

# The Political Business Cycles in the EU enlarged<sup>1</sup>

Mathilde Maurel<sup>2</sup>

## 1. Politics and business cycles

The rationale behind the EU enlargement has been extensively debated<sup>3</sup>. Several authors emphasised the lack of convergence between old and new members, and the risk of jeopardizing economic growth by limiting the room for political adjustment, others considered that the process of enlargement was a way of anchoring the transition towards the market, of stabilising the economies, and of accelerating the speed of convergence and catching-up. The most popular analytical framework used for assessing the pros and cons of the enlargement of the EMU is the OCA (Optimal Currency Area) theory. Basically, the theory tells that in the absence of economic symmetry, two countries are less likely to benefit from a common currency, and that if they do, the task will be easier with flexible markets. More recent studies go further by demonstrating that the process of monetary unification is an endogenous process. Once the political decision of entering a common market and sharing the same currency has been taken, business cycles become more synchronized - thanks to the increase in intra-industry trade amongst others - internal openness increases, capital market imperfection vanishes, contributing to ease the financing of backward regions.

Politics matters therefore, through the decision of making a currency union which is rendered rational *ex post* without being it necessarily *ex ante*. It matters also through political business cycles, which are key in the OCA literature, and which can be generated in Philips curves models under limited or perfect rationality. A good macro-economic situation is appreciated by the voters and helps incumbents to be re-elected. Hence politicians try to create political business cycles by tightening economic policy at the beginning of the political mandate and by relaxing it just before the elections. If they succeed, then business cycles are political in the sense that they are induced by political activism; they can be made more symmetric through electoral synchronisation, through convergence of political preferences, or through adherence to the same political agenda like the Stability Pact. All those factors should increase the symmetry of shocks that is the desirability of the common currency.

What is the state of arts of the empirical literature? First a strong economic situation favours the incumbents and their re-elections; this has been shown for several European countries<sup>4</sup>. Given that, politicians are likely to manipulate economic policy for trying to create (the

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<sup>2</sup> CES, Université Paris I Panthéon-Sorbonne, 106-112 Bd de l'Hôpital 75647 Paris CEDEX 13, France. Email: maurelm@univ-paris1.fr.

<sup>3</sup> See Fidrmuc and Maurel (2004), and Duchêne, Maurel and Najman (2004).

<sup>4</sup> Lewis-Beck (1988) for Britain, France, West Germany, Italy and Spain, and Madsen (1980) for Denmark, Norway, and Sweden.

illusion of) an economic expansion. If the public holds rational expectations, this is doomed to fail. If not, or if part of the information is hidden, political business cycles will happen: the cost of the deficit is delayed and inflation or devaluation ensue after elections. Empirical studies show that the deficit tends to increase during an election in both developed and developing countries, but significantly more in the latter<sup>5</sup>. Furthermore the result is driven by new democracies<sup>6</sup>, while in well established democracies, whatever developing or developed, it does not hold.

This has important consequences for economic policy and politicians in transition countries. First it implies that voters do not reward fiscal manipulation, and they do so only for the first three four years elections up to which the very mechanism of manipulation - its consequences on the increase in the level of prices and on the output – is known<sup>7</sup>. In other words if the information is perfect, voters are more likely to be “fiscal conservative”, and only if the information is not perfect, a myopic vote can reward opportunistic increases in deficits. Improving information by fighting against the lack of transparency, against corruption and any institutional mechanism lowering the well-functioning of the democracy will reduce therefore the scope for a political business cycle.

## 2. Transition countries and the EU enlarged

The evidence for transition and European economies echoes this overall pattern with specific features. Andrikopoulos, Loizides and Prodronidis (2004) examine whether EU member states manipulated the fiscal policy to create national political business cycles (PBCs), opportunistic or partisan, in the 1970–1998 period. Their analysis shows that governments have implemented stabilization policies rather. This finding is in contrast with that of Mink and De Haan (2006), who argue that fiscal policy-makers in the euro area have pursued expansionary policies before elections. “In an election year – but not in the year prior to the election – the budget deficit increases”. For Hallerberg and de Souza (2000), the ten Eastern European accession countries<sup>8</sup> have followed political business cycles during the period of their accession, but the pattern is no more pronounced than in the core EU 15 countries.

Those above contradictory findings are likely to be partially at least the product of different methodologies and specifications. In order to be able to compare our results with similar findings in the literature, we follow the specification of Brender and Drazen (2005):

$$f_{i,t} = \sum b_k f_{i,t-k} + \sum c' x_{i,t} + dELEC_t + \mu_i + \varepsilon_{i,t} \quad (Eq.1)$$

where  $f_{i,t}$  is a fiscal indicator in country  $i$  in year  $t$ ,  $x_{i,t}$  is a vector of control variables,  $ELEC_t$  is an electoral dummy set equal to one for the four quarter before and during the election, and  $\mu_i$  is a country fixed effect. In addition to fixed country effects, our control variables are those used by Brender and Drazen (2005)<sup>9</sup>, that is quarterly GDP per capita, the trade share, two demographic variables representing the fraction of the population aged 15–64

<sup>5</sup> See Shi, M., Svensson, J. (2002a, b).

<sup>6</sup> See Adi Brender, Drazen, Allan (2005).

<sup>7</sup> See section 5 of Adi Brender, Drazen, Allan (2005) and for Russia Akhmedov, A., Zhuravskaya, E. (2004).

<sup>8</sup> Russia is a very interesting example of a transition country which became suddenly a democracy. Using monthly Russian data between 1996 and 2003, Akhmedov and Zhuravskaya (2004) found sizable and short-lived political budget cycles which become smaller over time, suggesting a learning-by-doing process of voting.

<sup>9</sup> Who follow Persson and Tabellini (2003).

and 65+, and supply and demand shocks computed in the framework of a VAR, as a measure of the output gap<sup>10</sup>. Our sources are Eurostat, IMF, OECD, and the World Bank.

The empirical analysis includes 28 European countries, EU-25 members (including EMU members, EU-15, and some CEECs), plus Romania, Croatia, and Bulgaria, which are not yet members of the EU. It is based on a sample of 28 quarterly observations covering 1990 (first quarter) –2005 (fourth quarter), which makes a maximum number of 1792 observations. There are three fiscal instruments: total expenditure of the general government, total revenue of the general government, surplus (deficit), all three in percent of GDP, and one monetary instrument, the growth of M3. All variables are quarterly.

In the first column of [Table 1](#), we present fixed-effects regressions for the fiscal balance, revenues and expenditures, all as a percentage of GDP, and the rate of growth of M3. We find a highly significant political cycle in the fiscal balance, with the deficit rising in an election year by about five-tenths of one percent of GDP relative to non-election years. The political budget cycle is driven by expenditure, which increases by six-tenths of one percent of GDP relative to non-election years, it is not driven by revenue, which remains at the same level whatever the period under consideration, electoral or not. Our coefficient of -0.512 (equation 1) is comparable to -0.49, which is the coefficient found by [Shi and Svensson \(2002a, b\)](#), who considered a cross-section of both democracies and non-democracies over the period 1975–1995. The same equation over the same 20 year period is run by [Brender and Drazen \(2005\)](#), who obtain a significant coefficient of -0.632, insignificantly different from -0.49.

We run the same equation but within the sub-sample of transition countries, which are both developing countries and new democracies. We want to test the assumption that a voter in a developing country<sup>11</sup> or in a new democracy<sup>12</sup> has a lower ability to process the information correctly and therefore to punish incumbents for opportunistic deficits and wasteful spending. In the developed old Europe instead, voters are provided by experience with the electoral process, they benefit from institutions that collect and provide the relevant data, and from media which disseminate and analyze the information. Results do not support this story. Although completely new democracies and also developing countries, incumbent governments in CEECs do neither manipulate the economy in a more systematic way nor more efficiently than their Western counterparts. This of course has to be related to the fact that the EU enlargement has been processed under the tacit application of the Maastricht criteria, even though those criteria were heavily criticized as being not relevant for transition countries, catching-up the EU hub. It can be also related to the very limited room for adjusting external shocks given the trade dependence and the fact that monetary policy may create more volatility and noise in emerging countries, even in the short run<sup>13</sup>.

As emphasised in [Hallerberg and Vinhas de Souza \(2000\)](#), in a world of capital mobility and fixed exchange rates running larger deficits in election time is more likely than having a loose monetary policy. We replace fiscal variables by the rate of growth of M3 (columns 4), and find indeed that the latter is not used in order to manipulate the economy. This reflects the fact that the number of instruments available to the manipulation is constrained by the monetary regime and the construction of the euro zone.

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<sup>10</sup> For the methodology see [Babetski, Boone and Maurel \(2004\)](#).

<sup>11</sup> As suggested by [Shi and Svensson \(2002a, b\)](#).

<sup>12</sup> As demonstrated by [Brender and Drazen \(2005\)](#).

<sup>13</sup> See [Coricelli, Jazbec and Masten \(2004\)](#).

We test also the fear that once the currency has been introduced, nothing impedes the governments to resort again to economic manipulation. This would translate into higher levels of expenditures and deficits during election quarters after December 1999 (columns 3). But somehow surprisingly, the idea that free rider behaviours are more likely to occur once the monetary union has been achieved is not supported by the results. This of course may be due to the time span available, only 5-6 years.

### 3. Conclusion

This paper argues that the process of monetary integration across the 25 countries which constitute the enlarged EU has been successful in the sense that the budget cycle which was active at the beginning of the nineties vanished after the launch of the euro. Moreover, the magnitude of the fiscal manipulation or the increase in deficit in a year of election does not appear to be higher within the sub-sample of Ceecs, which are both developing and new democracies.

It has important implications for the perspective of the EMU extension to Eastern European countries. If we assume that part of the asymmetry in business cycles is due to opportunistic behaviour during election times, more particularly in developing and new democracies where the public is more likely to believe that fiscal manipulation can create jobs, then the participation to the EMU of those new democracies can embody costs to the monetary union as a whole. Our results do not support this view. In the new Eastern European countries, fiscal manipulation is not rewarded more than in other European countries and incumbents do not engage more in it.

The question of the participation of accession countries to the EMU remains unsolved. It depends upon many other costs and benefits which according to a recent literature have been shown to be endogenous. For instance, the decision of entering a currency union has a significant impact on the degree of openness, on the symmetry of shocks, if intra trade increases as a result of the adoption of a common currency, on capital mobility, etc. But could't this decision itself be delayed if politicians were tempted to keep an instrument of re-election? Such a question is beyond the scope of the paper of course...

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Table 1  
The political budget cycle across countries, fixed effects estimates, 1990–2005

Dependent variable <sup>a</sup>	All European Countries				Ceecs				After the introduction of the Euro				After 1995			
	(1)				(2)				(3)				(4)			
	Exp	Rev	Bal	tM3	Exp	Rev	Bal	tM3	Exp	Rev	Bal	tM3	Exp	Rev	Bal	tM3
ELECT <sup>b</sup>	0.679** (0.307)	0.193 (0.202)	- 0.512* (0.295)	0.002 (0.003)	0.775* (0.483)	0.181 (0.341)	- 0.556* (0.354)	0.002 (0.007)	-0.156 (0.240)	-0.203 (0.220)	-0.163 (0.268)	-0.001 (0.002)	0.710** (0.316)	0.326 (0.231)	-0.373 (0.300)	0.002 (0.003)
R2 within	0.3165	0.525	0.163	0.138	0.4722	0.6647	0.2243	0.240	0.3701	0.4397	0.1031	0.019	0.2182	0.3742	0.090	0.1804
F-Stat	67.55	161.74	28.42	23.33	40.70	90.18	13.15	14.06	40.25	53.75	7.88	1.32	30.78	65.93	11.02	24.09
N° of countries		26		26		10		10		26		26	26	26	26	26
N° of observations		1201		1192		382		374		582		576	916	916	916	910
Average time series length		46.2		4538				37.4		22.4		22.2	35.2	35.2	35.2	35.0

The covariates include one lag of the dependent variable, the log of per-capita GDP, the ratio of international trade (sum of merchandise exports and imports) to GDP, the fraction of the population over age 65, the fraction of the population between ages 15 and 64, and the supply and demand shocks, using the VAR methodology. For a presentation of this methodology in the present context, see Babetski, Boone and Maurel (2004).

\* Significant at the 10 percent level; \*\*significant at the 5 percent level; \*\*\*significant at the 1 percent level.

<sup>a</sup> Variable definitions (all in percent of GDP): balance—central government surplus; Exp—total expenditure by the central government; Rev—total revenue and grants of the central government; tM3- rate of growth of M3.

<sup>b</sup> ELECT—a dummy variable with the value 1 in the election year and 0 otherwise.