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A theory of political and economic cycles

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Abstract

We develop a theoretical framework in which political and economic cycles are jointly determined. These cycles are driven by three political economy frictions: policymakers are non-benevolent, they cannot commit to policies, and they have private information about the tightness of the government budget and rents. Our first main result is that, in the most favorable equilibrium to the households, distortions to production emerge and never disappear even in the long run. This result is driven by the interaction of limited commitment and private information on the side of the policymaker, since in the absence of either friction, there are no long run distortions to production. Our second result is that, if the variance of private information is sufficiently large, there is equilibrium turnover in the long run so that political cycles never disappear. Finally, our model produces a long run distribution of taxes, distortions, and turnover, where these all respond persistently to temporary economic shocks.
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1. Introduction

Economic and political cycles are deeply interconnected. On the one hand, economic shocks impact the tenure of leaders, as incumbents are often replaced following negative economic shocks. On the other hand, political risk and the threat of turnover can often induce policymakers facing potential replacement to become shortsighted and to choose inefficient policies.

For example, the collapse of commodity prices in the late 1970s and early 1980s caused a sharp decline in government revenues in many sub-Saharan African countries. Unable to fund public services, leaders faced the threat of removal. In some cases, they responded to this threat by taking measures which increased social programs while simultaneously expropriating private enterprises, further exacerbating the economic crisis.[1,2]

In this paper, we develop a framework in which political and economic cycles are jointly determined. In our environment, these cycles are driven by three key political economy frictions. First, policymakers are not benevolent, and are instead driven by political rents and by the desire to preserve power. Second, policymakers lack commitment, and once in office, they are not bound to the promises which they made to citizens. Finally, policymakers have private information about the tightness of the government budget and their rent-seeking activities. We embed these frictions in an environment which combines two frameworks. The first framework is a standard political accountability model with asymmetric information in which citizens can punish incumbents with replacement. The second framework is a dynamic production economy with rent-seeking.

More formally, our economy is populated by households which choose investment and a non-benevolent policymaker who chooses taxes and rents. The policymaker cannot commit to policies after households have made their investment decision, and households discipline the policymaker by threatening to replace him. The government controls a stochastic endowment, where this captures a shock to the value of government royalties or to the cost of public spending. The policymaker privately observes the size of this shock and privately chooses the level of rents. This implies that if citizens observe high taxes, they may not be able to determine whether this is due to an exogenous aggregate shock which tightened the budget or whether this is due to unobserved rent-seeking by the policymaker.

We consider the equilibrium which maximizes the ex-ante welfare of citizens, and we characterize the dynamics of distortions to production (economic cycles) and the dynamics of political turnover (political cycles). The equilibrium takes into account the joint interaction of the constraints of limited commitment and private information on the side of the policymaker. We show how in the absence of either friction, there are no distortions to production–and thus, no economic cycles–since the level of investment is efficiently chosen in the long run. In the absence of asymmetric information, for instance, our model features *backloading*. Specifically, a policymaker is never replaced, though if he deviates by expropriating households, he is replaced off the equilibrium path. While distortions emerge along the equilibrium path in order to limit the resources which can be expropriated by the policymaker, these distortions eventually disappear

[1] See Bates [18] for further discussion of these episodes. As an example, following the collapse of copper prices, President Kaunda of Zambia nationalized several milling companies, imposed price controls, and limited government debt service as part of the Interim New Economic Recovery Programme. Between 1988 and 1991, investment in Zambia declined by 17%. See Baylies and Szeftel [20] and Simutanyi [54] for additional discussion.

[2] As an another example, many Latin American countries dependent on commodity exports experienced economic and political crises following the collapse of commodity prices in the late 1970s and early 1980s. For a discussion of the experience of Mexico, see Bergoeing et al. [21], for example.

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