

Study Group on Local Governance and Democracy

THE IMPACT OF FISCAL DECISIONS ON LOCAL ELECTIONS: AN EXPLORATORY STUDY OF PORTUGAL

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Cláudia C. Silva Costa

Department of Business Sciences
School of Tourism, Administration and Communication - Mirandela
Polytechnic Institute of Bragança
Rua João Maria Sarmiento Pimentel, Apartado 128
5370-326 Mirandela
Tel. +351 278 201 340
Fax: + 351 278 265 733
E-mail: claudia@ipb.pt

Pedro J. Camões

Department of International Relations and Public Administration
School of Economics and Management
University of Minho – Gualtar Campus
4710-057 Braga
Tel. +351 253 604510
Fax. +351 253 676375
E-mail: pedroc@eeg.uminho.pt

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ABSTRACT

The analysis of fiscal performance is a hot topic either to policy makers or researchers and fiscal discipline is a key value in public finance management at the national and local levels. This growing attention to discipline may be explained with fiscal crisis and strict resource limitations, since in the three last decades a large part of those governments had high and persistent deficits and public debt.

Fiscal performance may also be an instrument that voters considered at the ballots. Elections are the main accountability instrument, used by voters to evaluate the incumbent's performance. Voters elected the incumbents if they consider satisfactory their performance; or otherwise they elect opponent candidates. The objective of this paper is to analyze relationship between several dimensions of fiscal performance and the probability of incumbent re-election, focusing on 2005 municipal elections. Based on public finance and public choice literatures we test some well-known hypothesis such as fiscal illusion and fiscal conservatism of voters.

1. INTRODUCTION

The analysis of fiscal performance is a hot topic either to policy makers or researchers and therefore acquired a relevant position in public finance literature in recent years (Calcagno and Escaleras 2005; 2007). Fölscher (2007) refers that fiscal discipline is a key value in public finance management at the national and local levels. This growing attention to discipline may be explained with fiscal crisis and strict resource limitations.

In the three last decades a large part of those governments had high and persistent deficits and public debt (Alesina, Hausmann, Hommes and Stein, 1999; Von Hagen and Harden, 1995; Lagona and Padovano, 2007; Alesina and Perotti, 1999; Hallerberg, Strauch and Von Hagen, 2007; Velasco, 2000; Kennedy and Robbins, 2001; Millar, 1997; File and Scartascini, 2004; Woo, 2003; Schneider, 2006 and Schaltegger and Torgler, 2007). Fölscher (2007) argues that expenditure claims would result in chronically high deficits and increasing debt and tax burdens if governments were not fiscally prudent.

In addition, fiscal performance can also be an instrument that voters considered at the ballots. Indeed, elections are the main accountability instrument, used by voters to evaluate the incumbent's performance. Voters elected the incumbents if they consider satisfactory their performance; or otherwise they elect opponent candidates (Von Hagen, 2007; Cleary, 2007; Martinussen, 2004 and Brender and Drazen, 2006).

The objective of this paper is to analyze relationship between several dimensions of fiscal performance and the probability of incumbent re-election, focusing on 2005 municipal elections. Based on public finance and public choice literatures we test some well-known hypothesis such as fiscal illusion and fiscal conservatism of voters.

The paper is organized as follows. In the next section we present the main theoretical and empirical arguments on this topic. In the third section, we describe the structure of intergovernmental relations and local government democracy in Portugal, which is the institutional setting in which the empirical analysis is based. The fourth section presents the analysis and discusses the main results.

2. FISCAL PERFORMANCE AND REELECTION

In a normative sense, democracy and the representation process are achieved through a relationship between citizens and the State that needs to work adequately, granting that the necessary distance is not dangerously large. This relationship of accountability resembles an exchange process, in which political institutions and politicians need to be responsive to the demands of the citizens, which, in turn, have to control that responsiveness by giving their

support (Fuchs and Klingmann 1995). This implies that a democratic government receives the votes from citizens, applies the preferred public policy, and is trusted and obtains political support. This process works this way because public resources are limited and because the implementation of a policy rules out the others and its supporters. This is an ideal picture and a simplistic explanation. At least, it provides a feasible framework to understand the process. In addition, because it is simple, the explanation can be turned into an empirical hypothesis that can be tested.

Concerning financial policies, two different and contrasting views explain how fiscal performance affects the electoral behaviour and, subsequently, the electoral results of incumbents (Brender and Drazen, 2005b and 2006). The difference lies in the adoption and support of prudent vs imprudent financial decisions, with respect to either short or long run.

The first view – *fiscal illusion* – argues that voters support financial policies originating high deficits and debt meaning that these policies increase the probability of incumbent's re-election. The true costs and benefits of government decisions are frequently and widely misinterpreted by voters, creating the incentive to manipulate financial decisions (Maher and Johnson, 2008).

The opposite view – *fiscal conservatism* – following the lines of Niskanen (1975) and Peltzman (1992), argues that electors are not sensible to the adoption of imprudent financial decisions. Rather, they are more inclined to sanction the incumbents that promote that imprudence. In sum, raising expenditures and running budgetary deficits seems not to be profitable to gain votes and remain in power. These two approaches have been subject to numerous empirical tests that we review briefly here.

Three main arguments constitute the approach. The first considers a simplistic vision of the interests of voters and incumbents. On one hand, assuming that electors support high budgetary deficits, they prefer high public expenditure and low tax levels, enjoying a larger and better amount of publicly provided goods and services, therefore electing the incumbents that satisfy those preferences. On the other hand, and taking this characteristics of electors as granted, the incumbents adopt opportunistic behavior, adopting those policies that increase election probability (Nordhaus, 1975). According to Brender and Drazen (2006), this view implies that electors are either myopic or they do not care about long run implications (costs) of those present decisions.

This argument is tested in the work of Sakurai and Menezes-Filho (2008) considering municipal elections in Brazil 1988-2000. They analyse whether the probability of election is affected by the expenditure level during the electoral cycle. The findings suggest a positive effect. In particular, they found that capital expenditures have a stronger effect than current

expenditures, suggesting that they are more visible to voters, which means they are more prone to manipulation in the years before elections.

A second argument considers voters as rational and prospective (Brender e Drazen, 2006) motivating the fiscal illusion effect. Rogoff and Siebet (1988) and Rogoff (1990) refer that voter's rationality is based on imperfect information because they accept high levels of expenditure and/or low tax levels believing that incumbents may adopt this preferred policies without running deficits and incurring debt. In sum, they ignore that these policies are unsustainable, therefore non-efficient, in the long run. Again, an incentive to use imprudent moves.

The third argument takes away the myopic nature of voters and is based on the electoral role of interest groups. In an attempt to gain electoral support, incumbents try to satisfy the requirements of some specific groups. This strategy is pursued mostly through target spending which, in turn, increase deficit. This line of research was tested by Drazen and Eslava (2005b) which found positive effects of these target spending.

The second approach presents several arguments that imprudent policies do not increase the re-election likelihood, rather they may end up sabotage that re-election. Supposing that voters are rational and informed, they are conscious of the governmental budget constraint and see deficits as onerous to social welfare. Consequently, they tend to punish them in elections. This is specially the case of governments that want to reduce public debt, such as Portugal and other developed countries (Brender and Drazen, 2006 and 2005b).

One of the first empirical studies testing the effect of financial performance on election results was written by Niskanen (1975). Considering American presidential elections in the period of 1876-1976, the author observed the relationship between the levels of public revenues and expenditures and the incumbents' vote share. The results suggested a positive effect. In addition, Niskanen (1975) found that raising taxes also has the same effect, which he interpreted as evidence of a *tax illusion*, that is, voters are significantly more affected by changes in tax weight than with changes in the costs of publicly provided resources.

Concentrating solely on taxes, Happy (1992) analyzed their effect on voting behavior, in a design of Canadian federal elections between 1953 and 1988. He tested the hypothesis that tax level is not a factor affecting vote. Nevertheless, the findings corroborate the works of Niskanen (1975) suggesting an effective electoral effect of tax weight. According to Happy (1992), the explanation lies in voters' concern with their disposable income.

Focusing on the American elections, presidential and others, between 1950 and 1988, and trying to evaluate the effect of public expenditure on vote shares, Peltzman (1992) found that citizens do not reward imprudent financial policies. Rather, they punish those acts, which

means they are not sensible to major increases in public spending, even with running deficits. The author called these voters as *fiscal conservatives*

A series of more recent works focusing on local governments deserve attention. The first by Brender (2003) analyzes the effect of fiscal performance on the likelihood of re-election of Israel local elections between 1989 and 1998 including three electoral moments, the author found that the factors determining vote choice were significantly altered in 1998 elections. Contrarily to the previous ones, those elections presented a strong relevance of fiscal performance. The author stresses that, if voters are able to control their incumbents effectively, they will be punished when adopting imprudent financial practices. The author suggests when voter has access to information due to transparency and effective auditing and when tough budget constraints are strict, fiscal performance turns out to be electoral relevant. A similar study by Drazen and Eslava (2003) focuses on Colombian local elections in the period 1992-2000. They consider how different groups of spending affect election results. In many ways similar to the studies of Peltzman (1992) and Brender (2003), they found that Colombian voters punish the incumbent party that incur in high budgetary deficits. With regard to spending, a larger share of capital expenditures increase incumbents votes share, while current expenditures have no effect. Globally, these findings mean that voters reward increases in investments outlays but only if that is not financed through larger deficits. In sum, voters are well informed and not easy to foolish by means of public expenditure.

Arvate, Avelino e Tavares (2007) replicates this type of analysis to Brazilian state elections in the period of 1990-2002. They found that re-election prospects are not larger in the presence of deficits. Similarly to Brender (2003), a change in electoral behavior appears to surface before 2002 elections. Facing tough budget constraints, Brazilian electors behaved as "*fiscal conservatives*".

The empirical studies just reviewed are all single country studies, addressing national, state or local elections. In an attempt to extend the analysis of fiscal performance to different institutional (electoral laws and government systems) and cultural settings (democratic traditions), Brender and Drazen (2005b) pooled 74 less-developed and developed countries, divided as new democracies and established democracies in the period of 1996-2003. Specifically, they were concerned on the voting effects of budgetary deficit in the election year and the adoption of imprudent financial policies during the entire electoral period. The results suggest that huge deficits do not alter re-election probability. Moreover those deficits have a clear negative impact in the case of developed countries and established democracies.

The same authors performed an analogous study but focusing solely on the 23 OECD countries in the period of 1960-2003 (Brender and Drazen 2006). The results show that raising public

deficits, specially in election years, reduces incumbent re-election probability. In sum, prudent financial policies have a positive effect on re-election.

Overall, the empirical tests just reviewed are summarized in Table 1 (see Appendix).

(Insert Table 1 here)

3. PORTUGUESE LOCAL GOVERNMENT

Since 1976 Portugal is a democracy, including existence of local authorities in state organization. In fact, the studies developed by Brender and Drazen (2005b and 2006) considered Portugal as a new democracy between 1976 and 1987. After that period they included Portugal in the group of established democracies, resulting in different interpretations of the relationship between fiscal performance and the reelection prospects of incumbents.

By the Portuguese Republic Constitution, local authorities – municipalities – are territorial bodies, with representative bodies designed to follow the interests of the local people. The local authorities' activity is structured by the principles of subsidiarity, decentralization and local autonomy. Since our goal is concentrated at the municipal level, the following description of the organization of Portuguese local governments and their financial system is focused only on municipalities.

At the organization level, the competences and attributions of municipalities predict the existence of two bodies: Municipal Council and Municipal Assembly. The first is the executive body and is constituted by one president and a number of councilors depending on the number of voters and elected on the basis of proportional representation of party closed lists (Hondt Method). The Municipal Assembly is the deliberative body and is constituted by members democratically elected also by proportional representation as well as the presidents of parishes located in the territory. Nowadays, there are 308 municipalities in Portugal: 278 in mainland and 30 in Madeira and Azores islands.

The structure of municipal financial system is established in a specific law – Local Finance Law nº 42/1998 of 6 August¹. Municipalities have their own recourses and finances. The model of allocation of public resources between the central government and the local governments gives municipalities 30,5% of the average revenue of main country taxes (corporate income

¹ Actually the municipal financial system is regulated by another law: Law nº 2/2007, of 15 January, but we do not consider it since our empirical analysis focus on the period of the previous law.

tax, personal income tax and value added tax). This 30,5% is divided in three separate funds: in 20,5% to the General Fund; 5,5% to the Cohesion Fund and 4,5% to the Basic Fund.

Concerning municipal indebtedness, the law establishes two limits considering separate nature of medium long-term loans and short-term loans. The annual charges with amortization and interests payments of medium long-term loans cannot exceed the highest limit of the value corresponding to one fourth of funds assigned to the municipality or to 20% of the investment expenditure of the municipality in the previous year. In the case of short-term loans, the annual average cannot exceed 10% of the revenues of the funds.

4. HYPOTHESIS and METHODS

As we referred previously, the aim of this paper is to examine the effect of local fiscal performance on electoral results of Portuguese municipalities. For two reasons, this is an exploratory study. First, there is almost a complete absence of this specific type of empirical studies regarding the Portuguese municipal case. Second, the unsolved theoretical and empirical puzzles presented in section 2, which renders very difficult the derivation of a clear hypothesis.

4.1. Hypothesis

Our hypothesis subject to test only specifies the relationship involved, without making explicit the direction and the magnitude of the effect.

H: Fiscal performance of municipal government affects the share of votes of the incumbent in the following election.

4.2. Design

We followed the approach of Sakurai and Menezes-Filho (2008), which considered only the elections years. A cross-section design is adopted to analyze the Portuguese municipalities in the election year 2005. Our dataset consists of 308 municipal governments followed between 2001 and 2005. All data as collected from the National Association of Portuguese Municipalities and from the Financial Yearbook of Portuguese Municipalities.

4.3. Dependent variable

The dependent variable of the analysis is the difference of incumbent party's share of vote between the two electoral periods. We intend to find out whether political parties that assume

the power in election year 2001 have a higher or a lower share of votes in election year 2005. If the difference party's share of vote is positive, it means that voters reward the fiscal performance of those parties. Conversely, if the difference is negative, it means that voters punished the party's fiscal performance. This strategy of measuring the electoral reward or punishment as a difference instead of a binary or choice variable is explained because we are also interested in observing elections as instruments of accountability. Therefore, the difference is more suitable to express that continuous, not binary, nature of the variable.

4.4. Model Specification

To examine the relationship between the fiscal performance and elections results, we test whether the electoral fortunes of the incumbents are affected by a set of fiscal and financial variables. Municipal debt is limited by the Local Finance Law. In this context of fiscal performance the existence of rules that regulate the local credit access is considered a strict instrument to the local fiscal discipline (Fölscher, 2007). This limit means the amount that municipalities can afford by annual charges (amortization and interest payments) with medium and long-term loans. This debt limit is measured through two indicators. First, we included a variable that tests if municipalities overcome the *debt limit* ruled by law (a *dummy* variable that takes the value of 1 if the municipalities overcome the limit and 0 otherwise). The expected sign is therefore negative, since it is an indicator of imprudent local fiscal performance. Second, we included a variable that represents the level of paid debt as a proportion of the debt limit, which represents the *debt capacity*. The expected sign is therefore negative. In addition, to measure fiscal performance we also included annual budgetary *deficit*, with the expected negative sign.

The structure of fiscal intergovernmental relations also may play a role. The share of own-revenue represents the municipal capacity to raise revenues and run business independently from national grants. At the local level, own-revenue *independency* is cornerstones of local fiscal performance. We expected a positive sign for this variable.

Spending structure is widely recognized as a major factor affecting electoral shares, with the particular case of *capital or investment expenditure*. We also included this variable with a positive expected sign.

We also include a battery of socio-economic variables to control for the differences and different preferences across municipalities: Cohesion fund, social development index, population, population density and ideology.

The model is represented by the following regression equation:

$$\text{Difference in vote share} = \beta_0 + \beta_1 \text{debtlimit} + \beta_2 \text{debtcapacity} + \beta_3 \text{deficit} + \beta_4 \text{finindependency} \\ + \beta_5 \text{capexpenditure} + \text{controlvariables} + \mu.$$

5. RESULTS

The results presented in Table 2 are standard OLS estimations with robust standard errors to correct for heteroskedastic problems.

[Insert Table 2 here]

Although somewhat mixed, these exploratory results present some interesting findings. First and foremost, debt has a strong and robust influence on vote share of incumbent parties. Whether the debt limit is surpassed strongly and statistically diminishes the share of vote from 2001 election to 2005 election. This is a long run effect and means that voters punish those municipal governments that incur in unsustainable financial paths. The effect of debt capacity, although statistically significant, has an unexpected sign, which renders the result difficult to interpret. We can speculate that voters accept debt, for example to investments, only to the point that the limit is not surpassed. Of course, more work on this puzzle needs to be performed.

In the short run, the effect of deficit is statistically significant but near to zero in magnitude, which means a neutral effect. In general these two effects signal a voter preference for long run.

The amount of capital expenditures is statistically significant but also near to zero, suggesting a neutral influence, which is not exactly what the literature suggest and the empirical tests have shown.

6. CONCLUSIONS

If democratic accountability is in place, incumbents need to be evaluated retrospectively. Given that public resources are limited, the options facing decision-makers are also limited. They have to be accountable for their use of public resources, which means that would expect them to be evaluated on their decisions affecting financial resources.

This study is a preliminary attempt dealing with the Portuguese municipal case. Municipal elections provide an interesting source of variability that allows comparisons. The main

conclusion is that debt limits are considered in voting decisions. While deficit are also considered, they seem to have a neutral effect. These suggests a preference for stable and sustainable, long-run policies with regard to financial resources.

Some limitations of this study are clearly recommendations for future research. More elections need to be analyzed. A recent Local Finance Law was enacted, which implied a different financial structure and new ways of measuring debt are now mandatory. This regulatory transformation is relevant and needs to be addressed.

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Table 1 – Empirical Studies on the effect of fiscal performance on reelection

Author (s)	Unit of Analysis	Dependent variable	Independent variable	Results	Technique
Niskanen (1975)	USA – Presidential Elections (1896-1992)	Fraction of major party popular vote for candidate of incumbent party	Real per capita federal expenditures Real per capita federal revenues	Tax illusion: voters appear to be substantially more affected by changes in taxes than by changes in the total recourse costs of federal services.	Multiple Regression
Peltzman (1992)	USA - Presidential Elections and non-Presidential Elections (1950-1988)	Incumbency party's share of the major party vote in a state	State spending State revenues State spending from own sources State spending from deferral aid	Higher levels of spending reduce the reelection perspectives.	Pooled Time-series Cross-sections
Happy (1992)	Canada – Federal Elections (1953-1988)	Percentage of the total vote obtained by the incumbent party	Rate of change in per capita personal direct taxes	Negative relationship between taxation and reelection.	Pooled Time-series Cross-sections
Brender (2003)	Israel – Local Elections (1989-1993)	1 - Reelected 0 – Non reelected or resigned (localities in which the elected major died are excluded)	Change in debt Debt Balance	Statistically significant effect of the fiscal variables on the results of the election campaigns in 1998.	Choice Models
Drazen e Eslava (2005a)	Colombia - Local Elections (1992-2000)	Votes share to party	Per capita investment spending Per capita current spending Per capita government deficit	Higher capital expenditures increase the share of votes obtained by the incumbent party, while current expenditure has no significant effect	Multiple Regression Pooled TSCS
Brender e Drazen (2005b)	74 countries – 347 election campaign (1960-2003)	1 - Reelected 0 – Non reelected (leader is running for reelection) 1 - Reelected 0 – Non reelected (leader was substitute)	Change in the ratio of the government deficit to GDP in the two years preceding the election year, relative to the previous years Change in the ratio of the government deficit to GDP in the election year, compared to the previous year.	In developed countries and established democracies election-year deficit spending and tax cuts are punished at the polls. Similar results for the effect of budget deficits in the earlier years of an incumbent's term in office.	Choice Models

Author (s)	Unit of Analysis	Dependent variable	Independent variable	Results	Model
Brender e Drazen (2006)	23 OECD countries – 164 election campaign (1960-2003)	1 - Reelected 0 – Non reelected	Change in the ratio of the government revenue to GDP in the two years preceding the election year, relative to the two previous years. Change in the ratio of the government expenditure to GDP in the two years preceding the election year, relative to the two previous years. Change in the government revenue ratio to GDP in the election year, compared to the previous year. Change in the government expenditure ratio to GDP in the election year, compared to the previous year.	Increase deficits during an incumbent’s term in office, especially in election years, reduce the probability that a leader is reelected.	Choice Models
Arvate et. al. (2007)	Brazil – State Elections (1990-2002)	1 - Reelected 0 – Non reelected (governing party) 1 - Reelected 0 – Non reelected (governing coalition)	Fiscal surplus (percentage of the state GDP) Fiscal surplus election year Fiscal surplus national (Percentage of national GDP)	Despite the prevalence deficits, the governors did not increase their reelection prospects by running large deficits.	Choice Models
Sakurai e Menezes-Filho (2008)	Brazil – Municipalities elections (1988-2003)	1 - Reelected 0 – Non reelected	Total expenditure (over the mandate) Capital expenditures Current expenditures	Mayors who spend more during their terms of office increase the probability of their own reelection or of a successor of the same political party .	Choice Models

Table 2 – Regression Results of effects of fiscal performance on reelection

Variables	Model 1	Model 2	Model 3	Model 4
Debt Capacity	.033** (.014)	---	.009 (.011)	.034** (.014)
Debt Limit	-5.332** (2.623)	-2.253*** (1.881)	---	-5.256** (2.560)
Deficit	.000*** (.000)	.000** (.000)	.000*** (.000)	.000*** (.000)
Capital Revenues	.000*** (.000)	.000** (.000)	.000** (.000)	.000** (.000)
Financial Independence	-.125*** (.046)	-.122*** (.045)	.110** (.045)	.124*** (.045)
Cohesion Fund	-.000 (.000)	-.000 (.000)	-.000 (.000)	-.000 (.000)
Social Development Index	-39.687 (24.316)	-37.476 (24.112)	-37.975 (23.929)	-40.768* (24.335)
Population	-.000** (.000)	-.000** (.000)	-.000** (.000)	-.000** (.000)
Population Density	.001 (.000)	.000 (.000)	.000 (.000)	.001 (.000)
Ideology	-.170 (.856)	-0.674 (.085)	.170 (.826)	---
Constant	30.510 (21.691)	29.930 (21.505)	29.203 (21.373)	31.084 (21.713)
Nº Observations	207	207	207	208
Prob > F	0.0093	0.0196	0.0113	0.0043
R-squared	0.1294	0.1079	0.1029	0.1307
Root MSE	0.2046	9.2938	9.3198	9.1928

NOTE: Regressions are run with robust standard errors;
The numbers between parentheses are standard errors:

*** Significant at the level of .01

** Significant at the level of .05

* Significant at the level of .1