

WELFARE STATE REFORMS AND THE POLITICAL BUSINESS CYCLE

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Introduction¹

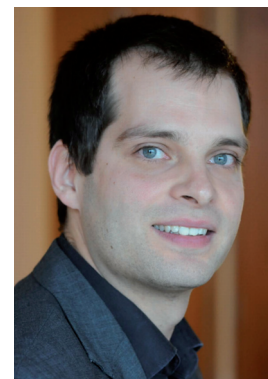
As the term already suggests, political business cycles should be a phenomenon that is of interest for both economists and political scientists. In general, political business cycles are cycles in macroeconomic variables that have their basis in electoral cycles.² Both disciplines focus on different models for different reasons. The first model – also labeled the “opportunistic political business cycle” – deals with expansionary economic activities induced by governments closely before elections. This model is normally referred to by economists. Nordhaus’s seminal work (1975) assumed a typical pattern of policy within a term in office: “starting with relative austerity in early years and ending with the potlatch right before elections” (Nordhaus 1975, 187). He was mainly concerned with election gifts that seemed to be available from Samuelson and Solows’ “menu of choice”. According to Samuelson and Solows (1960), policymakers are confronted with a trade-off between inflation and unemployment (their modified Phillips curve); assuming myopic and retrospective voters, the opportunistic political business cycle model predicts that governments will spur employment shortly before the next upcoming elections, accepting a higher inflation rate than is otherwise considered optimal.³

The second model – known as the “partisan political business cycle” – goes back to an article by Douglas

Hibbs (1977). The theoretical starting point for the partisan political business cycle theory is the Phillips curve again. However, Hibbs assumed that left and right party leaders have different policy objectives, in turn leading to different choices from the menu. As a consequence, Hibbs expected a relatively low unemployment and high inflation macroeconomic configuration under leftist regimes and the converse constellation under rightist governments (Hibbs 1977, 1471). Under the heading “partisan theory”, this has been one of the dominant theories in political science since the 1980s, mainly applied in welfare state research but also used in other policy areas.⁴ One difference between the opportunistic and the partisan political business cycle obviously lies in its timing: opportunistic behavior should take place in pre-election years, whereas partisan behavior should be observed between the tenure of different parties. Another difference is the respective origin of the assumed patterns of behavior. In the first model, it is simply the upcoming election day, whereas in the second model, it is the different party ideologies that triggers different actions.⁵

How to test the existence of political business cycles?

Both models contain some problematic assumptions. The most obvious one concerns the question whether politicians are indeed able to influence the economy in the described fashion or if they at least believe that they can do so.⁶ The problem with this assumption becomes apparent when considering the political and academic career of the Phillips curve. Confronted with the phenomenon of stagflation in the 1970s, theories based on the Phillips curve came in-



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¹ This article builds on a chapter in Petring (2010).

² Besides Nordhaus (1975), Kramer (1971) and Tufte (1978) were pioneers of the opportunistic political business cycle. For an overview of the theoretical and empirical literature see, for example, Alesina, Roubini and Cohen (1997), Drazen (2000) and Franzese (2002).

³ For an excellent review of empirical literature on the opportunistic political business cycle and own tests, see Alesina et al. (1997).

⁴ For social policy see, for example, Schmidt (1996) and Huber, Ragin and Stephens (1993).

⁵ This second difference might be one explanation for the different perception of the two models in economics and political science. For political scientists, it seems natural to deal with parties’ ideologies and to ask “do parties matter?” On the other hand, the methodological sophistication of the discipline, availability of macroeconomic data as well as the perception of politicians being mainly driven by opportunistic motives made the opportunistic political business cycle an obvious object of research for economists.

⁶ I leave aside other questions, related to the assumptions about voters’ behavior, for example.

creasingly under attack from Milton Friedman and other members of the “Chicago School”. The academic conflict also had an impact on policies. For the US, the inauguration of Ronald Reagan in 1981 clearly marked a change in economic policy (“Reaganomics”), with a similar tendency observable in many OECD countries during the 1980s. Therefore, it should come as no surprise that there is only little evidence for the political business cycle since the 1980s when it comes to inflation and unemployment rates.

Besides the impact of different economic paradigms on economic policy, one could additionally raise a general concern about governments’ ability to directly and substantially influence unemployment rates – at least in a free market economy. For similar reasons, it is questionable to rely on other indicators that are, to a greater or lesser extent, influenced by external shocks, such as budget deficits, output and spending levels.

The above does not hold true, however, for benefit levels. In contrast to spending levels (which are influenced by unemployment rates) the statutory benefit levels are direct results of political decisions. Additionally, in many countries, almost 50 percent of the electorate is in some way connected to the welfare state – be it by means of transfers or workplaces (Flora 1989). This makes social policy a predestined tool for electoral gifts and an adequate variable for testing the opportunistic business cycle theory. However, from the viewpoint of partisan political business cycle theory, we should expect a partisan pattern in social policy as well. It should be mainly left-of-center governments who fall back on expansionary social policy.

In order to test these assumptions, I constructed a database indicating visible reforms in unemployment insurance and public pensions in 18 OECD countries⁷ from 1980–2002. For pension systems, reductions of pension age, qualifying period and increasing benefit levels serve as indicators for expansionary reforms.⁸ With regard to benefit levels, inflation-adjusted increases of more than three percent in relation to the previous year have been coded as expansions. For the unemployment insurance systems, reduction of waiting days, extensions of benefit duration, reduced qualifying periods and increased

benefit levels were used as indicators. In line with the pension reform indicators, incremental adjustments have been coded as one reform and any inflation adjusted increase of more than three percent indicates reforms of benefit levels.⁹

Applying the above criteria has a major consequence: only visible reforms are covered. By capturing exclusively inflation-adjusted increases of more than three percent in benefit levels, I do not count increasing benefits via inflation indexation, for example, as a reform. The reason for this is twofold. First, inflationary adjustments could simply be due to an automatic indexation rule. Second, they are not necessarily perceived as an expansionary measure (which they are indeed not). In order to fulfill its electoral purpose, policymakers should make sure that the increase of pension benefits will be noticed by the electorate. Therefore, the three percent threshold seems to be reasonable. With these criteria we are able to identify significant and visible expansionary reforms. The coding followed a simple dichotomy: 1 for reform, 0 for no reform. Multiple reforms are coded as one reform.

In order to test the hypotheses, we need additional data: first, on election years in the 18 countries, and second, on the governments’ ideological positions. Information about election years stem from the WZB Democracy Unit’s Database “Parties, Elections and Governments” (2008). If the elections took place in the first six months (June 30), the previous year has been coded as “election year” instead of the actual. There are three reasons for this. First, if expansions are decided upon only one or two months before the elections, it is very likely that the opposition parties will blame the government for irresponsible policies. Second, governments ought to be sure that the expansion has been noticed by the voters. In cases where elections took place in the first half of a year, expansionary measures should have already come into effect in the previous year; and third, because we only have yearly data about the benefit conditions, if the elections took place in the very beginning of a year, expansionary measures might be an inauguration present of the successor and not a pre-election gift of the incumbent.

⁷ The countries are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Sweden, Switzerland, UK, USA.

⁸ Continuous incremental yearly adjustments have been coded as one reform.

⁹ Scruggs (2005) “Welfare States Entitlement Dataset” provides data on all mentioned indicators for pensions and unemployment insurance. For the 18 OECD countries, reliable information is available for the years 1980 to 2002.

The ideological position has been identified on the basis of the programmatic left-right position of the parties as it is given in the respective election manifestos. The Comparative Manifestos Project (CMP¹⁰) is based on quantitative content analyses of election programs of parties from more than 50 countries, where the parties' left-right positions are basically saliency measures of 13 topics. Many other scholars measure partisanship in terms of two variables: the share of cabinet seats held by social democratic parties and the share of cabinet seats held by Christian democratic parties (see, for example, Huber and Stephens 2001; Swank 2002). This way of measuring partisanship has two major implications: first, all parties within a party family are treated the same (for example the French socialists and the British Labour Party). Second, the ideology of coalition partners is completely neglected. In contrast to this, with the CMP data we are able to account for ideological positions of all governing parties individually for every legislative period. In the case of coalition governments, the left-right positions of the parties have been weighted with the respective share of the government's parliamentary majority. The sum of these weighted positions is the coalition governments' ideological position.¹¹

In the following analysis, I will also include the socio-economic situation under which the respective governments acted. In order to operationalize the socio-economic pressure, I used a combination of Okun's and Barro's misery indices. Okun's misery index is simply the sum of unemployment rate and inflation rate. Barro (1999) included GDP growth rates and interest rates in addition and calculated the difference between the beginning and the end of a legislative period. The modified misery index created here consists of unemployment rates, interest rates, inflation rates and GDP growth rates on a yearly basis. For reforms in unemployment insurance, unemployment rates are weighted by a factor of two. In pension politics, the pensioners' ratio has been included. Higher figures indicate more severe problem pressure.

¹⁰ For a detailed description of methods and data see Budge, Klingemann, Volkens, Bara and Tanenbaum (2001) and Klingemann, Volkens, Bara, Budge and McDonald (2006). Recent data can be downloaded at <http://www.wzb.eu/zkd/dsl/Projekte/projekte-manifesto.en.htm>.

¹¹ Left positions have negative values; right positions take a positive sign. For the 18 OECD countries from 1980 to 2002, the mean value is 1.7. The minimum value is -36.6 (Finland in 1990), the maximum value is 48.5 (Australia in 1990 and 2000).

Are governments opportunistic and does ideology make a difference?

At first glance, there seems to be no tendency to place expansionary measures shortly before elections (Table 1). In both unemployment insurance and public pension, the ratio of expansionary reforms is almost identical to or even slightly below the respective ratio in non-election years.

Does this picture change if we account for the ideological positions of the governments? The average of the ideological center of gravity gives us a first hint. As can be seen in Table 2, the differences in unemployment insurance between election years with expansionary measures and those without expansions are negligible. Furthermore, the small differences are in accordance with our expectations: left-of-center governments are more likely to increase generosity of the unemployment schemes than right-of-center governments. However, when it comes to pension policy, the differences between the ideological centers are larger, and rightist governments seem more likely to increase pensions before elections.

Table 1
Share of expansionary reforms in election and non-election years (in %)

	Share of expansions in non-election years	Share of expansions in election years
Public pension	32.3	30.1
Unemployment insurance	30.0	29.7

Note: In unemployment insurance, the US has been dropped because unemployment insurance is under states' authority.

Source: Own calculations.

Table 2
Ideological center of gravity in election years

	Ideological center of gravity in election years with expansionary measures	Ideological center of gravity in election years without expansionary measures
Public pension	4.5	1.0
Unemployment insurance	-0.4	0.4

Note: In unemployment insurance, the US has been dropped because unemployment insurance is under states' authority.

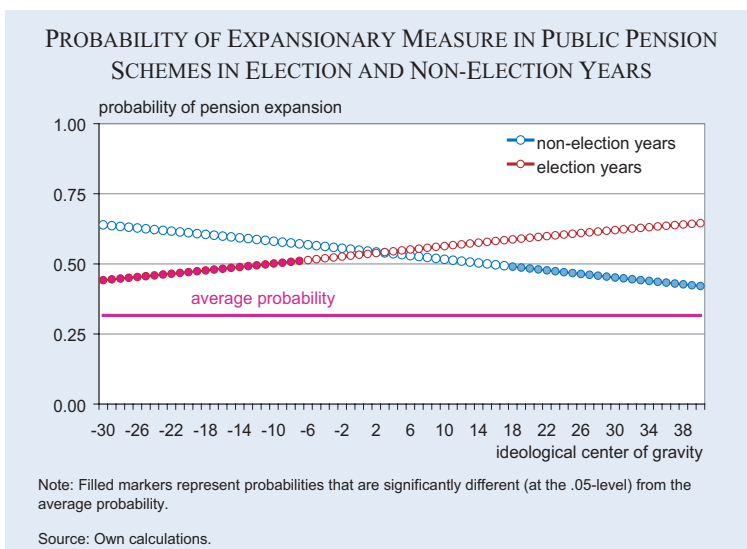
Source: Own calculations.

In order to investigate this finding more systematically and to control for intervening variables, it is useful to run a logistic regression. Because there are no relevant differences between election and non-election years in unemployment insurance policies, I will focus on pension policies.¹² Besides the variables for election years and ideology, an interaction effect of the two is included in order to check whether election years indeed change the “normal” behavior of leftist and rightist governments. Control variables are the level of socioeconomic pressure and the change of the socioeconomic pressure in the respective year. To capture the differences in the political systems, country dummies have also been included. The model is not expected to explain the occurrence of expansionary measures in public pension systems in general, but is used in order to investigate the impact of the most obvious variables in pension policy (Table 3).¹³

The two socioeconomic variables both have a significant effect on the likelihood of expansionary reforms. Interestingly, a higher level of socioeconomic pressure increases the likelihood of generous reforms. Maybe countries that are already in a comparatively bad situation do not care that much about further

¹² In election and non-election years, the likelihood of expansionary measures in unemployment insurance is greater under leftist governments than under rightist governments.
¹³ The model classifies 75.4 percent of the dependent variable correctly. Sensitivity is 39.7 percent, specificity is 91.9 percent. For detailed results see author’s homepage.

Figure



fiscal pressure. However, the actual change of the socioeconomic problem pressure influences the likelihood in the opposite direction. If the economic situation has improved compared to the previous year, expansionary reforms are more likely than in a deteriorating economic situation. As already expected from the descriptive tables, both election years and government’s ideology do not have a strong impact on the general likelihood of reforms. This is also true for the interaction effect. Because it is hard to interpret coefficients of logistic regressions when it comes to interaction effects, I plotted the predicted probabilities for expansionary measures in pension politics for election years and non-election years over the full range of governments’ ideological positions. The level of socioeconomic pressure has been set to its mean value. In order to simulate election years with an improving socioeconomic situation, the change of the misery variable has been set to -10 , indicating a strong improvement (it ranges from -12.5 to 16.9 in the 18 countries).

Table 3
Impact on the probability of expansionary pension reforms

Expansionary pension reform	Direction of impact	Level of significance
Election year	Negative	Not significant (0.86)
Ideological center of gravity	Negative	Sparsely significant (0.23)
Interaction of election year and ideological center of gravity	Positive	Somewhat significant (0.11)
Change of misery index	Negative	Very significant (.002)
Level of misery index	Positive	Very significant (.002)

Note: Stylized results of a logistic regression with country dummies. Detailed results can be reviewed at author’s homepage.

Source: Own calculations.

In non-election years, pension expansions are more likely to occur under leftist governments. The squared markers resemble partisan theory’s expectations perfectly. However, in election years, right-of-center governments show a greater tendency to decide upon expansionary measures in the pension system. As this is especially true under improving socioeconomic circumstances, it stands to reason that those measures are

indeed meant to convince voters who are located left of the government to vote for them.

The fact that pensions are the object of opportunistic behavior is probably due to its greater number of voters who benefit from it compared to unemployment insurance. Additionally, the benefit levels for pensioners seem to be less controversial than the benefit levels for unemployed. More puzzling are the findings with regard to the right-of-center governments' higher likelihood of making election gifts. Election gifts serve mainly the purpose of pulling undecided voters or voters of other parties to one's own party. To achieve this aim, a party must to some extent broaden its image or blur ideological shortcomings perceived by voters who normally vote for other parties. In social policy, right-of-center governments have a neutral or negative welfare image. Therefore it might be a promising electoral strategy to display a more positive welfare image to attract new voters. Pension policy is, in contrast to unemployment insurance policies, not a class-based policy field. People from almost all societal classes are beneficiaries. Right-of-center parties can therefore use expansionary pension policies to attract new voters without frightening off their own core voters. This argument is supported by the finding that an improving economic situation is positively related to the likelihood of opportunistic pension reforms: rightist governments are able to argue that under the current good economic circumstances, these expansions can be justified. By doing this, they keep their image of being prudent with regard to public spending and simultaneously appeal to voters left of them. Additionally, leftist opposition parties will find it hard to oppose the expansionary measures. For left-of-center governments, however, expansionary measures shortly before elections do not serve the purpose of attracting new voters. Leftist parties already have a positive welfare image. Expansionary social policy will not attract voters from the right but might in contrast create fierce critique from opposition parties.¹⁴

Conclusion

The findings presented here can be summarized as follows: we have only weak evidence of opportunistic governmental behavior, it is observable mainly in pension policy and the partisan pattern behind it is contrary to theory's expectations.

What does this mean for research on the political business cycle theory? If the calculus behind election gifts is mainly to attract undecided voters or voters of different parties, party leaders are very likely to choose policy measures that are not perceived as being their core concern. When studying opportunistic political business cycles, this means first that researchers should include parties' ideological positions. Second, one should investigate policy areas where the different ideologies indeed make a difference for the expected reform trajectories. Because of almost identical positions of left and right parties, it is not surprising to find only little empirical support for the political business cycle theory when it comes to unemployment and inflation since the 1980s.

And what does this mean for the assumptions behind the political business cycle theory? Parties might be opportunistic, but there are also counterincentives. First, the danger of repelling their electorate by loosening its ideological profile limits parties' possibilities of pursuing electoral gifts. Second, the danger of being blamed by competing parties also narrows the room for opportunistic behavior. Therefore, two core institutions of democratic regimes that allow the occurrence of opportunistic behavior also limit it considerably: elections and contestation by competing parties.

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¹⁴ Tax cuts might be measures used by leftist governments similar to the expansionary pension reforms of rightist governments.

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