



PRE: BOOM, POST: RECESSION

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“Parties formulate policies in order to win elections, rather than win elections in order to formulate policies”

The time leading up to political elections in a particular district, city, state or country involves a frenzy of political announcements, welfare schemes, infrastructural projects, cuts in petrol/diesel prices, slashing of interest rates, etc. This hysteria has economic, social, temporal and spatial consequences. The widespread observation of this phenomenon necessitated a deeper inquiry into how ‘election-induced’ policy reforms impact the economic conditions of a particular country.

William Nordhaus, in a seminal paper in 1975, theorizes this occurrence with the realization that governments are driven by self-interest rather than the welfare of the people. In Anthony Downs’s words: “We assume that they act solely in order to attain the income, prestige, and power which come from being in office”. This self-interest refers to the sole goal of being re-elected in the next election cycle. The incumbent government, therefore, uses expansionary monetary and fiscal policies to influence the short-term Phillips Curve. This includes falling unemployment and economic growth, a major driver of which is increased government spending on public goods and services. The decreased unemployment rate succeeds in winning over the voters right before re-election. However, the trade-off incurred is a rise in the inflation rate. Thus, in the post-election scenario, we see the government implement austerity measures, which only exacerbates unemployment. These cyclical fluctuations are linked to the rhythm of elections and these fluctuations are called “political business cycles” (PBCs). Schuknecht’s

studies revealed a group of 35 developing countries with Nordhaus-type policy cycles wherein governments try to implement expansionary fiscal policies before elections and fiscal austerity afterwards.

The extensive literature on the occurrence of Political Business Cycles can be categorized into two major schools of thought. While both models agree upon the fluctuations in the pre-election period, the economic consequences of policy changes differ. The pre-rational expectations theory, propagated by Nordhaus (1975) and Lindbeck (1976), argues for large cyclical changes in both output and employment, which affect macroeconomic variables. On the other hand, the post-rational expectations theory, devised by Rogoff and Sibert 1988 and Persson and Tabellini 1990, claims an increase in the budget deficit, the monetisation of which leads to an increase in the money supply. The change in monetary policy variables further has a cascading impact on inflation.

Like all economic models, the assumptions about the expectations of actors involved form the foundation of the model. This accounts for yet another distinction in the theory. Voters, in this case, could be assumed to have either adaptive or rational expectations. Adaptive theory dictates that expectations of the future are built on retrospective knowledge while rational expectations posit that individuals form expectations based on human rationality, experiences and availability of information. Political parties, on the other hand, display either opportunistic or ideological behaviour. Opportunistic political parties focus on maximising votes. Ideological political parties do the same while adhering to their beliefs.

Though voters are assumed to be rational, in most cases, they remain imperfectly informed. The

existence of political business cycles relies on this information asymmetry since if economic agents had complete information, they would act rationally and remain unaffected by pre-election reforms.

The information asymmetry, however, exists between the two agents regarding the political party's competence. The incumbent parties are assumed to know their own competence while voters learn about it only after the elections are over and they come to power. Thus, there exists a one-period lag. If the voters were able to anticipate changes in the pre-election period given the upcoming elections, there would be no substantial effect of these policies. However, voters are known to be myopic in nature. Had they been more future-oriented, they would assign greater weight to post-election performance.

An important illustration would be to consider a tax cut just before an election. Voters will be unable to distinguish whether it is implemented due to the higher competence of the political party or is just a transitory power move. Therefore, more evident actions, such as adding street lights or repairing roads, are preferred over long-term investments which are less visible, such as providing education. Politicians thus tend to focus on corpus spent on the 'visible' rather than on the productive. This leads to a 'stop-and-go' pattern leading to macroeconomic instability.

Another criterion that determines the projects that incumbent parties choose to invest in is contingent upon the constituencies of interest or special communities that may be acting as vote banks for them. This variation in the composition of expenditure incurred implies that while the total amount of government spending remains the same, the impact of political business cycles induced in different districts varies.

In India, this phenomenon is widely observed in state government elections, since they tend to be far more resource-constrained than the Union government. Conducting an extensive analysis of 14 Indian states between 1960 and 1996, World Bank researcher Stuti Khemani found little evidence of fiscal profligacy in an election year. However, the study found empirical evidence of fiscal

manipulation to target narrow interest groups. Khemani further states, "Tax collection from specific producer groups is lower and public investment spending is higher, while spending on what is generally regarded as more populist categories is lower."

The form of expansionary policy adopted differs across the ideological backgrounds of the political party in power. A tax cut can be as easily implemented as an increase in government spending. Leftist parties choose to focus on reducing unemployment rates, while rightist parties prioritize the reduction of inflation rates. An interesting point to note here is that people tend to vote for the political party rather than the candidate.

Political business cycles have been proven empirically to exist in different countries. While the common notion may suggest this fluctuation to exist in only developing countries, with newly-formed democratic structures, studies have observed that PBCs occur in advanced countries as well, but with reduced frequency. This increased frequency observation is supported by the argument that fiscal manipulation is rampant in these 'new democracies' because of inexperienced voters. The usually limited constitutional separation of power also fails to resist procyclical fiscal policy.

Svenssons and Chi (2006) used a large panel of data covering 123 countries over a period of 21 years to analyze the relationship between electoral cycles and politics. The study further distinguished between the composition and size of political cycles in developing countries. Svenssons' study proves, "The elections induced in the developing countries a budget deficit as a percentage of GDP almost double compared to the developed countries: on the eve of the election, the developed countries have recorded an increase in the average budget deficit by roughly 0.6 per cent on average, whereas in the developing countries the average percentage was around 1.3%." Looking at empirical studies proves the existence of political business cycles in several countries. Gonzalez (2002) illustrates the usage of public

spending on infrastructure to nudge elections in Mexican political business cycles. He categorizes certain countries in Latin America to be 'imperfect democracies', which have experienced frequent changes and shocks to the social and economic institutions.

While some of these emerge to move toward becoming advanced democracies, others settle for a system of reduced political and civil rights for their system. Kneebone and McKenzie (2001) found opportunistic PBCs in Canada in terms of both revenue and spending. By analysing periodic data from 44 sub-Saharan African countries from 1980 to 1995, Block (2002) found visible trends of election induced interventions in monetary and fiscal variables such as fiscal deficit, seigniorage and nominal exchange rate changes, inter alia. Schuknecht found strong evidence suggesting the existence of electoral business cycles in countries with a fixed exchange rate and sufficient foreign reserves. Monthly panel data sets on Russia from 1995 to 2003 also reveal strong evidence of the existence of opportunistic budget cycles. (Akhmedov and Zhuravskaya (2004)). Khemani (2004) proves the occurrence of the same correlation between election cycles and fiscal policy stimulus in India.

In the Indian context, both government spending and the fiscal deficit have been seen to increase on average during an election year. Vaidya and Kangasabapathy suggest that while revenue receipts might be overestimated, total expenditure tends to be underestimated in most election years. This implies that the budget deficits are often understated and digress from the facts. These deviations become more apparent in interim budgets. Their study provides evidence that the revised estimates place the borrowings and other liabilities at as high as nearly 46% over the budget estimates. This translates to revenue and fiscal deficits soaring by nearly 77% and 46%, respectively, contracted with 11.9% and 7.9% in regular budgets. Thus, interim budgets often serve as tools for manipulation by the governments to gain political leverage.

In India, the influence of such economic

manipulations for political benefit can be seen not only in terms of fluctuations in output, employment and inflation but also in terms of government spending on public sector enterprises. Uttar Pradesh, India's most populated state, is a great example. The data from its power corporation shows that electricity lines lost surge just before state assembly elections.

Though this seems contradictory, it happens as political parties advertently redirect power to unbilled users. Another change seen is the amount of farm loans given by state-owned banks. This is 5-10% higher in election years than in the years following it. The cost of these politically motivated loans are much higher as they are less likely to be repaid and tend to window dress the effect on agricultural output. These loans are also usually directed to districts in which the incumbent party had a narrow margin of loss or win in the previous elections. These tactics convince the voters of improved economic growth while allowing the parties to showcase their performance, thereby enhancing the 'political report card' just before the elections.

While voters get persuaded by the rosy political report cards curated by political parties right before elections, businesses and investors react in a counter-intuitive manner. Economic variables pertaining to new projects and investments dry up right before elections. It occurs because businesspersons and industrialists expect a plethora of policy changes preceding elections and thus become cautious about the direction of the wind.

A Mint analysis found a decline in consumption of raw materials, mainly cement and steel ahead of elections. This reflects how core industries like construction and steel restrict expansion in the face of political uncertainty. When the data from 1994 to 2004 was analysed, it was seen that the consumption of steel reduced significantly every time there was an election in India. This also affected the average growth in steel consumption which was 6.45% percentage points lower as

compared to non-election years.

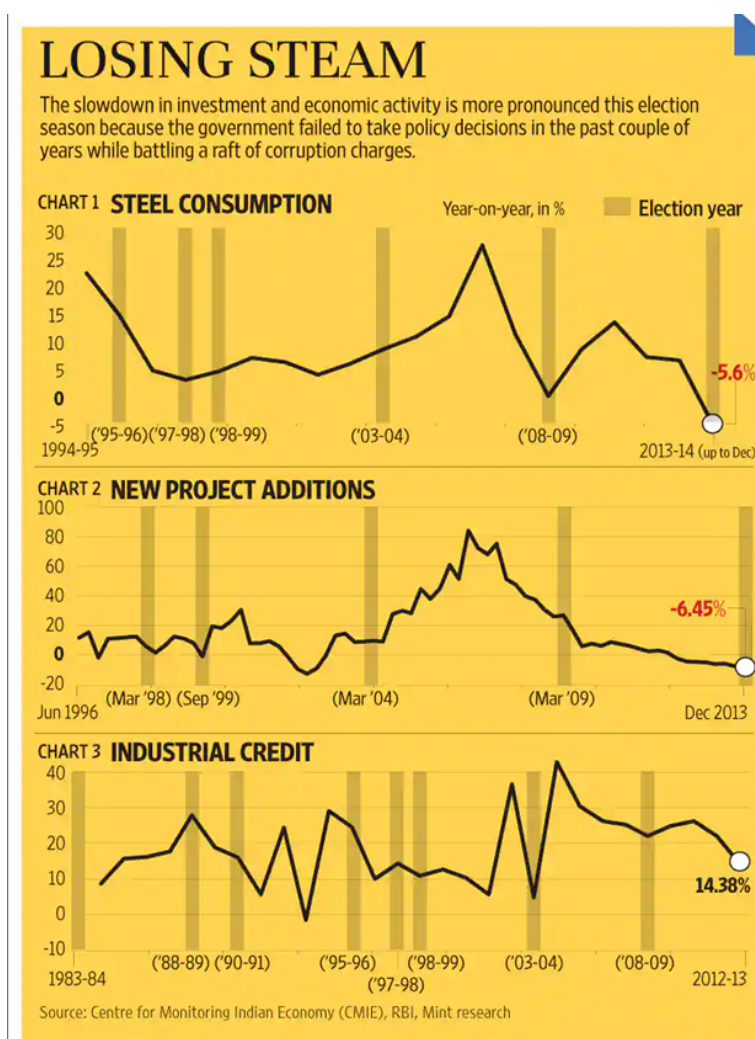
Since industrialists become cautious and want to see the changes brought about by the new government, they avoid investing in new projects. An implication of this is reduced industrial credit growth which was 1.8 percentage points lower in election years. There is also a clear spike in both total and revenue spending in the election year and the year just preceding it. However, this has a greater impact on inflation than on real economic activity.

These political business cycles, therefore, influence all agents of the economy in one way or the other. (Refer to the chart attached in references)

One might wonder then if there could be a systematic mitigation to fix the problem of political opportunism in government spending? The fact is, there is no easy way. These cycles, as

illustrated in this article, are inherent in the democratic structures across the modern world. However, political scientists propose that as democracy as an institution evolves to become more equitable and resistant to political manipulations, the propensity and intensity of these cycles may reduce.

As the society matures, citizens trust elected representatives more as well as have greater access to complete information. As voters get increasingly informed and aware of political incentives driving policy decisions, the less they would reward them for reforms enacted pre-election. There exists a negative correlation between the magnitude of the cycle and democracy, government transparency, media freedom, and voter awareness. The political parties also become incentivised to focus on long-term growth and development rather than short-term appeasement of its voters. Perhaps Indian democracy is still a work in progress in that respect.



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