Capital, cabinets and taxes: political and policy determinants of financial flows

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Abstract:
International capital flows hold a notable economic relevance within OECD countries, showing clear reactions to economic policy and to governments' political profile. This study explores these impact channels and tests them empirically. A game theoretical model is built, rationalizing the hypothesis that (a) left-leaning cabinets implement higher taxes and higher public expenditures and that (b) minoritarian or coalition cabinets react less actively to productivity shocks. The model predicts, thus, a negative reaction by capital flows to left-leaning cabinets and an uncertain reaction to both minorities and coalitions, depending on how efficient their inaction is – trade-off between productivity-boosting and policy uncertainty/"noise". Model predictions are tested on a set of 23 OECD democratic countries,
in the period 1960-2008. The hypothesis that left-leaning cabinets set higher taxes finds empirical support. This policy divergence is more intense in the context of single-party cabinets, suggesting that coalitions may be associated to fiscal policy inaction/blending. Consistently, equity inflows react positively to single-party right cabinets. FDI net flows react negatively to majoritarian cabinets and positively to budget deficits, signaling sensitivity to environment stability and fiscal stimulus.
Oppositely, equity inflows react positively to majoritarian cabinets (potentially more active in
countering negative GDP shocks) and negatively to budget deficits and public expenditure (potentially anticipating higher taxes). The magnitude of the direct impacts of political profiles on capital flows range from 0.3 to 4.7 GDP percentage points (0.5–2.5 standard deviations of the respective sample flows). Reactions to fiscal policy are attenuated when left or right cabinets are in office.