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Electoral Budget Cycles in Latin America and the Caribbean: Incidence, Causes, and Political Futility

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1. INTRODUCTION

Over the course of the last two decades Latin America and the Caribbean have gone through a wave of democratization without precedent. Apart from a few temporal backlashes the process has been sustained until the very day. The number of popularly elected central governments in the region has doubled from 13 in 1980 to 26 from 1995 onwards.¹ Today, Cuba is the only independent country in the western hemisphere where the population is still waiting for the opportunity to confirm or remove the sitting government through electoral mechanisms.

With the advent of democratic regimes ruling has become more complex for Latin American governments. They now face an additional limitation to their choices in policy making which is absent in states with authoritarian regimes. This restriction consists in having to renew legitimacy in the periodical recurrence of elections. If the incumbent (or her party) fails to convince the majority of the electorate that her bundle of policy initiatives will improve welfare more than the alternative strategies offered by opposition candidates, she will be removed by the voters and lose all the advantages that are related to public office. In this environment the politician becomes a "political entrepreneur" that tries to maximize the support of the voters. However, the incumbent does not need to be supported by a majority of voters all the time. In order to maintain power it is sufficient if the incumbent can gather a majority for her program at election day. Indeed, it is very common to see the popularity of a president being exposed to wild swings over the term in office, very often peaking at election time.

The current research investigates empirically whether the democratic institutions have led to electoral cycles in fiscal policy in the sense that electoral events contributed to shape budgetary policies. The paper is organized in the following manner. First a brief review of the different theories of the field is provided in part 2. Part 3 then looks at the empirical research on electoral cycles in developing countries that already exists in the literature. The description of the econometric model and the used variables takes place in part 4. Part 5 discusses the estimation results and part 6 contributes to the explanation of what are the driving forces behind the

¹cf. Inter-American Development Bank (1997)

phenomenon of electoral cycles in Latin America and the Caribbean. Part 7 investigates whether the strategy of embarking on electoral cycles pays politically on election day. A brief summary of the findings concludes the paper.

2. THEORETICAL BACKGROUND

Several theories linking electoral events and economic policy have been discussed in the literature. Broadly they can be classified according to two criteria: assumptions about the rationality of voters and the underlying motives of politicians (purely opportunistic vote maximizers versus ideologically motivated planner).

I. **Nonrational Voters and Opportunistic Governments**

This branch of the literature can be traced back to the seminal papers by Nordhaus (1977) and MacRae (1977). An exploitable modified Phillips curve is assumed in the short run. The incumbent tries to finetune the business cycle in order to maximize her electoral support. It is assumed that no point on the sustainable long run Phillips curve leads to a majority at the polls. As the electorate's inflation expectations are of the stationary type, the government will boost preelectoral demand and thus reduce unemployment. This increases the government's popularity. Inflation starts to surge only after a time lag - that ideally spans across election date - which will reduce the government's popularity again. After the upward shift of the short term Phillips curve the government has to introduce some austerity to control the inflation that resulted from the preelectoral demand shock. This will shift the short term Phillips trade off back into its original position. Only through moving the unemployment/inflation combination to the right of the vertical long term Phillips curve, i.e. through a substantial lengthening of the jobless queues, can the economy be repositioned into a situation that allows for another preelectoral boom when the next election is due.

Two aspects flaw this model theoretically. First, voters seem to be unable to learn and don't get suspicious at the repeated election synchronized business cycle. Secondly, the model assumes total control over the macroeconomic outcome that depends solely on the government's policy choice. In reality the most the government can hope for is controlling its policy instruments, whereas a myriad of influences beyond the government's control determine the actual inflation and unemployment.

ii. Nonrational Voters and Ideological Governments

In the work of Hibbs (1977) all voters know the ideological utility functions of different parties. A long term trade off between inflation and unemployment exists. Therefore economic agents behave irrationally and suffer from severe money illusion. "Left" parties are characterized by a higher marginal rate of substitution of inflation for unemployment whereas "right" parties have opposite preferences. Under left governments there will therefore always be low unemployment and high inflation with the opposite being true if a right party is elected. Each voter supports the party whose utility functions comes closest to his own preferences. If the incumbent disappointed her followers, another party will be elected and a different unemployment/inflation mix will result. Cycles will have a periodicity that is at least one interelection period long.

While this model allows the voters to be able to distinguish between different partisan ideologies, the exploitable long term Phillips curve points to a degree of irrationality that goes beyond the irrationality assumption in the Nordhaus model, which is at least compatible with a vertical Phillips curve in the long run. Thus the money illusion is even more complete in the Hibbs model.

iii. Rational Voters and Ideological Governments

Alesina (1988) introduced another model with ideological parties that have respective preferences as in the last paragraph. Rational individuals adjust the prices of their factor supply to maintain their real income. While they are not suffering from money illusion, the collective wage setting procedures imply a time lag in the adjustment of nominal remunerations to changes in inflation. Wages are adjusted only after the expiration of the collective contract. The contractual partners do not know in advance, however, whether a "left" party will win the election and bring higher inflation or whether a "right" party with more price stability will be victorious. Therefore the nominal wage is based on expected inflation, calculated as an opinion-poll weighted average of the likely inflation rates under each type of government. If a left party wins, the real wage will decrease, because the nominal wage has been fixed contractually. This will lead to an increase in the demand for labor and lower unemployment. This boom is only temporary, however, as the preelectoral insecurity about the postelectoral inflation rate has disappeared and the certain information about the ideological nature of the government will be incorporated in the next wage round. Nominal pay rises will be adjusted and the real wage will return to its preelectoral level. The opposite occurs when a "right" party wins: a temporary postelectoral recession. Governments stick

to their ideology and the cycle actually happens *after* the election as a result of imperfect information. The model does not address the puzzle that naturally arises as to why the information problem is not avoided. If contractual partners are rational agents neutral or averse to risk, letting all nominal wage contracts expire on election day would be the obvious thing to do. They can then start renegotiations after the election, endowed with perfect information about the new government's type and thus future inflation.

iv. Rational Voters and Opportunistic Governments

Persson and Tabellini (1990) postulate that governments are primarily interested in their reelection and are neither “left” nor “right”.² However, as a second order motivation they also care about national welfare. Voters are rational, i.e. they understand the intertemporal repercussions of preelectoral expansionary policies. Due to asymmetrical information, however, they do not know the “competence” of an incumbent, defined as the efficiency in the provision of public services. Naturally, voters prefer competent governments. Under these circumstances, rational voters will use an electoral boom as a signaling device. Why? Since the welfare costs of policy choices enter the politicians’ utility function, they will expand budgetary outlays to the point, where the marginal welfare costs equal the marginal benefits of increased reelection chances. Rational voters will vote for an incumbent who behaves opportunistically before elections if she is perceived competent. A big preelectoral spending boom signals competence, because only a competent incumbent can provide all these additional services at a welfare cost that is low enough not to outweigh the benefits of another term in office. For an incompetent incumbent this break even point comes much earlier, the maximum expansion will therefore be more moderate. In order to out herself as competent the incumbent has to expand the budget beyond the break-even point of an incompetent government. Although voters and incumbents are aware of the negative consequences of this discretionary abuse, it will still occur, as a competent incumbent has no less distortionary means at her disposal to credibly signal competence.

This model will serve as a starting point for the assumptions on political interactions in Latin America. It can probably safely be assumed that the distinction between competent and incompetent governments will be more blurred in the real world than in the model. The voters will still be unsure about the competence level of the incumbent government, because in the real world they can not observe the government’s utility function. Therefore they do not know, whether a mediocre expansion is due to incompetence of the incumbent (considered bad) or the latter’s strong concern about the adverse welfare effects of a more aggressive preelectoral fiscal stance (considered good). An incompetent government will mimic a competent one and expand spending/reduce taxation if elections are around the corner. There is a good chance that it will get away with it and be reelected, as the electorate does not possess a clear-cut decision rule to

²Similar models were introduced by Rogoff/Sibert (1988) and Cukierman/Meltzer (1986).

infallibly separate competent from incompetent contenders. If the government does not expand the preelectoral budget, however, this would be political suicide. As the electorate is unlikely to believe that the concern about future welfare costs overshadows all opportunistic motivations, it would identify this behavior with incompetence and remove the government from office. The current analysis is based upon this last line of reasoning. The absence of ideologic governments is also roughly realistic for Latin America, where partisan structures are very volatile and the ideological orientation of individual politicians are either blurred or can change radically and quickly.

Observers of real world electoral campaigns in Latin America would in general not spontaneously assume that all voters follow the rational and complex evaluation process of the signaling game described by Persson and Tabellini. But this does not do any harm to the theoretical statement. If a subgroup of the electorate is voting irrationally the incentives for the incumbent to create an electoral cycle are even stronger: the irrational (or better: uninformed) do not consider the negative long term economic effects of preelectoral expansions. Only the own current economic situation can be directly observed without further information gathering costs. In judging on the government's competence, uninformed voters will in particular look at the quality and quantity of the public goods and services provided, relative to the attached price tag in terms of taxes levied. If the incumbent increases the provision of public goods and at the same time follows a more lenient approach towards tax collection or cuts rates, the voters will be able to feel an improvement of their immediate economic situation. This will be interpreted as competence on behalf of the incumbent, as the latter appears to be able to provide services at a low tax burden.

It is true that the opposition will warn the uninformed voters about the adverse consequences of the incumbent's policy choice. But the electorate has no incentive to believe the government's reassuring statements any less than the opposition's gloomy predictions. Collecting all the necessary data and taking all the economic training necessary to process the macroeconomic information in a consistent manner is an extraordinarily unattractive strategy for most voter. Monitoring the government closely is costly individually whereas the weight of the own vote, informed or uninformed, is minuscule at best. Therefore most voters will cast their ballots with little well-founded information about the quality of the government. The vote is more based on past and current economic conditions that are used as a proxy for the government's competence, widely ignoring intertemporal links reaching into the future.

But even with less than full information on intertemporal economic relationships and the long term consequences of current fiscal behavior at hand: will the electorate not be smart enough to look through the government's opportunistic behavior when it observes an increase of public services at lower cost than before? Would even uninformed voters really believe in a sudden improvement of the government's competence? May be not. There is evidence that Latin American voters consider their politicians as opportunistic anyway. In an opinion poll Latin American voters made their deep rooted distrust of politicians clear: 70 percent had no or little trust for political parties and 54 percent had an equally distrustful opinion concerning the government.³ Even big business and the military, often the whipping boys of the general public, are considered more trustworthy. Maybe even uninformed voters spot opportunists when they come along. But even then the government has to opt for a fiscal expansion. If it refrains from doing so the voters, that look at the political leaders as opportunists, would have to conclude that the incumbent and her team are a bunch of incompetent losers: they try selfishly to hang on to power but are incapable to create favorable economic conditions to support their bid. If the preelectoral year is merely "normal" the voters would perceive the economy to be fundamentally in recession once the temporary electoral stimulus is subtracted. And who votes for a government that produced a recession, poorly masked by a generally suspected demand expansion?

Summing up the arguments, for the government it is rational to embark on the opportunistic strategy under all circumstances, no matter whether they face informed or uninformed voters. Rational and informed voters support a sitting government running a preelectoral boom since they interpret it as a signaling game in which the government proves its competence, as the perceived economic costs are lower than the benefits of additional votes. Uninformed voters, by contrast, do not anticipate any postelectoral contraction at all. Their backward oriented judgement of an incumbent's competence will lead to additional uninformed votes when the public services before the election increase and/or taxes fall. Analogously, continuing with "business as usual", i.e. showing fiscal prudence would be punished by both types of voters.

It is probable that the uninformed voters react more strongly to preelectoral upturns as they see only the bright side of it. The informed voters on the other hand also recognize the negative effects and if their judgement on the economic costs of the stop-and-go policy differs from the

³cf. Latinbarometro (1995, Question 27).

incumbent's they might support an opposition candidate because they consider the government's cost-benefit analysis as an incompetent calculation that results in a "wrong" break-even point between electoral benefits and economic losses. Hence, the higher the share of uninformed voters the unambiguously more attractive a strong expansion looks to the policy maker.⁴

Economists should worry about electorally induced cycles for several reasons. The endogenous cyclicity contributes to the volatility of economic conditions in Latin America, which, in turn, harms economic development in the region.⁵ Cyclical fiscal policy that does not try to compensate for the business cycle but is disconnected from the state of the economy and instead is synchronized with the electoral calendar will lead to an intertemporally inefficient allocation of resources. The government does not contribute to consumption smoothing but, on the contrary, introduces additional demand shocks to the economy. Moreover, where the public sector faces a ratchet effect that makes it problematic to cut back on entitlements once granted, the cyclical behavior of the budget will lead to an increase of the size of the state in the long run, as opportunistic spending before the elections cannot fully be undone afterwards. While big governments do not necessarily imply bad governance it is unlikely that the spending created for electoral purposes will always be of the most efficient sort.

3. PRIOR EMPIRICAL RESEARCH ON DEVELOPING COUNTRIES

The hypothesis that the state of the economy and the voters' economic welfare have a strong influence on their electoral decisions has been confirmed in several studies on industrial countries. Unemployment, growth and inflation usually enter as major arguments in the estimated "popularity function".⁶ If the government could improve the economic picture electoral benefits would therefore be very likely. But did elections matter in developed countries? While the results were in general mixed, the literature has found that the model with ideological governments and rational voters proved to describe the reality in industrialized countries best of all of the different electoral cycle hypotheses.⁷ The most encompassing research testing the different theories of electoral cycles

⁴cf. Cukierman/Meltzer (1986, p. 386).

⁵The most encompassing study on the empirical relationship between volatility and growth is Inter-American Development Bank (1995).

⁶cf. Kraemer (1997a, Section 4.2.3)

⁷A recent study confirms in principle this pattern for the last three decades in 9 OECD countries, using quarterly data. cf. Mishra (1997)

also finds some support for the Alesina model that is characterized by rational voters and ideological governments along the “left”-“right” continuum. It has also identified some evidence of electoral cycles in OECD countries caused by opportunistic governments. In the four quarters after the election inflation increased. This is - somewhat indirectly - interpreted as a result of the expansive behavior before the election, when seignorage had to close the rising gap in the budget.⁸

There are several reasons to believe that the problem of electoral cycles may be more relevant for Latin America than it is in the OECD countries. Firstly, in developing countries with lower material welfare the importance of the economic environment is even greater and other issues like foreign or environmental policy, that play a considerable role in some of the industrial economies, have only a modest impact on the election outcome. Not only is the marginal utility of income higher for a poor voter in comparison with a rich one, but empirical evidence suggests that the former's discount rate will also be higher, which in turn reduces the importance given to the negative long term growth effect of electoral cycles - where it is anticipated at all. Secondly, educational attainments are considerably lower than in the OECD countries. This makes the electorate at large more susceptible to be fooled by a sudden preelectoral boom in public services. Structurally, the lower level of human capital increases the share of “uninformed” voters which in turn strengthens the government's incentives to behave opportunistically. Thirdly, the prevailing volatility in Latin America makes it easier for the policy maker to disguise the opportunistic spending spree. If fiscal accounts fluctuate wildly most of the years, it is less problematic to cover up the welfare reducing opportunistic behavior behind the veil of general volatility. In countries with very stable fiscal behavior, the sudden surge would cause more informed voters to raise eyebrows. Lastly, political parties are less ideological as in the OECD countries and party loyalties are less pronounced. Only 11 percent of voters asked in a comprehensive survey in eight countries answered that they feel very or somewhat close (“muy o algo cercano”) to a political party.⁹ The greater proportion of uncommitted swing voters augments the vote buying impact of a given fiscal expansion, because voters change sides more easily.

Empirical research on electoral cycles in developing countries has been scarce, not least due to

⁸cf. Alesina/Cohen/Roubini (1992).

⁹ cf. Latinbarometro (1995, Question 32).

the fact, that the democratization is a new phenomenon in many of the countries. The earliest empirical evidence of an electoral cycle even preceded the first theoretical papers on the topic and stated the synchronization of the development of major macroeconomic aggregates with parliamentary elections in Israel (Ben-Porath 1975). Ames (1987) finds in a panel regression that in 17 Latin American countries between 1947 and 1982 public expenditure has increased by 6.3 percent in the preelectoral year and fell by 7.6 percent in the postelectoral year. Buffie and Sanguines Krause (1989) and Whitehead (1990) have shown that an electoral cycle in government spending existed in Mexico between 1965 and 1985. Agénor and Montiel (1996), in contrast, did not detect anything suspicious in the three most established democracies in Latin America in 1970-1990 (Costa Rica, Colombia and Venezuela). Remmer (1993) finds no electoral cycle of the fiscal balance during 1982 and 1991 in six countries investigated. Schuknecht (1994) performed the most comprehensive empirical research using a panel comprising 35 developing countries from 1970-1992. In general his empirical evidence is supportive to the existence of electoral cycles in the fiscal balance. Kraemer (1997a and b) provides some evidence for electoral cycles in Mexico on the subnational level. Various spending categories, namely social spending and intergovernmental transfers were used by the federal government to boost the ruling party's election prospects in gubernatorial races.

4. THE ECONOMETRIC MODEL

The current pooled regression analysis uses panel data for 21 Latin American economies, covering the period 1983-1995. The cutoff year 1983 was used in order to take into account the changed nature of policy making after the eruption of the debt crisis and of the relatively small number of democracies in the hemisphere before that time. All in all the panel comprises 53 elections. The month and the date of the elections covered in the analysis are shown in annex 3. Data sources will be displayed in the data annex.

The estimations consist of multiple OLS regressions. The dependent variable is the absolute deviation of an observed fiscal indicator from the country specific linear trend (OLS, 1981-1996) of the same indicator, measured in percent of GDP. To make the equations comparable all use the same set of explanatory variables. As very few countries in the region publish quarterly, let alone monthly data, all pooled regressions of this paper use annual figures. The lag structure is determined by conventional econometric criteria (Schwartz criterion).

ELECT is a dummy variable controlling for upcoming elections.¹⁰ As the preelectoral twelve months (called “election year”) are very rarely identical with the calendar year the dummy is decomposed to take the timing of polling into account. It is equal to one if a general election took place in December of the year, it equals 11/12 if it was in November and so on. The value of ELECT in the calendar year preceding the election ($t-1$) is equal to zero if the election takes place in December, it equals 1/11 if elections are held in November of the following calendar year and so on up to 11/12 if the elections will be held in January of the following calendar year. ELECT is therefore more precise than a dummy would be that takes on the value of 1 if elections are held in a certain calendar year. It can capture the information of *when* during a calendar year polling day will be. It is obvious that opportunistic politicians would embark on an expansive path much earlier if elections are held in January or February (e.g. in Ecuador and Costa Rica) than if they are in November or December (e.g. in Uruguay and Venezuela). With the weighted dummy presented here this decisive difference can be captured, whereas a simple dummy would give us a value of one in the calendar year of the elections and zero else, not allowing for the different months in which the elections will be held.¹¹ If added up, the value of ELECT in the calendar year of the elections and the preceding calendar year always equals one. It can therefore be interpreted like a simple 0/1 dummy variable.

An analogous definition underlies the POSTELECT variable measuring the twelve months after the elections (called “postelection year”). An election in August would result in a POSTELECT variable of the same calendar year of $(12-8)/12$ as 4 months of the calendar year are after the elections. In the following calendar year POSTELECT would equal 8/12 in order to add up to one year. Table 1 summarizes the possible values of the two electoral variables.

¹⁰In presidential systems the elections of the president are considered, in parliamentary systems where Congress elects a Prime Minister the focus is on the election that determines the distribution of seats within the Congress. If two step elections are present the first round is defined as the election date. Other elections like midterm elections that do affect the composition of Congress but not the presidency are ignored. Similarly subnational elections are not taken into account although they have gained tremendous importance in Latin America and the Caribbean in the last two decades. For example the number of countries where local governments are directly elected has grown eightfold between 1980 and 1997 (cf. Inter-American Development Bank, 1997, Fiscal Chapter).

¹¹There are some examples of a flexibilization of electoral dummies in the literature. Also working with annual data, Schuknecht (1994) has used a simpler, but somewhat less precise, way of taking the election month into account as presented here. Similarly, Kraemer (1997a) constructed an electoral dummy that is one in the calendar year if the election is held in July through December and that is one in the year preceeding the election calendar year if they are held in January through June.

Table 1: Definition of Electoral Variables

Election in month of calendar year t:	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	De c
ELECT(t) =POSTELECT(t+1)	.08 3	.16 7	.25 0	.33 3	.41 7	.50 0	.58 3	.66 7	.75 0	.83 3	.91 7	1
ELECT(t-1) = POSTELECT(t)	.91 7	.83 3	.75 0	.66 7	.58 3	.50 0	.41 7	.33 3	.25 0	.16 7	.08 3	0
Sum:	1	1	1	1	1	1	1	1	1	1	1	1

CATASTROPHY is a dummy measuring whether a year was characterized by a natural disaster (floods, earthquakes, hurricanes etc) that surpassed “normal” calamities induced by nature or by (civil) war. Under catastrophic circumstances revenues can be expected to shrink and/or spending to be increased to undo at least part of the damage. The IMF dummy is measuring whether the central government had signed an agreement with the IMF in the conditional tranches during the year under consideration. As fund policies typically call for strict fiscal consolidation a contractionary effect is to be expected. GDP is the deviation from the linear trend of the countries economic growth over the 1981-1995 period (in percentage points). A negative value signals lower than average growth, where fiscal deficits can be expected to grow if either deliberate anticyclical policies are pursued or where the tax and expenditure system contains some built in stabilizers. Not reported in the tables are country and year dummies. As data is not available for all countries for all years the number of observations is differing slightly from one equation to the next. Where Brazilian fiscal indicators have been overshadowed by hyper inflationary impact around election dates, the country has been removed from the sample.¹²

5. THE ELECTORAL BUDGET CYCLE IN LATIN AMERICA

Table 2 summarizes the OLS estimates on the determinants of a central government’s surplus, spending and revenue shares of GDP (Equations 1 through 3). Equations 4 and 5 investigate the effects of the discussed explanatory variables on some spending subcategories, transfer payments and capital spending.¹³

¹²That the timing and taming of hyperinflationary episodes can themselves be influenced by the electoral calendar has been shown in a model by Stein and Streb (forthcoming).

¹³Other explanatory variables had been used in earlier versions (such as the inflation of the consumer price index in order to measure the Olivera-Tanzi effect on revenues or refined IMF variables distinguishing between different fund supported programs according to the severity of conditionality). As no

I. Fiscal Surplus (equation 1):

On average, the fiscal surplus turned out to be over one percent of GDP below its trend value in election years, whereas in the twelve months after the election, the surplus is 0.74 percent higher than it would have been in normal years. Added up, this implies a substantial fiscal swing of 1.8 percent of GDP, indeed far from negligible. Both deviations from the trend are also statistically significant. The probability that the coefficients of ELECT and POSTELECT are different from each other is over 99.9 percent (last line). Electoral fiscal cycles in Latin America and the Caribbean therefore *are* highly relevant phenomena. It is also notable that the preelectoral expansion cannot be taken back immediately after the new government is inaugurated. Only about two thirds of the preelectoral laxness is corrected in the wake of the election.

The nonelectoral explanatory variables all have the expected sign. Where natural or manmade disasters struck, this reduced the surplus by a comparable amount as upcoming elections would have done. The existence of an IMF program increased the surplus by half a percentage point. However, the impact of the average IMF program is only two thirds of the size of the "automatic" postelectoral correction.

additional explanatory power was added by including them, they have been dropped from the list of variables.

Table 2: Determinants of fiscal indicators, 1983-1996

Dependent Variable:	(1) SURPLUS	(2) EXPEN- DITURE	(3) REVENUE	(4) TRANSFERS & SUBSIDIES	(5) CAPITAL SPENDING
LAG1	0.4281 (6.81)	0.2864 (4.75)	0.3806 (5.85)	0.5758 (9.08)	0.3298 (5.19)
LAG2	-0.1296 (-2.35)	-0.0270 (-0.44)	-0.1389 (-2.17)	-0.1258 (-2.11)	-0.0449 (-0.76)
ELECT	-0.0107 (-2.84)	0.0045 (1.16)	-0.0048 (-1.49)	0.0036 (2.13)	-0.0000 (-0.01)
POSTELECT	0.0074 (1.78)	-0.0068 (-1.73)	0.0027 (0.81)	-0.0006 (-0.35)	-0.0046 (-2.14)
CATASTROPHY	-0.0092 (-1.86)	0.0055 (1.14)	0.0003 (0.08)	-0.0001 (-0.04)	.0020 (0.77)
IMF	0.0051 (1.50)	-0.0017 (-0.53)	0.0051 (1.82)	0.0000 (0.02)	-0.0019 (-1.11)
GDP	0.0862 (2.46)	0.0266 (0.81)	0.0565 (1.81)	-0.0168 (-1.14)	0.0488 (2.69)
Observations	253	268	252	256	256
Adjusted R square	.280	.154	.215	.352	.200
P (ELECT=POSTELECT)	0.04%	2.78%	7.84%	5.95%	5.92%
Excluded countries	Brazil	Brazil	Brazil	Argentina	Brazil

Notes: The numbers in parenthesis are t-ratios. Coefficients that are significant at a level of at least 90% are printed in bold type. In all equations country and year dummies have been applied but are not reported here. All LHS variables are defined as percentages of GDP. For data sources consult annex 2. Fiscal data for 1996 was not available for all countries. 1996 elections were not used as this would have required the use of fiscal data reaching to 1997.

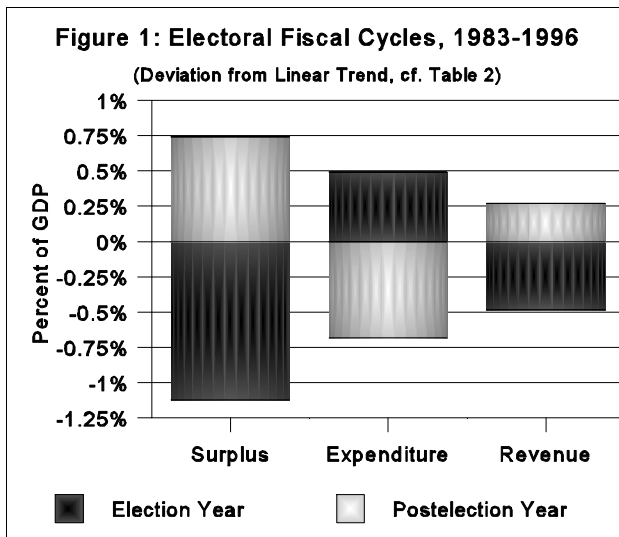
Business cycle effects are also present but rather weak. If the economy is in a recession, the surplus will on average be smaller, because tax receipts tumble and certain transfers will have to be increased. Each percentage point of growth above (below) the linear country specific growth trend (1981-1995) will lead to a fiscal surplus above (below) the trend by 0.086 percentage points of GDP.

ii. Expenditure and Revenue (equations 2 and 3):

Using similar estimation designs it can be shown that both the expenditure and the revenue side contribute almost symmetrically to the electoral cycle in the deficit. In electoral years revenues

decline below the trend by a margin of about 0.5 percentage points of GDP. On the other hand, in the twelve months following the election they increase by about 0.3 percent of GDP above the trend (equation 3). The reverse pattern is observed for central government expenditures. They increase by 0.45 percentage points in the electoral and decline by about 0.68 percent in the postelectoral year (equation 2).

While the significance levels of the electoral coefficients in the expenditure and revenue



equations are comparatively low individually, they are significantly different from each other. In other words, while the two years on each side of the election do not differ significantly from “normal” years, the election year is different from the postelectoral (as they are located on opposite sides of fiscal outcomes in “normal” years). The last line indicates that this is the case for revenues and expenditures with a probability of 92 to 97 percent respectively. This points towards the existence of an electoral cycle for both

the revenue and the expenditure side. Only if revenue and expenditure patterns are added up as the fiscal balance, both electoral coefficients are also significant in themselves. Only when looking at the surplus figures the electoral year is not only significantly different from the postelectoral one, but they are both also different from “normal” years, that is, times that are more than 12 months away from either side of the election. Figure 1 visualizes the effects of elections on the main fiscal aggregates. The dark bars are the deviations from the trend in the electoral year and the grey bars depict the postelectoral years (controlled for all the other influences used in the estimations).

iii. Structure of expenditures (equations 4 and 5):

Another interesting result is the structure of central government expenditure around elections. There is no across the board increase (cut) of spending before (after) elections. Instead the governments in the region followed a more discretionary pattern. The increased spending in the preelectoral year is originating in increased transfers to individuals and subsidies to enterprises

(equation 4). Over three quarters of the observed additional preelectoral spending that has been estimated in equation 2 (0.45 percent of GDP) is due to higher transfers and subsidies! This is the spending category that is likely to be most immediately felt by the electorate. Directly after the elections, however, only a tiny fraction of the granted generosities can be taken back. Looking at the coefficients for the lagged variables it can be demonstrated that transfers are particularly sticky. Accordingly, the POSTELECT coefficient has the “right” sign (negative) but is very low and statistically insignificant.

In the aftermath of the typical Latin election, in order to compensate for the increased government transfers, capital spending is cut, which had remained unchanged in the twelve months prior to elections (equation 5). This pattern can be subject to two interpretations. Firstly, the incoming government may have problems to formulate and implement a public investment strategy immediately. The drop in capital spending after the election would then be a natural phenomenon that is related to the time consuming process of determining investment priorities for the next term. The second interpretation is that incumbents time investment projects in a fashion that allows them to telegenically inaugurate as many public works as possible right before election day in order to signal competence and activity. As public investment projects are usually multi year operations, the projects that take longest to finish are initiated earlier in the term, the shorter projects later on, all timed to be finished in the electoral year. The drop of postelectoral public capital spending is then a result of opportunistic timing of projects that lead to an almost complete halt in public investment activity after the preelectoral inauguration wave. The fact that the electoral stop-and-go policy does affect not only overall levels of public spending and taxation but also its structure most likely exacerbates the welfare problems involved with electoral cycles.

Regional Heterogeneity

It must be clearly understood, however, that the region is not very homogeneous. Figure 2 gives an impression of the wide variety of experiences that can be observed in the region using a very crude indicator. For every country the simple average difference in percentage points of GDP of the fiscal surplus in the electoral year and the surplus in the postelection years is computed, covering the years 1981 to 1995. A negative value indicates more expansive fiscal policy before the election and hence an electoral cycle. As on average less than 3 elections fall into the observation period (we are not considering the first elections after transition from undemocratic

regimes as the outgoing incumbents did not stand for reelection, unanticipated elections due to exceptional circumstances were also excluded (cf. Annex 3)¹⁴, no meaningful country by country regressions could be estimated. Similarly the bar chart has to be interpreted with caution. One particularly strong fiscal cycle around an election date - that might have been caused by other events than the election (the difference shown is not controlling for other factors influencing the fiscal deficit) - can catapult a country into the league of strongly opportunistic governments, although fiscal policy around other elections show a neutral pattern. Thus the figure suggests no ranking of countries ranging from responsible to outrageous. It merely attempts to underline that wide differences can be observed across countries in the region.

A striking pattern, however, is the distinctive difference between the electoral experiences in OECD countries on one side and Latin America and the Caribbean on the other (both covering 1981-1995). The surplus in the electoral and postelectoral years was about the same in the OECD (actually it was even somewhat higher before elections!).¹⁵ If the outlier Finland is excluded, the average difference would be a mere 0.04 percent of GDP. The median of OECD countries showed a very low anti-electoral cycle pattern. The surplus was about 0.15 percent higher in the election year than in the postelectoral year.

The countries in Latin America and the Caribbean by contrast showed a very pronounced electoral cycle. Only one country (Costa Rica)¹⁶ had a surplus that was higher in the electoral year, vis-a-vis the postelectoral year. Nine countries of the region had a stronger electoral cycle than Portugal, the OECD country with the strongest electoral pattern. While in the last fifteen years electoral

¹⁴ The following elections of 1982 have been included that are not reported in the annex 3: Bahamas, Colombia, Costa Rica, Dominican Republic and Mexico. Panama 1989 was excluded as the substantial turnaround of the fiscal balance in postelectoral 1990 was exogenously due to the lifting of US sanctions (incl. tax nonpayments by US corporations operating in Panama). Argentina 1995 was excluded for lack of comparable surplus data in 1996. Brazil 1989 and 1994 have also been left out of the sample for the hyperinflationary distortions in fiscal figures.

¹⁵ The author thanks Alberto Alesina for providing information on OECD elections and changes in governments. The data has been complemented and updated with national sources in the Internet. OECD surplus data comes from OECD (1996, Statistical Annex).

¹⁶ Rodriguez (1995) identified a strong fiscal expansion in Costa Rican election calendar years and claims that this is a sign of an electoral cycle. But as elections are always held in February, most of the year (10 months) is actually falling into a *postelectoral* episode. The conclusion that Costa Rica is suffering from serious electoral cycles in fiscal policy can therefore not be drawn from this information alone. Since the present study corrects for the timing of the elections early in the year, the fiscal expansion that falls regularly into the calendar year where the elections are held is attributed almost wholly to the postelection year. For this reason Costa Rica displays a "perverse electoral cycle". This is not to say that electorally motivated fiscal policy is unheard of in Costa Rica. It means, however, that if such a manipulation exists it is of a different nature than in all other countries of the region.

cycles seem to have been overcome in the industrialized countries, the phenomenon still lingers on in Latin America and the Caribbean. In the next paragraph the reasons determining the very different experiences in the region are investigated.

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6. EXPLANATION OF THE ELECTORAL CYCLE PHENOMENON

What explains this heterogeneity observed within the region? It is hardly convincing to assume that it is pure coincidence whether a country will experience strong electoral fiscal cycles or not. In looking at the structural causes of the electoral cycle, we will consider different factors that might be lying at the root of the phenomenon.

Doing so, a series of calculations are undertaken.¹⁷ For each equation that is looking at a particular structural difference the sample was subdivided into three groups (or in two, when there is a dichotomous structural characteristic under investigation, like old vs. new democracy). In one group the structural factor under consideration is particularly pronounced, in a second the factor is of little or no importance. These two sharply contrasting subgroups of countries will then be used in order to check empirically whether the structural feature that distinguishes them from each other is an explanatory factor of the electoral cycle phenomenon in Latin America. A third group covers the “grey area” between the two. While the nonpolitical control variables (LAGs, IMF, CATASTROPHY, GDP, country dummies) of this in-between group also enter the equation, the electoral events (ELECT and POSTELECT) are omitted. The intention of this procedure is to be able to distinguish between clearly differing subgroups that are homogeneous within when it comes to the structural characteristic investigated. As the sample of countries is small (20, since Brazil has been excluded due to the hyper inflationary distortion in the fiscal data) the “in-between group” could effectively produce a muddy picture that hides the impact of underlying economic characteristics.

Equation 1 is then performed again, this time interacting the electoral dummies (ELECTION, POSTELECTION) with a set of structural dummies. The structural dummies differentiate two subgroups at the extremes of the continuum, indicating whether the factor under scrutiny is strongly present or not important). This exercise is repeated for each structural feature.¹⁸ Figure 3 displays graphically the effects structural differences have on the preelectoral budget surplus.

¹⁷The OLS estimation results are shown in Annex 1.

¹⁸ The coefficients of the electoral variables in the equations in the annex are in general somewhat less significant than in equation 1 that examined the determinants of the surplus for the whole sample. The reason is the lower number of observation (electoral events) in the annex equations. A subgroup sometimes consists of no more than 8 countries or so. As the number of elections of this subgroup is naturally smaller than of the total sample statistical significance tends to decline.

For definitions of the structural variables consult annex 2. A discussion of the results follows now.

Replace this page with a printout of Figure 3 (Quattro Pro)

A Countries with high underlying **volatility** in the surplus (measured as standard deviations, excluding the electoral and postelectoral years) show a very strong cycle, with a decrease of over 2 percent of GDP below the trend in the electoral year, rising again by over a percentage point in the postelectoral year (equation A1). This is a very substantial swing around election day. Countries that were classified as stable in their fiscal surplus, by contrast, showed only minor electoral cycles. This finding supports the hypothesis that governments in highly volatile environments are additionally tempted to disguise their opportunistic behavior behind the general instability of fiscal indicators. Since higher instability in the surplus is usually correlated with the size of the average deficit, a stabilizing fiscal strategy should in itself contribute to less pronounced welfare reducing electoral cycles.

B Similarly, **size of government** matters. Countries that were classified as having big governments (i.e. central government spending as a percentage of GDP exceeded on average 22 percent between 1981-1995) showed a very pronounced cycle, whereas "small-government countries" (central government expenditure less than 17 percent) experienced only a small and statistically insignificant cycle (equation A2). It can be argued that it is quite natural that smaller governments have smaller cycles, as for example a ten percent relative increase (decrease) in spending in the election (postelection) year translates into a cycle that is three times as big in a country with a state that comprises, say 30 percent of GDP than in a country with a state sector of only 10 percent. However, the cycles are far more than proportionately larger in countries with big governments. While the average government size in the "big government" group was about twice that in the "small government" group, the electoral boost is over six times bigger in the former group, whereas the postelectoral contraction is about twice as large. Not only are the absolute cycles more pronounced in the case of big governments, but clearly also the relative size. The probability that governments in the two subgroups behave systematically different in the electoral years is about 91 percent (cf. last line).

This phenomenon can easily be explained. If a government wants to increase its reelection chances by boosting demand, it can only do so if it has sufficient "ammunition" at its disposal, i.e. if it is sufficiently large. If it is arbitrarily assumed that it takes a short term expansive demand shock of the size of 2 percent of GDP in order to gain the votes missing to win an upcoming election, these 2 percent can be more easily provided by a big government than by a small one, as the relative change is a much larger one for the latter. And even if asymmetric information

exists about the conduct of fiscal policy, the electorate will recognize the small government's relatively stronger cycle faster than in the big government's case, although the absolute size in percentage points of GDP is the same in both countries. If rational voters dislike the welfare reducing discretionality of the opportunistic incumbent, they will vote him or her out of office. Thus, the incentive for the government to create cycles is reduced if it is a small one: it is relatively more costly to come up with the funds and entails higher risks of being caught in the act of manipulating public finances for electoral ends. While big governments are not necessarily bad, the result indicates that big governments stick more firmly to opportunistic habits than smaller government's do. This is not suggesting that smaller governments somehow boast wiser incumbents. But for any given incumbent the incentives to embark on opportunistic electoral cycles are stronger if she has a lot of spending power at her disposal, measured relative to the size of the economy.

C Another factor that helps explaining the existence and vigor of electoral cycles is **human capital endowment**. Countries with low average years of schooling of the adult population (5 or less) experience a 1.55 percent of GDP decrease of the surplus below the trend in the election year, whereas countries with higher educational attainments (more than 6 years schooling), realize a drop of only 0.4 percent (equation A4). Similarly, the correction in the form of higher surpluses in the twelve months following the election is higher in the countries with low average schooling levels (+1.25 percent of GDP) than in the country group with low educational achievements (+0.84 percent of GDP, equation A3).

While the difference between the two country groups is less significant than the differences between the subgroups volatile/stable and big/small governments, it suggests that the "quality" of the electorate in monitoring the government is important. If the low educational attainments do not allow for the representative voter to interpret the government's action correctly, taking the intertemporal welfare effects into account, the incentives for politicians to follow opportunistic behavior increases substantially, as they are not effectively held accountable for their actions. Welfare reducing manipulations of fiscal policy are not detected by the voters because their stock of human capital is insufficient for understanding the long term impact of the short-lived expansion. The share of "uninformed" voters is higher in countries with low average years of schooling. As even the well trained know this fact they will take it for granted that the government has to behave opportunistically in order to catch the vote of the uninformed and uneducated majority. Therefore even the informed voters will support the incumbent if at least the results of the opportunistic

behavior are good, i.e. there is a big demand shock, signaling government competence. If however, the share of uninformed and uneducated voters is small and this fact is common knowledge, the politician might think twice before boosting the fiscal accounts: he might gain some votes of the uninformed, but is likely to alienate some informed voters that do not see the government's need to behave in a fiscally irresponsible way: the easily deceived are in the minority and the government could therefore win the election by following a less destabilizing course, which would attract the majority of educated and informed voters. Increasing the educational achievements of the population has therefore an additional benefit that has often been overlooked. It does not only increase the workers' productivity and spurs economic growth, but it also enables the citizens to better monitor their rulers and vote them out of office if they opportunistically give higher priority to their private short term political goals than to welfare maximizing policy choices for the general public.

D It could be argued that electoral cycles are some sort of teething troubles of **young democracies** that are still in the process of establishing itself and a viable, more clearly demarcated party system. This however, does not seem to be true. We divided the sample into elections where at least two constitutionally elected governments have held office without interruption by unconstitutional power transitions after 1970 on the one hand ("old democracies") and elections where less than two elected governments ruled immediately prior to the upcoming election on the other ("new democracies"). The expected difference does not show (equation A4). Unexpectedly, the more stable democracies even produced stronger electoral cycles than the emerging ones! In mature democracies the postelectoral year is different from the electoral year in terms of fiscal balance with a probability that is considerably higher than in the nascent democracies. This can be interpreted as a consolation for new democracies. There is nothing inevitable about electoral cycles. At the same time, however, it is a challenge to young and old democracies alike: it is not enough to sit and wait for this phenomenon to pass by. The sit and wait approach may even be harmful, as with growing maturity of democratic institutions the governments will become more sophisticated in creating cycles. Under this interpretation the governments in new democracies are not better policy makers nor are they more concerned with not jeopardizing the credibility of democratic institutions. Rather, they are simply not (yet) able to orchestrate the still evolving institutional and power structure in their countries to their own benefit.

E Another surprise may be the fact that the presence or absence of a constitutional ban on

immediate reelection plays no significant role (equation A5).¹⁹ In countries with immediate reelection of the chief executive the electoral cycle was indistinguishable from those with forced rotations of the person occupying the chief executive position. Even in the absence of immediate reelection the incumbent embarks on an expansive path before the election, either to increase chances of reelection after a term at the sidelines, or to improve his alternative career perspectives after retiring from the presidency.²⁰ This may be personally important, as presidents in countries with prohibition of reelection are typically much younger when they leave office than in countries, where they can face reelection several times. It can even be argued that the cycle should be expected to be more pronounced in the case where no reelection is possible, as the departing officeholder knows for sure that it will not be her on whom the unpopular task of putting the house back in order is going to fall.²¹ Besides, the social integration in the political party can also be an important incentive for the outgoing president to fight for the party's candidate, never mind that she cannot stand again herself. The party may also try to protect itself by choosing only loyal candidates that are likely to support the party's cause even when reelection is unconstitutional. One conclusion that can be drawn from this finding is that the current trend towards abolishing the reelection prohibition in several of the region's constitutions does not necessarily bring a higher degree of opportunistic preelectoral behavior with it.²²

F Improving **budgetary institutions** and processes might be a starting point to reduce the importance of electoral cycles in Latin America. The empirical analysis does not support the hypothesis that a country with "good" budgetary institutions (using an index focusing on the level of discretionary decision making power constructed by Alesina et al. (1995)) leads to less pronounced cycles than where "bad" institutions prevail that allow for a large degree of discretionality of the executive branch of government (equation A6).

G But not only domestic issues are likely to determine the extent to which electorally driven fiscal policy is observable. **Relations with the outside world** could also matter. Two aspects come

¹⁹For a deeper discussion of the role of reelection bans cf. Kraemer (1997, Section 4.2.4.).

²⁰Even if the incumbent cannot be reelected, a triumph of her party is to be regarded as a "stamp of approval on an administration" (Ames 1987, p. 78).

²¹cf. Heredia (1992, p.6).

²²This is consistent with results by Besley/Case (1993) who find no difference in the preelectoral fiscal choices made by US governors standing for reelection and those that could not run again. If anything, the latter followed somewhat more expansionary policies, may be due to the fiscal conservatism of the US electorate.

immediately to one's mind: the exchange rate system and the degree of openness to trade.

A flexible exchange rate regime will reduce the effectiveness of a fiscal expansion. The resulting increase in domestic interest rates will prompt capital inflows and a real appreciation of the currency. This will eventually lead to a worsening of the trade balance by reducing the production of tradable goods and services. Aggregate demand remains unaltered. A greater openness to imports will also reduce the effectiveness of a fiscal expansion, as a higher proportion of the positive demand shock would leak to foreign suppliers. Since the latter are not eligible voters these benefits are wasted from the political point of view. Other things being equal one would therefore expect countries with exchange rates pegged to the dollar and small import ratios to engage in a more opportunistic fiscal policy stance than countries where the exchange rate is flexible and that have very important "import leakages".

Let us look at the openness of trade issue first. The empirical evidence does not support the hypothesis outright (equation A7). Countries that have been relatively more open to imports between 1985 and 1994 (over 30 percent of GDP on average) actually experienced, counter intuitively, a significantly *lower* surplus immediately before elections than countries with low import shares (under 20 percent of GDP). The open economies had a surplus that was 1.95 percent of GDP lower than the trend value, whereas the closed ones encountered a drop in the surplus of 0.1 percent. One possible explanation could be that governments of open countries, where the effectiveness of fiscal policy is lower, try to offset the disadvantage of more important leakages by simply increasing the dose of the expansion.

On the other hand the data supports the notion that countries with fixed exchange rates show stronger electoral cycles. The preelectoral drop in the surplus was about 0.6 percent of GDP in countries with flexible foreign exchange arrangements (cf. equation A8). If an election is coming up in an environment of fixed exchange rates, however, the surplus shrinks by over 1.7 percent of GDP (cf. equation A8). The likelihood that preelectoral surpluses are different between the two groups of countries is almost 90 percent. The post-electoral correction on the other hand is empirically independent from the exchange rate regime.

Thus, when trying to attract voters, governments do understand the restrictions on fiscal policy effects that come along with flexible exchange rates. The potential compensating effect of the exchange rate leads to reduced efforts to attract votes by means of carrying out an opportunistic

fiscal strategy. Openness towards imports, on the other hand, is not leading to a complete defeat of the expansionary intentions that are at the root of swelling preelectoral deficits. Instead they are watering down the politically desired consequences, to which governments seem to have reacted by simply augmenting the stimulus in order to compensate for import leakages.

7. DO ELECTORAL CYCLES PAY OFF?

The basic assumption of the foregoing analysis has been that the government accepts the welfare losses related to cyclical fiscal policy as a necessary evil to increase the likelihood of the reelection of themselves or their party's candidate, where reelection was not allowed. However, it has not been proven that electoral fiscal cycles actually increase the reelection prospects of the incumbent. Analyzing 55 elections (of which 22 were won by incumbents)²³ in Latin America and the Caribbean between 1982 and 1996 it can be demonstrated that reducing the surplus in a preelectoral year did not significantly increase the success-rate of the reelection bid of the incumbent (or her party where reelection is unconstitutional).

Equation 6 shows the result of a OLS estimation of the determinants of electoral outcomes. WINNER is a dummy variable and equal to one when the incumbent candidate or her party was reelected and zero if the opposition won the elections. As the equations 6 and 7 calculate the variables that influence whether an incumbent wins or loses an election, the *estimated* value of WINNER equals the probability that she will defeat the opposition.²⁴

The explaining variable SURPLUS is the deviation of the central government's overall fiscal surplus from the 1981-1995 linear trend in the twelve months prior to the election date, measured in percentage points of GDP at market prices in current local currency units.²⁵ For example, a 1.5 percent deficit results in the value -1.5. In the table it has been shaded in grey because this variable is the focus of our attention. While the empirical effect of a preelectoral fiscal boost is statistically not significant, it is at least pointing in the direction opportunistic governments had hoped for. An additional percent of GDP in the budgetary deficit in the 12 months leading to the polls improves reelection chances by 3.7 percentage points. But it must be kept in mind that this relationship is a very weak one and the statistical probability that it is completely nonexistent is

²³The elections used are the ones recorded in annex 3 with the inclusion of the 1996 elections in Ecuador and the Dominican Republic, the 1982 elections in The Bahamas, Colombia, Costa Rica, Dominican Republic and Mexico and the exclusion of elections in Argentina 1995 and Brazil 1994 for lack of comparable surplus data, Brazil 1989 due to hyperinflationary distortions in the surplus figures and Panama, where fiscal data between the two electoral episodes (1989 and 1994) was dominated by clearly exogenous influences like trade sanctions.

²⁴Equations (6) and (7) are OLS regressions. As the dependent variable is a dummy the estimates have also been repeated using Probit approach, which confirmed the results. For the sake of the ease of interpretation of the coefficients, only the OLS results have been presented here.

²⁵In the case of Ecuador and the Dominican Republic, where 1996 elections have been included the time period used to calculate the linear trend stretches from 1981 to 1996.

almost 30 percent!

Table 3: Determinants of Probability of Election Success for Incumbent in Latin America and the Caribbean, 1982-1995

Dependent Variable: WINNER	(6)	(7)	Avg. Winners	Avg. Losers
Constant	-.103088	-.273424E		
SURPLUS	-.036961E	-.023484	-0.7%	-0.6%
GDPLAG	.034030*	.030044*	+3.1%	+1.5%
LEAD	.007792**	.026279***	32.1%	11.8%
LEAD SQUARE		-.000220**		
REELECTION	.284334*	.252691*	36.4%	24.2%
POLITICAL RIGHTS	.080493E	.098033E	2.50	1.87
Observations:	55	55	22	33
Adjusted R square:	0.235	0.310		
Mean dependent variable	0.4000	0.4000	1.000	0.000

Note: Significance levels: ***99%, **95%, *90%, E70%. For data sources and definitions cf. annex 2.

GDP growth in the twelve months prior the elections proved to be electorally only marginally more productive: an extra percent growth stimulated the reelection chances by an additional 3.4 percentage points. While this is a statistically significant result the coefficient is lower than what might have been expected: A rather spectacular five percent growth rate in the year before the election would improve the reelection prospect by only 17 percent relative to a scenario with a completely stagnant economy! But putting solid growth-oriented macroeconomic policy in place seems to serve power hungry incumbents still somewhat better than non-sustainable short term gimmicks in the budget. Comparing the averages of preelectoral growth of governments that won elections and those that had lost them, the reelected ones showed a growth rate more than twice as high as governments voted out of office (3.1 versus 1.5 percent), whereas the deviation of the preelectoral surplus from the trend was virtually identical for both winners and losers (-0.7 versus -0.6 percent).

However, Latin American citizens vote predominantly along lines of reasoning that take the political capital of a politician into account and are less obsessed with short term macroeconomic results than politicians creating preelectoral expansions seem to believe. In the absence of gross and prolonged economic mismanagement, political capital depreciates only slowly over time and is not strongly affected by erratic fiscal behavior before elections. A proxy for political capital is

LEAD, which measures the margin at the preceding election of the current incumbent vis a vis the runner up (a 10 percentage point lead produces a value of the LEAD variable of 10). Equation 6 indicates that a larger success in the last elections does transmit into a higher probability of winning in the following election also. Each percentage point lead in the last election will lead to a significantly increased probability of being reelected (incumbent or party) of 0.78 percentage points. Winning incumbents/parties enjoyed on average a lead of 32 percent in the previous election, while the respective number for defeated incumbents was a much lower 12 percent (cf. last two columns).

While the LEAD coefficient is significant, it is also significant that this is not a linear relation but that, on the margin, an additional percentage point lead does less to the reelection chances if the preceding polls have been very clearly won. If the election was relatively close, however, the marginal improvement of the reelection probability per point of lead is higher. This becomes clear looking at equation 7, where the squared value of lead (LEAD SQUARE) coefficient carries a negative sign. This indicates that the effect of the political capital is not due to the influence of a few cases, where one party or candidate clearly dominated the electoral arena by wide margins. On the contrary, in competitive party systems each percentage point lead at the ballots is contributing more to the positive reelection outlook than in hegemonic party environments. Increasing the lead from 5 to 10 percent enhances the reelection chances at the next election by 11.5 percentage points, other things being equal. If the lead is raised by 5 percentage points starting from a 25 (45) percent lead, the probability of electoral success increases only by 7.1 (2.7) percentage points. Beyond that point the marginal effect is virtually zero. Political capital matters, but as with physical capital, decreasing returns to scale exist.

Also in line with the conclusion that political capital matters is the fact that reelection chances are roughly 25 percentage points higher in countries that allow for immediate reelection of the incumbent. This is shown by the coefficient of the dummy REELECTION that equals one if the reelection of the incumbent is possible.²⁶ After one term in office a politician can gain additional recognition value and political capital and therefore will be reelected if she proved to manage the

²⁶In some countries the chief executive can be reelected only once. After the first victory, when she stands for reelection at the end of the term, the dummy will be equal to one. If she is elected for a second consecutive term she cannot be a candidate again. At the following election the dummy would be zero. Note that the REELECTION variable is not a country specific one but an election specific one.

economy satisfactorily. In 36 percent of the elections that were won by the government, the chief executive was constitutionally allowed to run again. Among elections resulting in defeat the share of incumbents allowed to run a second time was only 24 percent.

Allowing reelection of incumbents may therefore *reduce* the prominence of electoral cycles, because the old and familiar faces can also be the new faces. The incumbent can draw on political capital accumulated during the previous term(s) in office and does not need to get engaged opportunistically as much as in an environment where only the party can stay the same, whereas the actual candidate has to change. In most Latin American countries, where a more personalistic style of policy making is common, the political capital of a party is relatively weak. A new chief executive often goes through pains to distance himself from his predecessor whom he blames for inherited woes. Furthermore several layers of decision makers are regularly replaced after each election, removing leading civil servants that have acquired a certain level of competence on their jobs. This maneuvering often takes place even if the predecessor belonged to the same party. As the voters are well aware of this ritual they know that a new candidate of the incumbent party can not be regarded as equivalent to an incumbent running for reelection. The identification of programs with names is usually higher than with parties which frequently proved to be lacking any clear ideological conviction.

According to equation 7 it takes in terms of reelection chances a brutal 11 percent of GDP of fiscal deficit just to compensate for an existing reelection prohibition $[-11 * (-0.023484) \cdot 0.252691]$! Institutional settings and accumulated political capital thus are far more important than electoral fiscal cycles. This knowledge does not seem to be very widely shared. Otherwise it is not explicable, why the existence of constitutional reelection did play no role in determining the intensity of the electoral cycle. Reelection candidates should ideally opt for milder cycles as they depend less on them. Allowing for immediate reelection per se does not introduce an extra dose of destabilizing electoral cycles.

If everything else fails, governments can try to survive elections by clamping down on political liberties of the population. The variable POLITICAL RIGHTS uses an index that is published annually by *Freedom House*, a US based human rights watchdog organization. It spans from 1 (most free) to 7 (least free). As the coefficient of the variable has a positive sign, repressive

governments have empirically a better chance to win. They might not have won in free and fair elections, of course, as the political restrictions may ban certain opposition parties from participating or vote rigging may be commonplace. But caution is to be applied interpreting this result. Firstly, the countries in the sample are not so very different from each other in the index number. The countries with the highest index, i.e. the politically least liberal ones like Haiti or Cuba, are not included in our sample. Comparing the averages of winning and losing incumbents in table 3 shows the relatively high homogeneity that exists within the country sample. Secondly, the index moves generally very little over time for each country. While the result may be valid if contrasting between free and less free countries, it may be electorally counterproductive to reduce the freedom the electorate has become used to enjoy as it may punish the government for this offence in the elections. Perhaps the reduction in political rights takes the form of fraudulent elections which leaves the voters electorally defenseless. But then it is hard to speak of “elections” in the sense as this paper did. If fraud is a very common feature then the government surely does not see the need to try fiscal expansions either in order to renew legitimacy. Under these circumstances the opinion of the population is of no importance.

8. CONCLUSIONS

Since the early 1980s Latin American and Caribbean fiscal policy shows on average an electoral cycle of the fiscal surplus of 1.8 percent of GDP, measured as the difference in the pre- and post-electoral figures, corrected for a number of other influences. Preelectoral surpluses were generally lower than in average years with the opposite being true in the twelve months following the election. Both revenues and expenditures contributed to this pattern.

Trying to explain the wide differences between different Latin American countries some structural causes have been identified. Countries with highly volatile fiscal policies, low human capital endowment of the electorate and big governments seem to suffer most under the discretionary manipulation for electoral reasons. On the other hand the quality of the budgetary institutions and the tradition of democratic mechanisms did play no significant role.

While the attempt to abuse fiscal policy for electoral purposes is widespread it appears to be electorally unproductive. Higher deficits before elections do not seem to contribute to victory at the ballot box. The bottom line of this study is clear: Latin American governments harm the welfare of their countries by introducing discretionary demand shocks that are clearly not justified as an

instrument of business cycle smoothing as advocated by Keynesian economists. While the economic damage is done, the political payoff is on average very low and unsuited to secure a successful reelection bid. The empirical rejection of the hypothesis that fiscal excesses can improve electoral prospects is strong. Governments' secret laments that they are forced to accept some expansion in order to win the election and to be able to continue with an otherwise strictly enforced stable macroeconomic management must be dismissed as unsubstantiated. Electoral cycles are both economically harmful and politically unproductive.