Political Competition and Macroeconomic Performance

ECO1028 – Politics Without Romance

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Outline

Do Governments Manipulate Budgets for Votes?

Before We Begin: A Diagnostic Question

Quick poll – imagine a government facing an election in 6 months:

- What do you expect to happen to the budget balance?
    - A) Deficit *increases*
    - B) Deficit *decreases*
    - C) No systematic change

Follow-up: If A, *how* do you think this happens?

- More spending?
- Lower taxes?
- Targeted projects?

Today's question: Are these patterns systematic or just political folklore?

The Central Puzzle

Two basic facts:

- Voters care about economic outcomes
- Politicians care about re-election

If voters reward "good" economic performance, politicians have incentives to *shape* those outcomes.

Public Choice perspective:

- Politicians are not benevolent planners
- They respond to incentives and constraints

Why Budgets Are Politically Powerful

Budgets are the main policy instrument governments control:

- Taxes
- Transfers
- Public investment
- Public sector wages

They are:

- Highly visible
- Easily targeted
- Adjustable within one fiscal year

So if manipulation exists, budgets are the natural place to look.

From Economic Voting to Political Incentives

Well-known empirical regularity:

- Incumbents perform better when the economy looks good

Implication:

- Governments have incentives to engineer favourable conditions
- Especially close to elections

This is the logic behind:

- Political business cycles
- Political budget cycles

Public Choice Microfoundation: Competition for Pivotal Voters

A simple electoral logic:

- Parties want office $\rightarrow$ they compete for votes.
- With single-peaked preferences, both parties target the median (pivotal) voter.
- Economic policy becomes an input into vote choice.

Implication for this lecture:

- If fiscal/monetary policy shifts perceptions of competence or wellbeing, incumbents have incentives to time policy to maximise votes.

Downs (1957); standard Public Choice logic.

Opportunistic vs Partisan Incentives

Two competing views of political cycles:

Opportunistic

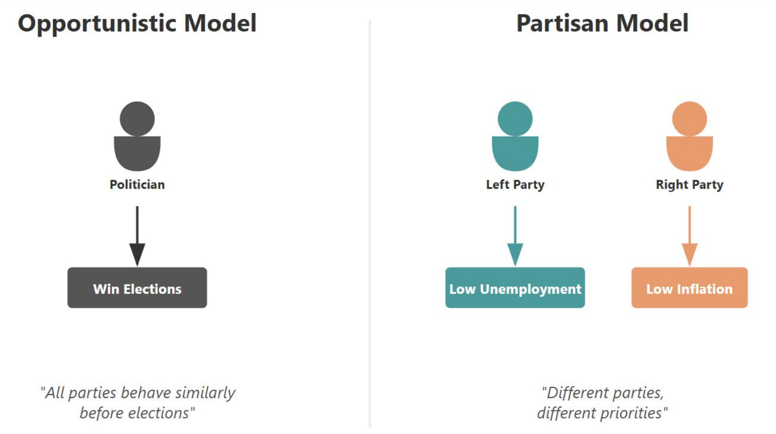
- All politicians want to win
- Act the same before elections
- Expand policy instruments

Partisan

- Parties represent different voters
- Left: low unemployment
- Right: low inflation

Mueller (Chapter 19): both mechanisms may coexist.

Opportunistic vs Partisan: Visual Summary



Today's focus: Opportunistic cycles, constrained by institutions.

What We Will Learn

By the end of this lecture, you should understand:

- Why early economists expected political cycles
- Why output cycles are hard to detect
- Why budget cycles are more robust
- How institutions constrain manipulation

Core readings:

- Shi & Svensson (2006): Political budget cycles: Do they differ across countries and why?
- Alesina & Summers (1993): Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence

Why Did Economists Expect Political Cycles?

The Original Political Business Cycle Story

Early intuition:

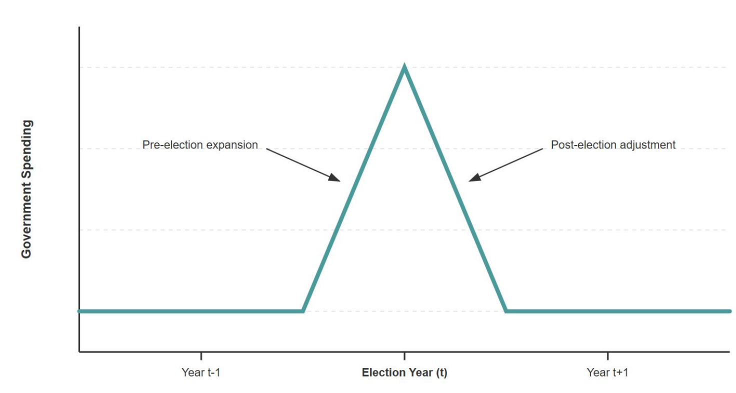
- Voters like low unemployment and high growth
- Politicians like re-election

So politicians try to "stimulate" the economy before elections, and accept the costs later.

Prediction:

- Pre-election expansion
- Post-election contraction

The Political Budget Cycle Pattern



Key insight: Budget deficits systematically increase before elections.

The Short-Run Logic (Phillips Curve Intuition)

Key assumption:

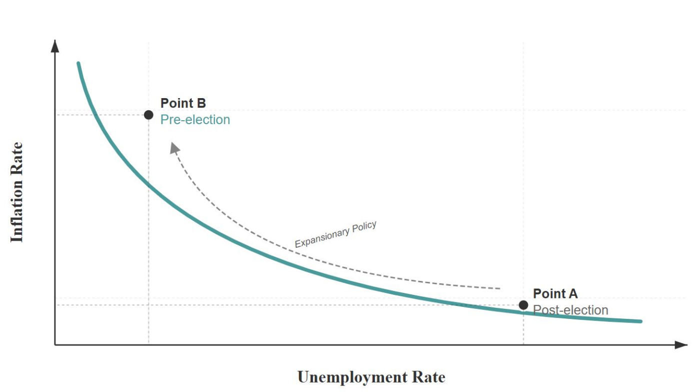
- In the short run, there is a trade-off between:
  - Unemployment
  - Inflation

If prices adjust slowly:

- Policy can reduce unemployment now
- Inflation rises later

This gives politicians a temptation before elections.

Phillips Curve Trade-Off: The Temptation



Politicians can temporarily move from A to B - but only if voters don't anticipate it.

Myopic Voters: The Simplest Case

Suppose voters are short-sighted:

- They focus on current unemployment and growth
- They heavily discount future inflation

Then:

- Incumbents can boost the economy before elections
- Voters reward them at the polls

This is the original political business cycle.

But Something Goes Wrong

Two problems:

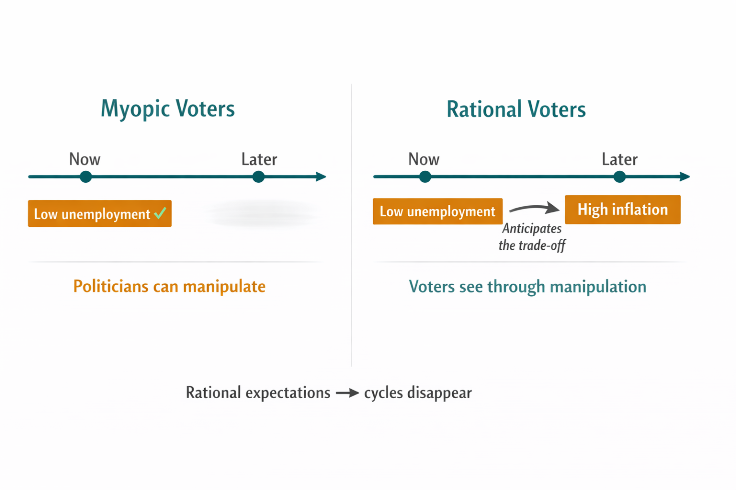
- People are not completely naive
- Expectations adjust

If voters anticipate manipulation:

- They demand higher wages
- They revise expectations

Short-run gains disappear.

Why Rational Expectations Defeat Manipulation



Key result: If voters anticipate the trade-off, output cycles disappear.

The Missing Link: Competence Signaling

If voters are rational, why does manipulation work?

- **Asymmetric information:** Voters cannot observe competence.
- **The signal:** High spending and growth *look* like ability.
- **The trick:** Taxes and inflation come *after* the election.

Result:

- Incumbents try to signal competence by expanding spending
- This creates future costs (debt, inflation, adjustment)
- Which voters may not fully internalise

So manipulation can survive under imperfect information.

Rogoff (1990); Shi & Svensson (2006); Caplan (2007)

Interpretation: electoral accountability with imperfect monitoring (principal–agent).

The Underlying Problem: Voters Can't Fully Monitor Politicians

Public Choice framing: a principal–agent problem

- **Principals:** voters want good policy.
- **Agents:** politicians want re-election (and sometimes rents).
- **Friction:** voters observe outcomes imperfectly and with a lag.

So manipulation can work when:

- policy is visible now (spending, tax cuts),
- costs are less visible or delayed (debt, inflation),
- information is limited (media/institutions are weak).

From Output Cycles to Budget Cycles

The empirical problem:

- Output and unemployment cycles around elections are weak (especially in advanced democracies)

So where is the manipulation?

Modern shift:

- Not "booms" and "busts"
- But deficits, spending, and targeted transfers

Why budgets? Politicians directly control them-they're visible and targetable.

Political Budget Cycles: Evidence

What Is a Political Budget Cycle?

Definition:

- A systematic increase in budget deficits around elections
- Followed by post-election fiscal tightening

Why focus on budgets?

Governments control:

- Public spending
- Taxes
- Transfers

They don't control:

- Growth
- Employment
- External shocks

So if manipulation exists, it should appear in budgets.

Shi & Svensson (2006): Research Design

The question: Do political budget cycles exist?

If yes:

- Are they larger in some countries?
- What explains the differences?

Dataset:

- Large panel of countries (democratic and non-democratic)
- Multiple election cycles
- Key outcome: Fiscal deficit as % of GDP

Identification Strategy

The problem:

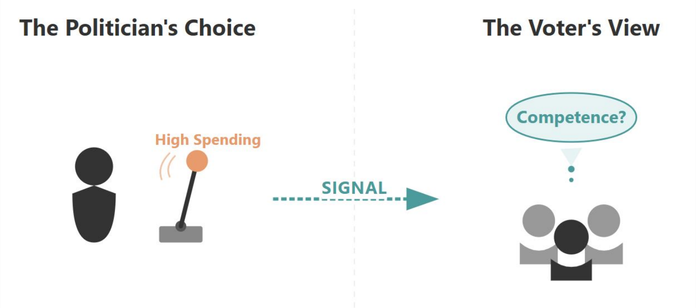
- Governments may call elections when the economy is already good
- We must separate manipulation from strategic election timing

The solution:

- Distinguish between:
  - **Predetermined** elections (fixed dates)
  - **Endogenous** elections (PM chooses timing)

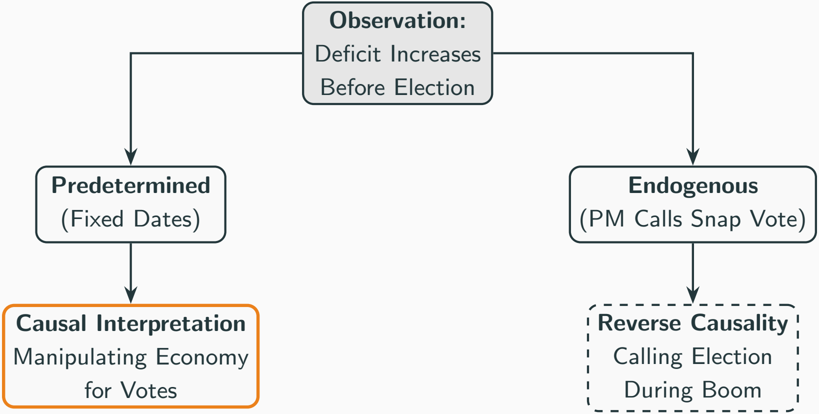
Logic: If cycles appear even with predetermined elections, they're less likely driven by timing alone.

Competence Signaling: The Mechanism



Modern insight: Politicians use spending as a signal of competence when voters have imperfect information (Rogoff 1990; Shi & Svensson 2006).

Identification: Predetermined vs Endogenous Elections



*Fixed timing rules
out reverse causality

Shi & Svensson Strategy

Main Findings

Headline result:

- Government deficits rise in election years
- By almost 1% of GDP on average

Key heterogeneity:

- Political budget cycles are much larger in developing countries

Question: Why the difference?

The Institutional Explanation

Two core mechanisms:

1. **Political rents**
2. **Share of informed voters**

Institutions determine how easy manipulation is.

Measuring the Mechanism

How do Shi & Svensson measure institutions?

- **Information:**
  - Radios per capita
  - Freedom of broadcasting
- **Rents:**
  - Corruption indices
  - Protection against expropriation

Finding:

- High info + Low rents $\rightarrow$ No cycle
- Low info + High rents $\rightarrow$ Large cycle

Two Mechanisms Behind Heterogeneity

1. **Political Rents**
   - Private benefits politicians get from staying in office
   - If rents are high $\rightarrow$ politicians distort policy more

2. **Voter Information**
   - If many voters are informed $\rightarrow$ they see through manipulation
   - If many voters are uninformed $\rightarrow$ manipulation succeeds

Result: High rents + Low information = Large cycles

Public Choice Interpretation

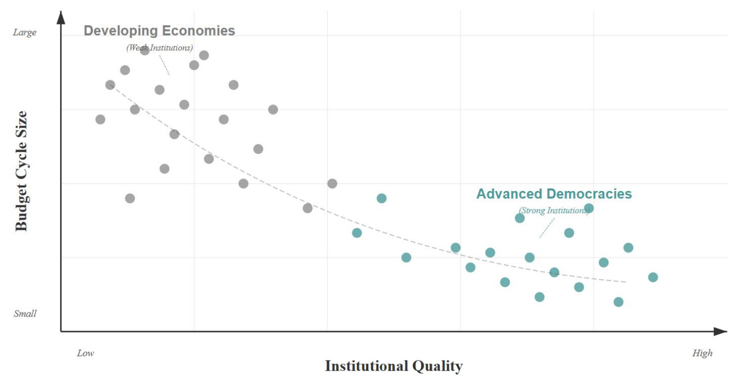
What this means:

- Political competition alone does not prevent manipulation
- Institutions determine the size of the problem

Core message:

- Politicians respond to incentives
- Voters respond to information
- Institutions shape both

Institutional Quality and Budget Cycle Size



Empirical finding: Budget cycles are larger in countries with weaker institutions (Shi & Svensson 2006; Brender & Drazen 2005).

Time Inconsistency and Inflation Bias

The Time Inconsistency Problem

Politicians may also try to influence monetary policy:

The temptation:

- Government promises low inflation
- After wages and contracts are set, it has an incentive to create surprise inflation

But rational agents anticipate this.

Inflation Bias and the Commitment Problem

If people expect manipulation:

- They demand higher wages
- Firms raise prices

Result:

- No long-run gain in output or employment
- Permanently higher inflation

This is the inflation bias.

Why promises don't work:

- Governments cannot credibly commit
- Future incentives differ from current promises

Institutional Solution: Central Bank Independence

If politicians cannot commit, they can delegate to an independent authority.

An independent central bank:

- Sets monetary policy without political pressure
- Has long, protected terms for governors
- Is legally insulated from the government

This motivates central bank independence (CBI).

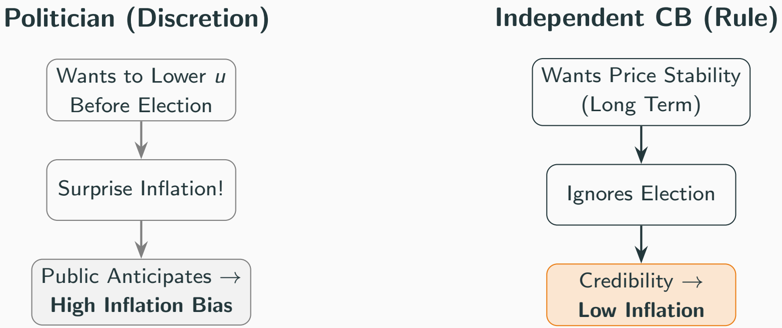
What Makes a Central Bank Independent?

CBI is measured by legal rules:

1. **Appointments:**
    - Who appoints the governor?
    - Are terms longer than electoral cycles?
2. **Budgetary freedom:**
    - Can the government force the CB to buy its debt?
3. **Mission:**
    - Is price stability the primary legal objective?

Grilli, Masciandaro & Tabellini (1991); Alesina & Summers (1993)

Delegation as a Commitment Device



Key lesson: Delegation to independent institutions solves time-inconsistency (Rogoff 1985; Alesina & Summers 1993).

Alesina & Summers (1993): Research Design

The question:

- Do independent central banks reduce inflation?
- Without harming growth or employment?

Approach:

- Cross-country comparison
- Measures of legal central bank independence
- Inflation, growth, unemployment outcomes

Main Findings: CBI Works

Inflation:

- Countries with more independent central banks
- Have significantly lower inflation

Real outcomes:

- No systematic evidence of:
    - Lower growth
    - Higher unemployment

Price stability appears to come without a real cost.

Why CBI Works: Parallel with Budget Cycles

CBI works because:

- It removes short-run political incentives
- It creates credibility
- Expectations adjust accordingly

Common structure:

- Politicians face short-run temptations
- Society faces long-run costs
- Institutions reduce the scope for manipulation

Fiscal Policy Cycles and Composition

Beyond Deficits: How Is Fiscal Policy Manipulated?

So far: election years $\rightarrow$ higher deficits.

But deficits are aggregates.

Which components of spending and taxation actually move?

Schuknecht (2000): Why Focus on Spending Composition?

Why developing countries?

- Weaker institutions
- Smaller tax base
- Greater scope for political discretion

What can politicians easily manipulate?

Taxes:

- Slow to change
- Administratively complex

Spending:

- Faster to adjust
- More visible
- Easier to target

So spending is the main vehicle for cycles.

Schuknecht (2000): What He Tests

Main hypotheses:

- Expenditure rises in election years
- Especially public investment
- Taxes respond less

Key Findings: Composition Effects

Election-year effects:

- Strong increases in public spending
- Weaker evidence on taxes
- Investment spending is particularly cyclical

Why composition matters:

- Shifting toward infrastructure, wages, local projects
- Creates short-run electoral gains
- But potential long-run fiscal costs

Targeted, visible projects are politically attractive.

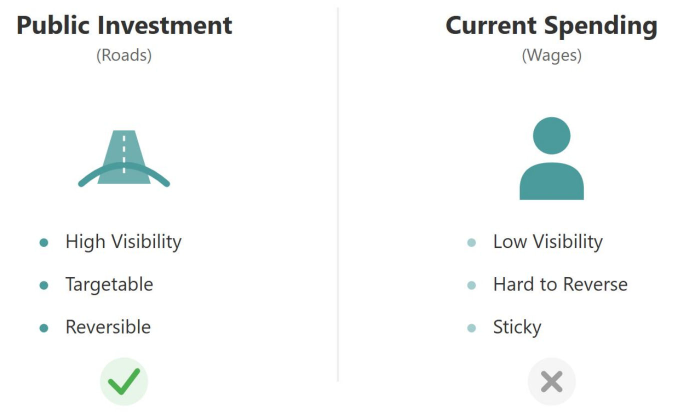
Why Public Investment Is Politically Attractive

Why roads, not nurses?

- **Visibility:** Roads are seen immediately.
- **Targetability:** Built in swing districts.
- **Reversibility:** Easy to stop after elections.
- **Wages are sticky:** Hard to cut later.

So politicians shift composition, not just levels.

Composition of Spending: Visual Summary



Composition matters: Cycles show up more in visible, reversible capital spending than in sticky current expenditures (Rogoff 1990).

Institutions, Incentives, and Performance

Commitment Problems and Institutional Solutions

Two parallel problems:

Fiscal policy

- Election-year deficits
- Spending manipulation

Monetary policy

- Inflation bias
- Surprise inflation

Same structure: short-run gains vs long-run costs.

Institutional solutions:

- Central bank independence
- Fiscal rules, budget transparency
- Independent fiscal councils

Evolution of the Political Cycles Literature

When are cycles largest?

- Weak institutions
- High political rents
- Low voter information

Old vs Modern View:

Old PBC	**Modern PBC**
Output cycles	Budget cycles
Myopic voters	Information frictions
Inflation surprises	Deficits and spending
Macro trade-offs	Institutional constraints

Key Takeaways

- Politicians face strong electoral incentives
- Manipulation shows up in budgets, not output
- Institutions constrain the size of cycles
- Credibility solves commitment problems

Discussion Questions

- Would you trust politicians to self-restrain?
- Are fiscal rules democratic or technocratic?
- Should monetary policy be insulated from voters?

Next Steps

Before next class:

- Read the required papers
- Think about Irish budget cycles

Questions?

Open discussion!

Irish Context: Budgets and Elections

Do Political Budget Cycles Exist in Ireland?

Ireland is a hard case:

- Strong Department of Finance
- EU fiscal rules
- Independent Central Bank (ECB)
- High media scrutiny

Prediction from Shi & Svensson: Budget cycles should be *smaller* than in weaker institutional settings.

Irish Election Timing and Budget Signals

General Elections: 2007, 2011, 2016, 2020, 2024

Budgets typically announced: October each year

Illustrative pre-election budgets:

- **2007**: tax cuts and spending increases before the crash
- **2016**: income tax reductions, public sector pay restoration
- **2020**: housing supports, welfare increases
- **2024**: cost-of-living packages ahead of election

Not proof of cycles - but consistent with the incentives.

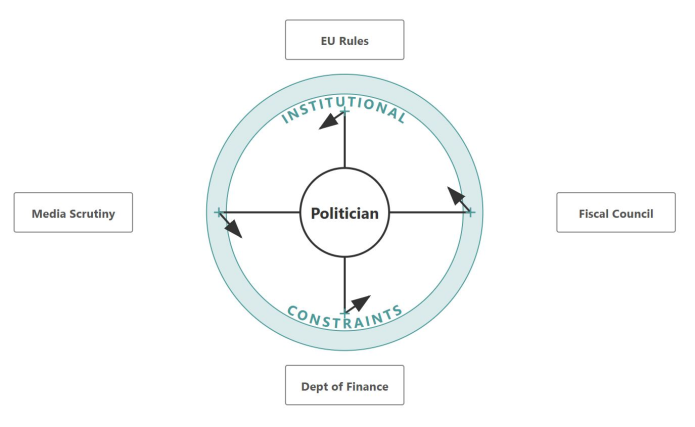
Irish Institutions as Constraints

Why large cycles may be limited:

- EU Stability and Growth Pact
- Fiscal Advisory Council (IFAC)
- Rainy Day Fund
- Parliamentary Budget Office

These play the same role as CBI in monetary policy.

Irish Institutional Constraints: A Visual Summary



Ireland's strong institutional framework limits political discretion over budgets.

A Testable Student Question

Mini research idea:

- Compare budget balances in:
    - Election years
    - Non-election years
- Control for GDP growth

Would you expect a difference? Why or why not?

Irish Takeaway

Ireland fits the modern view:

- Political incentives are real
- Institutions limit how far manipulation can go
- Cycles may appear in composition rather than deficits

Further Reading

Foundational Political Business Cycle Models

1. Nordhaus, W. (1975). "The Political Business Cycle." *Review of Economic Studies*, 42(2), 169–190.
2. Hibbs, D. (1977). "Political Parties and Macroeconomic Policy." *American Political Science Review*, 71(4), 1467–1487.
3. Rogoff, K. (1990). "Equilibrium Political Budget Cycles." *American Economic Review*, 80(1), 21–36.
4. Persson, T., & Tabellini, G. (1990). *Macroeconomic Policy, Credibility and Politics*. Harwood.

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1. Shi, M., & Svensson, J. (2006). "Political Budget Cycles: Do They Differ Across Countries and Why?" *Journal of Public Economics*.
2. Brender, A., & Drazen, A. (2005). "Political Budget Cycles in New Versus Established Democracies." *Journal of Monetary Economics*.
3. Brender, A., & Drazen, A. (2008). "How Do Budget Deficits and Economic Growth Affect Reelection Prospects?" *American Economic Review*.
4. Alt, J., & Lassen, D. (2006). "Fiscal Transparency, Political Parties, and Debt in OECD Countries." *European Economic Review*.

Fiscal Institutions and Rules

1. Alesina, A., & Perotti, R. (1995). "The Political Economy of Budget Deficits." *IMF Staff Papers*.
2. Debrun, X., et al. (2013). "The Functions and Impact of Fiscal Councils." *IMF Working Paper*.
3. Kopits, G., & Symansky, S. (1998). "Fiscal Policy Rules." *IMF Occasional Paper*.

Central Bank Independence and Commitment

1. Kydland, F., & Prescott, E. (1977). "Rules Rather Than Discretion." *JPE*.
2. Barro, R., & Gordon, D. (1983). "A Positive Theory of Monetary Policy." *JPE*.
3. Rogoff, K. (1985). "The Optimal Degree of Commitment." *QJE*.
4. Alesina, A., & Summers, L. (1993). "Central Bank Independence and Macroeconomic Performance." *JMCB*.

Comparative Political Economy

1. Persson, T., & Tabellini, G. (2003). *The Economic Effects of Constitutions*.
2. Besley, T., & Case, A. (1995). "Does Electoral Accountability Affect Economic Policy Choices?" *QJE*.
3. Besley, T., & Persson, T. (2011). *Pillars of Prosperity*.

Cultural Resources

Films & Documentaries

Elections, Strategy, and Power:

- **The War Room** (1993) – Clinton campaign and economic messaging
- **Inside Job** (2010) – political economy of financial crisis
- **Margin Call** (2011) – incentives inside financial institutions
- **The Big Short** (2015) – regulatory failure and incentives

TV Series

Politics and Institutions:

- **Borgen** – fiscal trade-offs in coalition government
- **The West Wing** – polling, budgets, credibility
- **Yes Minister** – bureaucracy vs politicians

Books for General Audience

- Tim Harford – *The Undercover Economist*
- Daron Acemoglu & James Robinson – *Why Nations Fail*
- Diane Coyle – *GDP: A Brief but Affectionate History*

Podcasts & Media i

Political Economy:

- **EconTalk** – episodes on central banking and political incentives
- **The Ezra Klein Show** – macro politics and institutions
- **Planet Money** – elections and budgets

Podcasts & Media ii

Data Journalism:

- **FiveThirtyEight**
- **FT Alphaville**
- **Our World in Data**

Final Thought

"Good institutions don't remove incentives - they redirect them."

Political competition does not disappear in democracies. It shows up where constraints are weakest.