

The Political Business Cycle

I. Introduction

- A. Through most of course we have examined consequences of alternative policies and in some cases evaluated alternative policies according to some welfare criterion.
- B. The political incentives regarding policymaking have been mostly left unexplored.
- C. Macroeconomic conditions seem to be highly relevant politically; and one would expect political concerns to influence observed policymaking procedures.

II. Nordhaus's political business cycle.

A. Assumptions

1. The economy can be characterized by an augmented Phillips curve (perhaps with vertical LR Phillips curve). Nordhaus's model was developed before rational expectations was firmly accepted.
2. Individuals prefer low inflation and low unemployment, and their voting reflects this. Essentially, they vote for an incumbent if conditions are currently better than average; otherwise they vote against. Voters are myopic - they do not look far into the future or the past when evaluating incumbents.
3. Voters know what they like, but they don't know much about economics. Specifically they do not understand current (and future) constraints relating economic variables. They do not distinguish temporary from permanent tradeoffs. Essentially expectations are adaptive - I expect future conditions to be much like they are today.
4. Politicians are vote maximizers.

B. Implications

1. There is an inflationary bias. This is because a given stimulus has immediate temporary benefits, but prolonged future costs.
2. Policy will create a PBC. Conditions will be unsustainably good just before elections. Show saw-toothed pattern for unemployment, inflation.

C. Evidence

1. Nordhaus looked at data from nine countries and provided casual empirical evidence regarding the PBC.
2. He looked at the direction of movement of the unemployment rate in pre-election as opposed to post-election periods (looking at the two year periods before and after elections in the U.S. case).
3. For Germany, New Zealand, and the U.S. Nordhaus found strong support for the PBC.
4. 1972 is a good example of an apparent PBC year.

III. Evidence from others

- A. Monetary Policy (Allen-N, Beck-N, Grier-Y, Laney and Willet-?).
- B. Fiscal Policy (Lowery-N, Kiewiet and McCubbins-Y).
- C. Outcomes (Beck-YN, Golden and Poterba-N, Haynes and Stone-Y, McCallum-N).
 1. Model Extensions (Rogoff and Sibert).