

Business Cycles: Political Business Cycle Approach

From the perspective of the political business cycle approach (PBC), macroeconomic fluctuations are generated or reinforced by the political system. Governments intervene in the economy to improve their chances of re-election and/or to pursue ideological goals. Governments thereby create business cycles, instead of pursuing a socially optimal stabilization policy. Political actors are not seen as benevolent, but rather as self-interested individuals, as is generally assumed in economics for other individuals acting in the economy.

The PBC approach builds on systematic interactions between the economy and the polity. A wealth of empirical evidence shows that macroeconomic conditions have important influences on voter attitudes and on election outcomes (Nannestad and Paldam, 1994). 'Vote and popularity functions' link a government's popularity (measured by representative surveys) or election outcomes to the state of the economy, as reflected in the rate of unemployment, inflation or real income. In turn, governments have an incentive to influence these macroeconomic variables by using fiscal and monetary policy instruments ('policy functions').

PBC models can be grouped into four types, which differ along the lines of two main theoretical building blocks. The first block refers to the preferences of policymakers: the government's actions can be assumed to be driven either by electoral considerations ('vote maximizing' or 'opportunistic' models) or by ideological considerations ('partisan' models). The second building block refers to the real impact of government policy: the individuals in the economy can be assumed to have either adaptive or rational expectations.

Although there are some forerunners (Kalecki, 1943; Åkerman, 1947; Frey and Lau, 1968), research on PBCs started with the seminal paper by Nordhaus (1975) entitled 'The Political Business Cycle'. It is the best known of the vote-maximizing models, which assume that the government's goal is to muster the largest possible popular support at election time, subject to the constraints imposed by the economic system. Nordhaus derives a political business cycle for a vote-maximizing government confronted with an exploitable Phillips curve, that is, one based on inflationary expectations adjusting over time. This allows the government to manipulate the economy in such a way that unemployment and inflation are low before an election, while the negative consequences (a rise in inflation and unemployment) appear only after the citizens' vote.

Vote-maximizing models have been criticized on various grounds. First, rational voters can be expected to react to the regular occurrence of electoral cycles produced by the government. Rational expectation approaches to PBCs have captured some of this aspect. Rogoff and Siebert (1988) show that PBCs are possible even when voters have rational expectations, especially when (at least temporary) information asymmetries exist between government and voters. Second, empirical studies, which tested for system-

atic Nordhaus-type business fluctuations coinciding with election periods in the major industrial countries, have found at best mixed results (see Alesina *et al.*, 1997). Third, governments can be assumed not to be simply vote maximizers (just getting votes does not yield much utility), but to have other goals, in particular putting their ideological ideas into practice.

A second central type of approach, known as 'partisan models', addresses how business cycles are influenced by various types of government ideologies. Hibbs (1977) shows for 12 West European and North American countries that governments pursue macroeconomic policies broadly in accordance with the subjective preferences of their class-defined core political constituencies. 'Left-wing' administrations tend to drive down the unemployment rate, and 'right-wing' governments increase it, at the same time lowering inflation. While Hibbs's analysis is based on an adaptive expectations framework, Alesina (1987) and co-researchers have developed partisan models further, and have succeeded in integrating this variant of political economy fully into modern macroeconomics by basing it on rational expectations. In these models, partisan politics does not result in permanent effects on the economy, but only in transitory post-election effects on output and unemployment. These emerge because it is to some degree uncertain which party will win the election and, as a consequence, which partisan policy is implemented. Given sluggishness in wage adjustments, changes in the inflation rate associated with changes in government then create a temporary business cycle, until agents have fully adjusted. In a study of OECD economies, Alesina and Roubini (1992) find evidence for this type of business cycle: there are temporary partisan differences in output and employment and long-run partisan differences in the inflation rate, but virtually no permanent partisan differences in output and employment.

Vote-maximizing models, as well as partisan models, produce rather mechanistic cycles, usually regular upswings and downswings around election dates. Frey and Schneider (1978a, 1978b), following the earlier model by Frey and Lau (1968), integrate the two types of models and therewith arrive at a less mechanistic view of government behaviour: when the government is confident of winning the next election, there is no need to produce a PBC—it would only do so if it would otherwise win too few votes. These vote-cum-partisan models combine the features that governments pursue ideological goals (ideology is an argument in the politicians' utility function) and that governments need electoral victories in order to stay in power (re-election is taken as a constraint). The resulting cycles are no longer regular. Econometric estimates of such a model for various industrial countries have produced evidence for more complex PBC patterns than predicted by less integrative approaches.

The PBC approach has been extended in various ways. First, the central bank has been analysed as an important additional actor. One possibility for governments to produce a PBC is to influence monetary policy. Several studies have shown that even formally independent central banks, such as the German Bundesbank or the United States Federal Reserve, are influenced by the political process, and electoral considerations have played a significant role in their policy decisions (Frey and Schneider, 1981; Grier, 1987; Mayer, 1990). It remains an open question, however, whether this aspect of the PBC phenomenon is time-dependent; that is, that changes in central bank independence and policies during the 1990s have altered the picture. As in most democracies elections take place only every four years, data limitations leave this question to future research. Second, political systems beyond representative democracies have been analysed. Differences in institutional settings matter as they shape the government's possibilities to produce a PBC. Politico-economic cycles have been studied and identified for direct democracies (Schneider *et al.*, 1981), for East European communist countries (Lafay, 1981) and also for developing countries (Schuknecht, 1996).

The literature on PBCs has recently been surveyed in Paldam (1997). More theoretically oriented accounts are given in Drazen (2000, ch. 7), Persson and Tabellini (2000, ch. 16) and Gärtner (2000). The most influential papers in the field have been collected in Frey (1997).

BRUNO S. FREY
MATTHIAS BENZ

See also:

Adaptive Expectations; Central Bank Independence; Phillips Curve; Rational Expectations.

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