Political Cycles in a Small Open Economy and the Effect of Economic Integration: Evidence from Cyprus

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This paper examines:

1. whether partisan politics and opportunistic government behavior generate political cycles in a small open economy
   • Under the “small country assumption” the room for national stabilization policy is limited (Lindbeck, 1976).
   • Politicians’ goals in small open economies are likely to be defined in relation to the rest of the world (Alesina et al., 1997).
2. whether such effects are likely to survive under increased economic integration
   • The process of European (and international) integration provides some direct and indirect constraints to autonomous policy making.

Political Cycles Models

Opportunistic or Electoral Models: claim that all governments propose the same platform to voters and choose policies to maximize their popularity and, therefore, their chance of being reelected.

Partisan Models: assume that government preferences differ over policies and that the economy is influenced by the ideological orientation and philosophy of the party in office.

Objectives

We consider Cyprus macroeconomic series for the period 1978-2006. The variables are extracted from data sources in Cyprus and the databases of IMF-IFS and Eurostat.

• The economic data consists of
  - quarterly observations on economic outcomes (output growth; unemployment; inflation rates)
  - quarterly observations on monetary policy instruments (M1 and M2 growth rates; 3-month t-bill rates; retail bank rates)
  - yearly observations on fiscal policy measures (budget deficits; components and sub-components of the fiscal balance)
• The political data include
  - executive (presidential) elections dates
  - governments political orientation (right, center-right, centrist, center-left, left)

Econometric Methodology

The design of our empirical analysis builds on the work of Alesina et al. (1997). However, in order to ensure that our estimated results will not draw misleading inferences, we adopt a more technical econometric approach and perform several robustness tests capturing the unique features of the Cypriot economy in a controlled environment era.

More precisely, our econometric methodology involves the following steps:

1. Examine the stability of the series by applying unit root tests, both in the absence and in the presence of structural breaks
   - Dickey-Fuller unit root tests
   - Perron one break exogenous unit root tests
   - Zivot-Andrews and Lumsdaine-Papell endogenous unit root tests
   - LM unit roots developed by Lee and Strazicich (2003a,b)
2. Model the stationary component of each regression equation and the variance of the error component
   - Box-Jenkins modelling procedure
   - ARCH techniques
3. Run-regressions of time-series data including among the regressors:
   - proxies for the effect of the world economy (to capture the impact of the world business cycle)
   - political variables (to capture the implications of the various political cycles theories)
4. Perform robustness analysis
5. Examine the stability of results over time (i.e. the impact of the European Monetary Union) by restricting the sample to include the pre-2003 period.

Data

Empirical Results

• Evidence for Cyprus supports the rational partisan theory in economic outcomes and policy instruments
  - Growth is temporarily higher and unemployment temporarily lower than normal for about two years after an electoral victory of the left while inflation is permanently higher when the left is in office
  - Left wing governments tend to follow more expansionary monetary policies and be more deficit-prone than right wing governments
  - Compared to large economies, as reported in previous empirical studies, the dimension of partisan effects is not as large
• Partisan effects do not persist in the run-up to EU accession and ERM participation
• No evidence of a traditional opportunistic (electoral) cycle in economic outcomes
• No evidence of a rational opportunistic (electoral) cycle in monetary policy, as in previous empirical studies
• Evidence of a rational opportunistic (electoral) cycle in fiscal policy
  - Governments tend to (i) increase indirect taxes at the beginning of their term and (ii) bias pre-election fiscal policy towards easily observed consumption expenditures (i.e. transfer payments) and away from investment projects.

Conclusions

1. The existence of partisan cycles is not only a characteristic of large economies; politicians in a small open economy lack some degree of freedom in the conduct of macroeconomic policies but eventually they manage to influence the domestic economy according to their ideological preferences.
2. The implementation of structural reforms and the Maastricht criteria affect governments’ ability to influence the domestic economy based on partisan considerations.
3. The political-economic profile of a country, coupled with the fact that different administrations use different instruments to achieve the same goals, seems to be responsible for the empirical success/failure of opportunistic theories in policy instruments.
4. Even in the context of a monetary union, member countries retain flexibility on the fiscal side and, hence, rational opportunistic cycles in fiscal policy (known as political budget cycles) are not expected to be mitigated in the future.

Subsequent Research

Political Budget Cycles in the European Union and the Impact of Political Pressures: A dynamic panel regressions analysis. Using a data set encompassing all 27 EU member states from 1997 to 2008, and employing a system GMM estimation technique

• we find strong evidence in favor of a systematic political budget cycle in the EU, derived mainly from increased government expenditure in election years
• we show that the size of such election-driven fiscal policy manipulations is inversely proportional to the relative weight voters assign to non-economic issues before elections and positively correlated with the uncertainty over the electoral outcome; once we account for these two features, differences across subsamples of countries disappear (i.e. between the Eurozone and the non-Eurozone countries).