

## **ELECTORAL OPPORTUNISM AND VERTICAL FISCAL IMBALANCE**

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Evidence of political budget cycles from cross-country studies has been rationalized as coming from the voters' cost to process the available information and asymmetric information. This explanation has also been adopted in most cross-province studies, leaving aside variables related to the incentive structure of fiscal federalism. This paper investigates electorally induced fiscal fluctuations in Argentina for the period 1985–2007. Province-level dynamic panel data reveal that vertical fiscal imbalances in subnational districts fuel fiscal expansion and changes in expenditure composition, favoring current expenditure to the detriment of investment, in election years. Vertical fiscal imbalances make electoral opportunism cheaper and more profitable.

*JEL classification codes:* D72, P16

*Key words:* political budget cycle, vertical fiscal imbalance, opportunism, Argentina

### **I. Introduction**

Retaining political power is one of the main goals of incumbent parties. Politicians devote a great deal of effort and rely on a wide variety of strategies, including budget manipulation, to help their parties (or themselves) to remain in office. The available evidence on politically motivated budget cycles based on subnational-level studies finds that incumbents from developing as well as from developed countries increase public outlays, change the expenditure mix, and avoid taxing their constituencies in election years (Galli and Rossi 2002; Gonçalves Veiga and Veiga 2007; Drazen and Eslava 2010). This opportunistic behavior is either

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reported but vaguely accounted for or explained by resorting to different degrees of voter awareness, voters' costs to process information, and low-transparency fiscal policy (Ahkmedov et al. 2004), leaving aside a more obvious candidate for subnational-level studies: the incentive from rules governing the distribution of resources and spending between the central government and the subnational districts in a federation.

This paper investigates the role of the incentive structure of fiscal federalism in electorally induced budget fluctuations for the case of Argentina. In particular, I focus on vertical fiscal imbalance (henceforth, VFI), a distinctive feature of Argentine fiscal federalism. Provinces' vertical fiscal imbalance originates from the fact that, on average, only a small fraction of their expenditures is financed by local taxes and the rest comes from sizable transfers from the central government. As pointed out by Saiegh and Tommasi (1999), large vertical fiscal imbalances in most subnational districts result in perverse incentives for local authorities and citizens. On the one hand, local politicians enjoy a large share of the political benefit of spending and pay just a fraction of the political cost of taxation. Most of the money they spend on public goods comes from the "common pool" of resources administered by the central government. Therefore, it is expected that local authorities use that additional low-cost spending power to remain in office. On the other hand, voters have incentives to reward local politicians who are effective in extracting resources from the central government. In a setting like this, political budget cycles (PBCs) may arise even if voters' awareness or ability to process information is uniformly distributed among provinces. That is, independently of the information structure of the game and its cost, local incumbents have incentives to manipulate fiscal variables because the benefits in terms of constituency support are substantially higher than the costs.

To preview my results, I find strong evidence that incumbents manipulate fiscal variables in election years. Governors increase expenditures, run budget deficits, and change the expenditure composition to remain in power. I show that this behavior is mostly driven by vertical fiscal imbalance. The results are robust to the estimation method.

The rest of the paper is organized as follows. The next section surveys the empirical literature on PBCs. Section III discusses some key features of the Argentine federalism and section IV considers the fiscal behavior of Argentine provinces in election and non-election years by means of non-parametric tests. Section V describes the two-step econometric strategy to study the importance

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