

An Outline on the Development of Political Business Cycles

Work-in-progress

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Definitions and Context

The recurring expansion and contraction of economic activity is given term ‘business cycles’ in the economics literature. Employment of labour is the most direct and identifiable outcome of the cyclical activity in an economy. Employment rises due to expansion through improved economic performance as a result of higher aggregate demand for products. Then, with a short time lag, employment falls due to contraction as lower aggregate demand reduces the need for workers. Business cycles in capitalist economies have a periodicity (peak-to-peak) of around eight to twelve years, as a broad generalisation.

Business cycles and their causes has been a large research project for many economists ever since the rise of the industrial revolution, with much effort being placed in the delineation of mechanisms that generate such recurring (if not regular) cycles of activity (see for example, Zarnowitz, 1985). Such analyses identify the endogenous and exogenous variables that influence this cycle pattern in pure capitalist model economies without any government intervention. From a Keynesian (endogenous) perspective, these cycles are self-sustaining and driven by the investment spending decisions on capital goods by firms. From the neo-classical (exogenous) perspective, these same cycles are responses to monetary and real disturbances.

Political business cycles (PBCs) refer to the additional layer of business cycle analysis over the pure business cycle that comes into operation with government intervention. Essentially, these are the political causes of any business cycle patterns that occur over and above the strictly economic causes. The first point to recognise is that with government intervention of any kind, the PBC comes into play. In the early part of the 20th Century, prior to Keynesian economic analysis, a balanced budget with no monetary intervention was considered to have no political implications for the business cycle. British ‘mandarin’ economist, John Maynard Keynes, introduced the idea of effective demand as the major factor on the business (or ‘trade’) cycle, which implies that any balanced budget has a stronger expansionary multiplier effect through direct government spending, compared to the contractionary multiplier effect of tax collections. This is due to the Keynesian ‘fact’ that taxation reduces personal consumption spending (excluding taxation out of savings) by less than what government spending increases effective demand. Thus, by governments making a decision to intervene in the economy by spending and taxing, this sets up a PBC path.

Governance of the business cycle path becomes a crucial issue for any government in a capitalist economy, both from the perspective of winning (and retaining) electoral power and in terms of responsible economic managers. The central question is how does public policy affect the path of economic activity? Answers to this question depend on the type of PBC that is specified. In the literature there exists the class-based PBC and the electoral-based PBC. The aim of this paper is to outline the historical development of two forms of PBCs and provide a history of economic thought perspective to the significance of PBCs in policy analysis.

Class-based Political Business Cycles

Andvig (n.d.) notes "...that Johan Åkerman tried to relate political events and business cycles as early as the 1930s" (Osiatyński, 1990, p. 573), with an English paper published on this relationship in 1947. However the person who has been credited with the first rigorous theory on the PBC is Michał Kalecki in his extensively quoted article, *Political Aspects of Full Employment* (1943). PAFE has a Marxian class analysis as the foundation, where the capitalist class prevails over the political institutions of the society. In this way, political influence on the business cycle is inextricably linked to the economic cyclical concerns of capitalists. Alexander (1948) also perceptively identifies this same mechanism, but without the strong class analysis underpinnings. Only Robinson (1964, 1971) identified the critical importance of Kalecki's PBC to understanding governance by Keynesian economic policies in Western capitalist economies during the 'Golden Period' of post-war reconstruction and mass consumption that ended with the first oil price shock in 1973.

Kalecki (1971) is a reprint of selected essays, including PAFE to which Kalecki identifies in the Preface as having correct predictions "*grosso modo*". This statement leaves class-based PBC open to two interpretations: stop-go 'fine tuning' and longer-term 'political trend'. The former is applied to the variations in cycle amplitude, especially during the relatively less unstable 'Golden Period'. The latter is applied to the change in political priority from full employment (anti-unemployment) in the 1945-73 'Golden Period', to price stability (anti-inflation) since 1973.

Boddy and Crotty (1975) and Robinson (1976) develop the former version in terms of the stop-go Keynesian policies of the 'Golden Period' that are aligned with the cyclical profit squeeze of capitalist firms. Profits begin to be squeezed at the top of the boom as consumption spending slows down. Capitalist entrepreneurs have the exclusive control of capital investment, and under these profit squeeze conditions they make the decision to reduce their investment spending which turns the pure capitalist business cycle into a contraction phase. Keynesian macroeconomic policies provide the method by which this contraction can be prevented and full employment be maintained. This is through stimulation of effective demand *via* government spending, reduction of taxes and lowering interest rates (with increased money supply). The three policy instruments are employed to affect an expansionary impact on the economy.

Keynes (1936) expressed the faith that the power of this effective demand idea will be used to stabilise the business cycle at full employment. Kalecki (1943) too recognised the powerful tool of effective demand management by government (since he developed this analysis in 1933), but he also recognised the stronger power of business interests to prevent this from occurring. Kalecki specified three fears that capitalists have with Keynesian full employment: (i) Loss of *economic* control with businesses' state of confidence reflected in investment decisions and the business cycle that they generate; public policy demand management would effectively deprive capitalists of their power to influence economic conditions and also governments themselves. (ii) Loss of *policy* control as governments extend their impact through its own investment spending into the

areas regarded as the private sector's legitimate sphere of influence (e.g. transport, public utilities). (iii) Loss of *industrial* control of the workforce if governments are able to maintain full employment over the long-run, so that 'the sack' ceases to play its disciplinary role for businesses.

Towards the top of the expansion phase of the cycle, the combination of profit squeeze and inflationary pressures manifests itself in a significant negative shift to the state of business confidence. This is reflected in profit rates falling, financial gearing rising and capacity utilisation falling as large capital investment projects come on stream at the time when consumption rates are slowing down (Courvisanos, 1996). Business interests enlist rentiers interests to support them in having mainstream economists identifying the economy as "unsound" (Kalecki, 1971, p. 144). Pressure is placed on governments to renege on full employment commitments and introduce the 'stop' elements of fine-tuning by dampening effective demand policy instruments. This ensures the demise of old capital stock and the reduction in real wages, essential in the renewal of capitalism.

The 'go' policy elements of government stimulation in effective demand are then used when business interests enlist workers to support them in having mainstream economists declare a slump as detrimental to the economy. There would, however, be strong debate between all these supporters of stimulation as to the precise instruments and extent of their use. A stimulation package allows the cycle to move into a new expansionary phase, with new capital stock coming forward on the basis of innovation in newer technological developments. Old capital stock can then be decommissioned so that utilisation rates are manageable in relation to new investment spending (Galbraith and Darity, 1994, pp. 459-68). Kennedy (1973) provides empirical support in the U.K (1953 to 1971) for a "predominantly" planned 'stop-go' policy approach, with technical errors due to poor forecasting playing only a relatively minor role.

Steindl (1979), Bhaduri and Steindl (1983) and Catley and McFarlane (1981) use PAFE to explain the long-term implications of the PBC in terms of a 'political trend'. These studies draw on the historical development of advanced capitalist economies like USA, U.K. and Australia to show that the shift in economic policies in the early 1970s from Keynesian 'stop-go' policies to Friedman monetarism and neo-liberalism is due to the same three fears Kalecki identified in PAFE. The difference is that in this version of the class-based PBC a longer timeframe allows for what Mair and Laramie (2002) refer to as "feedbacks between capitalists and workers over the political and social tensions of full employment to work themselves through." These feedback effects generate rent-seeking behaviour by powerful monopoly control interests who form 'distributional coalitions' to shift profit shares upwards by establishing obstacles in the road to full employment. These coalitions reduce efficiency and depress the adoption of new technologies in an effort to skew the income shares. Mair and Laramie (2002) provides empirical evidence to reveal the end of the post-war 'full employment' stop-go strategy in the early 1970s coincided with the only significant period of income share turbulence. Aschauer (2000) sets out empirical evidence for the USA that supports this contractionary political trend with the decline of public investment since the early 1970s. Catley and McFarlane (1981) provide similar historical evidence for Australia.

The contractionary political trend enabled the capitalist class to assert its economic and social dominance over labour and to cleanse capital of inefficient and oversupplied old stock. This process varies in time over different economies, with the USA leading the way after the 1990-92 recession into a new age of active innovation, stimulating large private investment spending and generating a new expansionary political trend. This expansionary trend consists of a new dynamic in public policy governance that has a PBC perspective as governments support re-armament (and war), tax cuts for the rich, innovation-supported subsidies and allowances, and 'cheap money' in a fragile financial system. Kalecki (1945) identified these stimulatory policies, and they have now been reactivated at the start of the 21st Century.

The class-based PBC provides a crucial appreciation of the way governance of the business cycle operates and also the challenges for public policy implementation in the face of capitalist interests. In this respect some aspects of the PBC approach are inadequate and need to be developed further. The areas of most concern are greater financial instability, market-based globalisation and mobility of capital funds, shifting of macroeconomic policy to central bank control with balanced (or surplus) budgets, and shift in politics from 'right to work' to 'right to manage' and the corporate governance problems that this has engendered.

Electoral-based Political Business Cycles

PAFE has an element of electoral concern that faces all capitalist democracies, when it notes the necessity that "something must be done in the slump" to stimulate the economy. Nordhaus (1975) acknowledges PAFE as the "only serious theory" on PBCs, and then he creates an electoral-based version of the PBC that is driven by politicians who manipulate macroeconomic instruments in concert with the electoral policy cycle. This type of PBC removes the class-base of PAFE and significantly shifts the initiating force from Kalecki's "business interests" to politicians with an eye to getting elected in the upcoming election and the aftermath of the election. However, without acknowledgement Nordhaus's approach is much closer to Åkerman who identified in his 1947 paper "the close correlation between cycles of prosperity and depression on the one hand and the duration of the different [political] cabinets on the other" (p. 107). While Åkerman identifies this correlation across five major capitalist economies of very different political systems (France, Sweden, England, Germany and the U.S.A.), Nordhaus goes on to develop a closed model of how this correlation can emerge.

The electoral-based PBC developed a separate and dominating position in the economics literature as mainstream economists now had, with Nordhaus (1975), a PBC analytical model that could be accommodated inside the standard neo-classical framework. In this approach the exogenous political influence on the business cycle could be divorced from the role of market-based business. Political scientists have proceeded to distinguish between two versions of this electoral-based PBC: (i) electoral vote-maximising model with office-seeking policy makers and (ii) partisan vested interests model with policy-

seeking policy makers. A vast political science literature has grown around these two versions and been recently reviewed in great detail by Franzese (2002).

The electoral (vote maximising) business cycle is the version in which the election cycle is the basis of politicians garnering popular support on the assumption that the general populace takes macroeconomic conditions of the business cycle into account when voting. Wright (1974) and Nordhaus (1975) are the initial authors of this version. As an election approaches, the incumbent government tries to ensure its re-election by expansionary policies that serve two purposes. First, the popularity of the government is increased as employment and real incomes rise. Second, the financial and business indicators will be interpreted in the media as forecasting continued boom conditions as the voters approach the ballot box. After the election, whichever party wins power, the government needs to react to the concerns of the financial press and business that the boom conditions will create unsustainable inflationary pressures. The populace begins to be concerned that any gains in the boom will be erased as price rises reduce real incomes. Newly elected governments respond through contractionary policies that dampen the economy and set the business cycle into contraction phase. The ‘toughness’ of governments in ‘making the hard decisions’ is applauded in the media, while the government has time until the next election in three to four years time creates the circumstances for expansionary policies that repeats the politico-economic cycle (Frey, 1978). The public choice literature lends support to this PBC version.

Empirical evidence is hard to generate that can fit into this electoral business cycle thesis. Many attempts have been made with “negative and inconclusive” results (see for details, Osiatyński, 1990, p. 575). Theoretical limitations also exist to this thesis in terms of Kalecki’s framework. Intervals of about four to five years between elections does not leave enough time for the disciplinary role of unemployment to act on unions and workers in bargaining for wages, nor enough time to effectively reduce the role of the State. There is an electoral connection to any business cycle, and this model provides a basis for understanding the processes operating (Tufté, 1978). However, governments do act in ways that often seem to be in contradiction to this electoral process (see for example, Galbraith and Darity, 1994, pp. 463-4) and this often has to do with responding to pressures from particular vested interests. This concern has led to the development of the second version of the electoral-based PBC.

The partisan business cycle thesis places vested interests within the context of the electoral cycle. Hibbs (1977) first developed this version, and it was refined by Alesina (1989) and by other Alesina articles with different collaborators. In this version, politicians are partisan in the way they deliver benefits to their constituent vested interests. The timing of economic policy activity is based on expansionary-based selected incentives to particular constituencies coming up to an election and then shifting to contractionary-based incentives to satisfy different constituencies after the election. The assumption is that voters react in a partisan way to politicians’ incentives that creates business cycle patterns.

Empirical studies on evidence of the partisan cycle thesis are related to tracking the timing of the electoral calendar with correlation to the incumbent partisan constituencies that are being influenced. Empirics reviewed by Franzese (2002) create a dilemma for this version. On the one hand, the evidence reveals strong partisan shifts that effect real economic performance, but not necessarily in tune with the electoral cycle. The electoral policy cycle does however exhibit partisan shifts within specific economic policies (monetary, fiscal, innovation, competition etc.), but this does not have the same significant effect on economic activity as altering the aggregate effective demand in the class-based PBC. General equilibrium neo-classical approaches incorporating rational expectations into the political behaviour of governments and interests groups, called rational partisan cycles, have been inadequate in explaining the empirical patterns observed. Yet, Franzese (2002, p. 369) concludes that although relatively new in approach, “research into such context-conditional electoral and partisan cycles seems to offer much promise for resolving anomalies and an ideal substantive venue for theoretical and empirical advancement...” in the study of PBCs.

Governance Issues

The PBC as a concept can be useful if it provides understanding of past governance practices and assists in managing future governance issues in the face of inherent economic fluctuations. Irrefutable statistical proof of any particular version of the PBC does not exist in the literature (see Frey, 1997). At the theoretical level, increasingly specialised research has diluted the original notion of the PBC. Specific mechanistic models developed for statistical validation are inappropriate in the fluid world of politics. What is left is a set of well-formulated, but divergent, political analyses that explain in various ways how pure capitalist-based economic fluctuations are exacerbated through political machinations.

All PBC versions can contribute valid elements to an overall PBC framework for governance issues. The PBC framework requires a class-based foundation that is modified by the electoral needs of politicians and partisan needs of vested interests. Such a framework would have to be underpinned by three crucial politico-economic features that motivate the PBC concept. These three features are:

1. ‘Stop-go’ economic policies have largely given way to ‘political trend’ policies relating to market-oriented economic commitments; together with discretionary political power in foreign wars, financial regulation and international relations.
2. Macroeconomic policy variables (i.e. employment, price stability) that affect all voters as against other policy variables that have relatively greater variability of affect between different groups of voters.
3. Limits to achieving full employment through economic stabilisation policies as capitalism demands renewal of capital stock through technological innovation via boom-bust cycles of economic activity.

These features are common to all advanced capitalist economies to which PBCs have been investigated; only the extent that these features affect various nations differs. The English-speaking nations are most influenced by the market-orientation political trend,

while Scandinavian nations and Japan have a stronger employment commitment. Mid-European nations like Germany, The Netherlands and France place more emphasis on economic stabilising elements. Southern European nations are still significantly subject to 'stop-go' policies due to less sophisticated economic and political institutions. Even nations without representative western democracies have shown PBC patterns subject to partisan and class-based interests. See Frey (1997) for a selection of PBC empirical studies covering different nations.

A set of governance issues can be derived from PBC analyses and the three features above:

- i. Co-ordination of investment decisions and financial commitments with supporting innovation policies.
- ii. Resolution of income distribution conflicts arising out of structural transition through technological change by the use of prices and incomes policies.
- iii. Broadening the base of participation to all citizens through indicative planning processes.
- iv. New assignment of policy instruments over local, regional, national and international jurisdictions; with closer interaction across jurisdictions.
- v. Alter the electoral period to allow for longer electoral cycles that can produce more stable and longer-term political perspectives.
- vi. Depoliticisation of some elements of the policy agenda by independent sources of economic decision-making (e.g. Central Bank independence, non-politicised public servants).

The research on PBCs needs to broaden its agenda to incorporate a framework of analyses that includes more of the factors identified in all the various versions of the PBC, and then crucial governance issues should be investigated using this framework. Only then will the PBC concept serve a very useful purpose in the field of public policy.

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