



## Political budget cycles and media freedom



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### ABSTRACT

This paper examines the effects of elections on the conduct of central governments' fiscal policies. To do so, it uses a unique panel database that includes disaggregated spending and revenue series at the central government level for multiple countries over the 1975–2010 period. Examining political environments under which incumbent governments generate political budget cycles (PBCs), and comparing the *relative* importance of factors influencing cycles, we identify media freedom as the factor that plays the most critical role. This result provides a micro-foundation for rational opportunistic models for PBCs that rely on asymmetry of information about politicians' competence, and also offers a way to relate different conditioning factors of PBCs, including fiscal transparency and the maturity of democracies. Further, we show that the election-year rise in budget deficits under low media freedom is primarily driven by an increase in the current, not capital, component of public expenditure.

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### 1. Introduction

Which political considerations *best* explain the occurrence of political budget cycles? And, which *components* of public spending and revenue are manipulated prior to elections in response to considerations?

To address these questions, we assemble a new comprehensive dataset on disaggregated expenditure and revenue series, which covers around 70 developed and developing countries over the period 1975–2010 at the central government level. We first examine circumstances under which fiscal manipulations may occur. Specifically, we condition our analysis on various political considerations suggested by the political budget cycle (PBC) literature: 1) those affecting the readiness and incentives of incumbent politicians to behave opportunistically; and, 2) those affecting the capacity of the opportunistic measures to yield additional votes. Then, after checking how each of these factors shapes PBCs in the context of our dataset, we systematically compare their *relative* importance, to identify the one that plays the *most* important role. Finally, making use of the disaggregated fiscal data series, we examine which fiscal *components* drive the electoral effects on budget deficits.

Our results are as follows. First, we find that the degree to which

voters are informed about incumbents' fiscal policy conduct is the most important conditioning factor for PBCs amongst those examined in this paper. Next, a deeper investigation of voters' informedness suggests that it is the degree of media freedom that is critical. Specifically, we provide robust evidence that when media freedom is low, and thus when the information content is possibly influenced by a government, the electoral effect on budget deficits is large, even when the other conditioning factors are controlled for. This result can be related to rational opportunistic models that highlight informational asymmetry between governments and voters to explain electoral budget cycles. That is, media freedom, by helping voters to distinguish between competence and electioneering, may make it unnecessary for incumbents to create political budget cycles. Also, the result provides a way to relate different conditioning factors for PBCs, including fiscal transparency and the maturity of democracy, both of which are closely associated with media freedom. Last but not least, we find that when an incumbent government engineers an election-year rise in budget deficits under low media freedom, it does so primarily by increasing current (but not capital) expenditures. This is consistent with Rogoff (1990), who suggested that immediately visible current expenditure would be more adequate to signal the incumbent's competence than capital expenditure which frequently takes long to materialize.

The paper is organized as follows. Section 2 presents the literature review, highlighting various conditioning factors for PBCs investigated previously. Section 3 describes the dataset, Section 4 explains the empirical methodology, and the empirical results are

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presented in Section 5. Finally, Section 6 discusses the results and provides concluding remarks.

## 2. Elections and opportunistic fiscal policy conduct: a literature review

Elections are the most important mechanism to hold elected politicians accountable for their policy choices. Based on the idea that all politicians want to secure re-election, Nordhaus (1975) and Tufte (1978) pioneered the literature on political business cycles. They posit that, before elections, politicians adopt opportunistic expansionary fiscal or monetary policies to woo voters, and increase their popularity. These classical studies assume voter myopia and an exploitable expectations-augmented Phillips curve. Therefore, macroeconomic policies could have real effects over extended periods of time. Associated with the political cycle, an economic cycle would emerge, with unemployment decreasing before elections. After the election, the victor would adopt anti-inflationary measures that would raise unemployment again. In the long run, politicians' opportunistic measures would increase average inflation, without generating gains in the real economy.

The rational expectations revolution led to criticisms to the classical models of political business cycles, requiring their reformulation. The hypothesis that voters could be systematically fooled by politicians, even though they could easily foresee upcoming elections, became no longer tenable. In their seminal paper, Rogoff and Sibert (1988) demonstrate that an electoral budgetary cycle can still occur when economic agents are rational if voters have less information than those who shape policy. Given the asymmetry of information about the elected officials' level of competence, the latter strategically interact with competing candidates for office and with the electorate. Incumbent politicians engage in opportunistic expansionary fiscal policies before elections to signal their competence and increase their chances of re-election. This is accomplished by reducing taxes (immediately visible to the electorate) financed through seigniorage (observable with a lag), thus generating a budget cycle. Subsequently, Rogoff (1990) extends the analysis to pre-electoral manipulation of the composition of public spending, suggesting that opportunistic incumbents signal their competence to the electorate by shifting spending towards (immediately observed) consumption expenditure and away from investment expenditure (visible only after the election). Following these contributions, several studies empirically examine the possible occurrence of political budget cycles, highlighting circumstances under which incumbents conduct fiscal manipulation to increase re-election prospects. In what follows, we review the literature, organizing the conditioning factors into those affecting: 1) the readiness and incentives of incumbents to behave opportunistically; and 2) the capacity of opportunistic behavior to generate additional votes.<sup>1</sup>

### 2.1. Factors affecting the readiness and incentives of politicians to act opportunistically

For incumbents to manipulate fiscal policies, certain conditions need to be satisfied. One important condition is the *predictability* of

*the timing of elections*. Some studies, using panels of countries, suggest that PBCs are more prevalent in samples including only predetermined elections; that is, elections held in the last year of a constitutionally fixed term for the legislature or executive (e.g., Shi and Svensson, 2006; Vergne, 2009; Efthyvoulou, 2012).<sup>2</sup> The *fragmentation of the government* appears to be another key factor, affecting the ability of politicians to implement their most preferred policies. Regarding this point, Chang (2008) finds that, in OECD countries, fiscal policy manipulation during elections is constrained when policymaking power is dispersed among multiple veto players. In the same vein, Persson and Tabellini (2003) justify their finding that pre-election tax cuts are larger in *parliamentary regimes* than in *presidential regimes* with the argument that the latter regimes tend to have more decision makers with proposal and veto rights than the former. While in many presidential regimes, both the president and the legislature must approve the budget, in parliamentary regimes frequently the same majority controls the executive and approves the budget, and is thus better able to fine tune fiscal policy to electoral concerns (Persson and Tabellini, 2003: p. 206).

Turning to factors affecting incumbents' incentives to generate PBCs, Efthyvoulou (2012), using data for EU member countries from 1997 to 2008, emphasizes the importance of *electoral competitiveness* on politicians' incentives to generate PBCs.<sup>3,4</sup> *Changes in ideology* may also affect politicians' incentives to engage in PBCs. Alesina and Tabellini (1990) indicate that spending and deficits increase before elections when politicians expect to be replaced by an opponent with a different ideology, in order to limit the options of the newly elected candidate.<sup>5</sup> Additionally, the *level of rents extracted while in office* is likely to influence the incentives to remain in power and thus the incentive for incumbents to engage in electoral fiscal manipulations. In this regard, Shi and Svensson (2006) argue that one of the reasons for PBCs to be larger in developing countries is that incumbent politicians gain more private benefits when in power than those in developed countries.

Finally, Persson and Tabellini (2003: section 8.5) shed light on the role of *electoral rules* (single versus multiple-district elections) in shaping incentives to engender PBCs. Based on Persson and Tabellini's (2000) career-concerns model, where individual accountability is stronger under majoritarian elections than in proportional elections,<sup>6</sup> they argue that the former generate greater incentives to create tax and spending fluctuations around elections. Regarding effects on the composition of electoral spending manipulations, Persson and Tabellini predict stronger incentives for the adoption of broad policy programs to woo the voters, such as

<sup>1</sup> For recent surveys on conditional budget cycles, see Dubois (2016), de Haan and Klomp (2013), and Veiga (2010).

<sup>2</sup> When the incumbent government can set the timing of elections, the analysis of PBCs becomes more complicated, since there are more options for electioneering. That is, politicians may choose the right time to call for elections instead of manipulating fiscal policy. We account for this possibility in the empirical analysis by estimating separate coefficients for pre-determined and early (potentially endogenous) elections, and by performing estimations for a restricted sample including only pre-determined elections. According to the literature mentioned above, stronger results for PBCs are expected when elections are pre-determined than when the electoral timing is uncertain.

<sup>3</sup> This factor was already a focus of the political business cycle literature starting in the 1970s. For instance, Frey and Schneider (1978a, 1978b) argue that when the election is competitive and incumbents are in danger of losing, they have a larger incentive to adopt expansionary policies before elections to stimulate the economy.

<sup>4</sup> At the local government level in Portugal, Aidt et al. (2011) take into account the interaction between the magnitude of the opportunistic distortion and the margin of victory, and show that incumbents behave more opportunistically when they expect elections to be more competitive.

<sup>5</sup> Partisan cycles were described by Hibbs (1977). For a survey of the impact of ideology on categories of public spending and revenues, see Franzese (2002).

<sup>6</sup> Furthermore, in proportional systems, incentives for good individual performance by a politician may be diluted because citizens vote on a list and, consequently, elections are a less powerful tool to discipline policymakers. Working with a panel of countries, Shelton (2014) confirms Persson and Tabellini's prediction that electoral budget cycles are stronger under majoritarian rules. He also claims, and finds evidence, that a strong party system mitigates the electoral budget cycles more in countries with majoritarian electoral systems than in those with proportional rules.

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