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The emergence of political business cycles in a two-sector general equilibrium model

Jan Tuinstra *

Department of Quantitative Economics and CeNDEF, University of Amsterdam, Roetersstraat 11, 1018 WB Amsterdam, Netherlands

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Abstract

We study a simple general equilibrium model with two sectors and two political parties, where each party represents the agents working in one of the sectors. The size of the sectors is endogenous since the government can set a minimum wage in one of the sectors. It is shown that there may be a continuum of political–economic equilibria, and that endogenous political business cycles can emerge. © 2000 Elsevier Science B.V. All rights reserved.

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1. Introduction

There is a close interaction between politics and economics. Political decisions influence the functioning of the economy and the performance of politicians is evaluated according to the state the economy is in. This interaction between politics and economics may result in a situation of economic inefficiency.[1] It may

* Tel.: +31-20-525-4227; fax: +31-20-525-4349.
E-mail address: tuinstra@fee.uva.nl (J. Tuinstra).

[1] On the subject of economic efficiency as against political efficiency, see Magee et al. (1989), who show that it may be political efficient for a government to introduce economic inefficiency, such as tariffs. Wittman (1995), on the other hand, claims that all political equilibria are economically efficient.

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in particular cause the emergence of so-called *political business cycles*, that is, fluctuations in prices, employment and output arising from the competition between political parties.

In this paper, we study a simple general equilibrium model with endogenous political behaviour and show that economically inefficient equilibria and political business cycles may emerge endogenously. The mechanism driving these results differs from the mechanisms identified in the earlier literature on political business cycles.

In voting theory, it is usually assumed that political parties select platforms in a way that maximizes the probability of being elected. Suppose there are two political parties, the policy space is one-dimensional and voting behaviour is deterministic, that is, an agent votes for the political party closest to his *ideal point*. Then the well-known *median voter result* follows: both political parties choose a platform coinciding with the ideal point of the median voter.[2] Nordhaus (1975) shows that in such a model an *opportunistic political business cycle* might emerge. The incumbent party stimulates the economy prior to an election, for example, by trading off a higher inflation rate and a lower unemployment level, in order to be re-elected. After the election, the government lowers the high inflation rate, which leads to a reduction of employment again. The model therefore predicts an upswing of the economy just before each election and a downswing after an election. This political business cycle only emerges if agents form expectations adaptively,[3] or if there is some information asymmetry between the government and voters. A number of contributions have criticized the assumption that political parties only care about winning elections (for example Wittman, 1977; Alesina, 1987; Alesina and Rosenthal, 1995). Rather, it has been argued that political parties have certain preferences and different political parties execute different policies when elected.[4] A ‘‘left-wing’’ political party may choose policies to reduce unemployment and a ‘‘right wing’’ party may choose policies focusing on lowering inflation. A business cycle may arise since, if a left-wing party is elected, inflation will rise and, if a right-wing party is elected, inflation will decrease. Business cycles emerging in this way are called *partisan business cycles* (Alesina (1987)). A necessary condition for these partisan business cycles to exist is incomplete information about voter preferences (see Alesina and Rosenthal, 1995).

[2] If, however, the policy space is multidimensional, an equilibrium only can be shown to exist under very restrictive assumptions (Kramer (1973)).

[3] Rogoff and Sibert (1988) show that such opportunistic business cycles can also arise when there is information asymmetry between a government and voters (this can, however, only explain cycles in macroeconomic policy and not cycles in unemployment).

[4] Wittman (1977) writes: ‘‘The extensive literature concerned with formal models of political candidate strategies has almost without exception viewed policy as a means to winning....I suggest that the reverse is true — that candidates view winning as a means to policy’’.