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To be or not to be in office again: an empirical test of a local political business cycle rationale

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Abstract

Empirical support is provided for our explanation for political business cycles (PBC) at the local government level. The rationale uses an ultrarational set-up to explore the incumbent leader's concern with his or her utility in cases of victory and defeat. The model is tested on Portuguese municipal data. The evidence reveals the role played by politico-economic determinants of local governments' investment outlays, such as electoral calendar, re-candidacy decisions, political cohesion and intergovernmental capital transfers.

JEL classification: C23; D72; H41; H72; R51
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1. Introduction

In very broad terms, political business cycle (PBC) analysis concerns short-run government behaviour within election dates. It is believed that authorities choose economic policy in typical intertemporal patterns each office term.[1] Theoretical approaches have searched for justifications of such patterns while empirical inquiries have tested the reliability of the models.

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[1] A different, historically oriented strand of literature has focused on the long-run interaction cycles between economic performance and political systems, seeking ties with the well-known economic history concepts of *Kuznets and Kondratieff fluctuations*. See, for example, Soldatos (1994).

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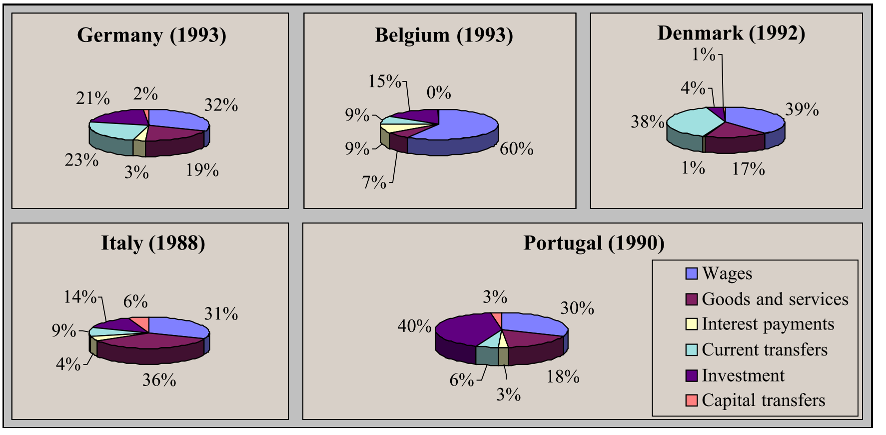

Chart 1. Economic breakdown of local public expenditure, selected EU countries. Source: IMF (1995).

1.1. PBCs with local governments

The focus has generally been on central government behaviour and macroeconomic data—see, for example, Gärtner (1994), Frey (1997) and Drazen (2000). This is not surprising since possibilities for influencing the economy increase with the level of aggregation. In general, central and even regional governments have discretionary power over many more policy instruments than do local governments. Monetary policy is not locally determined and, with respect to fiscal policy, spatial mobility considerably constrains local autonomy over stabilisation, redistribution and own revenue collection.[2]

Yet, we can think about the prospects of PBC at the local government level, in particular given the trend toward fiscal decentralisation over the last two decades (Yilmaz, 2001; IADB, 1997; Ter-Minassian, 1997). Local authorities have a role in the allocation function of fiscal policy. The provision of local public goods is their core economic activity. However, cross-country differences abound when it comes to the economic breakdown of expenditure. Chart 1 below shows a selection of EU Member States as an illustration of different specialisations. Whilst somewhat balanced distributions exist, such as in Germany, there are also many cases of local expenditure concentration. In Belgium, for instance, allocation seems to rely mainly on civil servant expenditure—which accounts for 60% of total local expenditure. In Denmark, current transfers show a remarkable share of 38%, reflecting the typical involvement that Scandinavian local authorities have in welfare programmes. In Italy, the largest share (36%) is public procurement for non-durable goods. Investment expenditure plays a chief role in Portugal (40%).

PBCs on the expenditure side of the budget require the strategic variable to have some particular features. It should be an expenditure item having local accountability and political visibility. In other words, such an item ought to be an expenditure category subject to discretionary change by the local authority and the manipulation of which from

[2] Other factors constrain autonomous local fiscal decision-making, notably scale economies in administration and tax compliance costs.