



# Political expenditure cycles and election outcomes: Evidence from disaggregation of public expenditures by economic functions



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## HIGHLIGHTS

- We test the existence and effectiveness of PBCs in 32 countries from 1990 to 2010.
- We add to the literature by disaggregating expenditure data by economic functions.
- Election cycles in total expenditure exist in the group of East European countries.
- Election cycles in East and West are found in specific expenditure sub-categories.
- Electorally motivated spending policies are ineffective means to win elections.

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## ABSTRACT

We analyze electorally motivated public spending using disaggregated expenditure data. Election cycles in total expenditures and in specific sub-categories mainly exist in newly democratized Eastern European countries. However, electorally motivated spending policies are ineffective means to enhance the re-election probability.

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## 1. Introduction

Does public expenditure growth significantly increase in election years? If yes, does this political budget cycle impact on the re-election probability of the incumbent and his political party? The empirical literature comes up with clear messages: first, except for new democracies political expenditure cycles do not exist. Second, election-year deficit spending does not lead to a higher re-election probability; in fact, it may even be decreased. Yet, these

findings are based on studies which focus on aggregate measures of public spending (e.g., Brender and Drazen, 2005, 2008).

However, election-year manipulation may take forms which are not fully captured by fiscal aggregates. Brender and Drazen (2013) construct an index to measure changes in the composition of total public expenditures. They find that the overall change in expenditure composition is higher in newly democratized countries. Yet, a larger change in expenditure composition in election than in non-election years is predominantly a phenomenon in established democracies. In addition, several recent studies disaggregate total budget categories into current and capital spending (e.g. Vergne, 2009) and find for high-income OECD countries that elections shift public spending towards more visible current expenditures (Katsimi and Sarantides, 2012). In a sample of Indonesian districts, Sjahrir et al. (2013) disaggregate administrative spending

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into non-discretionary and discretionary expenditures, finding that electoral expenditure cycles are driven by the more discretionary parts of the budget, e.g. donations or social assistance.

A further possibility is to structure public expenditures according to their economic function. Using expenditure data separated by economic functions allows isolating in more detail which expenditure categories incumbents conceive as visible and targetable to specific groups of voters. Indeed, based on a sample of Columbian municipalities, Drazen and Eslava (2010) find that governments, in their attempt to remain in office, tend to increase visible expenditures on housing, health, water and energy to target voters. However, evidence based on a broad sample of countries is lacking.<sup>2</sup>

The presence of electorally motivated expenditure cycles, however, is not sufficient to draw conclusions about the effectiveness of these measures with respect to the incumbent's goal of re-election. At the disaggregate level, only few empirical studies examine the suitability of electorally motivated budget policies to win elections. In particular, distinguishing between current and capital spending, Drazen and Eslava (2010) find "that voters penalize the incumbent party for running large deficits before elections, and reward it for increasing the amount of targeted (capital, authors) spending [...]" (p. 52).

Brender (2003) uses data on local government elections in Israel between 1989 and 1998. He shows that for a given amount of debt accumulation and a given debt level the re-election probability of incumbent local authority heads can be positively influenced by increasing the per-capita expenditure in the "extraordinary budget", which proxy for expenditures on development issues. Thus, Brender's (2003) results are also consistent with the view that electorally motivated increases in capital expenditure categories enhance the re-election probability.

Against this background the contribution of this paper is to offer a new perspective on the existence and effectiveness of electorally motivated budget policy by disaggregating public expenditures by economic functions. It adds to the literature by pinpointing in more detail which expenditure categories are used by incumbents to affect election results and by indicating if these expenditure manipulations increase an incumbent's re-election probability. We apply the Classification of the Functions of Government (COFOG) data for the EU-27 countries, Iceland, Norway, Canada, New Zealand and the USA over the 1990–2010 period.<sup>3</sup>

## 2. Empirical model, data and methodology

To isolate the presence of electorally motivated expenditure policies we apply the following empirical model (compare Fatás and Mihov, 2003):

$$\Delta \ln G_{jit} = \alpha + \beta \Delta \ln Y_{i,t-1} + \gamma ELEC_{it} + \theta \Delta \ln X_{i,t-1} + \nu_i + \rho_t + \epsilon_{it}, \quad (1)$$

where  $G_{jit}$  is either real total expenditure or one of ten COFOG expenditure categories ( $j = 1, \dots, 11$ ),  $Y_{i,t-1}$  is real GDP in national currency (both variables are defined in 2005 prices) and  $ELEC_{it}$  pinpoints election years following Franzese (2000). The matrix  $X_{i,t-1}$  contains control variables that capture inertia in public expenditure growth (lagged dependent variable), scale effects

(population), globalization effects (openness), the age structure (share of young and elderly in total population) and labor market effects (unemployment rate).

Additionally, in regressions for single COFOG categories the growth rate of total expenditures is included in  $X_{i,t-1}$  to reduce the possibility that the election variable merely picks up changes in total expenditures around election years.  $\nu_i$  and  $\rho_t$  are  $N - 1$  country-fixed effects and  $T - 1$  time-fixed effects.  $\epsilon_{it}$  is the remainder error term.<sup>4</sup> Control variables are lagged by one year to mitigate problems from reverse causality.

As stressed by Brender and Drazen (2005) it is important to distinguish between old and new democracies. Therefore, we estimate Eq. (1) not only for the complete country sample, but also separately for Western countries and the newly democratized countries in Eastern Europe.<sup>5</sup> Another relevant distinction is between predetermined and premature elections (e.g. Katsimi and Sarantides, 2012). To cope with this issue we include two separate election variables, one for predetermined and one for premature elections in  $ELEC_{it}$ . Yet, for East European countries our sample contains only three premature elections. Hence, this split of the election variable is not meaningful. To estimate model (1) we use the bias-corrected Least Square Dummy variable estimator advanced by Bruno (2005), which is suitable for our small  $N$  and small  $T$  application.

The second aim of the study is to investigate whether the existence of political expenditure cycles affects the re-election probabilities of incumbents. For those expenditure categories for which we establish the presence of a political expenditure cycle we estimate the following empirical model:

$$REELECT_{ie} = \alpha' + \beta' PBC_{jie} + \gamma' W_{ie} + \epsilon'_{ie}. \quad (2)$$

$REELECT_{ie}$  is a dummy variable indicating re-election of the incumbent party in country  $i$  and election year  $e$ . Following Klomp and de Haan (2012) we base our Political Budget Cycle (PBC) measures on the residuals of Eq. (1) when the latter is estimated with  $ELEC_{it}$  left out. These residuals comprise the election effect on growth in expenditure category  $j$ . Specifically, we define  $PBC1_{jie}$  as the difference between the election-year residual and the mean of the residuals over the incumbent's term in office. Hence, a positive value indicates an above-average (unexplained) growth in expenditure category  $j$  in election year  $e$ .  $PBC2_{jie}$  is a dummy variable which is 1 if  $PBC1_{jie} > 0$ , and 0 otherwise. Finally,  $PBC3_{jie}$  is a dummy variable which is 1 for the 25% largest values of  $PBC1_{jie}$ , and 0 otherwise. Matrix  $W_{ie}$  contains variables which control for the business cycle (GDP growth and inflation in the election year),<sup>6</sup> the strength of the incumbent party (vote share in the last election), total expenditure growth during the incumbent's term in office (mean growth rate of total expenditures) as well as the change in total expenditures over the incumbent's term in office ( $expch\_term_{ie}$ ). For right-hand side variables  $e$  refers to the year before the election if the election takes place between January and June.<sup>7</sup>  $\epsilon'_{ie}$  is the remainder error term.

Our dataset is based on several sources. Government expenditures, nominal GDP and GDP deflators (2005 as base year) are

<sup>2</sup> While Brender and Drazen (2013) isolate compositional changes around election years based on a broad sample of countries, their aim is not to provide information on the specific expenditure categories by which politicians try to affect election results. Moreover, Brender and Drazen (2013) do not investigate the impact of compositional changes in expenditures on re-election chances.

<sup>3</sup> We make use of first-level COFOG data which splits expenditure into the following ten functions: general public services (*admin*); defense; public order and safety (*security*); economic affairs (*economic*); environmental protection (*environ*); housing and community amenities (*housing*); health; recreation, culture and religion (*leisure*); education; social protection (*social*).

<sup>4</sup> As we apply a two-way-fixed effects approach we capture the impact of time-invariant, country-specific determinants (e.g. electoral and political system, welfare regime; level of social trust) as well as global economic factors (e.g. global booms and busts).

<sup>5</sup> Greece, Portugal and Spain are frequently treated as newly democratized countries in empirical studies based on samples beginning in the 1970s or the 1980s (e.g. Brender and Drazen, 2005). Our sample starts in 1990 and 1995, respectively. We therefore consider these three countries in the group of old democracies.

<sup>6</sup> Inflation is considered not least as several of the East European countries experience high inflation rates during the sample period. Note that in the first-step regressions inflation is not considered since real expenditure data are used and time-fixed effects are included in Eq. (1).

<sup>7</sup> For example, if the election takes place in January we assume that the GDP growth rate in the year prior to the election year is relevant to voters.

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