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Fiscal policy, growth, income distribution and sociopolitical instability

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ABSTRACT

This paper identifies the fiscal instruments that governments can use to promote economic growth when sociopolitical instability (SPI) is present. We show that fiscal policy that takes into account income distribution and SPI transforms a neoclassical growth model into one with both endogenous growth and a poverty trap. Under these circumstances, the growth rate of the economy depends upon SPI, fiscal policy and income distribution. The baseline level of SPI determines an economy's ability to grow. If SPI is high, the economy remains in a poverty trap even if fiscal policy instruments are set appropriately.

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1. Introduction

An important issue concerning the growth trajectory of a country is the influence of sociopolitical instability. An extensive theoretical and empirical literature has confirmed that SPI is detrimental to economic growth (e.g., Venieris and Gupta, 1983, 1986; Venieris and Stewart, 1987; Barro, 1991; Alesina et al., 1996; Devereux and Wen, 1998; Zak, 2000; Jong-A-Pin, 2009; Aisen and Veiga, 2013). According to this body of research, SPI affects growth by increasing uncertainty about the future which, in turn, has adverse effects on decisions regarding both investment and savings (e.g., Stewart and Venieris, 1985; Venieris and Gupta, 1986; Venieris and Stewart, 1987; Alesina and Perotti, 1996; Feng, 2001).

The purpose of this paper is to identify the fiscal instruments that a government can use to promote growth given the presence of SPI. More specifically, we consider a set of fiscal policies articulated in terms of a combination of government spending and taxes that keep SPI at bay while, at the same time, promote economic growth. These policies are derived in the context of a partial equilibrium growth model.

Additionally, we seek to link the relationship between economic growth and SPI with the pragmatic side of policymaking. The literature provides evidence of this possibility. According to Edwards and Tabellini (1991), in equilibrium, sociopolitical instability is associated with more seigniorage. Similarly, Devereux and Wen (1998) have argued that greater political instability leads to a higher spending by the government as a percent of GDP.

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In this context, it is plausible that fiscal policy may give rise to social and economic imbalances or it may dampen them depending on the circumstances. It behooves us, therefore, to address fiscal policy particularly in the context of an economy that is subject to sociopolitical instability.

To anticipate some of the results, our model demonstrates that the efficiency of the government in suppressing SPI and the sensitivity of SPI to changes in fiscal policy and income distribution determine the growth trajectory of a country. To obtain the equilibrium dynamics, we identify two scenarios: First, if the baseline level of SPI is not too high, an economy with growth-enhancing policies would exhibit a nearly linear growth path over transitional dynamics and balanced growth in the limit. Second, if baseline SPI is beyond an identified threshold, the economy's expansion path remains linear but the growth rate turns negative, leading the economy to a poverty trap. The conditions under which growth-enhancing policies are insufficient to permit the economy to escape from those conditions are also derived. Third, the position of the growth trajectory is predicated on income distribution and it shifts to a lower level as income inequality increases. We undertake the empirical tasks by using linear dynamic panel data with GMM estimators as is common practice in the empirical growth literature.

The rest of the paper is organized as follows. The definition of sociopolitical instability is presented in Section 2. Growth-enhancing fiscal policies are derived in Section 3. The empirical tests are presented in Sections 4 and 5 where we also simulate the model to obtain its equilibrium dynamics. Finally, Section 6 states the conclusions.

2. Empirical definitions of sociopolitical instability

Although SPI has been used extensively in the literature of political economy, there remains a lack of consensus as to how it should be measured and what the various measures of instability capture. First, sociopolitical instability has been identified in the empirical literature as "political instability", which is defined as the propensity of the executive branch of the government to collapse (Alesina and Perotti, 1996; Alesina et al., 1996). According to this view, this latent variable can be approximated by using a probit analysis that relates the probability of a change in the executive to several economic and sociopolitical variables (e.g., Cukierman et al., 1992; Edwards and Tabellini, 1991; Londregan and Poole, 1990; Alesina et al., 1996).

Second, sociopolitical instability has also been identified with social unrest and violence (Venieris and Gupta, 1986; Venieris and Stewart, 1987; Venieris and Sperling, 1989; Alesina and Perotti, 1996). The main characteristic of this approach is that it focuses on the construction of an index that summarizes the various manifestations of social unrest without addressing their causes. In particular, Taylor and Hudson (1972) identified a number of variables that record events of political instability and violence. These are: executive transfers, government sanctions and purges, riots, political protest and demonstrations, political strikes, number of armed attacks, deaths due to political violence, guerrilla warfare and assassinations. Application of factor analysis and principal components has resulted in the conclusion that the above forms of sociopolitical violence can be summarized in terms of two dimensions: the less and the more violent events (e.g., Hibbs, 1973; Venieris and Gupta, 1986; Gupta, 1990; Ozler and Tabellini, 1991; Benhabib and Spiegel, 1992; Alesina et al., 1996; Alesina and Perotti, 1996). In this sense, it would be more accurate to call this form of instability "social instability" in that it attributes the various manifestations of violence to reasons for social discontent.

In this study we have adopted the last approach and identified the less violent events with general strikes, riots and antigovernment demonstrations, and the more violent events with assassinations, guerrilla warfare and purges, respectively. Our reasoning is that social and political instability take the above forms regardless of their causes. Therefore, we identify "sociopolitical instability" with what we called "social instability".

3. Fiscal policy and sociopolitical instability

3.1. The model

Consider a standard neoclassical growth model with a single good where the primary and only accumulable factor of production is capital (K). The objective of the government is to promote income growth, which is equivalent to stimulating capital accumulation while, at the same time, keeping SPI at bay.[1] Towards this end, it uses the budget, which we have aggregated into three broad categories: the first includes expenses in education, health, social security and new infra-structure, which we define as public investment (I); the second includes all expenditures associated with police protection (P), and the third includes the remaining budgetary items such as social engineering and cultural programs, among others. We call this item 'residual' expenditure (R).[2]

The state revenues (T) are used to underwrite the items of the budget. The policymakers choose I, P, R and T as instruments to attain their goals and in principle all of them, except T, can affect growth positively both directly through their impact on

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[1] We recognize that economic growth is only one of the possible arguments in the preference function of the government. In practice, this preference function includes economic, social, political and institutional concerns and targets. One important political concern is whether the corresponding policies of the government contribute positively or negatively to its life expectancy. Here, in the context of partial equilibrium, we focus on economic growth and in effect we assume that all the other arguments of the preference function in question remain constant. It is also worth noticing that partial equilibrium ignores a number of conceivable binding constraints that might not be playing any role in the process of optimization of the growth rate. This, in turn, might result in an overestimation of the resulting rate. Clearly, this is an observation that holds for all models. This is also the reason why we do not use the term "optimum" rate of growth; instead, we use the modest term enhanced rate. Our motivation stems from the observation that the price of more realism is the loss of clarity.

[2] The model is general enough to accommodate a large number of budgetary items. The only reason for not including more items of the budget is to keep the model simple.