

## The Effect of Political Characteristics on the Budget Balance of Local Governments: A Dynamic System Generalized Method of Moments Data Approach

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**Abstract :** This paper studies the effect of political characteristics of 308 Flemish municipalities on their budget balance in the period 1995-2011. All local governments experience the same economic and financial setting, however some governments have high budget balances, while others have low budget balances. The aim of this paper is to explain the differences in municipal budget balances by a number of economic, socio-demographic and political variables. The economic and socio-demographic variables will be used as control variables, while the focus of this paper will be on the political variables. We test four hypotheses resulting from the literature, namely (i) the partisan hypothesis tests if left wing governments have lower budget balances, (ii) the fragmentation hypothesis stating that more fragmented governments have lower budget balances, (iii) the hypothesis regarding the power of the government, higher powered governments would resolve in higher budget balances, and (iv) the opportunistic budget cycle to test whether politicians manipulate the economic situation before elections in order to maximize their reelection possibilities and therefore have lower budget balances before elections. The contributions of our paper to the existing literature are multiple. First, we use the whole array of political variables and not just a selection of them. Second, we are dealing with a homogeneous database with the same budget and election rules, making it easier to focus on the political factors without having to control for the impact of differences in the political systems. Third, our research extends the existing literature on Flemish municipalities as this is the first dynamic research on local budget balances. We use a dynamic panel data model. Because of the two lagged dependent variables as explanatory variables, we employ the system GMM (Generalized Method of Moments) estimator. This is the best possible estimator as we are dealing with political panel data that is rather persistent. Our empirical results show that the effect of the ideological position and the power of the coalition are of less importance to explain the budget balance. The political fragmentation of the government on the other hand has a negative and significant effect on the budget balance. The more parties in a coalition the worse the budget balance is ceteris paribus. Our results also provide evidence of an opportunistic budget cycle, the budget balances are lower in pre-election years relative to the other years to try and increase the incumbents reelection possibilities. An additional finding is that the incremental effect of the budget balance is very important and should not be ignored like is being done in a lot of empirical research. The coefficients of the lagged dependent variables are always positive and very significant. This proves that the budget balance is subject to incrementalism. It is not possible to change the entire policy from one year to another so the actions taken in recent past years still have an impact on the current budget balance. Only a relatively small amount of research concerning the budget balance takes this considerable incremental effect into account. Our findings survive several robustness checks.

**Keywords :** budget balance, fragmentation, ideology, incrementalism, municipalities, opportunistic budget cycle, panel data, political characteristics, power, system GMM

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