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

Key Concepts: Political Budget Cycle

Definition

Political Budget Cycle (PBC): Systematic manipulation of fiscal variables (spending, taxes, deficits) timed around elections to boost electoral support.

Related concept:

- **Political Business Cycle:** Manipulation of macroeconomic outcomes (unemployment, growth) for electoral gain

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

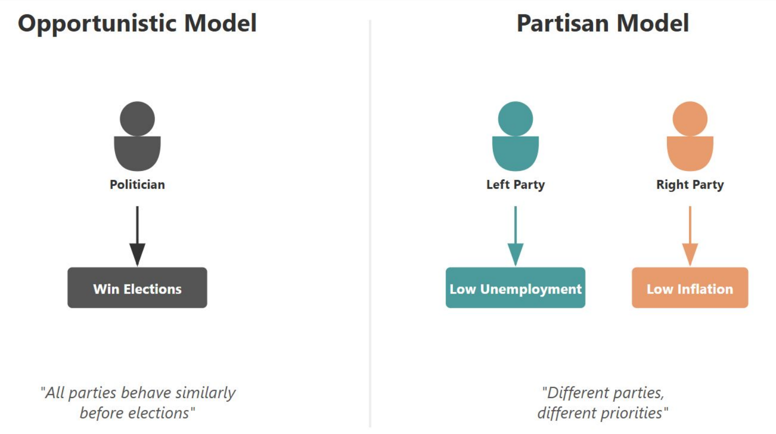
- All politicians want to win
- Act the same before elections
- Expand policy instruments

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:

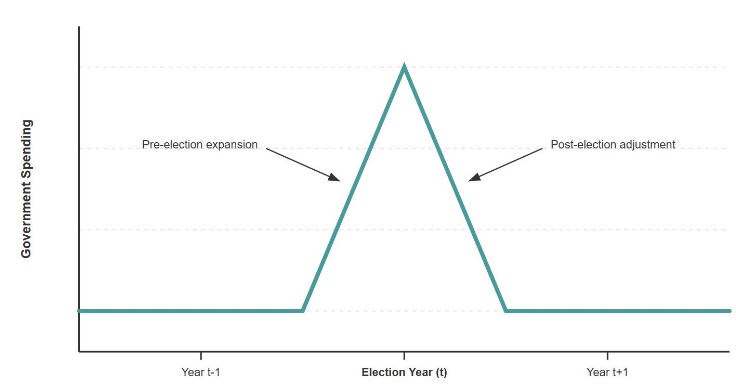
- Voters like low unemployment and high growth
- Politicians like re-election

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)

Definition

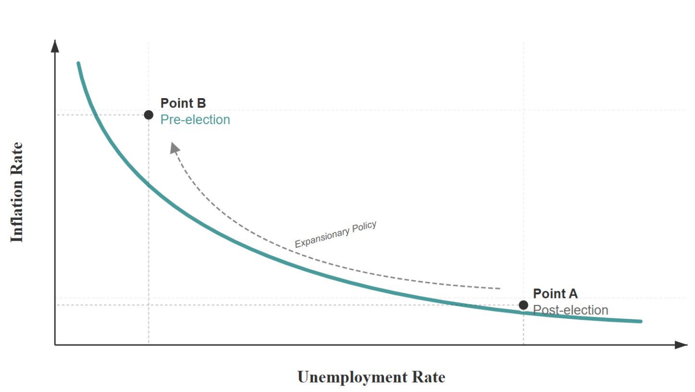
Phillips Curve: Short-run trade-off between unemployment and inflation. Lower unemployment $\rightarrow$ higher inflation (and vice versa).

Political application:

- Governments can temporarily reduce unemployment by accepting higher inflation
- Costs (inflation) come later; benefits (jobs, growth) appear first

This creates an incentive to stimulate 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:

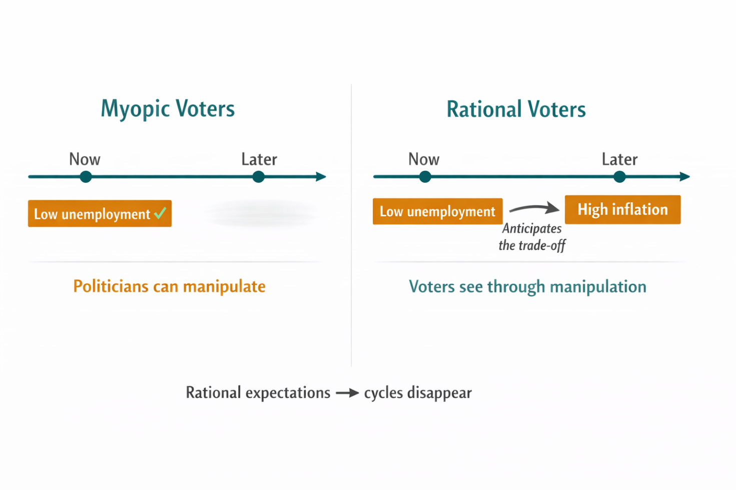
- People are not completely naive
- Expectations adjust

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:

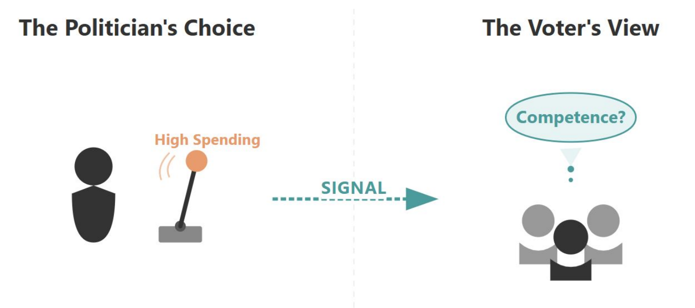
- Governments may call elections when the economy is already good
- We must separate manipulation from strategic election timing

The solution:

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

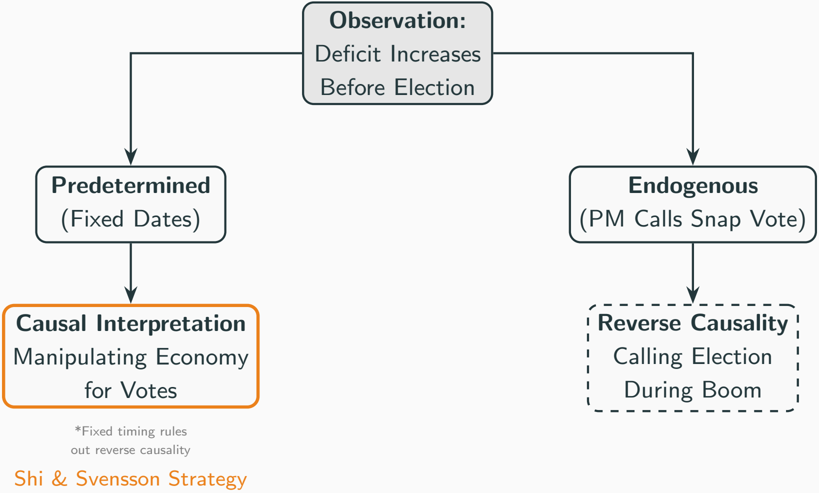
Logic: If cycles appear even with predetermined elections, they're less likely driven by timing alone.

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



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 → No cycle
- Low info + High rents → 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

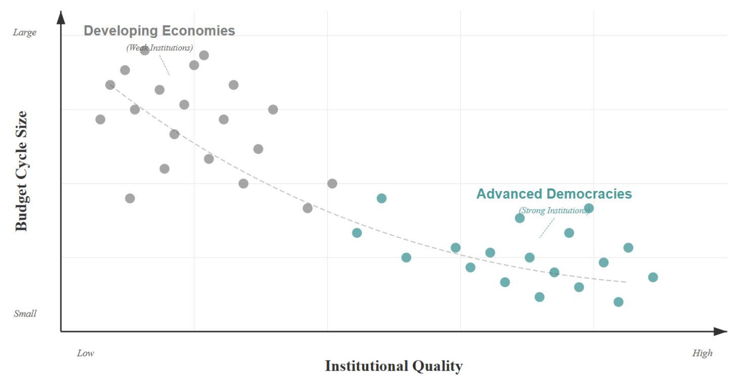
What this means:

- 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

Key Concepts: Time Inconsistency

Definition

Time Inconsistency: A situation where a policy that is optimal to announce ex-ante becomes suboptimal to implement ex-post.

In monetary policy:

- *Ex ante:* Central bank promises low inflation
- *Ex post:* Central bank has incentive to inflate (reduce unemployment)
- Result: Nobody believes the promise $\rightarrow$ high inflation, no gain

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).

Why Central Bank Independence?

Definition

Central Bank Independence (CBI): Legal and operational autonomy of monetary authorities from political control, particularly over interest rate decisions.

The logic:

- Politicians face re-election pressures
- They prefer short-term growth over price stability
- Independent central bank can commit credibly to low inflation

CBI solves the time inconsistency problem.

What Makes a Central Bank Independent?

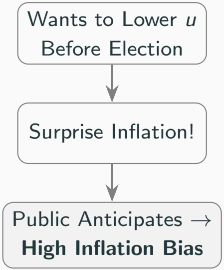
CBI is measured by legal rules:

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

Politician (Discretion) **Independent CB (Rule)**



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 → higher deficits.

But deficits are aggregates.

Which components of spending and taxation actually move?

Key Concept: Fiscal Policy Cycles

Definition

Fiscal Policy Cycles: Systematic changes in the composition and timing of government spending and taxation around elections.

Relationship to other concepts:

- **Political Business Cycles:** Focus on macro outcomes (GDP, unemployment)
- **Political Budget Cycles:** Focus on deficits
- **Fiscal Policy Cycles:** Focus on spending/tax composition

All three reflect the same incentive: manipulating policy for votes.

Nordhaus (1975): The Foundational Model

William Nordhaus (1975) proposed the first formal model of political business cycles.

His key insight: Politicians exploit the Phillips curve trade-off between unemployment and inflation. Before elections, they stimulate the economy through expansionary monetary or fiscal policy, creating jobs and growth that boost their popularity. After winning re-election, they accept the inevitable costs - higher inflation - and contract the economy again.

The original model assumed voters have adaptive expectations - they don't fully anticipate the manipulation. However, later work by Rogoff (1990) showed that cycles can persist even with rational voters, if there's asymmetric information about government competence.

Nordhaus gave us the "opportunistic politician" model that Schuknecht tests empirically in developing countries.

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

Schuknecht (2000): Empirical Results

Sample: 24 developing countries, 1973–1992

Key findings:

- Fiscal deficit increases by 0.7% of GDP in election years
- Two-thirds of this is from spending increases
- Only one-third from lower revenue

Statistical significance:

- Capital expenditure: Significant at 5% level
- Current expenditure: Marginally significant (10%)
- Revenue: Not statistically significant

Bottom line: Public investment is the main electoral tool.

Why Politicians Prefer Public Investment

What makes capital spending politically attractive?

- **Visibility:** Infrastructure projects are highly visible
- **Targetability:** Can direct to swing districts
- **Reversibility:** Easy to stop after election

The political calculus:

- Short-run electoral gains (jobs, contracts)
- Long-run fiscal costs (maintenance, debt)
- But those costs come after the election

Time-inconsistency in fiscal policy, not just monetary!

Schuknecht (2000): Institutional Constraints

What limits political budget cycles?

- IMF-supported programs reduce expenditure growth
- Trade-oriented economies face more constraints
- Countries with fixed exchange rates have different patterns

Policy implication:

- Weak fiscal institutions facilitate cycles
- Strengthening budget rules can reduce volatility
- Similar to CBI for monetary policy

Institutions matter for constraining opportunistic behavior.

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.

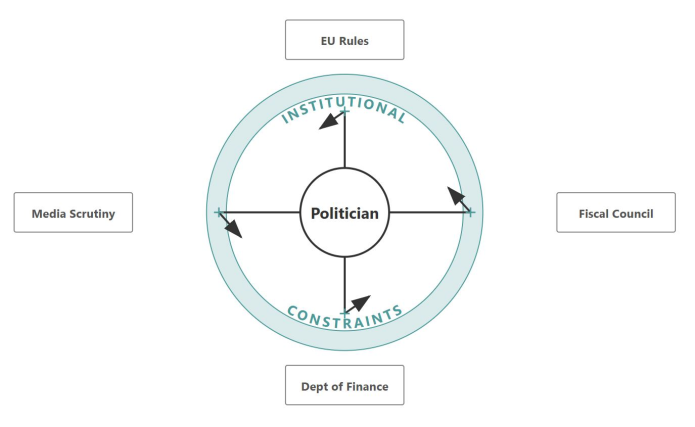
Irish Institutions as Constraints

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

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2. Tufte, E. (1978). *Political Control of the Economy*. Princeton University Press.
3. Hibbs, D. (1977). "Political Parties and Macroeconomic Policy." *American Political Science Review*, 71(4), 1467–1487.
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2. Schuknecht, L. (2000). "Fiscal Policy Cycles and Public Expenditure in Developing Countries." *Public Choice*, 102, 115–130.
3. Brender, A., & Drazen, A. (2005). "Political Budget Cycles in New Versus Established Democracies." *Journal of Monetary Economics*.
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5. Alt, J., & Lassen, D. (2006). "Fiscal Transparency, Political Parties, and Debt in OECD Countries." *European Economic Review*.

Fiscal Institutions and Rules

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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*.

Central Bank Independence: Recent Advances

New Measurement Tools:

1. Adrian, T., Khan, A., & Menand, L. (2024). "A New Measure of Central Bank Independence." *IMF Working Paper* No. 2024/035.
2. Romelli, D. (2022). "The Political Economy of Reforms in Central Bank Design: Evidence from a New Dataset." *Economic Policy*, 37(112), 641–688.
3. Romelli, D. (2024). "Trends in Central Bank Independence: A De-Jure Perspective." BAFFI CAREFIN Centre Research Paper.
4. Garriga, A.C. (2025). "Revisiting Central Bank Independence in the World: An Extended Dataset." *International Studies Quarterly*, 69(2). *Database.*
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Central Bank Independence: Contemporary Issues

Recent Research:

1. Garriga, A.C., & Rodriguez, C.M. (2020, 2023). "Central Bank Independence and Inflation." Various papers on distributional effects.
2. Bodea, C., & Hicks, R. (2015). "Price Stability and Central Bank Independence: Discipline, Credibility, and Democratic Institutions." *International Organization*, 69(1), 35–61.

Policy Perspectives:

- IMF (2024). "Strengthen Central Bank Independence to Protect the World Economy." IMF Blog (March 21).
- White House CEA (2024). "The Importance of Central Bank Independence." (May 22).

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

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.