CHAPTER 1

Introduction

> As soon as they decided to compete for votes, sometime between 1884 and 1892, socialist parties sought to gain the electoral support of people other than workers.
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> As socialists become parties like other parties, workers turn into voters like other voters.
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> —Adam Przeworski (1985)

On May 2, 1997, Tony Blair, an advocate of "Christian socialism" since his university days, became prime minister of the first Labour government in Britain in eighteen years. On May 6, his "New Labour" government moved to enhance the independence of the Bank of England by transferring day-to-day control over monetary policy from Whitehall to the "Grand Old Lady of Fleet Street." On September 27, 1998, Gerhard Schroeder was elected head of the first Social Democratic government in Germany in sixteen years, ending the record-setting tenure of conservative chancellor Helmut Kohl. Six months later, Schroeder parted ways with his finance minister amid concerns that Oskar Lafontaine's left-wing politics would no longer be tolerated by international markets—or, for that matter, by the Bundesbank. In both cases, left-wing governments were elected to replace long-lived conservative predecessors, only to take actions that appeared to hardwire policy outcomes that were strikingly similar to those favored by the conservatives. In the popular press, these and countless similar events have been interpreted as evidence of a growing convergence around market-friendly policies. National governments, it is widely argued, have been forced to accept this convergence because of the workings of an ongoing historical process known as globalization. The engine behind this globalization is believed to be the rapid increase in international financial integration that has taken place in the last few decades.

While this "convergence" view of the current international political economy is widely accepted, there is virtually no evidence to support its main dynamics. Empirical studies have been unable to demonstrate a convergence in either the macroeconomic policies or the macroeconomic outcomes produced by governments of the left and right as capital mobility has increased. This is surprising, because it is reasonable to expect that as it becomes easier to move financial assets to the place where they will bring the highest return, governments of every political stripe can ignore the policy demands of the holders of such assets only at their own great peril. What explains this contrast between expectation and observation? In this book, I argue that the standard interpretation of the convergence argument—both the version put forth by its proponents and that put forth by its opponents—is deeply flawed. Specifically, existing studies find no evidence of a growing convergence between parties as a result of increased capital mobility because, as the quotations from Przeworski at the beginning of this chapter imply, the convergence between parties is a hallmark of economic policy-making in democratic capitalist societies and, consequently, predated the recent increase in capital mobility. Recent empirical studies have produced confusing results because they were looking for the effects of capital mobility on a phenomenon that does not exist—namely, partisan differences in policies or outcomes.

One theme that emerges from my analysis of the politics of macroeconomic policy in the late twentieth century is that many of the domestic political consequences of "globalization"—partisan convergence, constraints on the choices of democratically elected governments, the need for governments to anticipate the response of "footloose" capital, and so on—are not the recent effects of changes in the international economy. Instead, they appear to be the enduring features of the process of economic policy choice in polities dominated by private investment and electoral politics. Such sweeping claims are typically accompanied by equally sweeping surveys of history. In this volume, however, I choose to examine just enough of recent history to get a glimpse of macroeconomic policy and performance before and after "globalization." Comparisons with earlier periods of mobile capital and experiments with central bank independence would be informative but will not be pursued here.[1]

Much has been written about the effects of international capital mobility and central bank independence and the way in which they may or may not constrain economic policy choice. International capital mobility, it has been argued, has torn down barriers between countries, barriers that had (depending on your perspective) prevented resources from being optimally allocated or served as a buffer between a nation's citizens and the risks of the international economy. Central bank independence has been declared to be a nearly magical technology that provides price stability without losses in output. But it has also been seen as a threat to democratic control over economic policy. Many such propositions are advanced—and accepted or rejected—with very little reference to empirical evidence. What empirical evidence does exist to support or challenge such broad claims tends to rest on one or another model (often implicit) of the political control of the macroeconomy. The results of such studies are, therefore, meaningful only to the extent that the appropriate underlying model of the political economy has been identified. Since the veracity of these models is highly contested, the conclusions about the effects of capital mobility or central bank independence are much more provisional than is typically admitted.

This book examines competing claims about the political sources of macroeconomic policy and performance in a manner that allows us to evaluate the ways in which central bank independence and increased capital mobility structure the interaction between political goals and macroeconomic policy outputs. Specifically, I compare the two main models of the political control of the economy—the partisan and the electoralist models[2]—and find more support for the latter. I argue that close attention to how these structural factors influence the behavior of policymakers reveals new insights about competing models of political processes within countries, and that, at the same time, an examination of the effects of international capital mobility and central bank independence in the context of the electoralist model sheds new light on their political and economic consequences.

The partisan model of the political control of the macroeconomy predicts that political parties with different ideological orientations will enact systematically different policies and produce systematically different macroeconomic outcomes (Hibbs 1977; Tufte 1978). Parties of the right will choose policies that maximize price stability, even at the expense of growth and employment, while parties of the left will be more inclined to trade away price stability to achieve higher levels of employment and faster rates of growth. In contrast to the partisan model, the electoralist model asserts that electoral constraints force politicians of all stripes to behave in much the same way—they must select policies and produce outcomes that please the median voter (Downs 1957). The electoralist political business cycle model adds to the Downsian model a number of assumptions about the way voters form expectations and yields predictions that tie the behavior of policymakers to the electoral calendar. Incumbents will do their best to create growth and employment in the period leading up to elections, even if such behavior leads to future inflation (Nordhaus 1975).

One assumption that the electoralist and partisan models share is that policymakers have sufficient control over the instruments of monetary and fiscal policy to determine inflation, growth, and employment outcomes. This book explores two structural factors that call that assumption into question. Central bank independence is specifically designed to shelter the instruments of monetary policy from the control of politicians. International capital mobility has also been thought of as a constraint on effective manipulation of monetary or fiscal (depending on the exchange rate regime) policy.[3] By relaxing this assumption, it is possible to produce a more nuanced set of expectations about the conditions under which partisan or electoralist behaviors might occur and, at the same time, an appreciation for the political and economic consequences of changes in the environment in which policy is made.

I find there is little evidence of partisan differences in either macroeconomic policies or performance—regardless of the degree of central bank independence or the degree of capital mobility. Consequently, it is difficult, if not impossible, to understand the consequences of central bank independence or capital mobility when peering through the lens of the partisan model. Electoralist political business cycles are also not ubiquitous, but when one pays close attention to the ways in which the degree of central bank independence and the degree of national policy autonomy structure the choices of politicians, electoralist behavior begins to come into sharper focus. Specifically, electoralist cycles in growth and unemployment, as well as budget deficits and money supply, occur under a specified set of conditions—that is, when incumbents retain sufficient control over the policy instruments necessary to engineer them. The frequent absence of such control explains why such cycles are relatively rare.

While a comparison of the partisan and electoralist models informs debates about the determinants of macroeconomic policy within countries, it also has clear implications for debates about the consequences of recent changes in the international economy. As already noted, a commonplace assertion is that increasingly mobile capital places new constraints on the choices available to policymakers. Attempts to evaluate this argument, however, have failed to find evidence of the predicted effects of globalization (Garrett 1995, 1998; Rodrik 1997; Iversen 1997). I argue that this is because such studies are looking in the wrong place. The consequences of increased international capital mobility cannot be seen in a convergence in the policies or performance of political parties because, the evidence suggests, partisan differences did not exist before capital mobility. International capital mobility has, however, had two important consequences. First, it has altered the circumstances under which incumbents may use macroeconomic policies for electoral purposes. Second, it appears—under certain circumstances—to have shifted the content of policies. The policies produced after capital mobility may be more deflationary than they were before.

Taken together, these findings have complex normative implications. If the consequence of capital mobility were the end of meaningful partisan differences and convergence around the policy preferences traditionally associated with right-wing parties and their voters, then one's assessment of international capital mobility would be a strict function of one's affinity for such policies. But the finding that politicians are discouraged from manipulating the economy for electoralist purposes agrees with what all citizens could be reasonably expected to support. Macroeconomic policy should be used to produce economic benefits for the people, not political benefits for officeholders. This normative conclusion, however, assumes a zero-sum relationship between those who govern and those who are governed—a radically predatory view of the state. If, on the other hand, democratic institutions are set up in a manner such that incumbents help society when helping themselves, then constraints on electoralist behavior are not necessarily socially optimal. In fact, I find that the conditions that discourage electoralist behavior have a tendency to push policy in the direction that partisan models argue is favored by right-wing parties and their constituencies. Whether this is good or bad for society as a whole is logically independent from whether it is helpful to survival-maximizing incumbents. Such normative issues are not the central focus of this book, but they will be explored in the conclusion.

In the remainder of this introductory chapter, I will briefly compare alternative versions of the partisan and electoralist models, discuss the overall structure of the book, and compare this work to other recent volumes that address similar topics.

Comparing Partisan and Electoralist Models of the Political Economy

One can organize the literature on the domestic political sources of macroeconomic policy by comparing the assumptions scholars make about the motivations of politicians and the process of belief formation employed by voters. Electoralist political business cycle (PBC) models assume that politicians are survival maximizers, whereas partisan models emphasize candidates' ideological motivations. "Adaptive expectations" arguments characterize voters as retrospective, whereas "rational expectations" models assume that voters consider the expected future effects of policy decisions.

Adaptive Electoral Cycles

In the founding works of the PBC literature, William D. Nordhaus (1975) and Duncan MacRae (1977) assume that politicians are "opportunistic" survival maximizers. That is, they care only about being elected and can control macroeconomic policy outcomes in a manner that maximizes the probability of reelection. Voters are assumed to be "retrospective" and "pocketbook"; that is, they assess candidates' performance on the basis of economic outcomes they produce without regard to the future consequences of these policies.[4] These assumptions imply that incumbents will lower the rate of unemployment prior to elections and raise it "to some relatively high level in order to combat inflation" in the period just after the election (Nordhaus 1975, 184; see also 1989).[5]

Nordhaus's model is controversial on both theoretical and empirical grounds.[6] His own results were weak: he found partial evidence for the existence of PBCs in only four of the nine countries he examined. Edward R. Tufte (1978) also predicts unemployment cycles tied to the electoral calendar, but his evidence based on U.S. presidential elections is less than robust. Similarly, Michael S. Lewis-Beck's test (1988) of key implications of the Nordhaus model shows no systematic relationship between the timing of elections and changes in unemployment, growth, or inflation in Britain, France, West Germany, Italy, or the United States. Studies that pool observations across countries of the OECD (Organization for Economic Cooperation and Development) also fail to provide substantial evidence that unemployment or output fluctuates with the electoral calendar (Alesina and Roubini 1992; Alesina, Cohen, and Roubini 1992).

Rational Electoral Cycles

The electoralist model has come under increased fire since the rational expectations revolution in macroeconomic theory. Rational expectations are germane in two ways. First, if private actors use all relevant information except the "competence" of different policymakers to predict the inflation rate, politicians should not be able to create preelectoral inflationary surprises in equilibrium. Second, if voters are rational, they should include the expected future costs of politically motivated expansions beyond the natural rate when formulating expectations of the incumbents' postelection macroeconomic performance (Cukierman and Meltzer 1986; McCallum 1978; Persson and Tabellini 1990; Rogoff and Sibert 1988). The primary empirical implication of the rational electoralist model is that, though informational advantages enjoyed by politicians may provide some incentive for the manipulation of policy instruments in the preelectoral period, this will not necessarily result in an association between elections and employment or output (Alesina and Roubini 1992).

Although the lack of systematic evidence linking macroeconomic outcomes to the electoral calendar is consistent with the rational expectations variant of the electoralist approach, evidence of preelectoral manipulation of policy instruments would lend more direct support. As it turns out, there is considerably more evidence of a connection between elections and the manipulation of policy instruments than has been the case for macroeconomic outcomes. Some evidence indicates that budget deficits and money growth tend to increase in preelectoral periods in several OECD countries (Alesina 1989; Alesina, Cohen, and Roubini 1992), and similar monetary cycles (Greir 1987, 1989) and budgetary cycles (Tufte 1978; Alesina 1988b; Nordhaus 1989) have been found in the United States.

Adaptive Partisan Cycles

The partisan explanation of economic policy choice departs from the Downsian approach to politics because it assumes that political parties differ in their evaluation of policy outcomes and, therefore, set policy in an effort to achieve their preferred outcome. Typically, parties of the left are assumed to be more sensitive to unemployment than parties of the right, while the latter place a higher value on price stability than do parties of the left (Hibbs 1977, 1987). Expectations are adaptive, and voters are assumed to vote for the party that they expect to implement the policy closest to their ideal point. Unlike in the Downsian model, however, this does not lead candidates' positions or incumbents' policies to converge on the preferences of the median voter. Many reasons have been offered for a lack of convergence, including the attempt to make campaign promises credible (Alesina and Rosenthal 1995), the need to deter entry of new parties (Palfry 1984), and the possibility that some voters will abstain (Calvert 1985).[7] The primary implication of the partisan approach is that parties of the left should produce consistently higher levels of output and inflation and lower levels of unemployment than parties of the right.

The evidence in support of the partisan hypothesis has been more consistent than that for its electoralist alternative. In early studies, Hibbs (1977) found support for the partisan hypothesis in the United States and Great Britain, and Alt (1985) found a link between decreasing unemployment and left government control in a sample of twelve OECD countries. Using a sample of eighteen OECD countries for the period 1960–87, however, Alesina and

Roubini (1992) find no evidence of permanent partisan differences in output and unemployment.

Rational Partisan Cycles

Alesina's 1987 analysis of macroeconomic policy choice in two-party systems suggests that partisan differences in policy outcomes can exist despite rational expectations (see also Chappell and Keech 1986). This is the case because wage contracts signed under one regime cannot automatically be adjusted to incorporate changes in inflationary expectations induced by the election of a government with different preferences over outcomes. Thus, the rational partisan model predicts partisan differences in macroeconomic policies in the period immediately following elections, but these differences are not expected to persist beyond the initial period of adjustment. This conclusion receives empirical support from Alesina and Roubini's failure (1992) to find a link between partisanship and permanent differences in macroeconomic outcomes.

PBCs and Endogenous Elections

The approaches to the politics of macroeconomic policy discussed up to this point either embrace the assumptions of the Nordhaus model or relax one or more of the original model's assumptions related to the preferences actors hold and the way in which they formulate their beliefs (see the comparison of alternative models in table 1, derived from Alesina and Roubini 1992). In so doing, these studies pay little attention to the extent to which behaviors associated with PBCs are influenced by the institutional structure in which politicians and voters operate. Studies examining the effect of endogenous election timing on PBCs are an important exception to this general trend. The empirical implications of endogenous elections for PBCs are not clear-cut, however. If voters' expectations are adaptive, it is possible that incumbents can take advantage of favorable economic conditions by calling early elections.[8] Note that the main empirical implication of the Nordhaus model holds both when elections are exogenous and when they are endogenous, despite the operation of different causal logics. For Japan, Thomas F. Cargill and Michael M. Hutchison (1991) use a simultaneous equation procedure and find evidence for a "two-way interaction" in which causation runs in both directions. In addition, multinational studies that use macroeconomic outcomes to predict the timing of elections find some evidence that early elections are more likely to be called when economic conditions are favorable (Alesina, Cohen, and Roubini 1993; Palmer and

TABLE 1. Alternative Models of the Domestic Political Economy

	Traditional Electoralist Model[a]	Rational Electoralist Model[b]	Partisan Model and Rational Variant[c]	Context-Dependent Partisan Model
		Assumptions		
Structure of macroeconomy	Output and employment are driven by changes in inflation	Output and employment are driven by changes in unanticipated inflation	Output and employment are driven by changes in unanticipated inflation	Output and employment are driven by changes in inflation
Inflation controlled by	Elected politicians	Elected politicians	Elected politicians	Elected politicians only under certain institutional arrangements
Politicians are	Electoralist	Electoralist	Partisan: Left-wing incumbents attribute higher cost to unemployment relative to inflation than right-wing parties	Partisan
Voters are	Homogenous, retrospective, and "pocketbook"	Homogenous, forward-looking, and "pocketbook"	Heterogenous, forward-looking, and "pocketbook"	Heterogenous, retrospective, and "pocketbook"
		Implications		
	Increase in growth and employment prior to elections. Increase in inflation either before or after elections	Monetary and fiscal variables may exhibit short-lived and irregular cycles, but growth and unemployment are all but unrelated to elections	Output growth and inflation should be permanently (temporarily, for rational variant) higher and unemployment lower under left governments	Output growth and inflation should be permanently high and unemployment lower under left governments, unless (*a*) central bank is highly independent; or (*b*) country pursues a fixed exchange rate amid highly mobile capital

[a]For example, see Nordhaus 1975.
[b]For example, see Rogoff and Sibert 1988; and Persson and Tabellini 1990.
[c]For example, see Hibbs 1977; Alesina 1987; and Alesina and Rosenthal 1995.

Whitten 1995). Although Cargill and Hutchison's study suggests that endogenous elections do not represent a barrier to a correlation between elections and increased growth, one cross-national study (Terrones 1989) finds evidence that macroeconomic policy cycles are more pronounced in countries with fixed-term elections than in countries where election timing is endogenous.

Alastair Smith's model (1996) of endogenous election timing in majoritarian systems has implications that are consistent with the rational expectations version of the electoralist model. Smith argues that it is difficult for governments to benefit from a strong economy by calling early elections because of the signal that this behavior sends to the electorate; voters are likely to infer that incumbents have called early elections because they expect the economic situation to deteriorate.

Context-Dependent Electoral Cycles

Although I would not argue that close attention to actors' preferences and beliefs is misplaced, I do argue that relative inattention to the structure in which actors operate explains, in part, why existing models have failed to receive robust empirical support. In this book, I relax one assumption of the traditional electoralist and partisan models that has been accepted in other models. I argue that the extent to which elected officials control the instruments necessary for guiding the economy can vary significantly depending on prior institutional choices. These choices can severely limit the ability of politicians to steer the economy in electorally advantageous directions.[9] In some cases the steering column may be locked, and in others elected officials may not even be in the driver's seat.[10]

In the next chapter, I present two different models that capture alternative ways in which central bank independence and the loss of national policy autonomy could be expected to influence partisan and electoralist behavior. I also address conceptual and measurement issues related to these structural factors, which will play a big role in the empirical tests in chapters 3 through 6. Chapter 3 uses time-series cross-sectional data to evaluate competing arguments about the effects of international capital mobility and central bank independence on partisan differences in fiscal and monetary policies. Chapter 4 uses similar data to test arguments about the existence of context-dependent electorally induced cycles in monetary and fiscal policy. Chapter 5 examines the evidence for context-dependent partisan differences in macroeconomic outcomes. Chapter 6 looks at the conditions under which we find a link between macroeconomic outcomes and the electoral calendar. Chapter 7 concludes by summarizing my findings and briefly addressing their normative implications.

Since there have been a number of excellent book-length treatments of issues closely related to the ones addressed here, it may be helpful to point out how this book differs from those. Keech 1995, which explores the logics behind and evidence for partisan differences and electoral cycles in macroeconomic policies, does a particularly fine job of linking positive analysis to normative questions about the costs and benefits of democratic governance. Along with Alesina and Rosenthal 1995, Keech's book is currently the definitive statement on the politics of macroeconomic policy choice in the United States. Alesina and Roubini (1992) extend the comparison of partisan and electoralist sources of macroeconomic policy and performance to the study of most OECD countries. They also present formal models of the variants of the partisan and electoralist models discussed above. The current volume also compares partisan and electoralist models and is cross-national in scope, but, unlike Alesina and Roubini 1992, it is self-consciously open-economy and institutionalist in spirit. In addition, while I present game-theoretic models in the next two chapters and rely on quantitative evidence to evaluate these models, it is my hope that less prior technical knowledge will be needed to follow the argument here than is the case for Alesina and Roubini's book. As a consequence, the current book may be a bit less daunting to those new to formal analysis than theirs is. This should not be construed as a criticism of formal analysis in general or of Alesina and Roubini in particular; the argument presented simply does not require much formalism.

This book is also quite close in spirit and substance to Garrett 1998, but there are important differences. Most obviously, I extend the analysis of the influence of capital mobility on the political sources of macroeconomic policy to the electoralist model. In addition, I examine the potentially perturbing effects of central bank independence and examine the ways in which the choice of exchange rate regime modifies the effects of capital mobility. Finally, unlike Garrett, I argue that the dearth of evidence in support of the partisan model—before, after, or during the recent increase in global financial integration—means it should be dispensed with entirely. I argue that the electoralist model instead is the appropriate baseline for understanding the politics of macroeconomic policy in rich democracies and, therefore, the effects of central bank independence and increased capital mobility in those countries.