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The new theory and empirics of political business cycles

The lack of fiscal policy discipline and the ways to achieve it are issues that have been in the focus of political and economic debates throughout the European Union, especially in Hungary. Inefficient fiscal policy practices are present in a significant number of EU countries and contrary to other areas of the economy, the way they are handled is far from being relieving. In the past decades, several elements of the economic policy have been removed from direct governmental control, one example being monetary policy. Albeit there is growing demand for linking discretional fiscal policy to certain rules or institutional forms in order to keep governments away from permanent deficit financing and excessive indebtedness, there is no agreement at all on the specific solutions to apply. It is so even though not only economic theory but real life experiences have shown by now that budget stabilization is an indispensable prerequisite of sustainable economic growth.[1]

The phenomenon of cyclical changes in certain aggregates of the economy before and after elections (i.e. political business cycles) has been on the mind of economists for decades. Several highly influential studies addressed the lack of fiscal discipline, starting from the now classic opportunistic *(traditional)* model published by *Nordhaus* in 1975, through *Rogoff's theory of budget cycles* published in the nineties to one of the most significant studies released last year (Drazen, Shi and Svensson, etc.).

Although economists researching into this topic typically emphasize different factors in their analyses, they all seek the answer to the following question: Is there convincing evidence that economic deflections are caused by policy makers? In other words: Is it correct to assume that reigning political powers (governments formed after democratic elections) manipulate the macroeconomic position of their country directly before elections in order to improve their chances for reelection? It also calls for clarification whether politicians employ specific monetary or fiscal policy tools to execute such manipulation.

Empirical studies pointed out that from a fiscal policy standpoint, there are "better behaving" and "underperforming" countries. Therefore, it is justified to pose the following question: How come that there is no detectable political cycle in certain countries while in some others the manipulation of budget policy appears to be a constant phenomenon? Could there be a trait that is characteristic to specific countries or voters living there which could show which countries are more inclined to pursue political manipulation?

During the 32-year history of the theory of political business cycles, the majority of these

questions have been answered successfully. These answers rest on a solid theoretical basis and have been confirmed by empirical test results. One of the key objectives of our article is to prove that albeit with the Nordhaus study, research into political business cycles took a rather different direction in 1975 compared to current research trends, there is still a proven continuity with present day research efforts.[2]

THE TRADITIONAL OPPORTUNISTIC MODEL OF NORDHAUS

The original model of political business cycles was developed by Nordhaus who believed that rational government politicians employ monetary policy tools before general elections in an attempt to manipulate real economic performance and thereby improve their chances of reelection. After the elections, however, the same government will have to follow a restrictive policy to stabilize the economy. Thus the endeavor to maximize votes results in policy-induced cycles. To successfully manipulate the real variables of the economy, however, any government has to rely on certain simplifying assumptions.

The conditions of the model[3]

CONDITION 1: The basis of the model is the short-term *Phillips Curve.* We assume there is a *trade-off* between inflation and unemployment on the short run and that voters are sensitive to changes of these indicators but only to that. This way, economic performance can be described with the Phillips Curve as corrected with expectations, i.e.:

$$y_t = \hat{y} + \alpha(\pi_t - \pi_t^e) \qquad 1.1$$

where

- y_t represents GDP growth,
- $\hat{y}$ is the natural growth rate of GDP, i.e. that at full employment,
- π_t stands for inflation over a t period,
- π_t^e stands for anticipated inflation over a t period, and
- α is a positive (estimated) coefficient.

This way, at specific levels of $\hat{y}$ and π_t^e, economic policymakers can raise the value of y_t by manipulating π_t.

CONDITION 2: Voters shape their inflationary expectations in an adaptive manner, i.e. retrospectively. Consequently, the inflationary expectations for a t period are mainly determined by the inflation rate of the (t-1) period:

$$\pi^e = \pi_{(t-1)} + \lambda(\pi^e{}_{(t-1)} - \pi_{(t-1)}) \qquad 1.2$$

where

$0 < \lambda < 1$, and the formula in brackets represents former estimation errors. Thus if λ is low enough, inflationary expectations are always identical to the inflation rate observed in the previous period. Concluding from equation 1.1 and 1.2:

$$y_t = \hat{y} + \lambda\,[\pi_t - (1-\lambda)\sum_{i=0}^{\infty} \lambda^i\, \pi_{(t-1-i)}] \qquad 1.3$$

Thus if an economic policymaker chooses the right value for π_t, he can achieve a higher growth rate by manipulating the inflation rate than without doing so – and voters appreciate it.

CONDITION 3: Another condition in the model is that the governing economic policymaker and his challenger are homogeneous and their only goal is to maximize the likelihood of being reelected, i.e. the utility for voters (voters should also be considered homogeneous). If the preference function is known, the economic policymaker's aggregate voting function is as follows:

$$\Sigma V_t = \sum_{i=0}^{t} \beta^i g(y_t, \pi_t) \qquad 1.4$$

where
$0<\beta<1$ is the discount factor of the economic policymaker.

As we can see, equation 1.4 is clearly dependent upon equation 1.3 above which determines the rate of economic growth. Put differently: the goal of the economic policymaker is to find a π^* that maximizes equation 1.4 by y_t and thereby renders him the highest achievable chance of reelection.

The model is built on several further assumptions in addition to those mentioned already.

CONDITION 4: Voters are "short-sighted", i.e. the future is much less precious for them than the present. When casting their ballots, voters they base their decision on current macroeconomic data, giving preference to high growth and low unemployment. Due to their short-sightedness (or myopia), voters have an extremely high discount rate.[4]

CONDITION 5: The discretional steps of a politician have an immediate impact on aggregate demand; real macroeconomic variables can be manipulated.[5]

CONDITION 6: The timing of elections is an exogenous factor in the model.[6]

Criticism of the model

Many of the numerous assumptions which the Nordhaus model is based on seem unlikely. First, voters are not thinking rationally when shaping their inflationary expectations and forming an opinion on the governing politician's "performance". If a politician in Nordhaus' model successfully manipulates the GDP growth rate before every election, he can stay in power on each occasion (despite the unfavorable consequences of manipulation), although rational voters would catch such politician in the act.

Another unrealistic assumption is that a politician is able to control monetary policy directly. The independence of the central bank is now a general requirement in every democracy. What especially devaluates the probability of the model is the widely accepted conviction that the independence of central banks is a key prerequisite of keeping inflation efficiently under control.[7]

Nordhaus (1975) published his study with the natural conviction that "all areas of the economy are influenced by government politics. Each decision is a choice between present and future welfare." (page 169) But he did not know, for he could not know the theory which is perhaps more famous now than the Nordhaus model: the Lucas criticism. While Lucas does not deny that government politics affect each segment of the economy, he is rather skeptical about the consequences. While Nordhaus, in accordance with conventional macroeconomic thinking that prevailed in the '50s and '60s, regarded the hypothesis of the Phillips Curve proved and thought that voters think rationally, *Lucas* (and modern macroeconomics that rely on rational expectations) sharply confronted these simplifying assumptions. Although the denial (or at least partial rejection) of the Phillips Curve significantly set back the research of traditional opportunistic political business cycles, it did not hinder authors in their attempts to explain differences in economic performance (between both different periods and different countries) along other model specifications.

MOVING ON FROM MONETARY CYCLES TO FISCAL CYCLES

Empirical examinations demonstrated little success in confirming the theory of political business cycles implemented with monetary means. The examinations by *McCallum* (1978),

Alt – Chrystal (1983), *Hibbs* (1987) and *Lewis – Beck* (1988) could not prove convincingly the correctness of the 1975 Nordhaus model. Testing a subsequent version[8] of the traditional model completed with rational expectations, *Faust – Irons* (1999) looked at the USA while *Alesina – Roubini* (1992) and *Alesina et al.* (1992 and 1997) examined OECD countries. Each effort yielded doubtful results concerning the reality of the model.

As analyses until the time had only limited success in confirming the theory of monetary cycles, the direction of research turned towards *fiscal policy-induced cycles* in the '80s. As independent central banks emerged one after the other, it was no longer realistic to assume that the holders of political power could use monetary policy tools to achieve their own short-term objectives. The reasoning behind the new direction of research was that politicians now use fiscal policy (which is still under their direct control) to manipulate the economy in a way that fosters their reelection chances.

The pioneer of probably the most popular area of new political economic research was Rogoff who set a direction for the unfolding new theories of budgetary cycles with his 1987 study. One possible definition of budgetary cycles could go as follows: A regularly returning, temporary fluctuation of fiscal policy induced by elections. Its impact is especially apparent in the size of budget deficit and/or government debt and in the structure of public revenues and expenditures.

Assuming perfectly informed and rationally thinking voters, no government manipulation could be successful, as it would be impossible to systematically deceit voters. Under such circumstances, election-induced fiscal cycles could not exist either. The theory of politically motivated fiscal cycles, however, challenges the assumption of perfectly informed voters, stating that voters suffer from being asymmetrically informed and not from myopia (as in the Nordhaus model). Similarly to other negative selection models, in this scenario one party, namely the governing powers have an informational edge over voters. The subject of informational asymmetry is the proficiency or competence of politicians.

In the model of Rogoff and *Sibert* (1988), voters and politicians alike are rational and utility maximizing individuals. Voters cast their ballots on the nominee who appears to be more competent than his opponent. Competence in the model is defined as the ability to implement more governmental investments at a given level of taxes and governmental consumption. If the competent candidate wins, the reduction of taxes and/or the increase of governmental consumption can be implemented at a lower marginal cost. However, as the competence of both the government's economic policymaker and his challenger is unknown, voters take taxes and governmental consumption as a basis for developing estimates on politicians' competence and vote accordingly.

As voters are unable to differentiate between competence and election-induced manipulation, they would perceive the growth of deficit as a sign of governmental competence. It is in the vital interest of a competent politician to accumulate a deficit because that is the only way for him to demonstrate high competence. Therefore, the cycle boosted by fiscal policy before elections is simply a socially efficient mechanism for diffusing information about who is a competent leader (Rogoff, 1990, page 22).

In summary: In this model, equilibrium is created by the mere existence of the fiscal cycle itself, as the cycle convinces voters that the economic policymaker is competent (which of course also matches the policymaker's intention). The reason is that a positive relation exists in the model between competence and the inclination to manipulate: For a less competent nominee, it is suboptimal to generate an

election cycle, while for the competent candidate it is the optimal way of demonstrating his competence.[9]

Most criticism against Rogoff's negative selection model relied on the argument that the real level of competence cannot be tested [see in particular the criticism by Shi and Svensson (2002a)]. Therefore, the newest, third generation theories of political business (or fiscal) cycles assume that not only voters have little knowledge about the competence of economic policymakers, *so do the politicians themselves.* What it actually means is that even politicians have no idea how efficiently they would be able to handle problems and how effectively they would be able to spend public revenues and create common goods. Naturally, rational voters prefer more common goods (at the same price) to fewer goods, in other words, they would vote fore a more productive, i.e. more competent politician. But even then, they can only take the current performance of the politician to draw conclusions on his competence.

The basic dilemma outlined in third generation budget cycle models, however, is still the same here: Voters are not able to tell which of the following two factors play a key role in the production of common goods:

- the competence of politicians, or rather
- the budget deficit (excess spending).

Naturally, a politician in power is aware of all this, therefore he intentionally decides on deficit financing in order to present himself to voters as a more competent person, even if he himself does not have a clear idea about his abilities. Thus the political fiscal cycle model which is based on *moral risk* assumes that a politician is able to implement fiscal policy while keeping its impact hidden from voters until the elections.

Of course, fiscal overspending and its consequences cannot remain disguised forever, they surface after the elections. What is more, witnessing the repetition of symptoms, voters will sooner or later realize that moral risk has become institutionalized and that rational politicians use manipulation to foster their reelection chances. But: As neither the voters nor politicians have ex ante knowledge of the candidate's competence level, politicians are *forced* to manipulate fiscal performance according to third generation models. Therefore, assuming equilibrium, politicians would routinely overspend before elections. This budget cycle would emerge upon each and every election under an economic equilibrium, regardless of the competence level of the politician in power[10] (cf. Persson-Tabellini, 2003).

Similarly to the Nordhaus model, the significance of rational opportunistic models lies in the fact among others that they provide a theoretical framework for an already existing hypothesis, i.e. that the holder of political power makes efforts to manipulate the economy with fiscal measures in order to improve his chances of reelection. One may have a suspicion, however, that if we assume homogeneous economic policymakers in the models, the cyclicality of fiscal variables should be observable in every country, for every government has an interest in getting reelected. This is not true, though. While a budget cycle is detectible in several countries, its presence cannot be proved everywhere. Consequently, one may raise the question: What are the factors which generate a fiscal cycle in some countries but not in others?

THE EMPIRICAL LITERATURE OF BUDGETARY CYCLES

In the eighties and especially in the nineties, mostly after the publication of Rogoff's model, a number of empirical studies were launched to reveal why some countries are more "inclined" to have fiscal cycles than others. These efforts produced different out-

comes. The cycle was mostly detected in developing countries. In one of the earliest studies, *Ames* (1987) carried out a panel analysis of 17 South American countries' data from 1947–1982 and clearly found the presence of the fiscal cycle. Government spend increased sharply (by 6.3 per cent) before elections while an average drop of 7.6% was seen after the elections. *Schuknecht* (1998) performed empirical studies of 24 developing countries (using 1973–1992 data) and found that fiscal expansion timed to the elections mostly related to expenditures and had little influence on tax changes. As he pointed out, the boom of public investments was especially typical shortly before elections. A similar conclusion was drawn by *Block* (2002) whose study proved the presence of fiscal political cycles in 44 African countries.

These findings among others laid the foundation of the popular belief that fiscal cycles are a characteristic feature of developing countries. This view seemed to have been confirmed by research in developed countries which repeatedly found the lack of cycles there. *Golden and Poterba* were one of the first authors to examine the presence of cycles in the United States in terms of budget equilibrium, taxes, government expenditure and transfers. Their conclusion was that the ability of US presidents to manipulate fiscal aggregates is rather limited.[11] In one of the most widely known studies, Alesina, *Cohen* and Roubini (1992) examined figures of 13 OECD countries from 1960–1990 in an attempt to detect cycles and came to less than robust findings. The same study presented similarly unconvincing results for the US after the analysis of 1961–1985 data. Later, Alesina et al. (1997) repeated the examination of OECD countries only to confirm their former findings: the presence of opportunistic fiscal cycles cannot be confirmed in developed countries. In a study targeted at the EU 14, *Andrikopoulos et al.* (2004), *de Haan* and *Sturm* (1994) found neither opportunistic nor partisan political business cycles. These studies focused on the 1970–1998 period and the eighties respectively.

The relative consensus of the nineties, namely that budgetary cycles are mostly characteristic of developing countries, seemed to have been broken by the 2000s. In one of their most frequently referenced studies, *Shi* and *Svensson* (2002b) looked at 91 developed and developing countries (examining 1975–1995 data) and asked the question: Is there really a significant difference between developed and developing countries regarding the likelihood of cycles? They found that the balance of the budget is deteriorating in both types of countries before elections, while the decrease of revenues and the increase of governmental spend are also significantly: in an election year, the budget deficit would be 23% higher at an average than in a regular year. The authors emphasize, however, that while the fiscal cycle is a universal phenomenon, its amplitude is typically lower in developed countries. Another pair of authors, *Persson* and *Tabellini* (2002) narrowed their research to democracies (taking a sample of 60 of them and using data from the 1960–1998 period). They detected very strong fluctuations on the revenue side.

The new and surprising result that fiscal policy cycles are present in both developed and developing countries was explained or criticized by various authors basically from two viewpoints. In one approach, it is the age of democracy while in the other it is the quality of democracy (or that of the political-institutional system) that plays the role of the explaining factor. Both approaches focus on the same question though: Under what conditions do politicians find the manipulation of fiscal policy an attractive and, more importantly, a feasible option?

Obviously, politicians consider manipulation attractive if it helps them retain power. The

issue of feasibility, however, calls for a more delicate explanation. The reason is that second and third generation rational and opportunistic models showed that the ability to manipulate (i.e. feasibility itself) principally depends on the depth of informational asymmetry. Therefore, what needs to be clarified is the following: *What factor causes the extensive variances of informational asymmetry* (and in the ability of manipulation) between different countries and different periods?

Drazen and the hypothesis of new democracies

Among others, *Allen Drazen* (2000a; 2000b) attempts to provide a satisfactory answer to the question above. His hypothesis is relatively simple: we find fiscal cycles in the so-called new democracies while the systematic manipulation of fiscal policy before elections is not typical in countries with a mature democratic system. According to Drazen's preliminary assumption, voters in new democracies do not (yet) know the functioning of the election system. They do not understand the motivations of politicians and cannot detect economic policy manipulations. Consequently, the power holder in a new democracy has all reasons to believe that he can improve his chances of reelection if he is able to affect fiscal performance temporarily.

The joint 2003 study of Drazen and *Brender* was based on a data sample of 68 democracies taken from the 1990–2001 period. The authors intended to prove that the formation of fiscal cycles is (exclusively) due to the fact that democracy is relatively new in a specific country.[12] The examination had multiple phases. In the first round, only OECD countries were selected into the sample. Greece, Spain, Portugal and Turkey "earned" the "new democracy" label. First, researchers took the full sample and successfully detected the cycle in it in terms of budget equilibrium, budget expenditures and revenues. When they removed new democracies from the sample, the cycle disappeared. In the second phase, all (68) countries were added to the sample and the authors found strong cyclicality again. The removal of new democracies, however, repeatedly resulted in the disappearance of the cycle. In the next step, they controlled for fiscal variables that depend on the age of democracy and examined if variables that relate to the quality of democracy can remain significant.[13] They found that after controlling for the variables, the attributes which grasp the quality and strength of democracy are no longer significant. More precisely, what appears to cause a cycle in "weak" democracies is that most "new democracies" fall in this category and (due to the very same reasons) there are no "new democracies" among "strong" democracies.

The primary significance of Drazen's work lies in the fact that his approach seems to help extinguish the contradiction between the theoretical assumption of rationality and empirical data (i.e. why do rational voters support politicians who generate cycles?): In the new democracies, voters "support" an economic policy which generates cycles not because they are not rational but because they do not have sufficient access to quality information that could help them see through the manipulation. Voters in these countries are not experienced enough. They have not yet gone through a sufficient number of elections to understand the nature of election-driven manipulation. After a certain amount of time, voters "learn" the rules of the game (i.e. they recognize fiscal manipulation) and become able to punish cheating politicians. This way, no government will have an *interest* in generating cycles. In Drazen's model, the process *of learning by doing* plays a key role. Voters learn the hard way that power holders in a democracy employ a wide range of opportu-

nities to foster their reelection. According to Drazen's examinations, four political cycles are usually sufficient for the average voter to "learn" the economic policy of elections and to understand that fiscal manipulation by power holders does not go hand in hand with actual welfare improvement.

Context dependence and political budget cycles

But is it really just a matter of time for a country to get rid of fiscal cycles and purposeful political manipulation? The latest results of research into political business cycles suggest that in addition to time, a proper political-institutional environment also plays a key role in reinforcing what Drazen called *learning by doing.* More and more authors focus their examination on the *quality* of democracy instead of its age. Drazen himself did not question the importance of institutions either. In his opinion, new democracies still do not have the institutions that could provide their voters with the necessary information (e.g. government-independent research institutions or independent media units that can assess government decisions and help make them transparent). While in Drazen's approach time resolves everything, authors who emphasize the importance of the political-institutional background say that the frequency and depth of fiscal manipulation upon elections principally depend on the context in which the politician shapes the economic policy.

As *Robert Franzese* pointed out in his review (2002), politically inclined fiscal cycles receive the biggest empirical support when their context dependence is realized by researchers. In other publications Franzese came to the conclusion that the size, frequency and scope of fiscal cycles are explained by differences that are observable in

- international and domestic,
- political and economical, and
- institutional, structural and strategic contexts.[14]

Thus it is the diversity of the institutional-political conditions that have a meaningful impact on the opportunities and actions of decision makers. Small and open economies supply a well-know example. Politicians in these countries have a lot more limited maneuvering space for shaping their economic policies than their counterparts in closed economies. Therefore, the probability of cycles generated with the purpose of manipulation in small countries is significantly lower [see in particular the writings of Adsera, Boix and Payne (2003), Clark and Hallerberg (2000) and Clark (2003)].

In their already quoted empirical work, Shi and Svensson (2002b) found that the formation of cycles is more likely in countries where the accountability of power holders is low, as in this case politicians may realize significant gains. This way, cycles will become typical in countries where only weak barriers exist in the way of gain-hunting by power holders – the respective institutions do not pose any limitations on it. Therefore, the authors render a key role to the stability of democratic institutions. According to their research, the likelihood of fiscal manipulation is higher in *weak democracies* and lower in strong, stable democracies. The authors consider the weakness of a democracy correlating with the level of freedom of accessing information.

Gonzales (1999) examined the data of 43 countries from 1950 – 1997. He also came to the conclusion that the existence of fiscal cycles is dependent upon the strength of democratic institutions, or more precisely, on the extent to which the politician can misuse his power. Surprisingly, they found the strongest presence of political cycles in medium-strong democracies.

In relation to Africa, Latin-America, and the CIS countries, Block (2002) notes that these are regions with extremely weak political and economical institutions. Therefore, there is a high probability that political business cycles will appear. Schuknecht (1998) cites similar arguments while *Hallerberg* (2002) is of the opinion that in countries with relatively few veto players, i.e. where the political contest is lukewarm (especially in developing countries) politicians typically gravitate towards monetary expansion. In countries with many veto players (like developed states), fiscal cycles are dominant.

At the same time, the pioneers of new political economics, Persson and Tabellini (2003) did not focus on the strength of democracies and the stability of institutions. Instead, in line with their former work, they named the difference between political and election regimes as the reason of variances in the presence and intensity of political cycles. In their study they argued that the dominance of the presidential system in a country positively correlates with the likelihood of fiscal cycles.[15]

A new direction of the contextual dependence of fiscal cycles is presented in the writings of James Alt and his associates. Alt and *Lassen* (2006) selected 19 OECD (i.e. developed) countries in their sample and were unable to reject the hypothesis that political fiscal cycles exist. The authors clearly blamed the lack of fiscal *transparency* for the emergence of manipulation, saying that a fiscal balance cycle was detectable in countries where institutions are less transparent, while countries with no pre-election fluctuations are characterized by high transparency (page 531). Alt, Lassen and Rose (2006) carried out a panel check of US states and came to a similar conclusion: the intensity of the political business cycle decreases with stronger transparency.

What renders decisive importance to fiscal transparency in the theory of political business cycles? Transparency becomes relevant if there is no perfect and complete information. For transparency strengthens discipline and accountability, thereby improving the credibility of the economic policy and eliminating uncertainty. With the establishing of transparency, voters, the media and financial markets can assess the consequences of the government's economic policy decisions, creating an obvious link between economic policy results and the person and actions of the decision maker. By reducing asymmetrical access to information, the strengthening of transparency also reduces opportunities for gain hunting, making fiscal manipulation less attractive for decision makers.

Yet the revaluation of transparency is not merely a consequence of the recognition that non-transparent conditions foster informational asymmetry. Instead, it is more of a result of the increasingly popular conviction that institutions themselves (budget planning, budget approval and budget implementation among others) play a decisive role in the shaping of economic policy decisions and even in actual fiscal performance [see in particular the writings of Alesina and Perotti (1996), Hagen (1992) or Kopits and Craig (1998)].[16]

In this approach, institutions function as external circumstances in the shaping of economic policy decisions. It is not surprising therefore that some authors expect institutional reform, e.g. the strengthening of transparency in the fiscal process, to reduce informational asymmetry and restore fiscal discipline. The change in the rules of the game (may) create a new institutional environment in which community welfare is growing. Hagen put it as follows (1992, pp. 54–55): “our findings suggest that the institutional reform of the budget process is a possible and encouraging way of establishing fiscal discipline. Naturally, it does not mean that every reform has necessarily an impact on decision makers [...], but [...] a suit-

ably executed institutional reform may help greatly the executive power and legislation in reaching a consensus about the importance of imposing stronger fiscal discipline."[17]

If we accept that higher transparency in budget preparation, acceptance and execution increases welfare, we should also ask the question: Why this guideline is not set as a basic rule everywhere? The answer was provided among others by Alesina and *Perotti* (1996) who claimed that this move is simply not in the interest of policymakers, as informational asymmetry gives power holders a strategic advantage over voters.

Still, reforms happen time to time. Obviously, the strengthening of transparency is not in the interest of a politician who is personally responsible for a negative shock (e.g. in the form of a high deficit or sovereign debt). In this case, the undisciplined politician has no interest in revealing his actions and their potentially negative consequences. Therefore, the "deceiving" politician attempts to prevent voters from finding a link between the actions of the incumbent government powers and the visibly low effectiveness of economic policy. In the other scenario, however, when a new government is elected, the fresh starters might have an interest in strengthening transparency even in an institutionalized form through legislation, because this way they can refer all liabilities to their predecessors, giving themselves a chance to start their term in power with a clean record.

CLOSING WORDS

The theory of political business cycles and the demand for finding empirical evidence of it continue to keep researchers and political decision makers excited about the topic. With its numerous simplifying assumptions, the traditional opportunistic model of Nordhaus is more of a benchmark today than a referential basis. Still, second and third generation opportunistic models keep the suspicion alive that fiscal policy regularly becomes a victim of manipulations in pre-election times. The question of "how" remains an empirical issue.

What researchers seeking to reveal the cause of political business (or fiscal) cycles have in common is the question they ask: Under what circumstances do politicians find the manipulation of fiscal policy not only desirable but feasible? In this brief overview we argued that the ability of manipulation (in fact feasibility itself) depends of the depth of informational asymmetry. Therefore, the amended question goes as follows: What causes the differences in informational asymmetry (and feasibility) between individual countries and different periods?

What can be good news for the transforming countries of Central and Eastern Europe is what we found out after Allan Drazen, namely that cycles are part of a maturing process. As voters learn the nature of policymaking, so decreases the likelihood of fiscal policy manipulation before elections. Some doubt is cast on this argument though, as after the selection of eurozone members in 1997 and the start-up of GMU in 1999, fiscal cycles reappeared in long-time EU countries. Without exception, these countries are economically developed and can be regarded as "old" democracies. Having examined indicators from the 1999–2002 period, *Buti* and *van den Noord* (2003) concluded that while following a strict macroeconomic policy was considered highly important in Europe during the nineties (as member states were heading to the GMU),[18] the motivation disappeared after membership was gained and politicians returned to manipulating fiscal policy variables. *Mink* and de Haan (2006) used 1999–2004 data to detect the use of expansive fiscal policy upon elections. Please refer to *Table 1* for figures.

Therefore, the conclusion of our study is that besides the age of democracies, their quality (especially the transparency of the fiscal bargaining process) also plays an important role in breaking down politically induced fiscal cycles. We are convinced that the approaches reviewed herein do not set off but rather complement each other.

Table 1

BUDGET BALANCE IN EMU MEMBER COUNTRIES, 1999–2004

	1999	2000	2001	2002	2003	2004	Election year	Non-election year	All year
Austria	**–2.3**	–1.5	0.3	**–0.2**	–1.1	–1.3	–1.3	–0.9	–1.0
Belgium	**–0.4**	0.2	0.6	0.1	**0.4**	0.1	0.0	0.3	0.2
Finland	**2.2**	7.1	5.2	4.3	**2.5**	2.1	2.4	4.7	3.9
France	–1.8	1.4	1.5	**–3.2**	–4.2	–3.7	–3.2	–2.5	–2.6
Greece	–3.4	**–4.1**	–3.6	–4.1	–5.2	**–6.1**	–5.1	–4.1	–4.4
The Netherlands	0.7	2.2	–0.1	**–1.9**	**–3.2**	–2.5	–2.6	0.1	–0.8
Ireland	2.6	4.4	0.9	**–0.4**	0.2	1.3	–0.4	1.9	1.5
Luxembourg	**3.4**	6.2	6.2	2.3	0.5	**–1.1**	1.2	3.8	2.9
Germany	–1.5	1.3	–2.8	**–3.7**	–3.8	–3.7	–3.7	–2.1	–2.4
Italy	–1.7	–0.6	**–3.0**	–2.6	–2.9	–3.0	–3.1	–2.2	–2.3
Portugal	**–2.8**	–2.8	–4.4	**–2.7**	–2.9	–2.9	–2.8	–3.3	–3.1
Spain	–1.2	**–0.9**	–0.5	–0.3	0.3	–0.3	–0.6	–0.4	–0.5

Note: deficit figures of election years shown in bold print; the last three columns contain averages.
Source: Mink and de Haan (2006)

Notes

[1] Read more about this approach in Erdős, 2000

[2] The purpose of this paper is to present certain suboptimal fiscal policy behaviors and the potential responses to them. Therefore, we exclusively deal with the opportunistic approach to political business cycles, not endeavoring to assess the "partisan" models of the theory. Similarly, we stay away from examining the economic policy of non-democratic countries as their fiscal policy makers are not directly accountable to voters (as far as we consider elections in a democracy a way of "holding policymakers accountable"). Summaries of the partisan models are provided , among others, in the works of Alesina, (1987), Alesina et al. (1997), Alt and Chrystal (1983), Hibbs (1987), Mosley (1984), Tufte (1978) and – in Hungarian – Mellár (1997).

[3] In this discussion, we follow the simplifications of Gautier (2001) and Alesina et al. (1997).

[4] This assumption means that voters can be deceived again and again through the manipulation of the inflation rate because they are unable to learn from their mistakes. Consequently, a government which regularly employs an expansive pre-election economic policy and a restrictive post-election economic policy can effectively manipulate the economy and get away with it.

[5] In the Nordhaus model, manipulation explicitly relates to monetary policy. Fiscal policy does not play a role in the traditional opportunistic model.

[6] Nordhaus did not cite this as a condition in his writing published in 1975 because the fixed timing of elections was an obvious factor in the USA. Later, however, Alesina and Roubini (1992) pointed out that the implicit assumptions of the traditional opportunistic model should include this condition as well. The reasons for this were outlined among others by Ito and Park (1988, page 234) in their "opportunistic government hypothesis". The point of this theory is contrary to the Nordhaus model, its not economic variables that governments directly manipulate. Instead, they wait for the supply shock of the

private sector so that they can call elections at a time of economic prosperity, cherishing better chances of reelection.

[7] For in the case of "Fiscal dominance", the central bank is forced to take suboptimal steps due to inflationary pressure from the government. See more in e.g. Kißmer, Wagner (1998).

[8] Persson – Tabellini (1990) attempted to rework the classic Nordhaus model in line with new requirements. E.g. they assumed that voters have rational inflationary expectations, meaning these expectations take into consideration all information available at any given time and thus they are not only based on equation 1.2. Specifically, ?et = E(?t|It-1), where It-1 means all information available in the (t-1) period. Furthermore, voters look ahead and not back, i.e. they always make decisions based on expected utility which means that the economic policymaker is forced to weight the future consequences of his decisions. One deficiency in the Persson-Tabellini (1990) model is, however, that it continues to assume direct governmental control over monetary policy which follows one of the basic assumptions in the original Nordhaus model.

[9] This model differentiates between two levels of competence: high and low. Before elections, the competent candidate wants to demonstrate the (high) level of his abilities to voters (and at the same time increase his chances of being reelected) by engaging in expansive fiscal policy which is less costly for him than for a less competent politician. Therefore, if the deficit is growing before elections (which functions as an indicator), voters perceive it as a sign that a competent politician is in power who should be reelected. At the same time, if incompetent politicians are in the government, they would not send a signal before the elections, i.e. they would not increase the deficit.

[10] Remember that in the second generation Rogoff-Sibert-model, pre-election deficit increased only if the candidate in power was a competent one. The reason is that a politician with a low competence level did not employ fiscal manipulation.

[11] The authors could detect cyclicality only in the case of transfers but not for the other variables. See Golden and Poterba (1980)

[12] It is important to emphasize that the authors consistently assumed rational voters even in new democracies.

[13] The robustness of attributes attempting to grasp the quality of democracy are discussed later herein.

[14] Franzese and Jusko (2005)

[15] It should be noted that in the majority of so-called new democracies, especially in CIS countries and Latin America, the presidential system is dominant. Therefore, the findings of Persson and Tabellini are not necessarily in irreconcilable contradiction with the conclusions in Drazen's writings referenced herein.

[16] By fiscal institutions we mean all rules and regulations which serve as a basis for budget planning, approval, implementation and checking. Therefore, the notion of fiscal institutions refers to the complex set of formal and informal rules used in the fiscal process.

[17] Supporters of high transparency often emphasize the importance of the strict use of fiscal rules in addition to that of fiscal procedure reform. In their empirical work, Alt and Rose (2006) pointed out that election-induced budget cycles are much less likely to occur in states where formal, numerically defined rules are applied. Having conducted an examination of US member states, the authors point out that fiscal rules have the highest disciplining power. In a review, Kopits (2004) came to the same conclusion and added that even fiscal rules are not a magic elixir: their success depends on political-institutional incentives. In an EMU context, among others Milesi – Ferretti (2004) examined the relation between transparency and fiscal rules. His model assumed myopia-struck politicians and concluded that under high transparency, rules urge politicians to implement real corrections in order to achieve the fiscal balance targets set in the Stability Pact. Amidst low transparency, however, the rules are counter productive because they only foster creative accounting. At the same time, Drazen (2004) turned the argumentation of Milesi – Ferretti upside down by stating that creative accounting practices which gain ground in countries with fiscal policy rules paradoxically prove the effectiveness of those rules: Politicians rely on creative accounting techniques because they are worried about the (political and economic) consequences of their not abiding by the rules.

[18] We can interpret it as a kind of a competence indicator: A government which is unable to make its country eligible for the eurozone is incompetent.

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