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Revenue decentralization, central oversight and the political budget cycle: Evidence from Israel

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This paper examines whether revenue decentralization and direct external financial supervision affect the incidence and strength of political budget cycles, using a panel of Israeli municipalities during the period 1999–2009. We find that high dependence on central government transfers – as reflected in a low share of locally raised revenues in the municipality's budget – exacerbates political budget cycles, while tight monitoring – exercised through central government appointment of external accountants to debt accumulating municipalities – eliminates them. We also find that this pattern is predominantly accounted for by development expenditures. These results suggest that political budget cycles can result from fiscal institutions that create soft budget constraints: that is, where incumbents and rational voters can expect that the costs of pre-election expansions will be partly covered later by the central government.

1. Introduction

A wide body of political economy literature debates the existence and potential determinants of political budget cycles – broadly defined as the manipulation of fiscal policy by incumbent politicians, and in particular accumulation of deficits – when an election is imminent (Alesina 1989; Alesina et al. 1993; Akhmedov and Zhuavskaya 2004; Drazen et al. 2008). According to theoretical contributions, electoral manipulation of fiscal policy can be effective in contexts where voters are not fully rational (Nordhaus 1975) or imperfectly informed (Brender and Drazen 2005; Alt and Lassen 2006; Shi and Svensson 2006), or where economic cycles induced by the manipulation of fiscal variables can serve as a signal of the incumbent government's competence (Cukierman and Meltzer 1986; Rogoff and Sibert 1988(. Rogoff (1990) presents a model where changes in fiscal variables themselves allow incumbents to reveal their competence, without inducing economic cycles. In all these models it is argued that voters'

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support for the incumbent would increase as a result of these short-term changes in fiscal policy.[4] As distortions in fiscal policy for purely electoral reasons may have significant economic costs, it is important to understand under what conditions such manipulation is most likely to occur.

A widely cited factor affecting the tendency of politicians to generate political budget cycles is the lack of accurate real-time information for voters regarding the status of public finances and the economy (Drazen et al. 2008; Eslava 2011). The relevance of such information stems from the argument that if voters are aware of the manipulation they might actually "punish" the incumbent at the polls, recognizing the inefficiencies caused by the manipulation. This notion is also supported by empirical evidence (e.g. Brender 2003; Brender and Drazen 2008).

In this paper, we examine the possibility that if some of the costs of electoral fiscal manipulations could be shifted outside the jurisdiction, e.g. to the central government, it may affect voters' attitudes towards the manipulation and, accordingly, the tendency of local policy makers to induce political budget cycles. This possibility may explain why political budget cycles are more commonly found to exist in subnational elections,[5] than in national ones. We thus study how revenue decentralization, reflected in the share of locally generated revenues, affects the incidence of political budget cycles. For that purpose we use a dynamic analysis of a panel of Israeli municipalities over the period 1999–2009. We focus on two institutional characteristics that were simultaneously present during this period: the degree of revenue decentralization and whether the municipality was subjected to tight central oversight exercised by the appointment of external accountants by the central government.

The degree of self-financing varies greatly among Israeli municipalities. While some finance their expenses mostly with locally raised revenues, many rely heavily on central government transfers. We hypothesize that the incentives to run deficits for electoral reasons are lower in municipalities that rely strongly on locally raised revenues, presumably because voters are aware that deficits imply higher local taxes or curtailed services in the future. Local politicians in such municipalities may thus anticipate that deficits will not lead to electoral rewards (Brender 2003). In contrast, politicians and voters in municipalities that rely on central transfers may reasonably expect that deficits will induce higher transfers in the future (Meloni and Tommasi 2012). The possibility to have the central government and thus the fiscal commons cover deficits may facilitate overspending and specifically the emergence of political budget cycles (Weingast et al. 1981). This argument corresponds with the findings of Aidt and Mooney (2014) that shifting from taxpayers' suffrage to universal suffrage significantly affects the shape of the political budget cycle by moving the focus of incumbents' manipulative behavior around election times from focusing on tax cuts and current expenditure retrenchment towards changes in the expenditure composition.

As for central government monitoring, from 2003 onward the Israeli central government appointed external accountants to several highly indebted municipalities and to municipalities that were poorly managed financially. These accountants had the special authority to monitor fiscal policy operations, and in particular to stop payment in cases of deficits. It is likely that such central oversight limits the ability of municipalities to generate electoral cycles in fiscal policy, or at least increases the likelihood that such attempts will be exposed in real-time. We therefore control for this effect, as it may be negatively correlated with the magnitude of the political budget cycles, as well as with the share of locally generated revenues.[6] However, based on past limited success with alternative measures, e.g., a ban on bank borrowing without ministerial approval, reporting requirements and recovery programs, it is also possible that municipalities are able to evade the supervision and accumulate deficits during election years despite the central oversight.

Our empirical results suggest that significant political budget cycles exist in Israeli local elections: controlling for other explanatory variables, municipal deficits are on average 8 percentage points larger in local election years than in other years. Further analysis also shows that cycles are less pronounced in municipalities that rely mostly on locally raised revenues, and do not exist in those subject to centrally appointed accountants. These findings imply that deficits are likely associated with electoral costs for local politicians if they may lead to higher taxes in the future. Previous empirical support for this notion is offered by Brender (2003) and Drazen and Eslava (2010), who find that deficits indeed lead to electoral losses in Israeli and Colombian local elections, respectively. We find, first, that low dependence on central transfers dampens political budget cycles, but they remain significant. Second, enforced control by the central government through external accountants turns political budget cycles statistically insignificant. Our results thus imply that either strong central oversight or significant revenue decentralization can limit opportunistic behavior by incumbent local governments. The institutional setup most prone for electoral manipulation of the budget appears to be when a high degree of local fiscal autonomy is combined with strong reliance on central transfers. We also find that these effects are accounted for by development expenditures, in line with the findings of Aidt and Mooney (2014), and consistent with Brender's (2003) result that Israeli voters tend to have a more supportive attitude towards election year development spending than towards current deficits during election years.

Our contribution to the literature is in exploring the role of fiscal decentralization and soft budget constraints as potential determinants of political budget cycles. Several other potential determinants have previously been discussed in the literature. Brender and Drazen (2005), for example, study whether the incidence of political budget cycles differs between new and established democracies. Their results indicate that experience with democratic politics and the quality of information as well

[4] Changes in fiscal policy can take the form of increases in spending (Sakurai and Menezes-Filho 2011), tax reductions (Foremny and Riedel 2014) or changes in the composition of spending (Vergne 2009; Brender and Drazen 2013).

[5] Studies that examined this issue at the subnational level include Blais and Nadeau (1992); Galli and Rossi (2002); Khemani (2004); Akhmedov and Zhuavskaya (2004); Coelho et al. (2006); Veiga and Veiga (2007); Cole (2009); Aidt et al. (2011); Dahlberg and Mörk (2011); Foremny et al. (2014); Tepe and Vanhuysse (2014) and Baskaran et al. (2015).

[6] The mean share of locally generated revenues in total revenues among localities that had an external accountant was 51% and among those that did not have one it was 61%. There is a broad range of overlap between the two groups with respect to the share of locally generated revenues.