid!
Political Constraints Determine Governments’ Reactions to the Great Recession

Fabian Gunzinger and Jan-Egbert Sturm
Common explanations for variation in stimulus size

- Economic need
  - The larger the external shock, the more stimulus is needed
- Fiscal space
  - Fiscal constraints might restrict the possibilities of governments to act
- Effectiveness of fiscal stimulus
  - In more open economies fiscal stimulus might evaporate more quickly
- The role the political environment plays is ignored in these considerations
  - What about political constraints?
What are political constraints?

- **Definition**
  - A government is free of political constraints if it can enact law unilaterally.
  - This is the case when the party holding the executive power also controls the legislative bodies that have law-making power.

- **Data needed taken from the Database of Political Institutions (DPI2012)**
  - **ALLHOUSE**
    - Does the party of the executive have an *absolute* majority in the houses that have lawmaking powers?
  - Political constraint = (ALLHOUSE==0)
Why should political constraints matter?

- Political parties want to be (re-)elected
- An election is a referendum on the government’s performance
  - Voters punish the incumbent government for poor economic conditions and reward it for circumventing the negative impacts of a negative external shock
- As a consequence,
  - the government wants to enact large (enough) fiscal stimulus measures – given the constraints it faces
  - the opposition wants to change the content and/or the scope of the stimulus package (to reduce the electoral reward for the incumbent)
- Hence, in case the incumbent government is constrained in enacting legislation, the fiscal stimulus measures are likely to be smaller
The story in a nutshell

- **Index (2008Q1=100)**
  - Industrial production
  - International trade

- **% of GDP**

- **Annualised growth rate**

- **Mean and standard deviation**
  - **No constraints**
    - Mean: 4.67
    - St.dev.: 3.05
    - (n=18)
  - **Constraints**
    - Mean: 1.53
    - St.dev.: 3.65
    - (n=27)
  - **Non-member**
    - Mean: 4.67
    - St.dev.: 3.05
    - (n=24)
  - **Member**
    - Mean: 2.70
    - St.dev.: 1.53
    - (n=18)

- **p-value of the t-test**
  - 0.3%

- **Full sample without Hungary, Iceland and Ireland**

---

- **Countries**
  - Argentina
  - Australia
  - Austria
  - Belgium
  - Brazil
  - Canada
  - Chile
  - China
  - Czech Republic
  - Denmark
  - Finland
  - France
  - Germany
  - Greece
  - Hungary
  - Iceland
  - Indonesia
  - Italy
  - Japan
  - Korea
  - Luxembourg
  - Malaysia
  - Mexico
  - Netherlands
  - New Zealand
  - Norway
  - Poland
  - Portugal
  - Russia
  - Singapore
  - Slovak Republic
  - South Africa
  - Spain
  - Sweden
  - Switzerland
  - Taiwan
  - Thailand
  - United Kingdom
  - United States
How to measure the fiscal stimulus?

  - Table 1.8: Fiscal stimulus ... in selected economies (Per cent of GDP)
    - Corresponds to discretionary measures on public spending or revenues in response to the financial crisis, excluding the “automatic stabilizers”.
    - Covers discretionary measures scheduled across 1 to 3 years and thereby largely reflect government “promises” (forecasts)
- Other (feasible) measures of “promises” (Sources: IMF WEO, July 2009 Update & October 2007)
  - The change in the forecasted fiscal primary balance for 2009
- Measures of actual realisation of fiscal policy
  - The actual change in the fiscal balance during 2009
  - The actual change in the fiscal primary balance during 2009
Control variables

- Economic need
  - Government size/expenditures in 2007 – as buffer to an external shock
  - Change in the growth forecast for 2009 (April 2008 -> April 2009)
  - Change in exports between winter 2008/09 and 2007/08 (%2007-GDP)
  - %-change local currency to USD between 2008Q2 and 2008Q4
  - Growth official reserves (in USD) between 2008Q2 and 2008Q4
- Fiscal space
- Effectiveness of fiscal stimulus

- International policy coordination and constraints
- Other domestic institutional and political variables
Control variables

- Economic need
- Fiscal space
  - Pre-crisis government debt (Gov.debt in 2007 as % of GDP)
  - Pre-crisis fiscal deficit (Gov.deficit in 2007 as % of GDP)
  - Lending rate in winter 2008/09
  - Central bank independence, legal measure / irregular turnover rate
  - Change in the lending rate between Aug. and Dec. 2008
  - Growth rate of M1 between between Aug. and Dec. 2008
- Effectiveness of fiscal stimulus
- International policy coordination and constraints
- Other domestic institutional and political variables
Control variables

- Economic need
- Fiscal space
- Effectiveness of fiscal stimulus
  - KOF Economic Globalisation in 2007
- International policy coordination and constraints
- Other domestic institutional and political variables
Control variables

- Economic need
- Fiscal space
- Effectiveness of fiscal stimulus

- International policy coordination and constraints
  - KOF Political Globalisation in 2007
  - G20 dummy
  - Dummy for EU membership
  - Dummy for EMU/euro area membership
  - Under an IMF program

- Other domestic institutional and political variables
Baseline regression results

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Political constraint</td>
<td>-1.195 (1.525)</td>
<td>-2.404** (-2.038)</td>
<td>-2.800*** (-4.139)</td>
<td>-2.445** (-2.326)</td>
<td>-1.974*** (-3.327)</td>
<td>-1.895* (-1.986)</td>
</tr>
<tr>
<td>Gov.expenditures in 2007 (%GDP)</td>
<td>-0.106*** (-3.310)</td>
<td>0.0584 (1.374)</td>
<td>0.0608** (2.310)</td>
<td>0.0598** (2.346)</td>
<td>0.0663*** (2.640)</td>
<td>0.0615** (2.351)</td>
</tr>
<tr>
<td>Gov.debt in 2007 (%GDP)</td>
<td>0.00774 (0.641)</td>
<td>-0.00920 (-1.510)</td>
<td>-0.0139* (-1.774)</td>
<td>-0.0193* (-1.121)</td>
<td>-0.00987 (-1.295)</td>
<td>-0.0157* (-1.609)</td>
</tr>
<tr>
<td>Gov.deficit in 2007 (%GDP)</td>
<td>-0.141 (-1.327)</td>
<td>-0.292*** (-3.524)</td>
<td>-0.433*** (-3.040)</td>
<td>-0.193** (-2.007)</td>
<td>-0.484*** (-3.631)</td>
<td>-0.215* (-1.819)</td>
</tr>
<tr>
<td>Under an IMF program</td>
<td>-6.223** (-2.694)</td>
<td>-1.868* (-1.982)</td>
<td>-1.072 (-1.146)</td>
<td>-1.609** (-2.018)</td>
<td>-0.562 (-0.856)</td>
<td>-0.541 (-0.826)</td>
</tr>
<tr>
<td>Constant</td>
<td>7.199*** (4.842)</td>
<td>5.257*** (2.839)</td>
<td>4.035*** (3.411)</td>
<td>3.840** (2.409)</td>
<td>3.154*** (3.303)</td>
<td>3.196** (2.166)</td>
</tr>
<tr>
<td>Observations</td>
<td>43</td>
<td>40</td>
<td>102</td>
<td>75</td>
<td>138</td>
<td>94</td>
</tr>
<tr>
<td>Adjusted R-squared</td>
<td>0.365</td>
<td>0.192</td>
<td>0.360</td>
<td>0.275</td>
<td>0.383</td>
<td>0.179</td>
</tr>
<tr>
<td>Mean dependent variable</td>
<td>2.444</td>
<td>4.973</td>
<td>4.073</td>
<td>3.491</td>
<td>3.903</td>
<td>3.336</td>
</tr>
</tbody>
</table>
Do other political variables matter?

- Plurality voting
- Parliamentary system
- Political colour: Left-wing executive
- Minority governments
  - Government is a minority government
  - Fraction of seats held by the government
- The cohesion within the government or opposition
  - Government is a coalition
  - The probability two deputies are not of different parties
  - The probability two deputies are not of different parties
- The occurrence of elections
  - Do executive or legislative elections take place
    - Cross-term with political constraints
Including additional political variables

<table>
<thead>
<tr>
<th>VARIABLES</th>
<th>Plurality system</th>
<th>Parliamentary system</th>
<th>Left-wing executive</th>
<th>Minority government</th>
<th>Fraction seats held by gov.</th>
<th>Coalition government</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gov.expenditures in 2007 (%GDP)</td>
<td>0.0607**</td>
<td>0.0799***</td>
<td>0.0597**</td>
<td>0.0631**</td>
<td>0.0543**</td>
<td>0.0583**</td>
</tr>
<tr>
<td>Change of exports in winter 2008/09 (%2007-GDP)</td>
<td>-0.194*</td>
<td>-0.203*</td>
<td>-0.194*</td>
<td>-0.195*</td>
<td>-0.206*</td>
<td>-0.191*</td>
</tr>
<tr>
<td>Gov.debt in 2007 (%GDP)</td>
<td>-0.0193*</td>
<td>-0.0200**</td>
<td>-0.0193*</td>
<td>-0.0201**</td>
<td>-0.0190*</td>
<td>-0.0193*</td>
</tr>
<tr>
<td>Gov.deficit in 2007 (%GDP)</td>
<td>-0.194*</td>
<td>-0.197**</td>
<td>-0.193**</td>
<td>-0.196**</td>
<td>-0.214**</td>
<td>-0.190*</td>
</tr>
<tr>
<td>Under an IMF program</td>
<td>-1.608*</td>
<td>-1.802**</td>
<td>-1.607**</td>
<td>-1.720**</td>
<td>-1.493*</td>
<td>-1.586*</td>
</tr>
<tr>
<td>Constant</td>
<td>3.763**</td>
<td>3.838**</td>
<td>3.854**</td>
<td>3.766**</td>
<td>3.226*</td>
<td>3.840**</td>
</tr>
<tr>
<td>Additional political variable (see column header)</td>
<td>0.0630</td>
<td>-0.988</td>
<td>-0.0252</td>
<td>0.653</td>
<td>1.229</td>
<td>0.178</td>
</tr>
<tr>
<td>Observations</td>
<td>75</td>
<td>75</td>
<td>75</td>
<td>75</td>
<td>74</td>
<td>75</td>
</tr>
<tr>
<td>Adjusted R-squared</td>
<td>0.265</td>
<td>0.284</td>
<td>0.265</td>
<td>0.269</td>
<td>0.294</td>
<td>0.265</td>
</tr>
<tr>
<td>Mean dependent variable</td>
<td>3.491</td>
<td>3.491</td>
<td>3.491</td>
<td>3.491</td>
<td>3.420</td>
<td>3.491</td>
</tr>
<tr>
<td>VARIABLES</td>
<td>(7)</td>
<td>(8)</td>
<td>(9)</td>
<td>(10)</td>
<td>(11)</td>
<td>(12)</td>
</tr>
<tr>
<td>---------------------------------------</td>
<td>--------------</td>
<td>--------------</td>
<td>--------------</td>
<td>--------------</td>
<td>--------------</td>
<td>--------------</td>
</tr>
<tr>
<td></td>
<td>(-2.360)</td>
<td>(-2.247)</td>
<td>(-2.287)</td>
<td>(-2.022)</td>
<td>(-2.355)</td>
<td>(-1.992)</td>
</tr>
<tr>
<td>Gov. expenditures in 2007 (%GDP)</td>
<td>0.0559**</td>
<td>0.0537**</td>
<td>0.0593**</td>
<td>0.0561**</td>
<td>0.0489*</td>
<td>0.0483*</td>
</tr>
<tr>
<td></td>
<td>(2.189)</td>
<td>(2.152)</td>
<td>(2.321)</td>
<td>(2.207)</td>
<td>(1.926)</td>
<td>(1.890)</td>
</tr>
<tr>
<td>Change of exports in winter 2008/09 (%2007-GDP)</td>
<td>-0.203*</td>
<td>-0.186</td>
<td>-0.193*</td>
<td>-0.194*</td>
<td>-0.228*</td>
<td>-0.232**</td>
</tr>
<tr>
<td></td>
<td>(-1.834)</td>
<td>(-1.641)</td>
<td>(-1.743)</td>
<td>(-1.730)</td>
<td>(-1.994)</td>
<td>(-2.040)</td>
</tr>
<tr>
<td>Gov. debt in 2007 (%GDP)</td>
<td>-0.0196*</td>
<td>-0.0181*</td>
<td>-0.0192*</td>
<td>-0.0191*</td>
<td>-0.0224**</td>
<td>-0.0232**</td>
</tr>
<tr>
<td></td>
<td>(-1.993)</td>
<td>(-1.793)</td>
<td>(-1.941)</td>
<td>(-1.897)</td>
<td>(-2.215)</td>
<td>(-2.319)</td>
</tr>
<tr>
<td>Gov. deficit in 2007 (%GDP)</td>
<td>-0.210**</td>
<td>-0.217**</td>
<td>-0.192*</td>
<td>-0.185*</td>
<td>-0.173*</td>
<td>-0.177*</td>
</tr>
<tr>
<td></td>
<td>(-2.078)</td>
<td>(-2.131)</td>
<td>(-1.969)</td>
<td>(-1.900)</td>
<td>(-1.872)</td>
<td>(-1.816)</td>
</tr>
<tr>
<td>Under an IMF program</td>
<td>-1.542*</td>
<td>-1.496*</td>
<td>-1.628*</td>
<td>-1.675**</td>
<td>-1.517*</td>
<td>-1.474*</td>
</tr>
<tr>
<td></td>
<td>(-1.832)</td>
<td>(-1.862)</td>
<td>(-1.987)</td>
<td>(-2.046)</td>
<td>(-1.992)</td>
<td>(-1.852)</td>
</tr>
<tr>
<td>Constant</td>
<td>4.007**</td>
<td>3.794**</td>
<td>3.859**</td>
<td>3.833**</td>
<td>3.960**</td>
<td>3.873**</td>
</tr>
<tr>
<td></td>
<td>(2.525)</td>
<td>(2.242)</td>
<td>(2.405)</td>
<td>(2.354)</td>
<td>(2.490)</td>
<td>(2.367)</td>
</tr>
<tr>
<td>Additional political variable (see column header)</td>
<td>-0.257</td>
<td>0.191</td>
<td>-0.202</td>
<td>2.381***</td>
<td>1.348*</td>
<td>1.991</td>
</tr>
<tr>
<td></td>
<td>(-0.205)</td>
<td>(0.139)</td>
<td>(-0.208)</td>
<td>(3.120)</td>
<td>(1.776)</td>
<td>(1.536)</td>
</tr>
<tr>
<td>Add. political variable * political constraint dummy</td>
<td>-3.512***</td>
<td>-3.152**</td>
<td>-2.302**</td>
<td>-1.792**</td>
<td>-0.921</td>
<td>-0.578</td>
</tr>
<tr>
<td></td>
<td>(-3.233)</td>
<td>(-3.233)</td>
<td>(-3.233)</td>
<td>(-3.233)</td>
<td>(-3.233)</td>
<td>(-3.233)</td>
</tr>
<tr>
<td>Observations</td>
<td>74</td>
<td>73</td>
<td>75</td>
<td>75</td>
<td>75</td>
<td>75</td>
</tr>
<tr>
<td>Adjusted R-squared</td>
<td>0.292</td>
<td>0.278</td>
<td>0.265</td>
<td>0.266</td>
<td>0.292</td>
<td>0.284</td>
</tr>
<tr>
<td>Mean dependent variable</td>
<td>3.420</td>
<td>3.340</td>
<td>3.491</td>
<td>3.491</td>
<td>3.491</td>
<td>3.491</td>
</tr>
</tbody>
</table>
Conclusions

- Traditional variables that explain the size of fiscal stimulus are
  - Initial public deficit (almost always significant)
  - Initial public debt (sometimes significant)
  - Initial size of the government (sometimes significant)
- Not a very robust relationship between fiscal stimulus and size of the shock
  - All countries were roughly hit to the same extent?
- In case a government does not control the legislative bodies, then this significantly and robustly reduced the size of fiscal stimulus
  - Depending on the fiscal stimulus measure used the average effect ranges from 1.2 to 2.8 percentage points of GDP
    - Note that the average fiscal stimulus measures range between 2½ and 5 percent of GDP