THE ELECTORAL BUSINESS CYCLE IN MALTA

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Abstract. Despite the fact that theoretical research on electoral political cycles is well developed, empirical literature has found relatively weak evidence of such cycles. This paper tries to reformulate the existing theory on two levels. On the empirical level, it investigates the existence of very short cycles by using monthly data. On the theoretical level, it argues that the action taken by the incumbent government varies from election to election depending on its opinion poll standing. The main hypothesis on which this theory is based is that the degree to which the party in government tries to manipulate the economy should be negatively correlated with the chances of being re-elected.

Introduction

The common perception regarding political business cycles is that incumbent parties often try to use expansionary economic policy before elections to increase their re-election chances. Most politicians and non-politicians alike would probably subscribe to this view, and the term ‘election-year economics’ is common in many countries. The theory rests on rather straightforward and plausible reasoning: incumbent politicians want to be re-elected, their electoral fortunes depend heavily upon the health of the economy (Kramer, 1971) and they have at their disposal policy instruments that can influence macroeconomic performance. From this reasoning, one can conclude that governing parties will attempt to influence the economy prior to elections in order to secure favourable outcomes. In the political economy literature, this view is summarised as the ‘political business cycle,’ that is, the possibility of a macroeconomic cycle induced by the political cycle.

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Despite the fact that theoretical research on political business cycles is very intuitive and well developed, empirical literature produced mixed results. This apparent contradiction between the theory and evidence created an intellectual puzzle. The purpose of this paper is to propose a possible solution to the puzzle.

Theoretical Overview

Kalecki (1943) was the first to develop the idea that politicians might alter policies before elections. This led to the development of the literature on political business cycles. Two main strands of literature emerged that tried to explain economic fluctuations around elections. The literature on opportunistic cycles argues that electoral pressures force the incumbent party to manipulate economic policy in order to increase its probability of re-election.

The alternative approach – partisan theory – argues that policies are predetermined by ideology. Specifically, left-wing parties are more conscious about unemployment than inflation, unlike right-wing parties. As a result, economic fluctuations arise as a result of policy changes when different parties alternate in office.

The theoretical literature came in two waves. The first non-rational wave flourished in the mid-1970s. These models use traditional macro-economic models which, taking advantage of an exploitable Phillips curve, governments can systematically and predictably influence macro-economic outcomes. Nordhaus (1975) and Lindbeck (1976) developed the first opportunistic model. On the other hand, the first partisan political business cycle model was built by Hibbs (1977). Frey and Schneider (1978) combined the elements of both models to develop the so-called weak partisan theory.

The second phase of the literature evolved in the mid-1980s as a branch of the game-theoretic approach to macroeconomic policy, with Kydland and Prescott (1977) as forerunners. These models of political cycles incorporate rational expectations and emphasise how a rational public limits the extent to which policymakers can influence the economic cycle. Amongst others, Cukierman and Meltzer (1986) and Rogoff and Sibert
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All of the mentioned models assumed that government has full control in the implementation of policy. However, this is not the case in reality. Government is basically the exercise of administration. We are increasingly administered and subject to a bewildering and complex structure of institutions. A new wave of literature extended the rational models to accommodate the importance of the institutional context of policymaking. Gonzalez (2000) models explicitly the levels of democracy and transparency prevailing in the economy. Brender and Drazen (2004) argue that experience with elections and democratic maturity are key factors. This has brought to the fore the concept of ‘old’ versus ‘new’ democracies.

Other authors present different variables which in their opinion influence the magnitude of political business cycles. These include the degree of discretionary power, Streb (2002), and the separation of powers, Saporiti and Streb (2003). Recently, literature has focused on the role and characteristics of elections and their effect on pre-electoral economic manipulation. The effect of electoral rules was examined by Persson and Tabellini (2003) whilst the mechanism that sets the election date was analysed by Shi and Svensson (2002).

However, the empirical support of the electoral-cycle idea is generally weak. Studies of developed countries (Alesina and Sachs, 1988; Alesina and Roubini, 1988) revealed much stronger evidence of partisan rather than opportunistic cycles. Non-convincing evidence for opportunistic cycles in developed countries motivated the new wave of empirical research using data from developing countries. These studies have identified determinants of the cycles, electoral competition (Block 2001) and levels of democracy and transparency (Gonzalez 2000). This recent research on developing countries produced more convincing evidence of opportunistic cycles. This evidence, however, is not always as strong as one should expect.

It is clearly evident that there is a gap between theory and empirical evidence. This mixed track record of the political business cycle has led some authors to abandon this theory. However, this conclusion is hard to reconcile with the intuitive plausibility of the model. What could be needed
is to bridge this gap and reformulate the existing model. This paper proposes a reformulation of both the empirical and theoretical aspects of the model.

**Model Reformulation**

*Empirical Analysis*

Most empirical studies so far have used quarterly or annual data. This implies that not all fluctuations can be captured especially if they are of short duration. Akhmedov and Zhuravskaya (2003) argue that monthly data should be used so as to allow a very careful measurement of even very short cycles. The empirical adjustment makes the model more able to detect fluctuations of short duration and this improvement is surely a step forward in bridging the existing gap between theory and empirics. This method will be used to test for opportunistic policy cycles in Malta.

*Theoretical Specification*

Traditional models of the political business cycle that assume that incumbents’ interests to manipulate the economy do not vary from one election to the next are flawed. In these models the key variable is the presence or absence of an election. Analysts employing these models often expect to find uniform and systematic policy cycles. However, elections are different from each other, and so are the incentives and political needs the incumbent government faces. Therefore, if an incumbent goes into an election relatively sure that it will be re-elected, the incentives it faces to engineer economic cycles would be different from those when its re-election prospects are weak. Therefore, many models may have misspecified the interests of the incumbent parties.

In order to gauge economic fluctuations, political business cycle models have to be sensitive to the political needs of the incumbent party. We would thus expect that the policy cycle will not be uniform and systematic but will vary from one election to the next as a function of the incumbents’ political security.
Marginal Benefits

The process of engineering economic cycles to gain votes entails both costs and benefits. The key benefit which governments derive from pre-election policy manipulations, and the sole reason why they engage in such activity, arises from the increase in probability of re-election. The benefit which they derive from those additional votes is not constant, but a function of how many votes they can already count upon. Its main aim is to get the number of votes that will ensure re-election. This is in line with the weak partisan theory developed by Frey and Schneider (1978). Manipulation takes place when the actual lead is below the critical lead, hence when the incumbent is facing a popularity deficit. The bigger the actual lead over the critical lead the less benefit is derived from pre-election policy manipulation. The law of diminishing returns holds in this case since the marginal benefit of winning additional votes through economic policy manipulation decreases as the actual lead gets higher.

Marginal Costs

An analysis of incentives of policy manipulations cannot focus purely on the benefit side. The potential costs of this behaviour will also figure into governments’ calculations. It is unrealistic to assume that governments can costlessly fiddle with the economy for political gain. Economic policy manipulations can entail substantial costs because of their effect both on the governing party’s reputation and on future macroeconomic performance.

Politically motivated manipulations of economic policy can lead to charges of myopic and opportunistic behaviour by both the press and opposition parties. Such charges can affect not only the current campaign, but future ones as well, since the reputational charge can lead to losses in long-term partisan support. Hence, the reputational risk involved in party manipulation will be likely to constrain governments to avoid this kind of behaviour, unless it is absolutely necessary. Furthermore, future economic consequences can also serve as an important disincentive to current manipulations. Another important consideration in this regard is that it may be politically costly, if not impossible, to reverse course after the election. A fiscal stimulus before the election cannot be easily erased by fiscal belt-tightening afterwards. After all, it
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is politically much easier to start a new spending programme than to get rid of one. The other alternative, of course, would be to raise taxes or cut spending elsewhere in order to counteract the initial stimulus. Such actions are not without their political costs.

There is therefore good reason to believe that governments do face future costs in pre-election policy manipulations. In addition to the reputational risk involved in such behaviour, governments will either suffer from the inflationary effects of the pre-election stimulus or from the attempts to disinflate after the election.

Through the above analysis of marginal costs and benefits, it is evident that the incumbent government faces an optimisation problem at each election. Theoretically this means that governments continue taking action until the marginal vote gain from such activity equals the marginal vote loss from same activities (Downs 1957).

This analysis clearly points out that the degree to which a government will manipulate the economy prior to an election will vary inversely with its political security when going into an election. Therefore, the key explanatory variable should be the chance of re-election of the incumbent.

To quantify those chances, the simplest indicator is its standing in public opinion polls. From this it follows logically that the degree to which the government will manipulate the economy prior to an election is negatively correlated with its lead in public opinion polls at the time. Thus the basic model can be improved in two ways namely by using monthly data and by referring to opinion poll data. The next section will apply these modifications analyse the electoral business cycle in Malta elections during the period 1996 to 2003.

Testing the Model

Case Selection

The Maltese case is particularly useful because the political variables of central interest are relatively easy to analyse. Since Malta has only two
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major parties, the poll lead can be readily measured as the differential between the governing party and the main opposition party. This analysis focuses on a number of fiscal policy instruments and economic outcomes over the elections held between 1996 and 2003.

Maltese governments, like most governments in the advanced democracies, can to an extent choose the date of the election. This means that the governing party has two tools for influencing outcomes: it can intervene in the economy to engineer a pre-election boost, or it can wait until it is doing well in the polls and simply ‘surf’ on a wave of high approval ratings. In practice, governments probably do a mixture of both. As a result, any model that looks only at economic policy instruments and treats election dates as exogenously fixed is looking at only part of the story.

To test the hypothesis that there was an electoral business cycle in Malta, it is necessary to examine policy instruments over which elected officials had some direct control on matters which can influence voters in the short term.

For this study a number of policy instruments are chosen. On the expenditure side government recurrent expenditure, social security benefits, as well as the social and infrastructural components of capital expenditure are chosen. On the revenue side, tax revenue and current revenue are considered. Public sector employment and inflation rates are also included in the analysis.

The important characteristics of these policy instruments are (a) they have the effect of raising real disposable income in the short run (b) they can also stimulate short term economic growth and thereby reduce unemployment.

1. There is a third political party in Malta which is the Alternativa Demokratika (the Green Party) but it did not pose a major threat to the two large ones (the Nationalist Party and the Malta Labour Party).
2. Such a short period was chosen due to the data limitations. Monthly economic data as well as voter intention statistics are not available. As a result one must interpret the results with caution as the number of observations is small.
3. “Blair banks on economic feel-good factor for election,” headline article on the Times (of Malta), of Saturday 12th February 2005.
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Test for Opportunistic Policy Cycles

The test for electoral business cycles this paper draws on Akhmedov and Zhuravskaya (2003), and is based on the 3-month moving average of seasonally adjusted de-trended policy instruments and outcomes from a year before to a year after elections. Detailed graphical representations of the changes described below are given in Fabri (2005).

1996 General Election

An examination of the dynamics of policy instruments and outcomes shows that government recurrent expenditure and social security benefits tended to increase right before the elections even though they did not reach their peak level.

Data also shows that the average values of the capital expenditure instruments in the year before elections were higher than in the year after. There is also an indication of political cycles in revenue policy instruments. All average values are lower in the year before elections.

Public sector employment reached its peak right before the election with the six months before the election showing a steady increase.

1998 General Election

The 1998 election is a special case as it was a premature election. If one examines the dynamics of the average values of government recurrent expenditure and social security benefits, one finds that these were higher in the year before the election. This was not, however, the case with the capital expenditure policy instruments.

There can be two possible explanations to interpret these figures. One has to keep in mind that since the government lost control of election timing it may not have had a chance to boost the economy sufficiently before the election. Another interpretation can be attributed to partisan effects. It might be that a left-wing party is more inclined towards recurrent expenditure and transfer payments than capital expenditure.
No politically motivated policy cycles can be identified when analysing the revenue instruments for this election. However, public sector employment figures show a notable upward trend just before the election.

2003 General Election

In this election the incumbent party enjoyed a comfortable lead in the polls. In this case, the average values of all policy instruments, except the social capital expenditure instrument, are lower during pre-election year. The revenue average values are lower in the case of total revenue in the year before as opposed to current revenue.

On the other hand the public sector employment graph shows some upward but was rather stable in the month before the election unlike other elections.

Overall Tendencies

The results also show that the cycles differed from one election to another. This seems to suggest that political business cycles are not only sensitive to the presence of an election but also to the political needs of the incumbent party. The following test, based on the arguments put forward in this paper, seeks to suggest a possible explanation.

Political Security and the Political Business Cycle

From the arguments put forward in this paper, it is evident that a political business cycle model must capture the incumbents’ political confidence in a political victory. Voter intention surveys provide an important measure of this confidence or security. Therefore, it can be argued that opinion poll standing of the incumbent government is an important variable explaining the electoral business cycle in Malta.

In order to test these arguments, the analysis focuses on the relationship between individual policy instruments and governing party’s lead in the polls. In this way, it is possible to model the impact of each election conditional on the government’s security at the time. It is important to note at this stage the importance and reliability of opinion polls in Malta.
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In Malta, opinion poll data tended to predict quite correctly the outcome of the elections.

In order to carry out this analysis, the 3-month percentage growth rate of the variable under study, cleansed of seasonal effects was calculated. This pre-election growth rate was then expressed as a function of the percentage of the governing party’s lead in the polls.

It is to be expected that expenditure items are negatively related to the governing party’s lead in the polls, while in the case of revenue instruments the relationship should be positive.

When the incumbent party has a low rating in the opinion polls its main goal is to try and improve its chances of re-election since the potential benefits of pre-electoral manipulation could be very attractive while the future reputational and economic costs could be discounted heavily. Therefore a low opinion poll rating is expected to result in policies that attempt to increase government expenditure and lower government revenue. Through these policy tools the incumbent party can induce a politically motivated economic cycle in order to improve its chances of re-election.

The analysis presented in Fabri (2005) shows that as regards the revenue sub-components, there was the predicted positive relationship in all three elections. This also holds true for all elections in the case of total government revenue.

When analysing current revenue and tax revenue, 1998 is an exception. As regards the capital expenditure policy instruments, the 1998 outcome warrants special consideration. As was argued earlier on, there are two possible interpretations, one being that 1998 was a premature election and the other, that there is an ideological explanation.

In the case of public sector employment, a negative relationship is envisaged. Once again, 1998 is the exception to the predicted behaviour. The arguments and evidence point out that voter intention surveys are likely to be good explanatory variables in determining the occurrence of political business cycles. It is therefore important that,
in order to capture the politico-economic process fully, voter intention surveys should be included in the analysis.

Conclusion

Keeping in mind the limitations of the analysis in particular the small sample, one can derive a number of stylised conclusions:
1. *Politicians have an incentive to secure re-election.* As a result economic policy instruments may be subject to manipulation.
2. *Cycles are relatively small and unsystematic.* The incentives of the party in government differ from one election to the next. The main reasons for this are that (a) policymakers do not have enough control over the economic cycle to be able to create changes that improve the chances of re-election immediately before each election, (b) an excessively open and systematic pre-electoral manipulation of the economy may be counterproductive due to reputational effects.
3. *The use of monthly data is important.* In Fabri (2005) the use of monthly data allowed a very careful measurement of even very short cycles. As the results show, most sizable positive changes happen a month or two before the election, thus, lower frequency data would have substantially underestimated cycles. This method, developed by Akhmedov and Zhuravskaya (2003), highlights the short duration of the cycles and may explain why many previous tests of the theory did not find convincing evidence of cycles.
4. *Opinion polls are important considerations.* In this paper, it was argued that the chances of re-election of the incumbent party is an important consideration when analysing pre-electoral behaviour. It was suggested that the best proxy for this security is opinion poll ratings. Such voter intention statistics can influence the incumbent to intervene in the economy to engineer a pre-election boost.

It should be emphasised here that, a test involving just three elections in no way constitutes the ultimate proof of the ideas developed here. Further testing that covers a larger time series is clearly required. Nevertheless, the analysis in this paper suggests that this approach to the political business cycle is promising and worthy of more research.
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References


