

POLITICAL BUDGET CYCLES AND CAPTURE IN TRANSITION ECONOMIES

By

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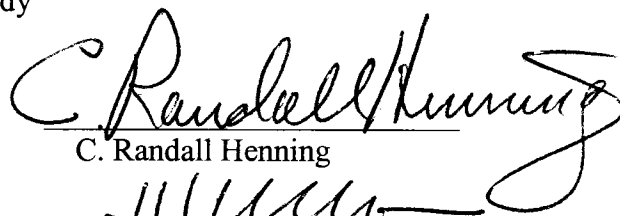
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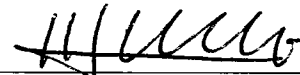
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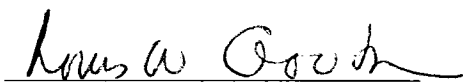
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To NN

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Marko Klasnja

ABSTRACT

This paper presents a stylized theoretical framework of fiscal policymaking in transition in an attempt to bridge the gap between the literatures on political economy (PE) of transition and political business cycles (PBC). It is argued that post-Communist political liberalization has generated political business cycles, warranting the application of the PBC approach, which has surprisingly scarcely been the case in the voluminous academic work on transition. Peculiarities of a transition country setting, however, may have bred cycles different in nature from those observed and theorized in developed democracies, inviting the insights of the PE of transition camp. Marrying the two literatures in a state-centric model, therefore, electoral fiscal cycles are argued to emerge as a confluence of political opportunism of the incumbent on the one hand, and conflicting demand-side transition-induced pressures by voters and interest groups on the other. Model is tested on alternative samples of transition countries by use of dynamic panel estimation methods.

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CHAPTER 1

INTRODUCTION

This paper presents a stylized theoretical framework in an attempt to bridge the gap between the literature focusing on the political economy of transition and its distributional consequences on the one hand, and the political business cycle literature, largely developed to suit the contexts of the developed democracies, on the other. It is argued that the two literatures both overlap and complement each other, but have not substantially interacted in attempts to theorize some aspects of policymaking in transition. By joining the two fields, this study hopes to raise new issues and shed new light on (fiscal) policymaking in transition economies, which is modeled as a confluence of political opportunism of the incumbents on the one hand, and demand-side induced pressures on the other. These generate political business cycles in transition countries, which are also argued to be different in nature from those observed and theorized in developed democracies.

The normative strand of the PE of transition literature has lent much attention and created an ample body of prescriptions for the conduct of (economic) policymaking in transition. The debate has mainly been focused on the distributional consequences of reforms and the resulting patterns of (political) opposition and support to the reformist policymakers. It has been set against the backdrop of the two dominating arguments from the positive PE of reform camp: Kornai's (1990, 1995) J-curve shaped distribution

of costs and benefits of transition, and the more general Olsonian environment of interest-group dynamics. These two sets of arguments constituted the typical political-economy framework of ex ante and ex post political constraints which the reformist policymaker needs to overcome in order to maintain the pathway of transition.

Kornai's insight induced the state autonomy 'benevolent-dictator' type of prescription where the policymaker needs to be insulated from the dissatisfaction of the initial large population of transition 'losers' so as to avoid the backlash against unpopular and painful reforms. The interest-group framework, on the other hand, turned the attention to special groups, predominantly transition 'insiders', members of former *nomenklatura*, newly arisen oligarchs, and the like, which may possess the incentive and the means to block the continuation of reforms in order to protect the rents and gains generated by pervasive transitional disequilibria. The task was then to shield the policymaker from the capturing influence of such concentrated (and likely small) rent-seeking 'winners' rather than, or in addition to, the wide-spread 'losers'.

Despite the plethora of prescriptions to the policymakers, this normative body of literature has essentially maintained the focus only on the 'demand side' of the political economy of reform, namely the 'winners' and the 'losers'. However, it has by and large neglected the 'supply side' of the process, failing to probe into the ways by which the policymaker itself may tackle the transition-induced political constraints in order to maintain its position in office. How do the policymakers in transition attempt to stay afloat amidst the dissatisfaction of losers seeking to vote them out of office, and/or the capturing influence of rent-seeking winners? How do they bid to balance these various challenges to their benefit? What strategies might they employ to stay in office in order

to maintain control over the reform process? The PE of reform literature has understudied these relevant issues.

It is here where another strand of political-economy literature can provide important insight – the political business cycle (PBC) literature. The typical PBC argument, that the policymaker is an opportunistic agent interested in getting reelected, and is therefore willing to manipulate (economic) policymaking for that purpose, clearly offers a departure point for examining the supply side of the political economy of reform. The political-liberalization aspect of the transition process, that is, the wide-spread introduction of multi-party systems and competitive elections in transition countries, has made the application of such a theoretical argument in the study of the PE of transition reform compelling, promising to offer fresh perspectives on policymaking in transition. For example, if the reformist governments face enormous political pressures and risks of electoral backlash due to unpopular and costly reforms, then it may be that the incentives of the incumbent for preelectoral economic policy manipulation would only have been magnified. One would then expect to see even stronger electoral policy cycles over the course of transition than in stable democratic systems. Bringing in the PBC perspective, therefore, promises to augment the investigation into how the confluence of political liberalization and economic transition shapes the behavior of policymakers in transition countries.

While studies in PBC tradition have been expanded from the original focus on OECD countries to encompass the developing economies, primarily those of Latin America, there seems not to have been a systematic focus on countries in transition. This is all the more surprising given that the J-curve argument, which can be thought of as a

cycle in its own right, has been a common building block in the PE of transition field. This paper makes a theoretical contribution in this respect, in hope to attract further research in this symbiotic manner.

At the same time, this paper argues that the PBC literature can also be augmented through this theoretical symbiosis. The preponderance of work within the PBC branch has been fairly agnostic of some of the main issues treated in the PE of reform literature, namely, those of corruption and capture, as potential factors significantly shaping the policymaking process. Broadly, the reasons for opportunism have been seen in either the 'ideological rents' (Hibbs 1977, Alesina 1987), stemming from different preferences over policy outcomes between the left and the right, or the 'ego' or 'reputation rents' (Rogoff 1990), that is, the status satisfaction and influence from holding office. However, these theoretical explanations may be somewhat esoteric for a transition country setting, where the private-regarding, material and distributional interests on the part of the policymaker may be more pronounced. Building on recent innovative work of Bonomo and Terra (2005), who propose an integration of the PBC literature with that of special interest and rent-seeking politics, this paper presents a stylized framework in which policymaking in transition is a result of both opportunism and the transition-related demand-side pressures. This amounts to arguing not only that political liberalization in transition countries has caused political business cycles, but that these cycles may be different in nature from those observed in developed democracies. This paper therefore attempts to make a contribution in this respect as well.

In line with the prevalent focus of the recent PBC work on fiscal policy (the so-called political budget cycles), this paper will focus on fiscal policymaking in transition

countries. An opportunist policymaker in transition may be particularly tempted to manipulate fiscal policy given its immediate distributional consequences and so potential effectiveness in garnering political support in conditions of transition-induced multiple shocks and aggregate uncertainty. Also, transition countries have by and large inherited large state apparati, which may present a particularly rich pool for policy manipulation. Similarly, given the necessity for restructuring the role and scope of the state, fiscal policy realm may be particularly susceptible to the establishment of patron-client relations between the interest groups and the policymakers.

The hypothesis to be tested is that the interaction between the voting power of the electorate at large and the capturing influence of the special interest groups on the policymaker brings about the preelectoral cycle in fiscal policy. The mechanism is engendered by the incumbent policymaker, who on the one hand has its own interests, which are in collusion with those of the special interest groups, and on the other is opportunistic with regards to staying in office, tries to disguise the proximity to the special groups by manipulating the fiscal policy before the elections towards the majority of the electorate. In other words, the opportunistic and ‘capture rent-seeking’ policymaker (terminology will be explained in the text) will use the fiscal policy manipulation in the run-up to elections to be able to maintain the achievement of two goals: getting reelected and extracting benefits (‘capture rents’) in exchange for favors to special interests.

Therefore, the relationship to be tested is between the magnitude of the electoral fiscal cycles and the capture rent-seeking behavior of the policymaker. It is hypothesized that the greater the proclivity for capture rent-seeking, the higher the cycle, given the

greater need for disguising these capturing links. This highly stylized model of tripartite relationships is also considered to be dependent on the level of information the electorate has and seeks about the policymaker, as well as the scope of the demand for capture. Therefore, transparency and strength of civil society, as well as the progress in the reform of the economy, particularly the business sector, are also included in the analysis of the hypothesized relationship.

The paper is organized as follows. The next chapter gives the critical literature review and theoretical background. Chapter 3 lays the case for the integration of the two literatures. On the basis of this, Chapter 4 outlines the theoretical model, and the empirical methodology for testing it. Chapter 5 presents the empirical estimation of the magnitude of the electoral fiscal cycles in transition countries, followed by the evaluation of the theoretical model itself, as well as different robustness checks performed. Chapter 6 gives a summary of the findings and conclusions, followed by a discussion of the potential shortcomings of the stylized model, as well as potential extensions to present research. Theoretical aspects of the methodology employed can be found in the appendix.

CHAPTER 2
LITERATURE REVIEW
Political Business Cycle

The crucial argument of the political business cycle literature (PBC) is that one of the effects of accountability in a democratic system is that elections in and of themselves may be a major factor dictating the outlook of economic policymaking. For better or worse, the competitive political environment breeds the incentive for an opportunistic behavior on the part of the incumbent policymaker: uncertainty regarding the prospects for reelection may tempt it into manipulating economic policy so as to increase these prospects. So, the fact that tenure of politicians is not assured brings about distortions of principal-agent relations, thereby inviting the use of policy manipulation (Offe 2004).¹ This argument is based on a rather intuitive and straightforward assumption that the economic conditions are a major factor in the voting function of a representative voter.

The first formal accounts and the theoretical treatment of this ‘electoral-year economics’ for the United States have been in the classical works of Nordhaus (1975), McRae (1977), Tufte (1978), and so on. These early works mainly focused on the

¹ The principal-agent problem has been a common framework for examining the electoral behavior of policy outcomes. As will be demonstrated below, the main justification for framing the arguments in this way stems from one of the crucial properties of the principal-agent relation: the asymmetric distribution of information between the two contracting parties, prior or subsequent to their agreement, or both. This is what is posited to reflect the relationship between the voter (the principal), who has the “coarser information partition”, and the agent (policymaker) who has the “finer information partition” (Rasmusen 1990) in the typical PBC argument.

macroeconomic effects of the policy cycles in OECD countries. Over time, the theoretical literature has closely followed the (r)evolutions in economic theory, particularly receiving revisions about the expectations and behavior of the agents in the theoretical modeling, given the initial assumptions of retrospective (adaptive) voting patterns and voters' myopia. Namely, that voters could simply be repetitively fooled by politicians was rejected. Rather, rational-behavior explanations in the dynamic setting were instead sought to account for the repetition of preelectoral manipulations (i.e. cyclicity). So, for opportunistic policymaking to affect the choices of rational voters, it was predominantly assumed that voters have less than full information, and that favorable past economic performance leads to retrospective voting reflecting a rational inference problem (Drazen 2000). The crucial assumption in this "rational retrospective voting" (Alesina and Rosenthal 1995), imperfect-information models was that past performance of an incumbent reveals something about his ability and competence, so that incumbents who performed well in the past will be expected to perform well in the future.

The empirical literature on the subject closely followed and in turn informed the theoretical works. Empirical predictions of the early Nordhaus-type models were that before elections, unemployment would be below normal while economic activity would be above normal, whereas after the election, inflation would begin to increase and a slowdown would set in. Therefore, initial empirical studies concentrated on possible cycles in economic outcomes in developed countries along the Phillips-curve trajectory. The evidence for real activity and unemployment turned out to be scant and contradicting, however. More conclusive results were obtained only for inflation (Alesina, Cohen and Roubini 1992). The interest, therefore, turned to policy instruments

rather than to economic outcomes, where evidence was found for fiscal transfers and expenditures, and less so for monetary policy tools (Grier 1989, Williams 1990), which was argued to probably be responding to the electoral manipulation of fiscal policy, rather than being the subject of the manipulation itself (Beck 1987).

Taken as a whole, however, the results were perplexing, since the case could be made for the existence of opportunistic preelectoral cycles in policy instruments, particularly on the fiscal side, but with limited or no effects on economic activity. If manipulation of policy instruments perhaps had no obvious effects on some aggregate economic outcomes, the logical question was how it would be hypothesized to affect election outcomes then? New theoretical explanations were developed in response to this question, such as signaling games, bargaining and clientelism, or changing voters' preferences, among others. For the model relied on in this study, the signaling explanation is of importance.

Namely, beginning with Cukierman and Meltzer (1986), Rogoff and Sibert (1988), and Rogoff (1990), preelectoral manipulations are undertaken with the intention of signaling to the voters a certain characteristic that the incumbent believes would increase its reelection prospects. So, even if the manipulation does not translate into aggregate economic outcomes, it may bear fruit as long as it conveys good information about the quality of the incumbent, that is, if it can help it signal its type and separate itself from other types. These works posit that the voters have imperfect information about how *competent* the policymaker is. Fiscal policy manipulation before the election is then used to send information about superior competence of the incumbent, in a sort of a brinkmanship game (Drazen 2000). The policymaker can afford worsening the budget

situation before the elections, since it is signaling that only someone competent enough would be able to overcome it later on, following its reelection.

A very similar logic will be applied in the model espoused in this paper: signaling is used to send information about the relationship (or rather absence thereof) with the special interests/captors. Namely, the incumbent stages a fiscal expansion towards the electorate at large, in an attempt to signal away its connections with the special interests/captors. It hopes that such a strategy will appear to be credible in that a higher degree of catering for the electorate would place it further away from the captors with whom it maintains the ties due to the collusion of interests. The opponents that are not of the same type, i.e. not (as) captured, would not choose a preelectoral expansion, but if the expansion really signals the distance from the special interests, then this (non)choice would be harmful for their election chances. The result, thus, is the preelectoral fiscal expansion.

Application of PBC Literature to Transition Countries

How does the literature on political business cycles relate to the study of transition and reform? Most simply, the fall of Communism and a subsequent political liberalization in many transition countries have made the electoral-year economics a plausible phenomenon there. The introduction of multi-party elections may have created the sort of opportunistic incentives suggested by the PBC literature, since the process of election of the chief executive bodies has largely been transferred from the organs of a single political actor (the Communist party) to the electorate at large. The changing institutional framework in which the policymaker operates has thus brought about

uncertainty in the election of the executive that was not present in the pre-transition era. As argued by Philp (2002), the post-communist political transformation has dramatically extended the state's need for legitimacy, given that its capacity to rely on coercion and non-democratic ruling was substantially reduced. This has created systems in which political office is much more reliant for its authority on the confidence that it can inspire among the public. It may therefore be expected that the policymakers in transition would adopt tools for remaining in office akin to those in the established democracies, which includes – as argued by the PBC literature – manipulation of policy instruments before elections.

So, transition countries may represent a rich pool for further theoretical and empirical work within the political business cycle literature. All the more so, given that this literature had until recently focused theoretically as well as empirically largely on the developed countries, predominantly the United States. It is true that in recent years there have been a number of empirical cross-sectional and case studies examining political business cycles in developing countries, mostly in Latin America (for example, Dornbusch and Edwards 1991, Kraemer 1997, Rojas-Suarez, Canonero, and Talvi 1998, Tornell and Velasco 1995, 1998, Frieden and Stein 2001, Gonzales 2002, Schamis and Way 2003, Eslava 2005), and less so elsewhere and/or comparatively, such as Blais and Nadeau (1992), Chowdhury (1993), Reid (1998), Brender (1999), Khemani (2000), Schuknecht (2000), Block (2001), Shi and Svensson (2002), Klein (2004), Brender and Drazen (2005), to name a few. Some of them included several post-Communist transition countries. However, the theoretical and empirical PBC literature systematically or solely focusing on post-Communist transition countries has not been as voluminous.

Only a handful of papers examined the existence of politically induced cycles in fiscal policy, such as Akhmedov and Zhuravskaya (2004) for Russian regions, Case (2001) for income redistribution policies in Albanian municipalities, Verstyuk (2004) for national and regional-level revenues and expenditures in Ukraine, Benecki, Hölscher and Jarmuzek (2006) for Poland, and Hallerberg, da Souza and Clark (2002) for Mundell-Fleming-model cycles in Central and Eastern Europe EU accession countries. There has not been to my knowledge a study of a larger cross-sectional sample of transition countries to date. This paper makes a contribution in this respect.

More important, a case will be made here that there exists an exciting unused opportunity to bring the arguments and implications of this strand of literature together with the arguments and implications of the literature on the political economy (PE) of transition. The two are the literatures with distinct lineages that seem to overlap and complement each other, but have all too rarely interacted. Joining them, however, promises to open interesting new research questions. For example, if one considers a typical argument of the early normative literature on the political economy of transition, namely, that the reformist governments face enormous political pressures and risks of electoral backlash due to unpopular and costly reforms (Williamson 1994, Intriligator 1998), then it may be that the incentives for preelectoral economic policy manipulation would only have been magnified. One would then expect to see even stronger policy cycles with respect to elections over the course of transition than in stable democratic systems. Joining the two therefore promises fresh perspectives on how the confluence of political liberalization and economic transition shapes the economic policymaking.

Political Economy of Transition

Roland (2000, 2002) posits that the literature on the political economy of transition reforms identifies two broad strands: normative and positive. The normative political economy of reforms focuses on the decision-making problems of reformers subject to political constraints. Reformers face two types of these constraints: the feasibility or the so-called ex ante constraints, that can block the reforms from being accepted; and the ex post constraints that are related to backlash and policy reversals after the reforms have been implemented and outcomes observed (Roland 2002). The key political economy question in this provenience can then be viewed as how to get the reforms enacted in the first place, which involves relaxing the ex ante political constraints, and then how to have the reforms stay in place, which means relaxing the ex post political constraints.

While much of the literature in this orientation has focused on the issues of the pace, scope and sequencing of reforms, such as in the discussion about the Big Bang vs. Gradualism approaches (Wei 1997, Murrell 1996, Dewatripont and Roland 1995), normative political economy obviously relates directly to the literature on political business cycles in that the outlook of policymaking is immediately shaped by the need to overcome political constraints, which clearly emanate from the voters, who bear the benefits and costs of reforms. Not surprisingly, discussing the strategies for easing political constraints – one of the paramount topics of the normative PE of reform literature – is very much interrelated with the focus on the strategies of maintaining office-holding of the PBC literature. The two foci are not identical, however, since the former does not comprehensively consider the assumption about the (electoral)

opportunism of the policymaker, even though it is not explicitly modeled as necessarily a welfare-maximizing one.² This is a crucial difference, and an area in which this paper argues the PBC literature can enrich the study of policymaking in transition.

Namely, it may be fruitful to subject the rather benevolent and under-theorized assumption of the normative PE literature that the policymaker is motivated to stay in office only in order to pass the reforms to the test of whether such motivation can be compounded with its opportunism in the face of electoral pressures as well. In other words, could employing the strategies for relaxing political constraints be interpreted not only as the wish of the policymaker to facilitate the enacting and implementation of reforms, but also as the wish to remain in office, for whatever other reason?³

The conclusions reached from the PBC perspective may be directly relevant for the normative PE literature because they share the empirical phenomena inspected. Among the strategies for easing political constraints so that reforms can be enacted, the latter has extensively discussed compensating transfers to those who may jeopardize the reform process. Naturally, expansion of fiscal outlays to the losers as compensating transfers has figured prominently. So, the behavior of fiscal policy has been a common subject. Also, a related topic in the PE literature has been the issue of how to make a credible commitment with regards to compensation transfers so as to secure the political acceptance of the losers (Dewatripont and Roland 1992). This is directly related to the

² The assumption of opportunism has received theoretical treatment in the PE of transition reform literature. Dewatripont and Roland (1992) consider the case in which the reformer would find it in its interest to strategically play different groups of cost-bearers of reform against each other in the 'divide and rule' game in order to relax constraints for both enacting and preserving the enacted reforms. Manipulation of policymaking stemming from electoral opportunism, however, has to my knowledge not been theorized.

³ Some of the possible reasons, as espoused by the PBC literature and the special interest politics literature, are discussed in the next section.

questions of signaling and competence, as examined by the PBC literature and outlined above. Bridging the two strands therefore can prove very useful in providing new perspectives on policymaking in transition. Still, this point can be further strengthened if one examines the other branch of the PE literature as well – the positive political economy of transition reform.

The positive PE of reforms builds on (and feeds into) the normative branch, primarily on its discussion about the distribution of costs and benefits of reforms across the population, and the consequent distributional conflicts among its members. So, the focus is on the evolution of the balance of power. In treating this subject, the common framework has been the dynamics between the reformers on the one hand, and the ‘winners’ and ‘losers’ of reforms on the other, largely in the framework of group interaction as postulated by Mancur Olson (1971). Namely, given the extent of the economic disequilibrium at the outset of the reform, and the scope of the transformation necessary, a J-curve-shaped distribution of reform effects (Kornai 1990) was seen to produce a large group of initial ‘losers’ and small groups of ‘winners’. Notwithstanding the continuous debate about the identity and theoretical cohesiveness of these concepts,⁴

⁴ Identifying the winners and losers of reforms has been and continues to be the topic of debate, however. Most commonly, the initial winners have been seen to include the members of the former *nomenklatura*, the socialist enterprise insiders and managers, leaders of the labor, and the like in possession of what Sajó (2002) terms the relational network capital which brings about information asymmetries and patron-client relations. The losers were hence commonly among those bereft of this relational capital, predominantly the rank and file of the former state economy. However, analyzing these categories against different criteria complicates the theoretical postulation. For example, sectoral, income, age, education, or occupational classifications can yield very different results, suggesting that there is much uncertainty about who may be the winners and losers of reforms. For the review of the empirical studies on this, see for example Fidmure and Noury (2003). A distinct issue is that of the dynamic nature of winners and losers. Namely, the preferences of the groups may change, which can then cause the identity of the group to change as well (Drazen 2000). Similarly, the gradual learning on behalf of the groups brings about adjustments in their political behavior (for example, Rodrik 1995). Yet another distinct issue is in the problematic assumption about the availability of the information about the losses of reform, which is a building block for the

the strategic interaction of such agents over distributional consequences (Knight 1992) was seen as reflecting the crux of the Olson's classical argument about group behavior in the (self)provision of public goods. The small initial winners enjoying the concentrated benefits of early transition bore all the characteristics of the Olsonian privileged group. They were seen to possess the selective incentives to overcome the collective action problem and influence the policymaker and the provision of public goods (Krueger 1993, Sonin 1999, Fidmurec and Noury 2003, Hellman 1998, Havrylyshyn and Odling-Smee 2000, Shleifer and Treisman 2000, Hellman and Kaufmann 2004). The large group of losers, incurring the diffused costs of reform in the short run with only a promise of gains in the longer run, corresponded to the concept of a latent group. It is unable to overcome the free-rider problem, due to insufficient incentives stemming from the negative ratio of benefits to costs from initiating action. According to Kornai, the continuation of reforms, however, would provide the incentives for the latent groups, since the benefits would start accruing along the upswing of the J-curve.

The implication of this for policymaking, expressed widely in the normative PE literature, was to insulate the reformers from any influence that would hamper this distributional dynamic from unfolding. One side emphasized the need for shielding the governments from the myopia and dissatisfaction of the losers in the 'benevolent-dictator' argument (Williamson 1994, Intriligator 1998, Cheung 1998), given the voting power with which they could oust the reformers from office. Their critics focused on the need for neutralizing the winners (Murphy, Schleifer and Vishny 1992, Hellman 1998,

position that the losers and winners are identifiable. If the information is lacking or the effects are unclear, it may be impossible to make a differentiation.

Sonin 1999, Slinko, Yakovlev and Zhuravskaya 2004) arguing that it is they who have the incentives and the power to prevent the diffusion of the benefits to losers in order to protect the rents and market reserves gained. Despite these differences, the two factions agreed that the government should be made autonomous in order to effectively implement the necessary reforms.

Much like its normative kin, the positive PE of reform literature is endemic in what it does not say about the policymaker rather than what it does. Whether cautioning against the losers or the winners, it has focused mainly on the ‘demand side’ of political economy of reform, perhaps because the public-good nature of the reform process directed the attention to the Olsonian groups (Fidmurec and Noury 2003). It did not, however, turn its attention sufficiently to the ‘supply side’ of this stylized setting, namely the government itself. If taken from the Olsonian perspective, why had not the government/policymaker received the treatment as a group with its own interests, as well as its own public good to provide for itself? What type of group then would the government belong to: privileged or latent? Given the passive role assumed for it by the PE of reform literature (namely that it is either threatened by the losers or captured by the rent-seekers) is it considered to be the latter? Moreover, what kind of public good would the policymaker seek to provide for itself? The normative PE theories seem to stay largely silent on this point, identifying the policymaker’s own public good with the public good of the reform process. This effectively amounts to the assumption of the government as a benevolent social planner.⁵

⁵ Not exactly so, since many of the writings cited did not see every office-holder in transition as benevolent. Fears were openly expressed that the electoral backlash bringing the former communist elites back to power would result in the reversal of the reform process.

This is where branching towards the political business cycle literature promises theoretical fruit, as it clearly offers a departure point for examining the supply side of the political economy of transition. It is surprising that the pervasiveness of the J-curve argument has not incited this symbiosis already. The J-curve pattern of the distributions of costs and benefits can be regarded as a cycle in its own right.⁶ If the policymaker is bound to face this cycle, it is logical that it would attempt to counter-cycle it with its actions. The question, however, is *how* it might go about doing it, if the J-curve cycle will generate strong political pressures. The PBC assumption about opportunism may be a too important one to overlook.

Political Business Cycles in Transition

The PE of reform field is not the only to gain from the introduction of the PBC argumentation. The PBC literature can also be augmented through this theoretical symbiosis. Given its predominant focus on the developed democracies, the PBC branch has been fairly agnostic of some of the main issues treated in the PE of reform literature, namely, those of corruption and capture, as potential factors significantly shaping the policymaking process. Broadly, the reasons for opportunism have been seen in either the 'ideological rents' (Hibbs 1977, Alesina 1987), stemming from different preferences over policy outcomes between the left and the right, or the 'ego' or 'reputation rents' (Rogoff 1990), that is, the status satisfaction and influence from holding office. However, these theoretical explanations may be somewhat esoteric for a transition-country setting, where the private-regarding, material and distributional interests on the part of the policymaker

⁶ I thank Professor Hector Schamis for making this suggestion.

may be more pronounced. So, while the PBC has addressed the issue of the relationship of the policymaker with the electorate, it has by and large failed to consider this relationship through the prism of group dynamics as done by the PE of reform literature. In other words, while examining the supply side, it has largely abstracted some political-economy aspects of its interaction with the demand side as identified and problematized in the literature on transition.

Building on a recent innovative work of Bonomo and Terra (2005), who propose an integration of the PBC literature with that of special interest and rent-seeking politics, this paper presents a stylized framework in which policymaking in a transition economy setting is a result of both opportunism and the transition-related demand-side pressures. This amounts to arguing not only that political liberalization in transition countries has caused political business cycles, but that these cycles may be different in nature from those observed in developed democracies.

CHAPTER 3

BRIDGING THE GAP: CAPTURE AND FISCAL POLICY CYCLES IN TRANSITION

Bonomo and Terra (2005) propose a model, focused on Latin America, in which a link is created between the theoretical work on the special interest politics and the political business cycle literature. The crux of their model (henceforth the B-T model), which will serve as the basis for the simple albeit modified model discussed in this paper, is that the interplay between the lobby power of the special interest group and the voting power of the majority of the population leads to the political business cycle. Such an outcome occurs because the government has an interest to maintain/establish ties with the lobbyists, but at the same time given the electoral pressures, it embarks on a policy manipulation in order to disguise its proximity to the special interest. In other words, the mechanism behind the cycle is engendered by the incumbent trying to signal that he has not been captured by the interest group, biasing its policy in favor of the electorate at large before the elections.

This seems to be a framework conducive to modeling the stylized environment of transition in terms of the distributional dynamics among different groups. As previously argued, the introduction of multi-party elections in many countries may have introduced the incentive for opportunism, all the more so given the argument about the risks of electoral backlash and the reversal of reform. The B-T model helps introduce this

political business cycle rationale for the possible behavior of reformers in the countries generally undergoing political liberalization of the electoral process.⁷ On the other hand, the focus on the rent-seeking capturers in transition (the winners) by the PE of reform literature relates to the influence of the special interests in the B-T model, which hence sheds light on the possible collusion of interests of the policymakers and the capturers, rather than viewing the government merely as a captured victim. Finally, the effects of the voting power of the electorate in their model are in conjunction with the emphasis of the PE of reform literature on the impact of the behavior of the losers on policymaking in transition. By building upon their model, the integration of the two literatures promises to be achieved: the impact of electoral uncertainty in the form of preelectoral policy manipulation by the incumbent is joined with the impact of interaction over distributional consequences between the groups in the society bearing the costs and benefits of reform. In other words, the key tension by which the cycle is engendered is the distribution of resources between two groups in society: one with the lobby/capturing power, and the other with the voting power. This is clearly what has been in the focus of the PE of reform literature as well. Moreover, the model is centered on the policymaker and its behavior in the process, highlighting therefore the under-analyzed supply side of the political economy of reform.

⁷ Political liberalization rather than 'democratization' is used here to signify the difference in what is the subject of analysis here. Namely, the latter is broader, and while it involves a change in the selection process for political office from a regime in which the government is not determined by popular vote to one which it is, it also presumes, as Offe (2004) argues, vertical and horizontal consolidation of institutions. That is, democratization is taken to mean both that there be democratic politics (competitive elections), and there is a system of rules ensuring a democratic political process of policymaking (separation of power, checks and balances, etc.). The term 'political liberalization' used here denotes only the first part.

Before laying out the model and explaining its implications, some nuances and distinctions between the B-T model and its intended extension here should be noted. This will also help ground the model in the transitional setting, which is not the explicit aim of their model. Namely, Bonomo and Terra model the lobby groups as conceptualized and espoused by the special interest politics literature, whereby the influence on policymaking is mainly channeled through lobbying, campaign contributions and information provision (Grossman and Helpman 2001). Many of these activities are endowed with legitimacy in democratic systems, or are at least mostly considered a regularized part of policymaking formation. The focus in the model application in this paper, however, is somewhat different, and is turned to the aspects of capture, political corruption, and rent-seeking, rather than special interest politics. The most immediate reason for this shift in focus is that the market for special interest politics in transition countries has not been nearly as structured, or at least not as regularized, given the extent of political restructuring. Many special interest-policymaker exchanges in transition take place in ad-hoc and non-regularized ways (North 1990).⁸ Therefore, the model postulates the ‘capturers’ rather than the lobbyists, capture rather than lobbying.

That said, the terms ‘special interests’ and ‘capturers’ will be used interchangeably. The reason is primarily in the fact that the capturers here are perceived

⁸ This is not to say that campaign contributions, information provision, lobbying and the like have not been present, or that they should be excluded from the theoretical treatment here. On the contrary, as argued by Sajó (2002), with the introduction of mass participatory politics with competitive elections, these activities have gained importance in the transition countries, because they promise electoral returns in the environment where winning elections is increasingly expensive. Nevertheless, given that this study is addressing the special interest-policymaker relations primarily through the PE of reform lens of group interaction over distributional consequences, the focus will differ from that of the special interest politics literature. Namely, as argued above, the PE of transition reform literature focused largely on the illicit, capturing, distorting activities of groups able to organize in pursuing their interests, which were mainly seen in collision with efficiency and welfare maximizing outcomes of reform.

to be the groups capable of organizing to further their narrow, i.e. special, interests, on the track of the PE of reform approach to the winners as Olsonian privileged groups. Also, conceptually, the capturers in the model preserve the main motive for their activities as postulated by the special interest politics literature: the influence motive. Similarly, the term rent-seeker would also apply, since the capturing activities are aimed at ensuring or preserving the rents created in the process of transition (Hellman 1998).

However, the impact of the interest groups' activities on the reelection prospects of the policymaker is different in the model presented here (as well as in the B-T model) than posited by the special interest politics literature. In the latter, by providing campaign contributions to politicians, special groups *promote* electoral prospects of their preferred candidates. In the former, the existence of links *jeopardizes* electoral prospects. As explained by Bonomo and Terra, the difference stems from the type of the variable the special interest group influences in the two types of models. The special interest politics explains the impact of lobbying on microeconomic variables. The level of such variables should not be of concern for the hypothesized majority of the population in our model, and therefore should not have a significant impact on the election prospects of the policymaker. In our model, the capturers' influence translates into macroeconomic variables (fiscal policy), which factor in the voting behavior of the electorate.

How does the capturers' influence translate into aggregate macroeconomic variables – in this case into fiscal policy – in transition countries? In other words, how does the patron-client structure between the special interests and the policymaker affect the distributional effects of the aggregate fiscal policy for the special interests vs. the majority of voters? Without attempting to pre-specify the identity of the special interest

groups, thereby constraining the theoretical modeling, many examples come to mind. Government credits and subsidies to industry and agriculture in support of production can result in high inflation and low real interest rates. Enterprises borrowing at such attractive rates and depreciated principal acquire funds that can be siphoned off through favorable contracts with new spin-off (but related) enterprises (Havrylyshyn and Odling-Smee 2000). This redistributes resources in favor of these enterprises. Similarly, asset-stripping in state enterprises pending for privatization by the ‘insiders’ redistributes resources in their favor (Stark and Bruszt 1998), and away from other direct and indirect fiscal beneficiaries, including the users of the social safety net, number of which has by and large increased dramatically in transition (Jurajda and Terrell 2003, Boeri and Terrell 2002). Tax breaks and/or reduction in employers’ social security contributions (a remnant from the communist system) puts additional burden to social-related budget outlays (Ham, Svejnar and Terrell 1998). “Pork-barrel” cycles in public investment (Drazen and Eslava 2006) or lack of transparency in public procurement (Dixit and Londregan 1996, Jarmuzek 2006) tend to redistribute resources to small groups of privileged service providers and contractors, with the consequent underprovision of public goods (Lizzeri and Perisco 2001, Gray, Lane and Varoudakis 2007). Organized interest groups aim to increase the stakes in regulatory politics in order to streamline benefits in their favor through ‘regulatory capture’ (Laffont and Tirole 1991). Obtaining government licenses for doing trade in formerly monopolized primary products may promise rents from disparities in domestic and world prices under conditions of incomplete price liberalization (Banaian 1999). And so on.

It is therefore clear that fiscal policy realm carries immediate and pronounced (re)distributive effects. It may thus represent fertile ground for the patron-client relationships to spring up. On the other hand, representing a set of such strong redistributive instruments, fiscal policy can be a powerful political tool in the hands of the policymaker, all the more so given the pervasive disequilibria caused by transition that augment political uncertainty and electoral pressures. Namely, if the links with the capturers slant the policy away from the electorate at large, the consequent dissatisfaction in the population causes these links not to better the reelection chances for the policymaker. Hence the need for disguise, which is not prominent in the special interest politics literature: due to the interaction between the distributional consequences of (captured) fiscal policy and its pliability as a tool for political manipulation.

So, in the special interest politics theoretical setup, the incentives are aligned for both actors: policymakers get the information and the funds needed to increase their standing at the polls, while special groups vote-buy their way towards realizing their interests. In our model, however, the critical question that arises is why would there be a collusion of interests between the policymaker and the special interest/capturer, if the existence of the ties threatens the policymaker's reelection? Typical arguments of the special interest politics and rent-seeking literatures, which rationalize the emergence and existence of interest groups, do not provide us with an answer, although they do illuminate the incentives on the capturer's side. This is why this study adopts a focus different from the special interest politics literature.

The key to the answer lies with the incentives and interests of the policymaker, not those of the special interest/capturer. And in the model presented below, they stem

from what will be termed the ‘capture rent’. This is basically a typical framework explaining the workings of what is commonly called ‘political corruption’. Namely, in the principal-agent setup, where the voter is the principal and the policymaker is the agent, the relationship can be thought of as the contract which specifies a delegation of responsibility and the exercise of some discretionary power (della Porta and Vannucci 1999). In other words, this contract imposes respect for certain rules restricting the discretionary power of the agent, as well as those of the principal. Political corruption exists when this contract is secretly violated by the agent (and typically against the preferences of the principal). The crucial aspect of this definition, still, is that the agent acts in favor of a *third* party, from which it receives a reward (Philp 2002). The third party induces the agent to surrender resources connected to its role in order to obtain the desired rent. Clearly, the third party implied here is the capturer, and the reward for the policymaker is termed the ‘capture rent’. The capture rent is therefore the crux of the model, as it creates the incentive for opportunism: the policymaker wishes to stay in office in order to be able to continue extracting the capture rent, that is, the reward from the capturers.

It is advisory to deploy an explanatory note here with regards to terminology. The (ego and ideological) ‘rents’ discussed in the PBC literature share the common economic meaning of the rents from the rent-seeking literature, but are not conceptually identical. Namely, they relate to the benefits that the policymaker extracts from holding office *in addition* to the typical returns of political tenure endowed to it by the voting franchise. So, the capture rent is the rent in the sense that it is a premium over and above what the incumbent would normally receive by occupying office. This is closely related

to the concept of rent as in rent-seeking, as presented by Tullock (1967), and Buchanan, Tollison and Tullock (1980). The rent there is typically defined as that part of the payment to the owner of resources above the alternative earning power of those resources, that is, a receipt in excess of the opportunity cost. The main difference between the two then is in who is seeking the rent, and by whom it is created. In the PBC literature, it is the policymaker who seeks the rent created by another subject. i.e. the capturer, as proposed in the model below. On the other hand, in line with the common rent-seeking literature, the rent is created by the action of the policymaker, such as the restriction of the access to the market through regulation, licensing, etc, and is sought by another subject, the special interest/capturer in our model. The two – capture rent and rent proper – are obviously related. In line with the adopted terminology, the policymaker commits ‘capture rent-seeking’, while the capturer does simply the rent-seeking. This relationship makes the two rents conditional on each other, then.⁹ This point is elaborated in the model outline below.

It should also be noted that while reflecting the result of political corruption as the private-regarding benefits from catering to the capturer, the capture rent is not assumed to necessarily come in a pecuniary form. While much of political corruption is in the form of monetary bribes, there are also many other ways that the exchange can come about. For example, capture rent can denote the promises of future employment of the policymaker in the firm of the capturer (should it be an enterprise, a think tank, or the like), since it would mean an assured future flow of income, position of influence and

⁹ Literature on political corruption distinguishes between the policymaker-led and the capturer-led relationship. While the difference may be meaningful since it can carry different implications for the two relationships, it is of no crucial importance here, since rent-seeking is assumed to be two-way. For details, see for example Gambetta (2002)

prestige, etc. In conditions of uncertain tenure of a politician, this may be very important. Or quite differently, the capture rent can be in the form of the capturer agreeing to refrain from publicly criticizing the policymaker (should the capturer have a strong influence on the media, for example), thus augmenting the policymaker's "office-tranquility" (Laffont and Tirole 1991). Such a capture rent could be in direct function of reelection chances of the incumbent. Furthermore, a well-known 'regulatory capture'/'state capture' is another modality, whereby the capturer attempts to influence the way the playing field is incepted or restructured in the legislation-drafting and enactment phases. And so on.

Finally, it is useful to discuss the relation of the capture rent to the 'rents' previously discussed in the PBC literature. The 'ego' and 'ideological' rents – common concepts used in PBC modeling – do not include the aspect that received much attention in the literature on transition which is in focus here: the private-regarding, corruption-based considerations about private benefits from holding office. This is why the capture rent may be particularly potent in explaining the transitional economy setup. From the theoretical perspective, as argued by Bonomo and Terra, this is a convincing explanation of the policymaker's opportunism, since it is modeled as endogenous, and not pre-set. Namely, the incumbent has real, tangible reasons for wishing to be reelected, which is the reward from the capturer. This stands in contrast to the somewhat esoteric and exogenously (to the PBC modeling) assumed ego rent, which denotes the pre-set reputation, status-related benefits the policymaker extracts from holding office. While it is likely to describe the motivation of politicians to some extent, it fails to address the issues taken up by the PE of transition reform literature. The issue was descriptively put by Drazen (2000:332), who notes a distinction between the 'good' and the 'bad'

politician. Namely, in the Rogoff and Sibert (1987) model, which is modeled on the latter, the ‘good’ politician cares both about remaining in office and about social welfare, while the ‘bad’ politician does the same, but is only less competent than the ‘good’ politician – in that it is not as effective in staging the fiscal expansion. In other words, both types (only two types are assumed for the sake of simplicity) have the same motivation for preelectoral manipulation (ego rent), and it is the competence in catering to the welfare of the electorate that makes a difference. It is in this sense that the ego rent is exogenous, since the (pre)electoral outcome is not conditional on it, but only on the extent of competence of the incumbent vis-à-vis its contenders. Competence is signaled through policy outcomes, since the information about the incumbent is not available to the voters. Hence the fiscal policy manipulation. The distinction is somewhat arbitrary, however, and leads to an unusual result in which only the ‘good’ politician – the more competitive one – distorts the policy in the equilibrium. It is so because the less competitive contender chooses not to distort the policy knowing that it cannot stage the fiscal expansion as effectively. The theoretical outcome is therefore that different types choose different preelectoral policies, whereby only the competent one is able to opt for the distortion.

Persson and Tabellini (2000) and Shi and Svensson (2002) propose an amendment to this adverse selection model by introducing a simple twist: the incumbent chooses its action before knowing its own type. So, both the ‘good’ and the ‘bad’, i.e. the more and the less competitive politicians are impelled to choose the same policy, given the ego rent. The observed economic outcome ends up revealing the type of the policymaker, as it is determined by the interaction between its competence and the

chosen policy. Such modeling generates the desired result lacking in the *adverse selection* models – in equilibrium both types distort the policies, and not just the more competent type. Hence the name: *moral hazard* models. Still, an unappealing part is that the both types choose the same policy before elections. This is so again because the rent from office is exogenous. The distinction between the types of policymakers is therefore still questionable.

The B-T model mixes the desired features of the two. If the ‘good’ politician would be opportunistic and care about the social welfare, the ‘bad’ policymaker would care about both these aims *and* about exchanging the policies for the capture rents from the capturers. In this framework, different types of policymakers choose different policies, as in adverse selection models, and both distort policies before elections, as in moral hazard models. This is achieved by pairing two assumptions in the context of different levels of connection with the special interests. First, the rent from office is not strictly exogenous, but also depends on this connection with the special interests. The connected type derives therefore a different expected rent than the non-connected type. These different rents bring about different policy choices. Second, the departure from adverse selection models is in the assumption that policy outcomes are observed with noise. This assumption yields the incentive for both types to distort policies before elections, as the policymaker’s type can never be perfectly inferred by the voters. Hence the ability to disguise the links with the capturers. The model based on the endogenous rent is therefore stronger in explaining the policy outcomes possibly influenced by political corruption. As for the ideological rent, it is endogenous to the models based on it (for example, Alesina 1987), since it stems from the long-standing preferences of the

constituencies that the left and right wing parties traditionally serve. The right-wing policymaker will extract different expected rent from the left-wing policymaker. It carries less appeal for the transition country setting, however, since empirically, it would be difficult to analyze transition politics in terms of the left-right framework (for a discussion on this, see for example Fidmurec and Noury 2003).

CHAPTER 4
METHODOLOGY
Theoretical Model

A simplified and modified version of the B-T model, which is the foundation of the testable hypothesis for this paper, can be presented as a following simple utility function of a policymaker:

$$G(g, c, X) = E[nv_c(g) + (1 - n)v_s(g, c) + \theta c - X], \quad (4.1)$$

where $nv_c(g)$ is an indirect utility function of the electorate at large (or rather, a representative voter) when the policymaker implements the level of fiscal policy g . $(1 - n)v_s(g, c)$ is an indirect utility function of the special interest group, given the policy g and the (per capita) benefit/the rent c (part of which is the capture rent; see below) it will provide to the policymaker in exchange for a policy choice favoring this group, θ is the relative weight the policymaker gives to receiving personal benefits from the capturer vis-à-vis the electorate's utility, while X is the level of transparency and accountability of the policymaker to the electorate at large. The policymaker therefore chooses the level of fiscal policy g to maximize the weighted sum of social welfare and the gains it derives from the capturers (Grossman and Helpman 1996, Bannedsen 2000), with respect to the weight θ , in its attempt to achieve both goals: reelection and extraction of capture rents.

There are a number of assumptions: 1) the society consists only of these three groups, and the proportion is such that the electorate constitutes the majority $n > 0.5$; 2) only the special interest group is organized to influence the allocation of fiscal policy, but the electorate is not; so the objective of the organized group is to maximize its net welfare $E[v_s(g, c)] = v_s(g) - E(c)$; 3) for the sake of simplicity, and without a loss of generality, it is assumed that the electorate benefits from the higher level of g , while for the special interest, the lower the g the better; that is, $v_c'(\cdot) > 0$ and $v_s'(\cdot) < 0$, and $v_s(\cdot)$ is assumed to be concave;¹⁰ 4) $\theta > 1$, so that the policymaker always has a net benefit from receiving the 'capture rents'.

The mechanism engendered in this simple model is the following. Had the policymaker cared only about the welfare of the electorate at large, it would have been maximizing its own utility by increasing the level of g , thereby maximizing the welfare of the electorate, and its electoral prospects (see assumption 3). However, its utility function here also incorporates the personal benefits from the special interest group, which depends on the distortion of the policy in its favor. The policymaker desires the 'capture rent' B , which is a portion of the net gain $c(g)$ (the rent) that the special interest gets from the distorted policy:

¹⁰ The assumption is such so as to facilitate the argument that slanting the policy towards the special interest means directing it away from the electorate. This opposition of the welfares of the capturers and the electorate at large is maintained to reflect the negative impact of capture, highlighted in the winners-losers framework. Such relationship is by no means always present. This critique is addressed in section below.

$$c(g) = B(1 - n)[v_s(g) - v_s(g^*)]^{11}$$

Therefore, in order to secure the B , the policymaker will strive to raise the utility of the special interest. Note here the interrelation of the two rents discussed above, namely, that the benefit the policymaker derives and the welfare of the special interest are conditional on each other.

So, the equilibrium allocation of g for the policymaker must be jointly efficient for it and the special interest group. In other words, it must maximize the utility of the special interest group, given the welfare of the electorate.

Thus, the policymaker is maximizing the capturer's welfare $E[v_s(g, c)] = v_s(g) - E(c)$, where

$$\hat{G} = \theta \max_{v_s(g, c)} [nv_c(g) + (1 - n)v_s(g, c)] \quad (4.2)$$

This is the same as maximizing $(1 - n)v_s(g, c) + \theta(nv_c(g))$, so as to satisfy:

$$(1 - n)v_s(g, c) = \theta(nv_c(g)) \quad (4.3)$$

Solving Equation (4.2) following Bonomo and Terra (2005) gives:

$$\hat{G} = nv_c(g) + (1 - n)\{v_s(g) - B[v_s(g) - v_s(g^*)]\} + \{\theta B(1 - n)[v_s(g) - v_s(g^*)] - X\}$$

or rewritten as:

$$\hat{G} = U(g) + b[v_s(g) - v_s(g^*)] - X, \quad (4.4)$$

¹¹ This is interpreted as a result of a Nash bargain, where B depends on the bargaining power of the policymaker vis-à-vis the special interest. These details are abstracted in the simplified version presented here.

where $b \equiv (1 - n)(\theta - 1)B$

As can be seen from Equations (4.2) and (4.3), the crucial ingredient in this simple model is the policymaker's capture rent-seeking proclivity θ . In the absence of capture, and/or when the policymaker attaches no weight to the 'capture rent', the allocation that maximizes social welfare is the one that distributes g across the special interests and the electorate at large according to their relative shares.¹² But, when the policymaker attaches positive weight to the benefits received from the capturer – and assumption 4 is that this is always the case – the allocation to the unorganized group (the electorate) is lower than the one without the capture. Namely, the higher it is, the less weight does the policymaker put on the welfare of the electorate vis-à-vis personal benefits from the capturer. That means it will be more willing to distort the policy g in favor of the special interest, and away from the electorate in order to take a hold of B . So, the higher the proclivity, the lower is the allocation towards the unorganized group (the electorate). Given these allocations and shares, the model can also be used to predict the size of the equilibrium per capita benefit c that the capturer should provide in exchange for policy favors. It is interesting that it does not monotonically respond to the value of θ . Fidmure and Noury (2003) show that if the policymaker does not attach any importance to the welfare of the electorate, the benefit c , and correspondingly the capture rent B would be zero. In other words, the capturer does not gain by trying to capture the policymaker that does not attach any importance to the welfare of the society. On the

¹² Had we assumed that the shares are equal, that is, that the electorate is $n = 0.5$, then g would have been divided equally, i.e. $g^1 = g/2$.

other hand, as already argued, it is readily visible that c is also zero when $\theta = 0$, that is, when the policymaker cares only about the welfare of the electorate. This again shows the conditionality of the two rents upon each other.¹³

Given that \hat{G} in (4.4) is still the weighted sum including $U(g)$, the distortion of policy towards the special interest means a concomitant increase in the risk of reducing the reelection prospects due to a decreasing welfare of the electorate. Hence, for the policymaker who also cares about getting reelected, and not just about the personal benefits from the capturers, the distortion back towards the electorate in the run up to the election will have to be larger as well with higher θ . This is the *key* prediction of the model: the higher the θ , the larger the change in the fiscal policy g before the elections. In other words, the closer the incumbent policymaker is to the special interest/capturer, the more it will tip the fiscal policy to the electorate at large before the elections. This change represents the aforementioned ‘disguising’, as a result of the desire of the policymaker to achieve both goals: reelection and continuation of the extraction of capture rents.

There is another important ingredient in the model driving the magnitude of the change in g , designated by Bonomo and Terra as the level of noise in the system. Namely, it is assumed that the electorate observes the government policy with noise, that is, it can never obtain perfect information about it. This is justified as resulting from the voters’ rational inattention (Sims 2003). The voters have limited information capacity

¹³ Using the same framework, Persson and Tabellini (2000), show that the first best allocation is reached when everybody in the society gets organized and tries to influence the policymaker. This is important in that it clearly demonstrates that the problem of capture and its impact on the allocation of g stems from the fact that not all groups get organized, but some remain inactive, as postulated by Olson.

and they also have several other decision problems to solve that require information collection. Therefore, Sims argues that it is reasonable to assume that the voter will be imperfectly informed about government policies. At the same time, organized groups are better equipped and motivated to overcome this costliness of collecting information. They can pool members' resources and exert the expense to obtain superior knowledge of the policymaker, as well as about the outcomes of alternative policies.¹⁴ This may not be so much the case for the individual voter. As argued by Downs (1957), the free rider problem may be quite pronounced for the individual unorganized voters: they may not have strong incentives to spend resources to get informed, since their capacity to individually affect election results is quite constrained.

More important, given the lack of information, the voter cannot infer the type of the policymaker with certainty. In our model, the types depend on the proximity to the special interest.¹⁵ Since the voter cannot know the type of the policymaker, it will try to infer it on the basis of the observed policy, information about which is imperfect. This creates a signaling game between the incumbent and the electorate. In other words, it brings about the incentives for the policymaker's opportunism, and creates space for manipulation of the policy as a tool for disguising. Naturally, information asymmetry is instrumental in enabling the policymaker to resort to the capture rent-seeking behavior in

¹⁴ Given the structure of the model, this argument does not completely remove the possible inference and information problem for the special interest. Namely, the policymaker is assumed to be opportunistic, and so will try to distance itself from the capturer before the election by distorting the policy in an unfavorable way for the interest group. This distancing therefore provides costs for the capturer, and under the conditions of imperfect information, creates risks of losses. This risk is accounted for in the B-T model with variable X , and so the capturer's information problem is explicitly modeled.

¹⁵ Bonomo and Terra start off with two types, π_c and π_f , the types close to and far from the special interests respectively.

the first place.¹⁶ In this sense, it is reasonable to assume that the higher the information asymmetry (X), the fewer the restraints on the policymaker to seek capture rents; and consequently, the higher the X , the greater the scope for the change in g , as it can be tilted more towards the special interest before being distorted back towards the electorate. So, X generally stands for the levels of transparency and accountability in the system. In the B-T model, X is the cost for the policymaker in case of being deceived by the special interest who fails to honor the deal. Alternatively, however, they model it as a reputation cost of the deal being revealed to the public, whereupon the reelection prospects of the policymaker are severely reduced. This second usage can be generalized as the extent of transparency and therefore accountability in the system, as has been done in the simple model used here. In this sense, the level of noise, and thus θ and the change in g , are in reverse proportion to the information available to the electorate (hence the minus sign in the Equation (4.4)). So, the higher the transparency/accountability of the policymaker, the more constrained it is in its ability to extract capture rents, and consequently, the lower the subsequent disguise.¹⁷

So, it is obvious that this is a state-centric model, whereby it is conceptualized that the policymaker is an actor with its own interests and distributional calculations, and it is these that crucially shape the outcomes of fiscal policy, indirectly through the

¹⁶ This is conditional on the model assumption that the electorate never belongs to the special interest group, and therefore would always like to vote for the policymaker further from the capturers. This in turn relies on a simplistic assumption of a 'mean' voter, representative of the whole electorate. In this way, possible distributional conflicts and different and changing preferences within the electorate at large are abstracted. This is addressed in the section on model critiques below.

¹⁷ The relationship between the level of transparency and the need for a disguise may not be monotonic. On the one hand, the higher the availability of information about the policymaker, the less likely will it be able to resort to disguising. On the other, the higher the public concern and awareness of corruption issues, the greater may be the need for a disguise. The net outcome would depend on the nature and scope of information available, and the nature and effectiveness of oversight.

interaction between the voting power of the electorate and the capturing influence of the special interest group. The theoretical contribution of this paper with respect to the literature on political business cycles and PE of transition is that it attempts to bridge the gap between the two, in that it introduces an explicit focus on the supply side of the distributional dynamics of the transition process. That is, it augments the former by focusing explicitly on the interests of the policymaker, and it supplements the latter by treating it as a distributional actor in its own right.

The model also provides a good ground for empirical evaluation of the influence of the incumbents' capture-rent-seeking behavior on fiscal policy outcomes. Several studies in the PBC literature have generally covered this ground, such as Shi and Svensson (2002), who looked at the relationship between fiscal policy and corruption in developed versus developing countries, Gonzales (2002) who looked at how the varying levels of democracy affected government spending in Mexico, and Eslava (2005), who looked at the relationship between electoral rules and the structure of local government expenditures in Colombia. To my knowledge, there have been no studies concentrating on transition countries, despite much writing about the issues of corruption and capture within the PE of transition reform camp. This paper therefore attempts to make a contribution in this respect as well.

Empirical Model

Empirical Model Specification

The model will be empirically tested by means of econometric estimation performed on the sample(s) of transition countries. The choice of the method of

empirical testing has predominantly been driven by two factors. First, it has been conditioned on the choice of theoretical framework outlined above. Namely, the formal modeling used commonly in the political business cycle literature, and applied here, has normally been tested by means of statistical non-parametric and parametric analysis of time-series and/or time series-cross section (panel) data. This has been so partly because the highly stylized nature of the PBC theoretical models renders some other methods of empirical analysis, such as case studies, somewhat complicated. While general expectations of the PBC models are pliable to the exhaustiveness and meticulousness of case studies, as in the example of the seminal work of Tufte (1978), a grid of implicit assumptions and on them based relationships built in these models represent a somewhat more rigid ground. For example, in our model, an important theoretical assumption is that of the opposed impact of the level of public good provision g (taken to represent the whole fiscal policy) on the welfares of special interests and the electorate at large. This basically amounts to assuming that a lower level of g always benefits the special interests, while the higher level of g always benefits the voters, and vice versa. Such a situation is of course by no means universal, not least because the analytical separation of the population into a representative voter and a special interest group represents an extensive abstraction. So, while this assumption is warranted only inasmuch as it leads to the final expectation of the reasons for and mechanism behind the preelectoral manipulation of fiscal policy, it may in and of itself complicate the methodological process of case study analysis.

Second, this study attempts to shed a new light on the impact of transition on the policymaking process, thereby focusing on the possible generalizations about the

peculiarity of economic-cum-political transition. Testing the predictions of our theoretical framework against as many cases of post-Communist transition setting as possible thus seems logical, since the focus is on the possible common patterns and general phenomena.

The most common form of econometric test of the PBC opportunistic models is to run an autoregression of economic policy outcome on itself, a small set of economic control variables, and political dummies and interaction terms to test a specific theory (Drazen 2000). The usual specification is of the following form:

$$Y_{i,t} = b_1 Y_{i,t-p} + \sum b_2 X_{i,t} + dPDUM_i + e_{i,t} \quad (4.5)$$

where Y is an economic policy outcome, X are other variables that may also affect Y , and $PDUM$ is a political dummy variable representing a given political model.

For the purposes of testing our model, then, Y represents a fiscal policy outcome, which will be measured alternatively by an overall fiscal balance and total government expenditures. $PDUM$ will be meant to represent the time of the polling, in order to capture the impact of elections on fiscal policy variables. Finally, $PDUM$ will be interacted with the proxies for capture rent-seeking behavior of the policymaker, rent-seeking of the capturers, and the level of noise in the system, to analyze their impact on fiscal policymaking. More details on specifications are given below with the presentation of results.

Variables & Data Sources

Dependent Variables

In line with much of the recent empirical literature, the focus is on the fiscal policy outcome in terms of policy instruments. The primary dependent variable of interest is therefore the overall budget balance, defined as a difference between the revenues and the expenditures. In line with the theoretical model, the expectation is that the balance worsens before the elections due to the ‘disguising’ fiscal expansion. Note that this does not necessarily imply running a fiscal deficit, but just a deterioration of the overall balance. The data for this were taken from the European Bank for Reconstruction and Development Economic Statistics,¹⁸ since it contains the wealthiest dataset for all transition countries with the fewest missing observations. The variable is expressed as a share of GDP.

It could be argued that the budget balance variable may not be the perfect one for testing the B-T model. Balanced budget target may be a more sensible option for the policymaker maximizing reelection prospects in the case when the voters are ‘fiscal conservatives’ (Peltzman 1992), that is, tend to punish rather than reward the government for the preelectoral fiscal expansion. However, this argumentation can perhaps be relaxed for a country in transition for a number of reasons. First, fiscal policy management in the period of central planning differs substantially from the typical mechanisms assumed in the political business cycle literature. Therefore, it may take time for the voters to develop into ‘fiscal conservatives’, given the time it may take to get

¹⁸ <http://www.ebrd.com/country/sector/econo/stats/sei.xls> (last accessed July 27, 2007)

familiarized with the processes of fiscal policymaking in the transforming environment. Also, Schamis and Way (2003) posit that the shortened time-horizons in conditions of uncertainty and probability of an impending shock – pervasive in transition – can induce the voters to prefer the rise in income today to the uncertain income in the future. In any case, under the balanced budget constraint, a fiscal expansion on the expenditure side would have to be accompanied by a counterfactual tax cycle, whereby the taxes are increased. This seems relatively unrealistic, as Bonomo and Terra (2005) argue, given that the taxes are relatively hard to change in the short run, and the consequence would be that any eventual budget imbalances could only be financed by government debt, which may be a politically desirable and viable solution (see for example Ball, Elmendorf, and Mankiw 1995). For this reason, an alternative dependent variable will also be tested, namely the overall government expenditure. Irrespective of the budget constraint (and the mode of conforming to it), it is expected that the expenditures rise before the elections, and more so when the policymaker exhibits greater capture rent-seeking behavior. The data for the expenditure variable are obtained from the same source, and it is also expressed as a share of GDP.

Figure 1 and Figure 2 help provide a feel for the data behind the two variables. It can be seen that many countries experienced a very sharp drop in fiscal balance and total government expenditures in the early years of transition.

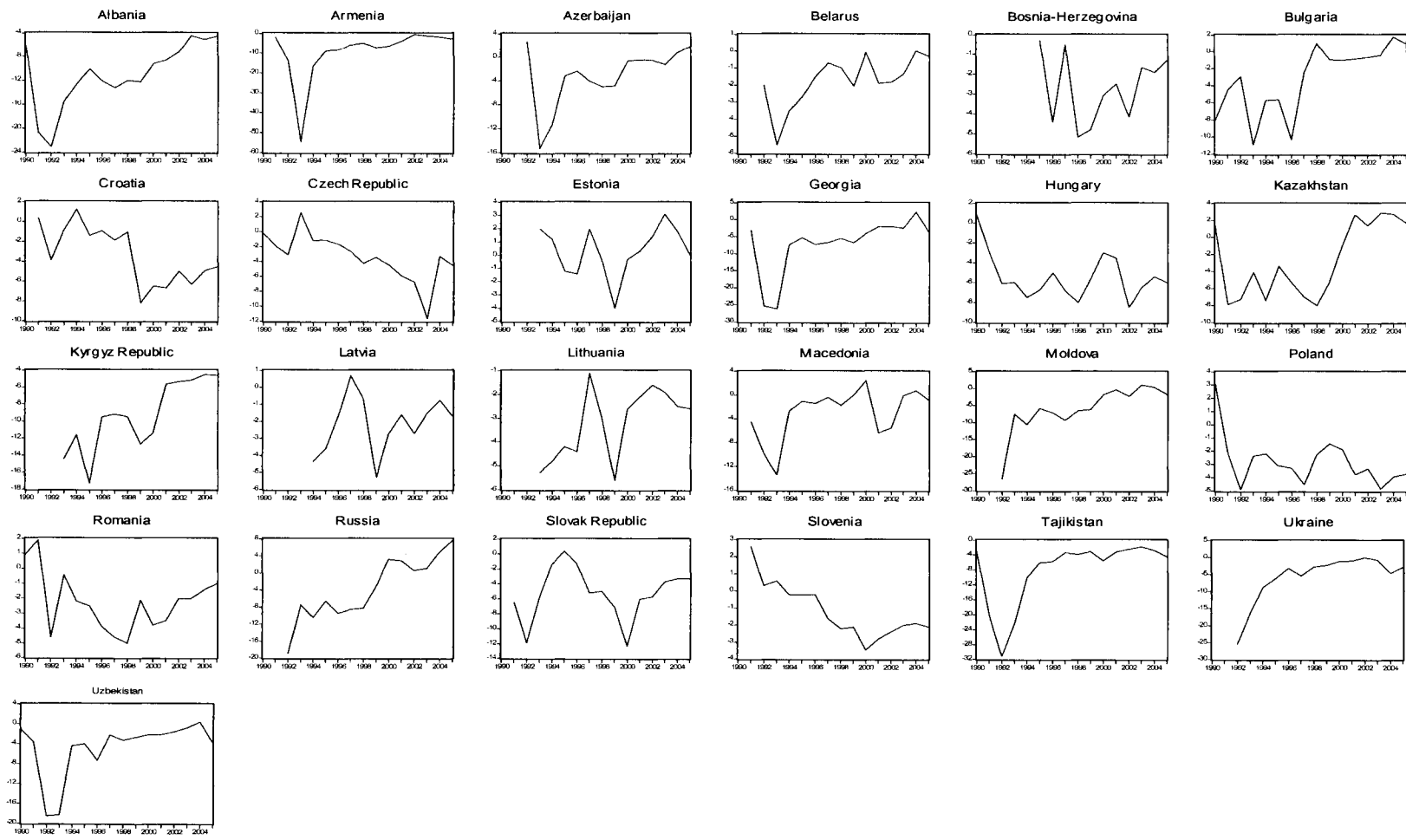


Figure 1. Budget Balance by Country, 1990-2005

Source: EBRD Economic Statistics, <http://www.ebrd.com/country/sector/econo/stats/sei.xls> (last accessed July 10, 2007)

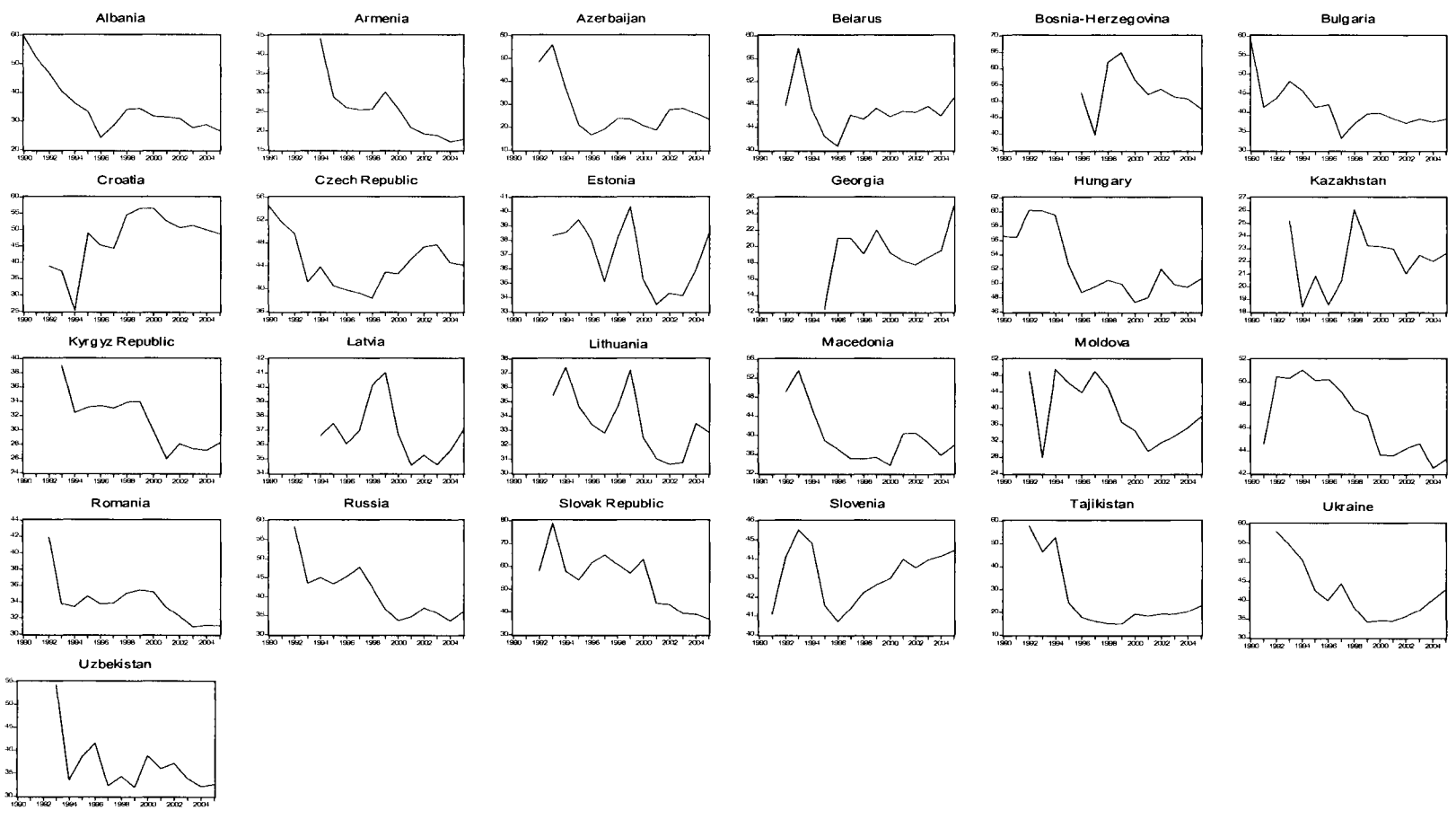


Figure 2. Government Expenditure by Country, 1990-2005

Source: EBRD Economic Statistics, <http://www.ebrd.com/country/sector/econo/stats/sei.xls> (last accessed July 10, 2007)

Budget balances deteriorated into sizeable deficits that have mostly persisted and receded only gradually. What is also striking is that in many countries expenditures remained at a much lower level after a large one-off drop at the beginning of transition. This has obviously been the consequence of the retreat and shrinking of the state. Most importantly for this study, many countries, particularly Estonia, Lithuania, Bosnia and Herzegovina and Kazakhstan, have experienced prolonged large fluctuations in budget balance and expenditures. It is the magnitude and the possible reasons of fluctuations around elections that are of primary concern here.

Electoral Dummy

The data for the key regressor, the dummy variable *ELECT* (which is a rendition of the political dummy *PDUM* from the above general econometric model), are the election dates, collected from Armingeon and Careja (2004). This dummy variable is designed to measure the impact of the election on the fiscal variable of interest. The same dataset contains the data on the type of the political system, according to which it was decided whether to include the elections for the legislature (parliamentary systems) or the executive (presidential systems). In the case of the mixed systems or the ambiguities about who actually decisively controls the fiscal policy decision-making, sources such as Berglund, Ekman and Aarebrot (2004), Banks et al. (various), and Beck et al. (2001) were consulted. For example, where the fiscal policy is in the hands of the government responsible to the legislature, but which can be recalled by the president without a no confidence vote, the executive elections are taken despite the fact that fiscal authority does not directly reside with the president. This is being done out of the

assumption that in such a case the president holds the ultimate veto power over fiscal decisions, and also possesses the capacity to endogenize the fiscal process according to their interests.¹⁹

Typically, the election date dummy would take the value of 1 in the election year, and 0 otherwise. The headline *ELECT* variable then takes the value of 1 in the year of election and the value of 0 otherwise.

Interaction Terms

Given the outline of the theory above, another crucial set of independent variables, to be interacted with the *ELECT* dummy, contains the measures of capture rent-seeking, rent-seeking and transparency/accountability. These interaction terms will measure how the preelectoral effect on the fiscal outcome varies among countries with different levels of corruption, governance quality, economic reforms and transparency and accountability.

Proxying these aspects is difficult, and much of the pertinent data is highly imperfect. First, most available data is based on survey results and expert opinions, and is thus subjective and prone to many types of bias (ideological, recall, etc.). Also, much of the data is in the form of indices that are aggregated from multiple sources, which reduces the precision, and introduces many difficulties for cross-section and across-time comparison, since in some cases the variation could be attributed to the changing number of components rather than the actual qualitative change. The components are often interdependent and highly correlated, which *inter alia* may invoke a selection bias.

¹⁹ This is for example the case for Ukraine, and had been the case for Moldova until the changes to the Constitution were passed in late 1999.

Furthermore, many sources do not contain time-series data, or if they do, the data are not collected on a regular-frequency basis, further reducing the possibility to employ the analysis in a time-sensitive manner. Also, some sources change the methodology or the survey instrument along the way. Finally, many sources on corruption suffer from the lack of representativeness, as they are often based on non-random, small samples.²⁰ Be that as it may, some of this data will be used in this analysis, albeit with a considerable dose of caution.

Three different measures were used concomitantly in an attempt to analyze the three crucial aspects of the theoretical model: capture rent-seeking behavior of the government, rent-seeking behavior of the capturers, and the level of noise in the model, indirectly measuring the level of transparency and accountability of the policymaker to the electorate.

Capture rent-seeking

The first measure, called the Composite GI, was created with the intention of proxying the first aspect, i.e. capture rent-seeking. It was obtained by aggregating the World Bank's Governance Indicators (Kaufmann, Kraay and Mastruzzi 2005). The indicators are: Voice and Accountability, Political Stability, Government Effectiveness, Regulatory Quality, Rule of Law and Control of Corruption. As perception-based measures, these all help instrumentalize two important features of the theoretical model, namely both the proclivity to capture rent-seeking, and the need of the policymaker to disguise its proximity to special interests. In other words, they help track the most

²⁰ For a critical overview of the perception-based measures and their use in research, see for example Knack (2006), Treisman (2002) or Sik (2002).

important supply-side aspects of political corruption. For example, a less stringent rule of law and a lower regulatory quality would provide the policymaker with a greater leeway to maintain the ties with the special interests. Likewise, lesser accountability may reduce the electoral pressure and thus the need for a disguise, while at the same time increasing the viability and the appeal of the ‘capture rents’. Therefore, this measure is considered to be a solid proxy for the general environment in which the policymaker would engage in the capture rent-seeking activities. Also, in analyzing different indices of corruption and quality of governance perception, Knack (2006) argues that the Governance Indicators give perhaps the most all-rounded assessment of political corruption and governance quality in comparison to some other existing measures, such as Transparency International’s Corruption Perception Index, Freedom House’s Nations in Transit Index of Corruption or World Economic Forum’s Executive Opinion Survey, which by and large focus only on some aspects of corruption – predominantly petty administrative bribery – and are based on the opinions of limited segments of society – mostly panels of experts.

The aggregation was done in such a way that more weight was put on the three of the six measures, namely, on the fourth, fifth and sixth components. The aggregation was partly used to minimize the effect of measurement errors,²¹ and partly to obtain a more comprehensive proxy, that would include aspects such as regulatory quality, corruption and rule of law. In composing the measure from these aggregated scores, the following

²¹ The Government Indicators are already transformed so that the series have a mean of 0, and has been normalized so that 95% of the score fall within -2.5 and 2.5. That means that the scores can only be taken relative to the scores of other countries. The aggregation as it is applied here thus implies an additional loss of already aggregated information, but I was aware of no other choices. For the details on the methodology, see Kaufmann, Kraay and Mastruzzi (2005).

rescaling procedure was then used: a country-year observation aggregated score was subtracted from the average across all countries for a given year. The country-year observation with an average capture rent-seeking activity by the government thus received the value of 0; countries with the higher level got positive, and countries with the lower levels received negative scores.²² The data for the Composite GI are available from 1996 to 2005, but until 2000 observations are available on a biannual basis.

Rent-seeking

The second measure, called here the Composite TI, is based on a number of components of the EBRD's annual Transition Indicators (EBRD Transition Report, various). The composite index includes the following components (8 out of 14), weighted equally: Large Scale Privatization, Small Scale Privatization, Enterprise Restructuring, Price Liberalization, Trade and Foreign Exchange System, Competition Policy, Banking Reform and Interest Rate Liberalization, and Security Markets and Non-Bank Financial Liberalization. A country receives a score from 1 to 4.5 in half point increments for each of the components, with the higher scores representing more successful reformers.²³ The rationale for including this measure stems from the 'demand side' of the capture concept, namely the market for political influence. Although it

²² A potential problem with this rescaled measure for comparison over time is that the mean of the series is not stable, but changes from year to year, given the change in the average across all countries for a given year that is used to construct the year means. However, the measure will be used in the analysis in such a way that only the impact of the distance from the mean (in terms of standard deviations on the interaction term) will be assessed against the change in the dependent variable, abstracting the potential change over time. In any case, the alternative would be to use a subjectively determined value as a comparator instead of the year-mean for the series. This would complicate the interpretation of the results, however. For this approach, see the methodology for constructing the Human Development Index, at http://hdr.undp.org/reports/global/2004/pdf/hdr04_backmatter_2.pdf (last accessed July 27, 2007). I thank Talip Kilic of American University for suggestions on this.

²³ For methodology, see <http://www.ebrd.com/country/sector/econo/stats/timeth.htm> (last accessed July 27, 2007).

mainly focuses on the business and financial sectors of the possible market for influence, it is assumed to be a relatively comprehensive variable for capturing the pool of potential capturers. Namely, with the inclusion of privatization and trade aspects of transition, this measure also potentially encompasses capturers in labor and trade unions and organizations, which may be as likely to organize in special interest groups as businesses and financiers. In any case, as argued by Gray, Hellman and Ryterman (2004), the more unregulated/unreformed this market is, the more unconstrained the rent-seeking behavior on the part of the capturers and so the higher is the capture, given the higher concentration of economic power, greater control of information, lower extent of interest competition, participation and transparency, and so on. The Transition Indicators' components on business environment reform broadly track the extent of the regulation of this market, thereby providing a potentially satisfactory proxy for the strength of the demand for capture (expressed in the form of the extent of rent-seeking behavior) as opposed to the 'supply' of capture, measured generally by the Composite GI. The same rescaling procedure as with the previous measures was applied. Therefore, countries with above average demand for corruption (below average reforms) received positive scores, and vice versa.

Another potential source on the demand side of capture was the Business Enterprise Environment and Performance Survey (BEEPS) portions related to state capture. Gray, Hellman and Ryterman (2004:10) define state capture as “the actions of individuals, groups or firms in both the public and private sectors to influence the *formation* of laws, regulations, decrees, and other government policies to their own advantage as a result of the illicit and non-transparent provision of public benefits to

public officials.” Administrative corruption is seen to refer to “the provision of such benefits to influence how these establish rules are *implemented*.” While the difference is somewhat fluid, and not of crucial importance for the theoretical model since it is not seen to make a substantial difference in influencing the need for disguising, it may be a welcome addition. However, this source had a limited amount of data, and suffered from measurement inconsistency across the available period.²⁴ Also, it is not as representative, as it focuses exclusively on the enterprise sector.

In any case, proxying rent-seeking behavior is of secondary importance in testing the model, since it has been highlighted that we are taking a state-centric approach, with a focus on political corruption. While the fact that special interests influence the policymaker is an important one, it is assumed that it is the government that writes the rules and implements them, especially given the importance of state structures in transition. In this sense, Sajó (2002), for example, points that regulations are often written in an open-ended way, without pre-assigning the ‘winners’, arguing that state capture is also by and large state-driven. That said, the two-way rent-seeking process outlined above should not be understated either. Both sides have to find it beneficial for an exchange to ensue.

Transparency/ accountability

Finally, the third measure, called FH Press, attempts to capture the capacity of the electorate at large to control and sanction the policymaker, as well as the level of ‘noise’

²⁴ BEEPS has been conducted every three years, starting in 1999, giving only three observations for each country in the period examined. Also, the survey question used for the construction of the index changed substantially from 1999 to 2002, and again slightly so in 2005, rendering the time-series aspect of the series problematic.

in terms of the transparency of the political system. As stated in the theoretical model, an important ingredient in the explanation of the existence of a political fiscal cycle is that the voter cannot infer with precision the type of the policymaker and its ties with the special interests, observing fiscal outcomes with noise. The level of noise depends on the transparency of the political and electoral processes, and the level of accountability. A proxy for the level of transparency of the system may perhaps be the extent of the freedom of media. Investigative and active media can have an impact on the ability of the policymaker to extract capture rents, and thus on the need to disguise. If the risk of it getting caught in the compromising capture relationship is high, the cost for engaging in it can be prohibitive in the first place, if it negatively affects its reelection prospects. This is where accountability comes in, since it designates not only the extent to which the policymaker would suffer consequences for such a conduct (in elections), but also whether there is a structure in place to act as a deterrent. This can perhaps be proxied by the strength of the civil society in a country. As argued by Rose-Ackerman (2004), competitive elections are necessary but not sufficient routes to policymaking accountability. Institutions that are meant to provide additional oversight and control, she argues further, may not be sufficiently developed in transition, and are often politicized and co-opted in the context of political corruption. Achieving accountability outside the electoral and institutional settings per se may therefore be of particular importance.²⁵

²⁵ Rose-Ackerman further posits that civil society-led oversight should include procedures under which the government consults with non-partisan groups that are also centered on special interests. This could be an interested extension to the model presented here, and is contained in one of the critiques of the model presented below. Namely, it suggests that civil society (if assumed to be a subset of the electorate at large) can a) also supply special interests groups, and b) that such lobbying may be (or may not) be qualitatively different from capture. Neither possibility is allowed in the model presented here.

Table 1. Descriptive Statistics of Key Variables

Variable	Sample	Mean	St.Dev.	N
Fiscal Balance (% GDP)	Full Sample	-4.29964	5.751052	382
	Excluding Conflict	-4.02997	4.962377	329
	Competitive Elections	-4.58719	6.216364	215
	Predetermined Elections	-4.12732	5.220655	344
Expenditure (% GDP)	Full Sample	37.90703	11.54549	358
	Excluding Conflict	39.49892	10.74256	311
	Competitive Elections	41.02256	9.879818	205
	Predetermined Elections	37.42394	11.23852	321
Composite GI ¹	Full Sample	0	0.629706	182
	Excluding Conflict	-0.05689	0.638951	161
	Competitive Elections	-0.31956	0.501236	118
	Predetermined Elections	-0.01069	0.637829	175
Composite TI ²	Full Sample	0	0.593164	416
	Excluding Conflict	-0.05125	0.605084	355
	Competitive Elections	-0.26526	0.459493	248
	Predetermined Elections	0.013625	0.596385	376
Freedom of the Press and Civil Society ³	Full Sample	0	1.819896	395
	Excluding Conflict	-0.20012	1.842879	338
	Competitive Elections	-0.968	1.300488	247
	Predetermined Elections	-0.02038	1.845325	355

¹ Components: Voice and Accountability, Political Stability, Government Effectiveness, Regulatory Quality, Rule of Law and Control of Corruption. Aggregation: double weight on the first, fourth and sixth component. Data for: 1996-2005, but until 2000 observations on a biannual basis. Inverse scale.

² Components: Large Scale Privatization, Small Scale Privatization, Enterprise Restructuring, Price Liberalization, Trade and Foreign Exchange System, Competition Policy, Banking Reform and Interest Rate Liberalization, and Security Markets and Non-Bank Financial Liberalization. Aggregation: weighted equally. Data for: all years. Inverted scale.

³ Components: Freedom House's Freedom of Press Index and Freedom House's Civil Liberties Index. Aggregation: weighted equally, fitted to 1-10 scale. Data for: 1994-2005 (Freedom of Press); all years (Civil Liberties).

It is expected that civil society consists of active social groups that are interested in acquiring additional information about various policy agendas, thus increasing the information-processing capacity of the electorate at large. Likewise, by raising the level of political awareness, social cohesion, etc, these groups may be instrumental in generating ways of overcoming the collective action problem and forcing the policymakers to be more accountable.

Freedom House's scores on the freedom of the press and civil liberties were therefore chosen as proxies. The score on civil liberties takes the values from 1 to 7, from the highest to the lowest level. That is, the closer a country scores to 1, the greater the extent of civil liberties. Score on the freedom of the press takes the values from 1 to 100, with the same ordering form – the closer to 1 means a greater freedom of media. To get the unique measure, the second score was divided by 10 to get the 1-10 scale, and then a simple average of the two was taken.²⁶ The same rescaling principle as in the previous two cases was applied, indicating that the positive values denote lower freedoms and civil liberties, and negative values higher civil and media liberties.²⁷ Descriptive statistics of these key independent and dependent variables are presented in Table 1.

Control Variables

The data on controls are by and large obtained from the World Development Indicators of the World Bank. Following the literature (Brender and Drazen 2004,

²⁶ This is justified by the fact that 95% of the scores for this measure lie within the 1-75 range, so the actual scoring resembles the 1-7 scale for the other measure.

²⁷ The reason for the inverted scale which gives a somewhat awkward impression is that the original scale is inverted. As has been already pointed out, Freedom House's indices give the lowest score (of 1) to the best ranking country, and vice versa.

Persson and Tabellini 2002), the vector of control variables contains proxies for the level of development, measured by the log of real per capita income, a demographic structure of a country, represented by the variable measuring the percentage of the population between 15 and 64. These variables have been shown to correlate strongly with measures of fiscal policy in previous studies, such as Rodrik (1998) and Persson and Tabellini (1999). Also, following Persson and Tabellini (2002), to control for the fluctuations in fiscal policy induced by the business cycle and/or external shocks, a measure of output gap (*GAP*) is included: the log difference between the change in real GDP and its country-specific trend, computed using the Hodrick-Prescott filter, with $\lambda = 10$, given the relatively short time period (higher values of λ imply greater smoothing of the series). This variable is implicitly also used to account for the possible endogeneity bias in election dates in those instances where they do not follow a constitutionally fixed schedule. This problem and the means to explicitly control for it are addressed in more detail below.

Samples

The main sample includes all transition economies except for Serbia and Montenegro (Yugoslavia),²⁸ over the 1990-2005 period. This amounts to a total of 416 country-year observations (26 countries x 16 years), but since some countries gained independence later than 1990, the panel is inherently unbalanced. In this full sample, there are a total of 98 elections used to create the *ELECT* dummy variable.

²⁸ Serbia and Montenegro was dropped due to an utter lack of usable data. Also, while Turkmenistan is formally included, it is effectively dropped from the analysis given that there was only one election in the reference time period.

However, there is a substantive concern related to the nature of the elections under study. The assumption underlying the opportunistic behavior of the policymaker in the theoretical model is that it is faced with a level of uncertainty about its reelection prospects. In other words, only a certain level of competitive pressure in the electoral process is assumed to breed the incentive for the incumbent policymaker to manipulate the fiscal policy. If the incumbent is sure of being reelected/reappointed, the incentive for signaling away the ties with the special interests may be removed or greatly attenuated. Likewise, if the incumbent is confident that the electorate has limited means of sanctioning these ties, it may be likely to engage in more extensive rent-seeking behavior in the first place.

Therefore, although the existence of elections is a necessary precondition for a study of political fiscal cycles, it may not be a sufficient condition for including the country-year observation in the analysis. A selection criterion is needed, therefore, to differentiate between the competitive and non-competitive executive appointments. Achieving this is not a matter of routine, however. An election may allow for a multiparty or multi-candidate ballot, but in reality involve rigged outcomes in which the opposition does not have any chances of replacing the incumbent. Likewise, an election may be truly competitive for an institution that is constitutionally designated to provide for economic policymaking, but which in actuality may be deprived of these powers on behalf of another political institution. Similar is the existence of a shadowy informal set of powers that a policymaking institution may be able to exercise outside of the scope of the constitution.

Table 2. Alternative Sample Characteristics

Country	Number of Elections	# of elections excluded			
		Full Sample	Competitive Elections ^a	Excluding Conflict	Predetermined Elections ^b
Albania	6	-	3	-	3
Armenia	3	-	2	all (3)	1
Azerbaijan	4	-	all (4)	all (4)	2
Belarus	2	-	all (2)	-	-
Bosnia and Herzegovina	4	-	-	-	-
Bulgaria	6	-	-	-	3
Croatia	4	-	2	1	1
Czech Republic ^c	5	-	-	-	1
Estonia	4	-	-	-	1
Georgia	2	-	-	all (2)	-
Hungary	4	-	-	-	1
Kazakhstan	2	-	all (2)	-	-
Kyrgyz Republic	4	-	all (4)	-	1
Latvia	4	-	-	-	1
Lithuania	4	-	-	-	1
Macedonia	3	-	-	1	-
Moldova	4	-	1	-	2
Poland	5	-	-	-	2
Romania	4	-	1	-	1
Russia	4	-	-	-	1
Slovakia ^c	4	-	-	-	-
Slovenia	4	-	-	-	1
Tajikistan	3	-	2	2	2
Turkmenistan	1	all (1)	all (1)	all (1)	all (1)
Ukraine	3	-	1	-	-
Uzbekistan	3	-	all (3)	-	1
Total # of elections (excluded)	98	97 (1)	70 (28)	84 (14)	68 (30)
Percent of total	100%	99%	71%	86%	69%

^a Also excluding elections with contested results (coded 1 on the FRAUD variable in DPI)

^b Elections are considered predetermined if: a) if the election is held on the fixed date (year) specified by the constitution; b) if the election occurs in the last year of a constitutionally fixed term for the legislature; c) if the election is announced at least a year in advance. Note: all initial elections in the full sample are dropped.

^c Excluding Czechoslovakian elections (1991-1993)

In order to address as many of these challenges as possible, a composite measure combining three variables from POLITY IV (Marschall and Jaggers 2005) and the Database of Political Institutions (Beck et al. 2001) was created. The POLITY IV variables EXREC, measuring the competitiveness and openness of the executive recruitment process, and POLCOMP, measuring the regulation and competitiveness of political participation, were weighted and then interacted with the binary FRAUD variable from DPI, which indicates whether the election procedure was breached and/or results contested on the grounds of discrimination, oppression or fraud.²⁹ When this criterion is applied, 28 elections and 292 country-year observations are excluded.

Additional samples were used for robustness checks, as described in the following chapter. Characteristics of some different samples are shown in Table 2.

²⁹ On the EXREC and POLCOMP variables, a country can score from 1 to 8 and 1 to 10 respectively. These variables are in themselves a combination of 3 and 2 components respectively, and so their values do not carry a unique description. For the purpose of sampling here, the values of 3 and 5 respectively were taken as a necessary threshold for an election to be considered sufficiently competitive. The individual scores of the countries for these two variables were therefore weighted with the 3/5 and 5/10 ponders respectively, giving a score whose value of higher than 5 indicates a competitive system. This score was then interacted with the 0/1 FRAUD variable, recoded so that the value of 0 (as opposed to the value of 1 in the original form) represents a contested electoral process/result. Therefore, in the case of a fraud, the country would receive an overall result of 0, even if the POLITY IV variables weight up to more than 5. In other words: the competitive score was obtained by the following formula:

$$Score = \left(\frac{3}{5} EXREC + \frac{5}{10} POLCOMP \right) * FRAUD$$

CHAPTER 5

EMPIRICAL ESTIMATION

I. Estimating Political Budget Cycles in Transition Countries

Non-Parametric Tests

In order to empirically test the theoretical model, it first needs to be established whether there is any cyclicity in fiscal policy outcomes with respect to the elections in transition countries. Therefore, before testing the hypotheses of the theoretical model, the hypothesis that fiscal policy is manipulated before the elections needs to be explicitly tested first.

Following the literature, before resorting to a parametric test of the relationship between elections and fiscal variables, two simple descriptive techniques were used to estimate the possible magnitude and composition of the political budget cycles in transition countries (Shi and Svensson 2002). In Table 3, a measure of the average size of the election-induced budget cycles (APBC) in government balance (BA) and government expenditure (EXP) are reported. APBC is the average of the country specific measure of the cycle, calculated as follows. For a given country, the average of all election-year fiscal deviations, defined as the difference between the fiscal balance (expenditure) in the election year and the mean of the fiscal balance (expenditure) in the two adjacent years is computed. In other words, for an election in country i and year t , and $BA_{i,t}$ denoting its fiscal balance, the deviation in the election year is calculated

as $BA_{i,t} - \frac{1}{2}(BA_{i,t-1} + BA_{i,t+1})$. The significance of this difference is then examined by using the one-sample means comparison test.

As can be seen from the first column of Table 3, in the full sample, the APBC(BA) is -.976, and significant at the 1% level, meaning that on average, the fiscal deficit as a share of GDP is approximately one percent larger in the election year (as defined by the ELECT dummy variable) than in (the average of) the two adjacent years. Given that the mean of the fiscal balance for the full sample is -4.3 % of GDP (Table 1), this suggests a substantial preelectoral effect. The results for this full sample, broken down by country, can be seen in Figure 3.

The size of the change in the fiscal balance is confirmed by the results for APBC(EXP). The expenditures are higher by approximately 0.9% of GDP, and the difference is significant at the 5% level. Looking only at the competitive elections somewhat reduces the size of the cycles, but the difference remains statistically significant. At first sight, this is somewhat curious. A general expectation of the model is that the fiscal cycles will be more pronounced in the competitive political environment, given the greater electoral pressures. However, greater political competitiveness may imply higher policy accountability, which can be translated into lower preelectoral cycles. Whatever the reason, the difference between the APBC(BA) in the full sample and the competitive sample is not too pronounced anyway, and is still large for the latter, which is an important and expected result. This is less so for expenditures, as can also be seen from Figure 4.

Table 3. Descriptive Statistics on the Size and Composition of Political Budget Cycles

Variable	Full Sample	Competitive Elections	Excluding Conflict	Predetermined Elections
APBC (BA)	-0.976***	-0.811**	-0.845**	-0.463*
<i>BA/ELECT=1</i>	-4.602	-4.277	-4.611	-4.021
<i>BA/ELECT=0</i>	-4.102	-3.967	-3.875	-3.976
$\Delta BA/ELECT$	-0.500	-0.309	-0.736	-0.045
APBC(EXP)	0.896**	0.340*	0.416*	0.186
<i>EXP/ELECT=1</i>	39.717	41.791	40.872	38.171
<i>EXP/ELECT=0</i>	37.924	40.152	38.951	37.177
$\Delta EXP/ELECT$	1.793	1.639	1.920	0.994

* significant at 10%; ** significant at 5%; *** significant at 1%

^b APBC – Average size of the election-induced budget cycle, calculated as $BA_{i,t} - \frac{1}{2}(BA_{i,t-1} + BA_{i,t+1})$

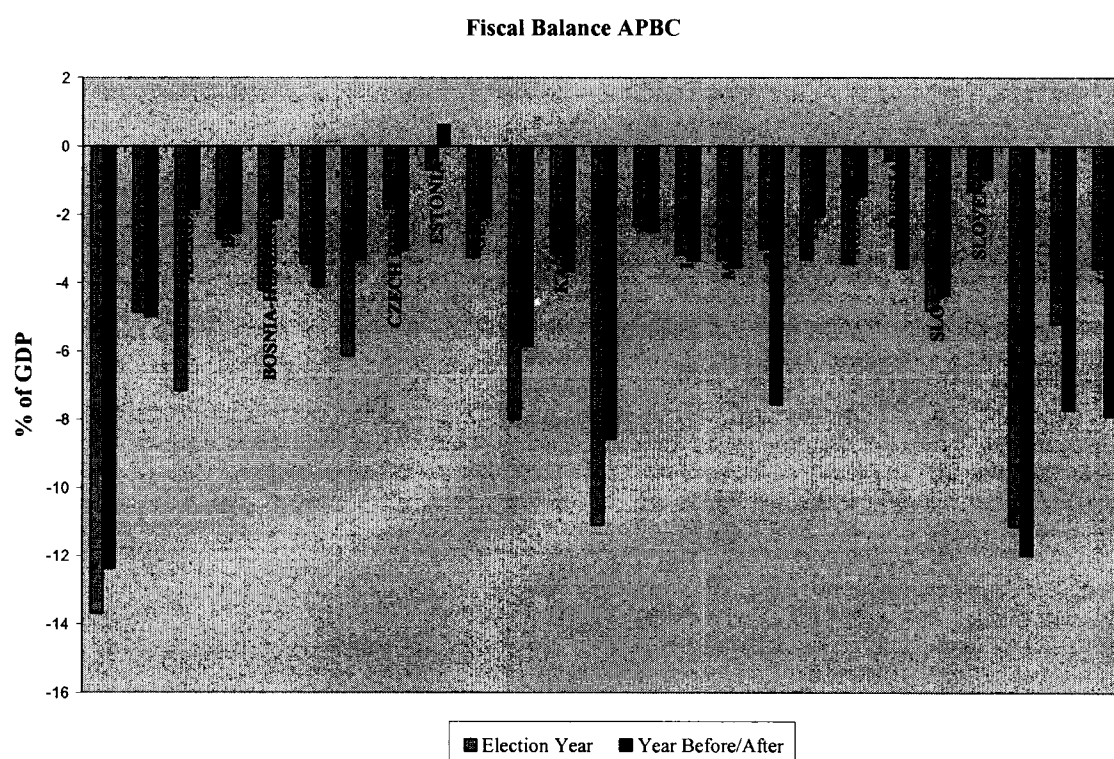


Figure 3. Average Political Business Cycle in Budget Balance by Country

Election Year: Average budget balance in the year of election

Year Before/After: Average budget balance in the adjacent years to the election year, or $\frac{1}{2}(BA_{i,t-1} + BA_{i,t+1})$

Source: EBRD Economic Statistics, <http://www.ebrd.com/country/sector/econo/stats/sei.xls> (last accessed July 10, 2007)

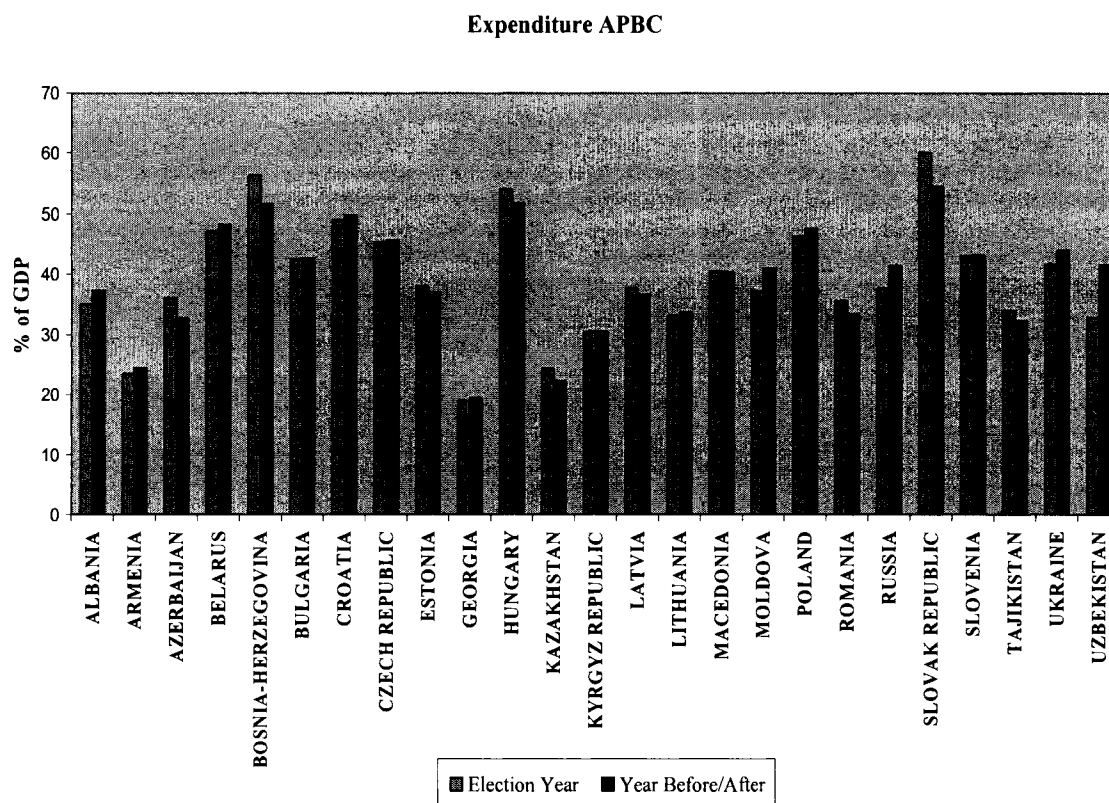


Figure 4. Average Political Business Cycle in Government Expenditure by Country

Election Year: Average government expenditure in the year of election

Year Before/After: Average government expenditure in the adjacent years to the election year, or $\frac{1}{2}(EXP_{i,t-1} + EXP_{i,t+1})$

EBRD Economic Statistics, <http://www.ebrd.com/country/sector/econo/stats/sei.xls> (last accessed July 10, 2007)

In any case, it may be useful to address the issue of outliers in the full sample for fiscal balance, and see how the measure performs by eliminating them. Doing so may be problematic, especially given the time-series format of the data (where individual observations entering the mean measure should actually be indicative of the trends). Still, by inspecting Figure 3, it could be seen that the two out of the three biggest outliers are from the non-competitive group, namely Azerbaijan and Kyrgyz Republic. These two countries are also outliers in terms of the scores on the competitiveness measure

outlined above. They had a score of 0 and 2.125 respectively, suggesting the examples of extremely non-competitive political systems which may warrant a separate treatment. Therefore, excluding them from the full sample was attempted. The results change. The APBC(BA) for the full sample now becomes -.823, which is very close to the competitive elections sample. The bottom line is that the preelectoral effect is strong for both samples. The result for predetermined elections, which is noticeably different, will be discussed in the section on robustness checks.

A similar way to get a feeling for the trends in the average is to compare the average fiscal balance (expenditures) in the election year ($BA|ELECT=1$) with that in the non-election years ($BA|ELECT=0$). This technique utilizes more data, as the previous one excluded the observations at the ends of the time series for each country. For the full sample, the difference in BA (EXP) is -0.5% (1.7%) of GDP. So, the balance cycles seem somewhat less pronounced, while the expenditure cycles seem stronger. The competitive election sample gives similar results, and the difference is less pronounced than for the previous measure, especially for expenditures. This is observable from Figures 5 and 6.

What is particularly noticeable is that for the expenditures there are basically no outliers, and the difference seems relatively evenly distributed among both competitive and non-competitive countries. Also, a very interesting is the case of Russia, which has by far the highest deficit reduction in the election years in the sample, only comparable to that of Czech Republic. So, it is clearly an outlier in the opposite direction, and may deserve special attention. This is addressed in the section on robustness checks.

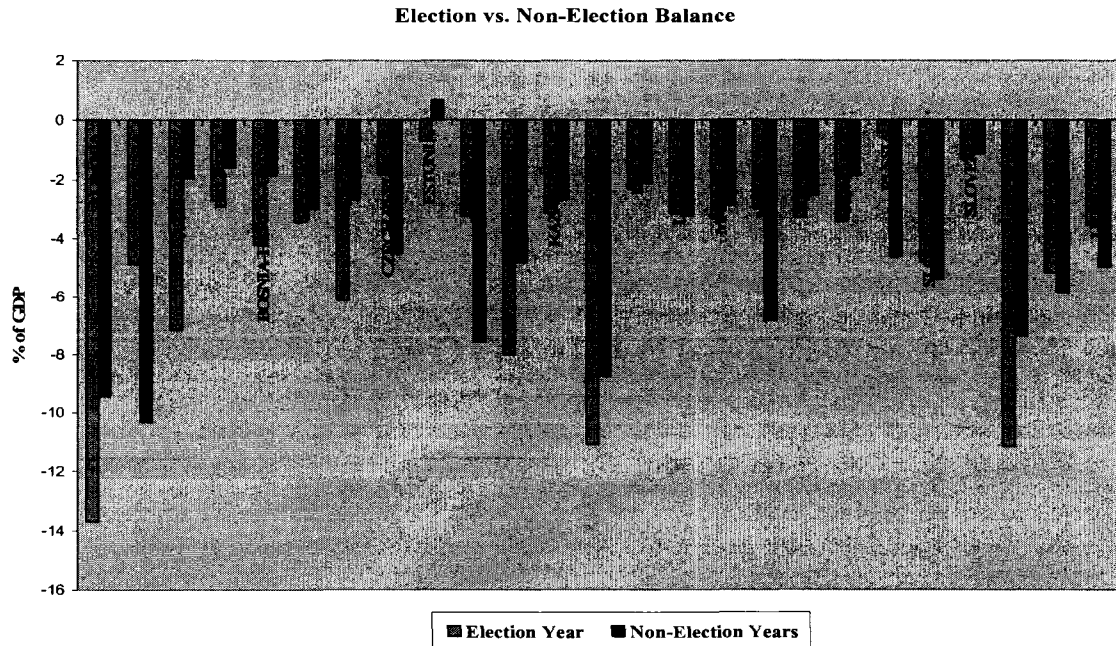


Figure 5. Budget Balance in Election vs. Non-Election Years, by Country

Source: EBRD Economic Statistics, <http://www.ebrd.com/country/sector/econo/stats/sei.xls> (last accessed July 10, 2007)

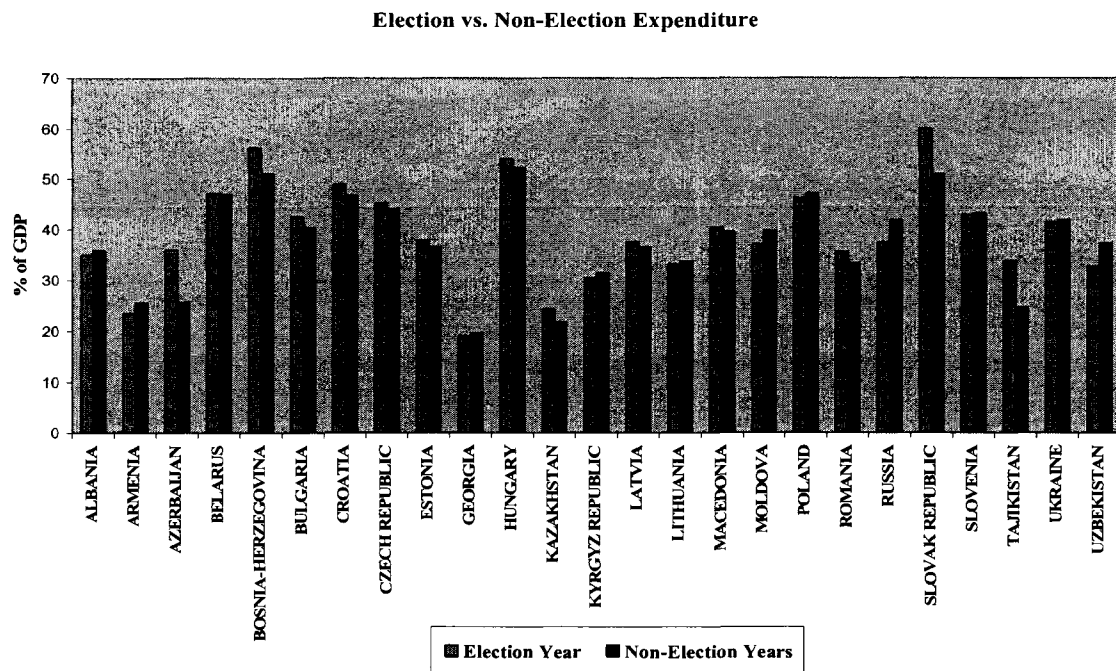


Figure 6. Government Expenditure in Election vs. Non-Election Years, by Country

Source: EBRD Economic Statistics, <http://www.ebrd.com/country/sector/econo/stats/sei.xls> (last accessed July 10, 2007)

In summary, the first cut at the relationship suggests the existence of substantial preelectoral fiscal manipulation in transition economies, whereby the balance generally deteriorates and the expenditures increase in the year of elections.

Parametric Test

The results in Table 3 suggest that political fiscal cycles indeed seem to exist in transition countries. Here, this relationship between the elections and fiscal policy outcomes is explicitly tested in a regression analysis. The estimates of the parameters reported below are based on different versions of the following regression equation, which is a variant of Equation (4.5) in the previous section:

$$Y_{i,t} = b_1 Y_{i,t-p} + \sum b_2 X_{i,t} + dELECT_t + \gamma GAP_{i,t} + u_i + \lambda_t + e_{i,t} \quad (5.1)$$

In the expression, $Y_{i,t}$ denotes a fiscal indicator in country i and year t . $ELECT_t$ is the electoral dummy variable indicating the election in year t , and $X_{i,t}$ is the common vector of control variables. Because the fiscal instruments are most likely to change only gradually and so exhibit a level of inertia from previous years, lags of the dependent variable $Y_{i,t-p}$ are included.³⁰ Also, as argued above, given that fiscal instruments tend to be highly responsive to external shocks, a measure of cyclical deviations from the trend in output $GAP_{i,t}$ is also included. Finally, u_i and λ_t are country-specific and year-specific intercepts.

Equation (5.1) represents a dynamic panel data specification. Given the presence of the lagged dependent variable, as well as the country-specific and year-specific

³⁰ Up to 3 lags were tested, but only the first lag consistently delivered significant parameters, and so others were dropped from estimation.

unobserved effects, the OLS estimator will be biased. The endogeneity bias caused by the unobserved effects can be eliminated by the use of the (country and year) fixed effects method to be employed in the analysis here. It is the OLS estimation technique that uses the time variation in the variables within each cross-sectional observation (country), controlling for the variables that are constant over time but differ across entities (country-specific effects), and for the variables that are constant across entities but evolve over time (year effects).³¹ However, the bias caused by the inclusion of the lagged dependent variable remains, since one of the assumption of the fixed effects estimation, namely that the errors $e_{i,t}$ are uncorrelated with all the explanatory variables in the specification, is violated (Wooldridge, 2003).³² Alternatives used in the literature (for example, Block 2001, Shi and Svensson 2002, Brender and Drazen 2005, and Eslava 2005) to avoid this problem are the methods utilizing the instrumental variable approach (IV), such as the estimation in the first differences with instruments, or the so-called Anderson-Hsiao estimation (Anderson and Hsiao, 1982), and the IV estimation in both the level equation and the differenced equation with the GMM estimator (Arellano and Bond 1991). The panel structure of the data presents a good pool for the instruments on the regressors, as it is assumed in the literature that the further lags would help avoid the correlation bias of the initial conditions and the country specific effects.

Indeed, Judson and Owen (1999) show that the GMM estimation as proposed by Arellano and Bond may be more robust in the case of $T \leq 20$ than the Anderson-Hsiao

³¹ The time-fixed effects proved in the analysis not to be significantly different from zero for the expenditure series, while being significant for the balance series. Therefore, for the latter the results are presented for the specification including the year effects, while for the former, they are dropped.

³² See Appendix A for details.

and the fixed effects estimators. So, it is used alongside the fixed effects estimation as a sensitivity check. Nevertheless, fixed effects method utilizes more data points given the absence of estimation in first-difference, and will therefore be performed as well. Since most of the capture/interest measures used in this study contain missing values, especially at the beginning of the series, GMM under-uses an already limited dataset.

Parametric Test Results

The results of the estimations are presented in Table 4. As can be seen in columns 1 and 3, the existence of electoral cycles in fiscal balance and expenditures is confirmed. Overall, for the full sample, the fiscal deficit in the election year increases by around 0.4% of GDP, while expenditures increase by approximately half a percent of GDP. For the competitive election sample, the cycles in expenditures are larger amounting to 0.77% of GDP, while those in budget balance are lower. This is a curious finding, perhaps suggesting that the voters in more liberalized political systems indeed may be more prone to not rewarding the promulgation of preelectoral manipulation into the budget balance, despite perhaps accepting the increase in expenditures.

Using the GMM estimation method does not change the results substantially. The magnitude is somewhat greater for both the balance and expenditure measures, and the results remain statistically significant at the 5% level. Still, it is noteworthy to mention that the two methods show signs of inconsistency interchangeably, as judged by the F-test values for fixed effects and the Sargan and 2nd Order tests for the GMM.

Table 4. Political Budget Cycles in Transition Countries: Elections and Fiscal Policy

Method	(1)	(2)	(3)	(4)
	FE	GMM	FE	GMM
Variable	Fiscal Balance (% GDP)		Expenditure (% GDP)	
Full Sample				
ELECT	-0.392**	-0.435**	0.493**	0.505**
	-0.195	-0.214	-0.232	-0.241
N	350	313	326	295
Countries	26	26	26	26
R ²	0.450	...	0.434	...
F-test	1.574	...	4.672	...
Prob>F	0.042	...	0.000	...
Sargan Test	...	0.132	...	0.521
2 nd Order AR	...	0.770	...	0.099
Competitive Elections				
ELECT	-0.243*	-0.297**	0.637**	0.774**
	-0.133	-0.148	-0.317	-0.362
N	228	206	217	195
Countries	19	19	19	19
R ²	0.398	...	0.499	...
F-test	1.283	...	4.829	...
Prob>F	0.202	...	0.000	...
Sargan Test	...	0.904	...	0.131
2 nd Order AR	...	0.815	...	0.029

* significant at 10%; ** significant at 5%; *** significant at 1%

The covariates include one lag of the dependent variable, log of per capita GDP, fraction of population between ages 15 and 64, and the log difference between real GDP and its (country-specific) trend, estimated using the Hodrick-Prescott filter.

¹ ELECT – a dummy variable with the value of 1 in the election year, and 0 otherwise

⁴ F-test of the null hypothesis that all country specific effects in the specification are equal

⁵ P values for rejecting the null hypothesis that the instruments are uncorrelated with the residuals

⁶ P-values for rejecting the null hypothesis that there is no second order serial correlation in the first-difference residuals

The latter is more robust for the budget balance variable, while the former is stronger for the expenditure variable. Neither performs consistently for both variables, however. This is attributed to the nature of the data, especially: 1) the length of the period, and 2) the properties of the dependent variables in terms of stationarity. Namely, the variables in levels are not stationary according to the augmented Dickey-Fuller test of

unit roots (with the automatic Schwarz criterion used to estimate the appropriate number of lags), while they are in first-difference. However, the results of the stationarity test can be argued to be problematic due to the shortness of the period itself, so it is questionable whether checking for stationarity is theoretically justified. In any case, GMM does not seem to be superior to fixed effects in terms of robustness and consistency.

In summary, regression analysis confirms that fiscal manipulation with regards to elections does seem to exist in transition countries. While the preelectoral effects are not as large as suggested by non-parametric tests shown above, the main findings are still preserved. The balance deteriorates across the board, but less so in politically more competitive countries. Cycles in expenditures, on the other hand, seem to be especially pronounced in countries with competitive electoral systems, which has not been the case in Table 3. The differences likely stem from the fact that in parametric testing, additional factors have been accounted for, especially the deviations due to trends in economic output. In any case, cross-testing clearly shows the existence of preelectoral cycles in fiscal policy. We can therefore proceed to testing the theoretical model itself.

Estimating the Theoretical Model

Parametric Test

Regression analysis of the theoretical model was performed on an augmented specification in (1), whereby interaction terms between the ELECT dummy and the capture independent variables ($ELECT * INT$) were added:

$$\begin{aligned}
Y_{i,t} = & b_1 Y_{t-p} + \sum b_2 X_{i,t} + dELECT \\
& + \delta ELECT_i * INT + \gamma GAP_{i,t} + u_i + \lambda_t + e_{i,t}
\end{aligned}
\tag{5.2}$$

Three terms were alternatively used to measure the impact of capture rent-seeking, rent-seeking and noise on fiscal policymaking: *ELECT_GI*, *ELECT_TI*, and *ELECT_PRESS*, for the interaction between the Composite Governance Indicators, the Composite Transition Indicators, and the Freedom of the Press and Civil Liberties variables and the dummy variable respectively. So, three different regressions were run for the balance measure, as well as for the expenditure measure, giving a total of six regressions corresponding to six columns in Table 5.

The coefficient δ on the interaction term measures how the electoral effect on fiscal outcomes varies among countries with different levels of proxies for capture rent-seeking, rent-seeking and noise, namely, corruption, governance quality, economic reforms and strength of media and civil society. More precisely, in this setup, the coefficient d on the *ELECT* dummy shows the electoral effect on the fiscal variable when the country has an average level of the proxy independent variable (=0), controlling for other factors in the specification. The coefficient on the interaction term δ then shows how the fiscal policy indicator behaves on average when the country scores lower or higher than average on the corruption/reform/noise indicators.

Parametric Test Results

Table 5 shows the results of the fixed effects estimation for the two different samples and the three interaction terms. The fixed effects estimation is reported rather than GMM because the latter utilizes less data. Namely, given the lack of data for

country-year observations for the Composite GI and FH Press variables, estimation in first-difference eliminates a significant number of data points for certain cross-sectional units on the two measures. This is considered to be a suboptimal choice then, given the not-so-large difference in estimations between the fixed effects and GMM in the previous section.

For the fiscal balance variable (columns 1-3), the election term and the interaction terms enter with the predicted sign, and by and large significantly. This is the case irrespective of the sample characteristics, that is, for both the full and the competitive elections sample. The effects of the composite governance quality (the ‘supply side’ of capture) and the progress in economic reforms (the ‘demand side’ of capture) on the political cycle in fiscal balance seem particularly strong. For example, in column 1, for a country with a competitive political system the magnitude of the cycle increases from roughly 1% of GDP if it has the average level of governance quality, to around 1.16% of GDP if its score is one standard deviation above the mean (‘above’ being worse in terms of the scales applied here).³³ In other words, a one-standard-deviation greater capture rent-seeking proclivity (θ) increases the fiscal deficit in the election year by about .16% of GDP. This is a sizeable additional impact – more than half of the estimated size of the cycle in Table 4, and attests to the importance of the presence of political corruption for the preelectoral conduct of fiscal policy. In the theoretical model language, this is the

³³ To get the result for one standard deviation away in terms of the parameter values, the coefficient on the interaction term is multiplied by the value of the standard deviation in the corresponding sample, and then added to the value of the coefficient on the term for which the mean is 0, that is, for the *ELECT* variable. So, for the *ELECT_GI* interaction term in the competitive elections sample, the one standard-deviation-away result is obtained by multiplying the value of the coefficient (-0.335) with the value of the standard deviation in the competitive sample from Table 1 (0.501), and then added to the value of the coefficient on the *ELECT* variable (-0.984). So: $(-.335 * .501) + -.984 = 1.152$

one-standard-deviation measure of the disguise in terms of the change in the level of g . Similarly, column 2 shows that if a country is a standard-deviation below-the-average reformer of the economic and business environment, it is predicted that its electorally-induced deficit would rise from around -0.6% of GDP to around -1% of GDP, or by .36% of GDP, which is an ever stronger effect. The less regulated the demand market for capture, the higher the capture-rent seeking behavior, resulting in the greater level of disguise. Therefore, the findings support the expectations of the theoretical model: collusion of the supply (policymaker's interests in capture rent-seeking) and the demand (special groups' interests for economic rents and protection) for capture, coupled with the competitive pressures from the electorate breed strong incentives for opportunistic fiscal behavior on the part of the policymaker. Once again, the higher the proclivity θ as measured by the Composite GI, and the higher the ability of the capturers ($\max_{v,(g,c)}$ in Equation (4.2) of the model) as measured by the Composite TI, the greater the distortion of the policy outcome g , as expressed by the overall budget balance. The results seem to be very similar in terms of magnitude for the full sample. This basically means that the cycle in expenditures doubles with a standard-deviation higher capture rent-seeking proclivity of the policymaker (given the result in column 3 for competitive elections in Table 4). In other words, greater political competition may be a particularly fertile ground for opportunism if the governments' rent-seeking interests are not properly checked.

Table 5 Political Budget Cycles and Various Measures of Capture/Special Interests

	(1)	(2)	(3)	(4)	(5)	(6)
Variable	Fiscal Balance (% GDP)			Expenditure (% GDP)		
Full Sample						
ELECT ¹	-1.128***	-0.524*	-0.369	1.173**	0.507	0.607*
	-0.368	-0.28	-0.401	-0.576	-0.602	-0.316
ELECT_GI ²	-0.496**			0.882*		
	-0.238			-0.462		
ELECT_TI ³	-0.943*			0.082		
	-0.479			-1.087		
elect_press ⁴	-0.089			0.301*		
	-0.282			-0.16		
N	178	350	350	177	326	326
Countries	26	26	26	26	26	26
R ²	0.548	0.452	0.45	0.413	0.434	0.436
F-test ⁵	0.891	1.599	1.573	2.241	4.636	4.7
Prob>F	0.617	0.037	0.043	0.002	0.000	0.000
Competitive Elections						
ELECT	-0.984*	-0.622*	0.092	1.700**	0.718	1.401*
	-0.508	-0.331	-0.835	-0.677	-0.73	-0.758
ELECT_GI	-0.335*			1.407**		
	-0.179			-0.689		
ELECT_TI	-0.802**			0.248		
	-0.393			-1.276		
elect_press	0.127			0.718**		
	-0.474			-0.341		
N	120	228	228	119	217	217
Countries	19	19	19	19	19	19
R ²	0.45	0.404	0.398	0.524	0.499	0.506
F-test	0.727	1.291	1.275	2.14	4.716	4.984
Prob>F	0.775	0.197	0.208	0.010	0.000	0.000

Standard errors under coefficient values

* significant at 10%; ** significant at 5%; *** significant at 1%

The covariates include one lag of the dependent variable, log of per capita GDP, fraction of population between ages 15 and 64, and the log difference between real GDP and its (country-specific) trend, estimated using the Hodrick-Prescott filter.

¹ ELECT – a dummy variable with the value of 1 in the election year, and 0 otherwise

² ELECT_GI – an interaction term between the elect dummy variable and the Composite GI index, rescaled to change the sign

³ ELECT_TI – an interaction term between the elect dummy variable and the Composite Transition Indicator, rescaled to change the sign

⁴ elect_press – an interaction term between the elect dummy variable and the Freedom of the Press and Civil Society Variable

⁵ F-test of the null hypothesis that all country specific effects in the specification are equal

This seems to be confirmed by the results on the FH press variable. Namely, coefficients on ELECT_PRESS in column 6 of Table 5 imply that the level of transparency and accountability may be particularly important for keeping the policymaker in check, and especially in the competitive election sample. A country with a competitive electoral system having a standard-deviation ‘weaker’ media and civil society see their average electoral change in expenditures increase from 1.4% of GDP to as much as 2.33% of GDP. This indeed seems to underscore the importance of X . Electing the executive in the competitive polls in and of itself does not seem to be a sufficient check on economic policymaking. On the contrary, based on the results from column 6, if not accompanied by an increased level of transparency, electoral activism and pressures for greater accountability, the existence of electoral competitiveness can bring about a retarded outcome of democratization/political liberalization: greater opportunism on the part of the policymaker, and therefore greater preelectoral changes in economic policy.

Robustness Checks

A number of additional robustness tests were run. First, the baseline *ELECT* variable may not capture the effect of elections on fiscal policy with sufficient precision, given that the election dates are likely to be dispersed across the year. For example, should the election take place in January, most of the pre-electoral fiscal effect is most likely to occur in the previous year, not in the year of the election. This is of particular importance for those countries in which elections are continually

designated to take place early in the year. A way to deal with this is to include a pair of dummies which would be coded on the basis of whether election took place in the first or in the second half of the year respectively. Therefore, *ELECT_H1* and *ELECT_H2* were used instead of *ELECT* in alternative specifications. The results obtained were mixed. The coefficients on *ELECT_H1* were largely of the opposite sign and insignificant (i.e., higher standard errors), while the parameters on *ELECT_H2* mirrored fairly closely those of the baseline dummy. This conforms to the observation by Brender and Drazen (2005) that *ELECT_H1*-type dummy may lack analytical precision, in that taking the whole previous year is inadequate to capture the possible pre-electoral effect. It would then be desirable to use perhaps quarterly or monthly data, and code the dummies accordingly, which has already been done extensively in the literature (for example, Alesina and Roubini 1997, Gonzales 2002). However, since such data of higher than annual frequency is not available for most transition countries, there is little that could be done. The fact that *ELECT_H2* yields similar results justifies the use of baseline *ELECT*.

Following the relevant literature (Shi and Svensson 2002, Persson and Tabellini 2002, Brender and Drazen 2005), additional control variables were also used, such as a proxy for the openness of the economy, measured by the share of international trade in GDP, additional demographic variable of the share of population aged 65 and above, the price of crude oil to control for resource-related fiscal revenues in resource-exporting countries, and the average international interest rate to account for pressures on expenditures. The coefficient estimates on the election dummy, as well as the interaction term, remained essentially the same. On average, the additional controls had no robust significant relationship with the policy measures considered and are uncorrelated with the

timing of elections. Since including them reduces the number of degrees of freedom, they were left out of the baseline specification.

Also, additional samples were used to estimate the baseline specification. One version excludes the country-year observations in which there was a conflict, whether a cross-border (such as in the case of Azerbaijani-Armenian dispute over the Nagorno-Karabakh enclave), or an internal one (such as in Tajikistan and Bosnia and Herzegovina). The rationale is that the conflict influences the fiscal policy measures, due to the likely higher defense-related expenditures and the constrained revenue-collecting abilities of the governments, thereby possibly confounding the preelectoral and conflict-related fiscal effects. This sample excludes 61 country-year observations and 14 elections. The results are mostly the same as for the whole sample, perhaps because some of the conflict observations were already excluded due to missing values on fiscal policy variables (for example Bosnia and Herzegovina), or because the elections in the conflict years mostly received the scores that left them out of the competitive election sample. In any case, this alternative does not provide drastically different results.

Potential source of bias in all previous samples may stem from the fact that the election timings are treated as exogenous, although this may not be the case in reality. For example, both the timing of elections and the fiscal policies could be affected by a common set of (unobserved) variables. Excluding the country-year observations with conflict, and controlling for the external shocks and deviations from the output trend should control for this endogeneity problem to a certain extent, but may not account for all unobserved factors. Hence, the coefficient on the *ELECT* dummy may contain a downward bias if the omitted variable is positively correlated with the election timing

and negatively with the fiscal policy outcomes, possibly overstating the preelectoral fiscal effect. Also, if the electorate highly values the fiscal policy outcomes, the timing of elections may be moved around the 'state' of the fiscal variables themselves, thus generating an upward bias in the estimation of the coefficient. A way to isolate the bias is to focus only on predetermined elections in the sample. This is no trivial task, but it has already been attempted in the PBC literature. Following Shi and Svensson (2002), an election in the sample is considered predetermined if: a) it is held on the fixed date (year) specified by the constitution; b) it occurs in the last year of a constitutionally fixed term for the legislature; and/or c) it is announced at least a year in advance. The information for this was collected from the Political Handbook of the World (Banks et al., various issues) and from the Handbook of Political Change in Eastern Europe (Berglund, Ekman and Aarebrot 2004). Given that none of these conditions could have been met in the first elections following the collapse of communism or the gaining of independence, all initial elections from the full sample were also dropped. This leaves out 30 of the total 98 elections. For the non-parametric test, applying this sample specification creates a very pronounced difference. As can be seen in Table 3, the APBC for budget balance cycle is almost halved, while for the expenditures, it is almost 4 times smaller. Similarly, the alternative measure of budget balance difference ($\Delta BA/ELECT$) is noticeably smaller as well. This would suggest that fiscal manipulations take place mostly when the elections are not predetermined. In other words, it may suggest that the dates of elections in transition have indeed been endogenous to the manipulation of fiscal policy, or that the two have been driven together by other factors. However, these curious findings may just be a reflection of the sample selection process outlined above. Namely, most of the 30

left-out elections are those of early years of transition, where the political process was by and large still adjusting and was characterized by increased instability. As was already observed from Figures 1 and 2, this was precisely the period when many of the countries experienced the largest fluctuations in fiscal policy, also perhaps due to the exigencies of early transition. So, the tumultuous initial transition phase may be the common unobserved factor driving the two together, and so, it would perhaps be warranted to eliminate these early years from investigation. Be that as it may, considering the argument of the PE of reform literature about the threat of electoral backlash and reform reversal in this stage of transition, this may not be so useful after all. Early transition has also been argued to be a particularly fertile environment for political corruption, investigation of which is in the focus of this study.

However, most of these considerations are attenuated by the results of parametric tests including predetermined vs. endogenous elections. In order to make this distinction, two additional interaction terms with the *ELECT* dummy were created: *ELECT*PRE* and *ELECT*END*, where the former takes the value of 1 if the election is predetermined according to the above criteria, and 0 otherwise. The latter is coded in the opposite way. The specifications including these instead of the baseline *ELECT* are the same as Equation (5.1) and Equation (5.2) above, with unchanged interpretations. Columns 5 and 10 of Table 6 show the results for the PBC hypothesis, while Table 7 shows the results for testing of the theoretical model. Results are generally unchanged.

Table 6. Additional Analysis – Political Budget Cycles and Additional Controls/Samples. GMM estimation

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Variable	Fiscal Balance (% GDP)					Expenditure (% GDP)				
Sample	EU Cont. ¹	Non EU ²	Major Resource ³	Non-Major Resource ⁴	Pred./End. ⁵	EU Cont.	Non EU	Major Resource	Non-Major Resource	Pred./End.
ELECT	-0.507*	-0.384**	-1.748*	-0.324*		0.823*	0.429*	1.441*	0.470	
	-0.261	-0.194	-0.906	-0.167		-0.424	-0.229	-0.774	-0.276	
ELECT*PRE ⁶					-0.580					0.228
					-0.534					-0.561
ELECT*END ⁷					-0.417					-0.176
					-1.039					-1.284
N	115	198	45	268	322	115	180	42	253	298
Countries	14	26	4	22	26	14	26	4	22	26
Sargan Test ⁸	0.128	0.868	1.000	0.441	0.840	0.015	0.987	0.963	0.655	0.655
2nd Order AR ⁹	0.085	1.000	0.495	0.819	0.425	0.670	0.220	0.137	0.156	0.068

Standard errors under coefficient values

* significant at 10%; ** significant at 5%; *** significant at 1%

¹ EU Cont. – a dummy variable with the value of 1 if the country had or was negotiating the Pillar I contractual arrangement – European Agreements and Stabilization and Association Agreements (instruments within the Pillar II Common Foreign and Security Policy and Neighborhood Policy were not included), 0 otherwise

² Non EU Cont. – opposite of EU Cont.

³ Major Res. – a dummy variable with the value of 1 if the country is a major exporter of a natural resource commodity (oil, gas, coal, etc.), 0 otherwise;

⁴ Non-Major Res. – opposite of Major Res.

⁵ ELECT – a dummy variable with the value of 1 in the election year, and 0 otherwise

⁶ ELECT*PRE – a dummy variable with the value of 1 if the election date is predetermined, 0 otherwise; the selection criteria are: a) if the election is held on the fixed date (year) specified by the constitution; b) if the election occurs in the last year of a constitutionally fixed term for the legislature; c) if the election is announced at least a year in advance. Note: all initial elections in the full sample are dropped

⁷ ELECT*END – a dummy variable with the value of 1 if the election is not predetermined (see above), 0 otherwise

⁸ P values for rejecting the null hypothesis that the instruments are uncorrelated with the residuals

⁹ P-values for rejecting the null hypothesis that there is no second order serial correlation in the first-difference residual

Table 7. Additional Analysis – Political Budget Cycles and Capture/Special Interests in Predetermined vs. Endogenous Elections, FE estimation

Composite GI			Composite TI			FH Press		
	Fiscal Balance	Expenditure		Fiscal Balance	Expenditure		Fiscal Balance	Expenditure
ELECT_GI	-0.21*	0.637	ELECT_TI	-0.674**	0.036	ELECT_PRESS	0.091	0.218*
	-0.122	-0.951		-0.281	-1.050		-0.281	-0.114
ELECT*PRE ¹	-1.069***	1.237**	ELECT*PRE	-0.442*	0.543	ELECT*PRE	-0.427*	0.017
	-0.372	-0.571		-0.240	-0.596		-0.240	-0.596
ELECT*END ²	-0.519	1.889	ELECT*END	-0.676	1.720	ELECT*END	-0.710**	1.697*
	-1.111	-1.712		-0.975	-1.218		-0.376	-0.701
N	178	177	N	350	326	N	350	326
Countries	26	26	Countries	26	26	Countries	26	26
R ²	0.545	0.421	R ²	0.452	0.437	R ²	0.451	0.438
F-test ³	0.908	2.278	F-test	1.619	4.685	F-test	1.600	4.730
Prob>F	0.650	0.000	Prob>F	0.052	0.000	Prob>F	0.115	0.000

Standard errors under coefficient values

* significant at 10%; ** significant at 5%; *** significant at 1%

¹ ELECT*PRE – a dummy variable with the value of 1 if the election date is predetermined, 0 otherwise; the selection criteria are: a) if the election is held on the fixed date (year) specified by the constitution; b) if the election occurs in the last year of a constitutionally fixed term for the legislature; c) if the election is announced at least a year in advance. Note: all initial elections in the full sample are dropped

² ELECT*END – a dummy variable with the value of 1 if the election is not predetermined (see above), 0 otherwise

³ F-test of the null hypothesis that all country specific effects in the specification are equal

Preelectoral fiscal manipulation seems to exist in both predetermined and endogenous elections, although the standard errors rob the coefficients of significance. Similarly, testing the theoretical model with these alternative terms demonstrates that fixed election dates do not eliminate political corruption. That is, manipulation is not only present when the policymaker is able to move the polling date around, upholding our assertion that the manipulation may be the result of disguise and not only of electoral timing.

Further sensitivity checks were performed by dividing the sample into countries with and without the EU contract arrangement.³⁴ Also, the sample was divided between the major resource commodity exporters and the rest, according to the dummy taking into account the country's exports of oil, gas and coal.³⁵ The results do not depart from those obtained in the baseline specifications. It is useful to note, however, that major resource exporters exhibit higher balance deterioration and expenditure change than non-resource exporters. But both groups still exhibit high cycles.

The major exception in this respect, as already noted in Chapter 4 after observing Figures 3 and 5, is Russia. It is an outlier in that it has by far the biggest budget balance improvement in the election years in comparison to averages of two adjacent years and all non-election years alike, comparable only to that of Czech Republic. Given the results for major resource exporters, it is obviously an outlier in this category. More importantly though, it is bound to be an outlier in terms of the theoretical model presented, given its scores on the three proxies. Namely, on average, it scored just above the mean (0) in all

³⁴ The EU-dummy takes the value of 1 if the country concluded, or was negotiating, the Pillar I contractual arrangement, or in other words, was linked to the EU with an instrument involving some economic conditioning.

³⁵ The main source for this was the CIA Country Factbook.

three categories, indicating a somewhat higher level of corruption, rent-seeking of the capturers and freedom of media and civil society. On the other hand, its policymakers were way above the average in conducting fiscal policy in times of elections. Therefore, reestimating Equation (5.2) without Russia seemed like a useful exercise. However, the results were left almost unchanged, irrespective of the sample specification.

Nevertheless, examining the Russian case in detail with the framework proposed here may be a fruitful opportunity for future research.

Countries with the contractual arrangements with the EU exhibit higher electorally induced expenditure cycles than the non-EU contracting countries, which again seems in line with the findings on competitive election sample. It appears from this that the EU did not have a noticeable conditioning impact in this respect, even if it was expected to have a strong influence on the quality of governance. Results of these additional tests are shown in Table 6. All the same tests were run for the theoretical model as well. Results were similar, and were therefore not shown.

To conclude, the results presented in Tables 4 and 5 appear to be robust to various potential statistical and sample selection problems. So, the predictions of the model remain valid. Predetermined vs. endogenous elections give somewhat mixed results, and suggest areas for future research.

CHAPTER 6

CONCLUSIONS

Summary

It has been shown in this study that countries with higher levels of corruption, weaker governance, poorer record in economic reform and more restricted information or political participation of civic groups tend to exhibit larger cycles in fiscal policy in times of elections. It has been argued theoretically that this is a consequence of the policymaker's tendency to pursue dual goals in transition: get reelected, and extract 'capture rents'. The collusion of the two engenders the fiscal cycle in that a policymaker attempts to disguise its proximity to special interests by catering towards the electorate at large. To the extent that a government has greater proclivity towards capture rent-seeking (i.e., is more political corrupt), that the demand for capture is more concentrated (i.e., poorer record in economic reform), and that there is greater noise present (i.e., where the information about the policymaker is scant and political participation low), the cycle in policy will be larger. In other words, on the one hand, a policymaker will be able to maintain closer links with special interest, biasing the policy in its favor. On the other, it will have greater room for opportunism before elections, distorting the policy towards the electorate in order to increase reelection prospects. It has also been shown that these aspects may be particularly important in those countries where competitive political pressures are stronger in combination with the weak oversight by the electorate

at large. This suggests that political liberalization may have a retarded effect if not accompanied by measures to increase government accountability and availability of information, as well as further economic reforms.

Discussion

Instead of a conclusion, it is important to point to some potential weaknesses of the model presented in this study, and how some of them can suggest areas for future research and theoretical refinement.

Conceptually, perhaps the most serious critique is the same as that plaguing the branch of PE of reform literature focusing on the capturers ('winners') and the concomitant risks of getting stuck in the partial-reform equilibrium (Hellman 1998). The B-T model – and hence a simplified version presented here – does not explicitly address the possible impact of the capture rent-seeking behavior of the policymaker on the footpath of reform and transition. However, the link can be implicitly established due to the fact that public good allocation (g) is conceptually similar to undertaking a reform program, so that, without loss of generality, one can see a decision on allocation of a public good as a reform (Fidmurec and Noury 2003). Since the key result of the model are the adverse shifts in the allocation of g , which are implicitly regarded as socially suboptimal, even if they maximize the utility of the policymaker, the B-T model thus focuses on the negative aspects of distributional dynamics, much like most of the literature on the political economy of reform. In other words, distributional dynamics are inspected from the negative vintage point. However, as argued by Schamis (1999), the distributional coalition in favor of reform progress may arise out of the same strategic

behavior: the prospects for market reserves and rents upon (this time) liberalization (and not the blockage of reform). Framing the argument in these terms may be of interest in future research.

A related critique may be directed to the implicit assumption of who is expected to strike a deal with the incumbent. While the special interest group in the model is conveniently unspecified, it is clear from assumption 2 of the model that it would not be of those belonging to the majority of the population. The model thus joins the purview of theories that largely de-link the state from the societal base, eliminating it from the distributional coalition-building (Schamis 1999). Therefore, allowing in the model the possibility that the electorate can also get organized and exhibit the same kind of strategic behavior over distributional consequences may prove beneficial.

Furthermore, the model assumes that the deal between the incumbent and the capturer can always be struck. However, both sides could find themselves in a position where the benefits of it would not outweigh the costs. The cost of disguising may substantially rise for the incumbent if, for example, the risk of making public his ties increases (X in the model).³⁶ Without a deal to strike, the need for disguising would thus be eliminated. This out-of-equilibrium outcome is precluded in the model due to the assumption 4 above.

³⁶ A similar argument is made by Krastev and Ganev (2004). Namely, they posit that the corruptness of the policymaker is a result of the cost/benefit analysis of how much corruption and anti-corruption would further its reelection prospects. A non-corrupt policymaker is not an incorruptible or a clean policymaker, but only the one that has calculated that seeking reelection through “corruption-centered politics” does not pay off, and so has consciously decided not to rely on such a strategy. This is an argument akin to the critique above; namely that the policymaker will choose not to strike a deal with the special interest if it establishes that the costs (X in the model, regardless of whether it is defined as the risk of making the deal public or the higher transparency) outweigh the benefits (the ‘capture rent’ B)

Moreover, as already mentioned, the electorate is modeled as a monolith, a single ‘principle’, with no factionalizing, grouping, or coalition-building within. This stems from the fact that the voter-policymaker relationship is viewed as a principal-agent problem. Drazen (2000), however, posits that the principal-agent paradigm may not be so useful for modeling the voter-policymaker relations, since there could perhaps be many principals, whose preferences are not fully known and whose behavior cannot easily be collapsed to that of a single principal. In the Olsonian language, disallowing the distributional dynamics within the electorate eliminates the possibility that it can transfer from the latent into the privileged group, or that it can at least supply sub-groups that would be able to overcome the free-rider problem. So, while in the political business cycle and the PE of reform literature the benevolent reformer is always the ‘victim’, in the B-T model, much like in the Olsonian framework, it is the electorate. As has already been suggested above (footnote 25), civil society may indeed provide groups for more effective oversight, which may also center on special interests. Also, Ferejohn (1986), for example, demonstrates that having multiple principals and distributional conflicts among them may completely change the modeling results.³⁷

³⁷ It is interesting to note, however, that Ferejohn’s implications of allowing for multiple principals would have exactly the opposite results from the same exercise in the B-T model. Namely, in the Ferejohn’s ‘disciplining’ model, it is the electorate that sets the optimal policy level \tilde{g} to which the policymaker responds. It is a moral-hazard type model, in which the voters as principals try to control the agent’s behavior by threatening to replace him. Therefore, the policymaker has the incentive to actually implement the policy level \bar{g} , which is closer to \tilde{g} than the level \hat{g} that it would implement in the absence of the disciplining electorate. However, Ferejohn argues that if there are multiple principles with distributional conflicts, the policymaker will have an incentive to ‘divide and rule’, in order to come closer to the preferred \hat{g} . Therefore, the inefficiency arises from the existence of the so-called ex-post heterogeneity, or the distributional conflicts between multiple principles. In the B-T model, however, the existence of ex-post heterogeneity means that some groups within the electorate would actually organize to press for the lower level of g , or that the policymaker would not be able to achieve the same effect by increasing g across the board. Therefore, the inefficiencies would likely be reduced. The difference

In this context, the most important may be that the utility the policymaker derives by catering for this group may be over-simplified, in that it would increase its reelection prospects by simply biasing fiscal policy towards the whole group across the board. In reality, the policymaker may wish to maximize only the welfare of the swing voters, for example, or just that of the pivotal voting groups that show strong allegiance, which may be influenced by the number of factors. Lindbeck and Weibull (1987), for example, demonstrate how both the design of the electoral system and the structure of the political system may be important determinants of the incentives for policy manipulation with regards to vote maximization. In any case, focusing on the parts of the electorate rather than the whole of it may dampen the overall preelectoral effect on the change in g .

Another substantive question in a repeated game setting is why rational voters would repeatedly allow to be fooled by the disguising manipulation by the incumbent.³⁸ The model in the present state does not allow for the effects of learning, for example, which has been theoretically and empirically addressed elsewhere (Brender and Drazen 2005).

Also, one critique can be pointed to the main expectation of the model: namely, it is expected that the consequence of the special-interests' rent-seeking and the electorate's voting power is the fiscal expansion. However, if the voters are 'fiscal conservatives' (Peltzman 1992), the expansion of the deficit is not necessarily the best tool for

mainly stems from the agent who sets the level of g . In Ferejohn's model it is the electorate, in the B-T model, it is the policymaker.

³⁸ Drazen and Eslava (2005), for example, argue that voting for fiscal expansions is a function not only of information asymmetry, but also the uncertainty of particular groups of voters about the sensitivity of the government expenditures to their voting patterns. In other words, the uncertainty about how much the targeted expenditure rise is due to the extent to which these voters may be considered as 'swing' or due to the lasting commitment may induce the voters to rationally opt for the expansion.

increasing the reelection prospects. In this case, it would be wrong to expect the expansion to take place as a result of a policymaker's opportunism. Rather, it would either signify his lower competence or the lack of accountability, or both.³⁹

Finally, the policymaker (with its opportunism and capture rent-seeking proclivity) is taken as a monolith itself. This may be a particularly vulnerable aspect of the model that attempts to explain the policy-related phenomenon in a rapidly changing and unstable political environment such as that in transition. The policymaker's incentive function can be influenced by the type of the executive and/or electoral system (Persson and Tabellini 2002, Haggard, Kaufman and Shugart 2001, Lizzeri and Persico 2001), intra-governmental relations (Brusis and Dimitrov 2001) the structure of checks and balances (Alesina and Perotti 1996), and so on. These are all aspects that suggest areas in which it would be beneficial to subject the model to additional tests. For example, the type of political and/or electoral regime (presidential vs. parliamentary, majoritarian vs. proportional, etc.) may be an important unobserved factor in explaining the proclivity to capture rent-seeking, or perhaps influences strongly the ability to move the date of polling. Incorporating these aspects in the present model may prove to be fruitful in terms of additional explanatory power of policymaking in transition.

³⁹ Drazen and Eslava (2005) model the political budget cycle explicitly under this condition, given the finding in their previous empirical research in Colombia that the voters may indeed be fiscal conservatives. Their expectation is that the expansion of spending will still take place, albeit not at the expense of the overall budget balance. The way to do this, according to Drazen and Eslava, is to target the expenditure increase on the swing voters, while undertaking cuts elsewhere. Bonomo and Terra, however, note that the government may still run a deficit if it has a possibility of financing it through public debt. However, the empirical issue of sorting out the policy outcome – debt or deficit – then becomes prominent.

APPENDIX: FIXED EFFECTS AND SYSTEM GMM ESTIMATOR

ASSUMPTIONS⁴⁰

In this appendix, theoretical assumptions and moment conditions of the Fixed Effects Method and a system Generalized Method of Moments (GMM) estimator of Equation (4.5) are shown respectively.

Fixed Effects Assumptions

Fixed Effects estimation is the OLS estimation technique that uses the time variation in the variables within each cross-sectional observation (country), controlling for the variables that are constant over time but differ across entities (country-specific effects), and for the variables that are constant across entities but evolve over time (year effects).

$$Y_{i,t} = b_1 Y_{i,t-p} + \sum b_2 X_{i,t} + dELECT_t + \gamma GAP_{i,t} + u_i + \lambda_t + e_{i,t} \quad (\text{A.1})$$

The fixed effects estimator is based on the so-called within transformation, whereby the level Equation (A.1) is averaged over time by a ponder $Y_i = T^{-1} \sum_{t=1}^T Y_{i,t}$ and so on. The latter is then subtracted from the former to eliminate the unobserved and time-effects, and the remaining variables become time-demeaned. An OLS estimator is then used on the time-demeaned variables. This is called the fixed effects estimator. In order

⁴⁰ This section is based mostly on Wooldridge (2002) and Shi and Svensson (2002).

to get an unbiased estimation, it is necessary to fulfill the following two moment assumptions:

$$E(e_{i,t} | X_i, u_i) = 0 \quad (\text{A.2})$$

$$\text{Cov}(e_{i,t}, e_{i,s} | X_i, u_i) = 0 \quad (\text{A.3})$$

Assumption (A.2) is that of strict exogeneity: the error term should be uncorrelated with each explanatory variable across all time periods. Fulfilling this assumption means that the fixed effects estimator is unbiased. Assumption (A.3) is that of serial correlation. If the errors are serially uncorrelated conditional on all explanatory variables and unobserved effects, the fixed effects estimator becomes the best linear unbiased estimator.

The presence of a lagged dependent variable in (A.1), however, renders the assumption (A.2) violated. The reason is that the initial condition of the dependent variable Y_{i0} is correlated with the country-specific fixed component u_i , which creates a correlation of the order $1/T$ between the lagged dependent variable and the random error term $e_{i,t}$ (Nickell 1981). Given the $1/T$ bias, the FE estimator becomes the best linear estimator only when T approaches infinity (Kiviet, 1995), which is not the case in our estimation ($T=16$). In order to eliminate this source of bias, an instrumental variable-based estimator called the Generalized Method of Moments can be used.

GMM Moment Conditions

The key idea with the Generalized Method of Moments is to find instrumental variables which correlate with the explanatory variables, but not with the error term. In this way, the bias present in the FE estimation is eliminated.

$$Y_{i,t} = b_1 Y_{i,t-p} + \sum b_2 X_{i,t} + dELECT_t + \gamma GAP_{i,t} + u_i + \lambda_i + e_{i,t} \quad (A.4)$$

To eliminate the country-specific effects u_i , we can take first-differences of (A.4) to get

$$\Delta Y_{i,t} = \sum_{p=1}^k b_1 \Delta Y_{i,t-p} + \sum b_2 \Delta X_{i,t} + d\Delta ELECT_t + \gamma \Delta GAP_{i,t} + \Delta e_{i,t} \quad (A.5)$$

where $\Delta Y_{i,t} = Y_{i,t} - Y_{i,t-1}$. Arellano and Bond (1991) note that under the assumption that the error term $e_{i,t}$ is not serially correlated, values of lagged dependent variable two periods or more are valid instruments for the transformed lagged dependent variables $\Delta Y_{i,t-p}$. For the control variables, it is assumed that $X_{i,t}$ is weakly exogenous; that is, $X_{i,t}$ is uncorrelated with future realizations of the error term. Thus, the GMM dynamic first-difference estimator uses the following linear moment conditions:

$$E[Y_{i,t} - s\Delta e_{i,t}] = 0 \text{ for } s \geq 2, t = 3, \dots, T \quad (A.6)$$

$$E[X_{i,t} - s\Delta e_{i,t}] = 0 \text{ for } s \geq 2, t = 3, \dots, T \quad (A.7)$$

One potential weakness of estimating (A.5) with GMM is that the independent variable $ELECT$ from (A.4) is also assumed to be strictly exogenous so as to be able to use $\Delta ELECT$ as its own instrument in (A.5). In the baseline specification in (5.1) and

(5.2), this however is not exactly the case, since both predetermined and endogenous elections are included in the *ELECT* variable. Nevertheless, it is still included in the estimation of Equation (4.5), since it is difficult to find an appropriate instrument for election dates.

While the moment conditions above are sufficient to estimate the parameters of the model, GMM estimators obtained after first differencing have been found to have large finite sample bias and poor precision in simulation studies. The intuition for this is simply that when the explanatory variables are persistent over time, lagged levels of these variables are weak instruments for the regression equation in first-differences.

In order to increase the precision of the estimates, Arellano and Bover (1995), and Blundell and Bond (1998) proposed to combine the above differenced regression with original regression in levels. The instruments for the regression in differences (A.5) are those described above, while the instruments for the regression in levels (A.4) are the lagged differences of the dependent variables. Formally, the additional moment conditions are the following:

$$E[\Delta Y_{i,t} - s(u_t + e_{i,t})] = 0 \text{ for } s \geq 1 \quad (\text{A.8})$$

$$E[\Delta X_{i,t} - s(u_t + e_{i,t})] = 0 \text{ for } s \geq 1 \quad (\text{A.9})$$

Combining the moment conditions for the difference and level equations yields the system GMM estimator. Note that consistency of the system GMM estimator depends on the validity of the instruments. Two tests are commonly considered. The first is a Sargan test of over-identifying restrictions, where the null hypothesis is that the instruments are uncorrelated with the residuals. The second is a test of the assumption of

no serial correlation (in levels), which the moment conditions (A.6) and (A.7) rely on. This test is implemented as a test of second-order serial correlation in the differenced equation (A.5).

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