



# Political pressure and procyclical expenditure: An analysis of the expenditures of state governments in Mexico <sup>☆</sup>

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## ABSTRACT

Government expenditures are procyclical if they increase in periods of economic growth and decrease in periods of economic downturn. This paper tests the proposition that (within federations) political pressures for public expenditure increase the likelihood that expenditures and inter-governmental transfers will be procyclical. An analysis of political pressures in Mexico suggests that political pressures will produce a distinct pattern of procyclical expenditures across fiscal tiers and across government budgets. This prediction is tested with reference to the expenditures of 31 states in Mexico between 2005 and 2010.

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## 1. Introduction

While economists often anticipate countercyclical government expenditure (Alesina et al., 2008), an established literature reports evidence of procyclical government expenditure. Expenditure is procyclical if it increases in economic upturns and decreases in economic downturns. There is evidence of procyclicality in developing countries (for example Gavin et al., 1996) and in developed countries (for example Woo, 2009).

Beneficent governments might spend procyclically to maximise welfare if government consumption and private consumption are complements (Lane, 2003). However, the conditions required to rationalise procyclical expenditure as a welfare-maximising strategy are very restrictive and it is impossible to dismiss the relevance of political pressures for increased public expenditure. Lane and Tornell (1996) and Tornell and Lane (1998) argue that there are voracity effects if political pressures for increased public spending

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are more intense in economic upturns than in economic downturns. Lane (2003) employed Henisz's (2000) index as an indicator of political pressures to test the proposition that political pressures influence the cyclicity of government expenditure.<sup>1</sup> While the index was not relevant when analysing every component of government expenditure in the OECD, it was statistically significant when explaining procyclical consumption and procyclical wage expenditure.

Lane (2003) argued that the likelihood of procyclical government expenditure depended on the 'distribution of fiscal power' across different branches of government. He did not consider sub-central government expenditures, but suggested that "... other political claimants such as state or provincial governments within a federal system" (p. 2665) are relevant when explaining procyclical expenditure. Very few studies focus on the procyclicity of sub-central government expenditure (Abbott and Jones (2012), Arena and Revilla (2009) and Sturzenegger and Werneck (2006) are exceptions). In this paper, the objective is to consider the proposition that the likelihood of procyclical sub-central government expenditure is influenced by the 'distribution of fiscal power' across fiscal tiers.

In the next section of the paper, the objective is to explore the impact of the 'distribution of fiscal power' across fiscal tiers on the cyclicity of expenditures and intergovernmental transfers within federations. This exploration suggests that: (i) sub-central government expenditures are likely to be procyclical; (ii) discretionary transfers are likely to be procyclical and more procyclical than non-discretionary transfers; (iii) sub-central government expenditures are more likely to be procyclical if discretionary transfers are procyclical; (iv) sub-central government capital expenditures are more likely to be procyclical than sub-central government current expenditures; and (v) sub-central government expenditures are more likely to be procyclical if there is a co-occurrence between representatives of the same political party holding office at both state and federal government.

These predictions are tested with reference to the expenditures of 31 states in Mexico. The paper focuses on Mexico because as much as 86% of state government revenues are received as intergovernmental transfers from the federal government. The majority of transfers are non-discretionary (they are provided for specific expenditures, like education, health, crime prevention, etc.). While these transfers depend automatically on pre-determined formulae, one-third of all sub-central government revenues are received as discretionary transfers.<sup>2</sup> Mexico is a particularly interesting case study because it relies more heavily on intergovernmental transfers than almost every other federation.<sup>3</sup> Section 2 describes the way that the 'distribution of fiscal power' across tiers of government influences the cyclicity of sub-central government expenditure. Section 3 presents the econometric model and the data employed to test predictions. Section 4 reports the estimation results and Section 5 concludes.

## 2. Political pressures and procyclical expenditures

This section of the paper focuses on the cyclicity of intergovernmental transfers and sub-central government expenditures.

### 2.1. Political pressures for increased public expenditure

Governments are more likely to spend procyclically if political pressure to increase public expenditure increases as national income increases (Lane and Tornell, 1996; Tornell and Lane, 1998). In empirical studies, political pressure to increase public expenditure has been identified as a significant determinant of procyclical expenditure (e.g. Lane, 2003; Abbott and Jones, 2013).

Downs (1957) highlights politicians' incentive to increase public expenditure to win votes and he also argues that politicians focus, myopically, on a four- to five-year electoral cycle. When national income is increasing (and tax revenues are increasing), politicians are able to accommodate pressures to increase spending without ever announcing a new tax (or a new tax rate). With a tendency to be indulgent in an economic upturn, they 'sow the seeds' of the difficulties that they face in recessions. When national income and tax revenues are falling, they are not able to sustain their new commitments; in economic downturns they face pressures to reduce public expenditure.

In economic upturns the 'flypaper effect' increases the likelihood that politicians in sub-central governments will indulge pressures to increase public expenditure. If intergovernmental transfers increase as national income increases, pressures to increase public expenditure are more intense in sub-central jurisdictions because voters underestimate the tax-cost of expenditure programmes when they receive transfers financed by taxpayers in other jurisdictions (Oates, 1979).<sup>4</sup> Hines and Thaler (1995) and Bailey and Connolly (1998) review this literature (there is a 'flypaper effect' because 'money sticks where it hits' — in the public sector). With a 'flypaper effect', sub-central governments spend more when they receive an intergovernmental transfer than when their citizens

<sup>1</sup> Henisz's index is based on the number of veto points in the process of decision-making and on the distribution of differences in preferences for government spending. The first step in compiling the index is to count the number of veto points over policies in branches of government. Voracity effects are likely to be less relevant as this number increases. The index also considers differences in group preferences but voracity effects are likely to be more relevant as these increase.

<sup>2</sup> Sub-central governments are free to spend discretionary transfers as they wish. In some cases the intention is to rely on pre-defined formulae to allocate discretionary transfers, but in practice the allocation of discretionary transfers depends on pressure exerted at the lower chamber of federal government (from the *Cámara de Diputados*).

<sup>3</sup> In 2005, intergovernmental transfers were 23% of total government expenditure in Mexico while, on average, they were only 13% of total government expenditure in the OECD (Blöchliger and Vammalle, 2009).

<sup>4</sup> Local politicians must respond to political pressures for increased spending from: local bureaucrats (Niskanen, 1971; Romer and Rosenthal, 1980); local interest groups (Dougan and Kenyon, 1988); and local voters (Oates, 1979).

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