Available online at www.sciencedirect.com

ScienceDirect

ELSEVIER Journal of Economic Dynamics & Control 31 (2007) 1051–1080

JOURNAL OF Economic Dynamics & Control

www.elsevier.com/locate/jedc

Electoral uncertainty, fiscal policy and macroeconomic fluctuations

Jim Malley[a,*], Apostolis Philippopoulos[b], Ulrich Woitek[c]

[a]*Department of Economics, University of Glasgow, Glasgow G12 8RT, UK and CESifo*
[b]*Apostolis Philippopoulos, Athens University of Economics and Business, Greece and CESifo*
[c]*University of Zurich, Switzerland and CESifo*

Accepted 23 June 2006
Available online 7 September 2006

Abstract

In this paper we study the link between elections, fiscal policy and aggregate fluctuations. The setup is a stylized dynamic stochastic general equilibrium model incorporating both technology and political re-election shocks. The latter are incorporated via a two-party model with elections. The main theoretical prediction is that forward-looking incumbents, with uncertain prospects of re-election, find it optimal to follow relatively shortsighted fiscal policies, and that this hurts capital accumulation. Our econometric estimation, using U.S. data, finds a statistically significant link between electoral uncertainty and policy instruments and in turn macroeconomic outcomes.
© 2006 Elsevier B.V. All rights reserved.

JEL classification: D9; E6; H1; H5

Keywords: Political uncertainty; Business cycles and growth; Optimal policy; Hybrid maximum likelihood estimation

*Corresponding author. Tel.: +141 330 4692; fax: +141 330 4940.
E-mail address: j.malley@lbss.gla.ac.uk (J. Malley).

0165-1889/$ - see front matter © 2006 Elsevier B.V. All rights reserved.
doi:10.1016/j.jedc.2006.06.004

1. Introduction

Modern business cycle theory treats growth and cycles as integrated phenomena that cannot be analyzed separately. It also suggests that both should arise as the equilibrium outcomes of rational optimizing private and public economic agents. As is well recognized, the reference model of this research program (known as real business cycle (*RBC*) theory) is the standard neoclassical growth model augmented with technology shocks.[1] In recent years, there have been numerous developments that have attempted to improve the model's ability to reproduce both bi-variate and multi-variate correlations between key macroeconomic time series.[2] Two common features of all these extensions (known as dynamic stochastic general equilibrium (*DSGE*) models) are the inclusion of various demand and supply shocks, as well as the introduction of market frictions that affect the channels through which these impulses propagate through the economy.

An important branch of the DSGE literature has introduced fiscal policy into the basic setup.[3] An effective way of achieving this is to model economic policy as the outcome of elections between alternating political parties (see e.g. Drazen, 2000, Persson and Tabellini, 1999, 2000, for thorough surveys). A central result of these models (known as political business cycle (*PBC*) models) is that uncertainty about remaining in office pushes incumbent politicians to follow relatively short-sighted policies and engineer electoral business cycles, which in turn result in inefficient macroeconomic outcomes.[4]

The quantitative link between electoral uncertainty, endogenous changes in fiscal policy and the ensuing macroeconomic impacts is still an open issue. For instance, while there is some evidence of electoral effects on fiscal policy instruments, there is no evidence that this is translated into changes in the macroeconomy (see Alesina et al., 1997; Drazen, 2000). More importantly, there seems to be a gap between the albeit parsimonious theoretical *PBC* models and their econometric counterparts. In particular, with few notable exceptions,[5] existing empirical work has been only loosely guided by the theory. Typically, these studies are based on simple autoregressive specifications in which various policy instruments and

[1]For a critical review of the basic *RBC* model, see e.g. King and Rebelo (1999).

[2]For the main extensions of the basic *RBC* model, see e.g. the papers in the volume edited by Cooley and Hansen (1995).

[3]For *DSGE* models with exogenous fiscal policy, see e.g. Christiano and Eichenbaum (1992); Baxter and King (1993); McGrattan (1994), Gali (1994), McGrattan et al. (1997), and Baier and Glomm (2001). For DSGE models, where fiscal policy is chosen by a benevolent Ramsey government, see e.g. Lucas (1990), Chari et al. (1994), Lansing (1998); Klein and Rios-Rull (2003).

[4]On the other hand, elections (or the fear of losing them) can work as a disciplinary device. For instance, they control the moral hazard of politicians, help voters to select the most competent politician, or help voters to select the policymaker whose ideology is closer to their own. Here, following most of the related *PBC* literature, we abstract from the benefits of electoral uncertainty.

[5]Examples of papers, which formally estimate theory-based *PBC* models, include: Alesina and Sachs (1988) for a partisan model of monetary policy for the U.S.; and Lockwood et al. (1996) for a public-finance model for the U.K.

Download English Version:

https://daneshyari.com/en/article/5099698

Download Persian Version:

https://daneshyari.com/article/5099698

Daneshyari.com