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Populist political business cycle

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Abstract

Motivation: Understanding the government's role in shaping business cycles in light of rising populism within the political environment.
Aim: This article aims to refine the existing models from the political business cycle literature, emphasising populist phenomena to lay the groundwork for the populist political business cycle (PPBC).
Materials and methods: The study employs the selected conceptual approaches in analysing populist presence in the political realm. The inferences from the analysis are then applied to construct a new framework tuned towards delineation of the link between populists and business cycles.
Results: The analysis gives a pathway for a new PPBC model, which describes the political order predicated upon three scenarios with variable sequencies: moving towards a heterodox economic status quo, inducing a Latin American populist cycle, or returning to the previous economic status quo.

Keywords: *political business cycle; populism; political parties*
JEL: *B22; D72; E32; N10*

1. Introduction

The conception of the political business cycle can be traced back to Kalecki's article (1943) on the inducement of unemployment by the government working in collusion with the entrepreneurial class to discipline the workers; thus, the political business cycle takes shape. The stricter analysis, however, came about in the works of Nordhaus (1975) and Hibbs (1977). Both of them analysed how governments can create fluctuations in the economy.

According to Nordhaus, opportunistic politicians stimulate the economy right before the election. After forming the government, they applied unpopular restrictive economic policies to alleviate excess inflation. Because of the short-term memory of voters, the politicians repeat the manoeuvre before the next election. Meanwhile, Hibbs contended that left-wing governments decrease unemployment and increase inflation and output; this relationship is inverted for right-wing governments.

Both approaches have met criticism on theoretical and empirical grounds, especially after the dawn of the rational expectations revolution. However, Alberto Alesina (1987) later showed how PBC could be synthesised with the neo-classical paradigm. He created a model in which left-wing and right-wing governments have different preferences for policy surprises. Meanwhile, rational voters anticipate these surprises and cast their votes accordingly. The degree of polarisation and uncertainty affects the magnitude of economic fluctuations. After that, Rogoff and Sibert (1988) developed another conceptualisation — the incumbent wants to signal his competency to rational voters by delivering government services with the least tax. The incumbent, however, may sometimes cheat by increasing the seigniorage tax, and he can succeed at it because of information asymmetries.

Attempts at finding evidence for the concept abounded after its first introduction, with mixed results (Philips, 2016). Although not commonplace, the concept of PBC has influenced the political economy and remains a regularly investigated topic.

The PBC approach may prove helpful in enriching the literature around populism, which, in most general terms, is described as the idea of the rivalry between the common people and the corrupt elite (Mudde & Kaltwasser, 2017). Despite the plethora of studies around the concept of PBC and populism, there has not been any attempt to investigate the relationship between them. It is therefore worthwhile to establish a model integrating both concepts, which is the primary goal of the inquiry.

The paper is structured as follows. Section 2 presents two well-established PBC models and the definition of populism. Section 3 describes methods for analysing different scenarios of populist governance through the lenses of the models described in the preceding section, with support of empirical data and other conceptualisations not directly related to PBC and populism. Section 4 presents the analysis and, consequently, the Populist PBC framework. The last section concludes with a summary and several remarks for the future research agenda.

2. Literature review

The models I will be using are Nordhaus' and Alesina's models. The first one is the most basic. Such design provides many avenues for its modification. The second one bridges the traditional political economy and new classical macroeconomics. Depending on the historical, geographical or political context, each model can provide a beneficial understanding of national economies and their political environments.

I will base the analysis of populism on the definition expounded by Mudde and Kaltwasser (2017). It provides the lowest common denominator, which is conducive to analysing differing scenarios.

2.1. Nordhaus' model

In the Pure Political Business Cycle, the first formalised model, the voters are focused on satisfying their basic economic needs without observing the whole economy (pocketbook voting or egocentric voting). They look at the past behaviour of political parties in determining where to cast their vote (retrospective voting) and have decaying memory, namely, on the election day, past decisions of the incumbent seem blurry compared to the recent policies. Political parties act opportunistically, taking advantage of the short-term Phillips curve by decreasing unemployment on election day and inducing recession after the election to combat inflation. There is no ideological component implied.

The main inferences from the model are a high inflation equilibrium in the long run, increasing present welfare at the cost of future welfare, and, most crucial for our analysis, cyclical economic fluctuations around the election dates.

The simplicity of the model makes it a valuable tool for prediction. However, it has omitted or oversimplified aspects such as ideology or future prediction based on the competence of the incumbents.

The scenario created by Nordhaus resembles the game plan of Richard Nixon's 1972 win (Abrams & Butkiewicz, 2012). Nixon's administration is known to be one of the most corrupt in US history, so the model seems to be accurate at assessing instances of unscrupulous candidates.

2.2. Alesina's model

The Rational Partisan PBC was developed to synthesise the old framework and the increasingly dominant neoclassical school. In contrast to the previous conceptualisation, voters have rational expectations. In the political environment, there are two competing left-wing and right-wing parties. The former prefers lower unemployment for the cost of higher inflation, for which the party has less commitment. The latter focuses on decreasing inflation without bringing attention to increasing unemployment. Politicians choose their preferred policy not only according to their ideology but also with their popularity and, thus, the probability of winning in mind. In the pure scenario, there are inflation surprises and higher output growth under the left-wing government. On the contrary, right-wing governments do not affect inflation and induce recession. The economic fluctuations depend on the level of polarisation, which determines the cleavage between the parties' preferred economic stances — the larger the difference, the wider the fluctuations in output and inflation. In addition, uncertain election results induce stronger surprises for voters, and thus, the state of the economy becomes less stable.

Based on Barro and Gordon's study (1983), there are also distinct patterns in rule-based and discretion-based regimes. In both systems, the parties can arrive at a political equilibrium, if not due to the binding commitments as in the first regime, then due to the repeated interaction in the second case — cooperation emerges when the two parties' discount rates are low. If there is a bipartisan policy commitment, the political equilibrium is met and the business cycle is alleviated. However, suppose there are no rules and parties primarily focus on short-run costs. In that case, the cooperative strategy may not be feasible, and the economic output varies wildly.

Accounting for the ideological component and including rational expectations are assets of Alesina's approach. However, the lack of specification of available policy instruments impedes this framework's explanatory power.

The model's premises characterise a democracy with left-wing and right-wing representatives, where the governments may cause minor fluctuations by their platforms. However, because of different regulations such as deficit limits, common agreement among leading political actors and the rationality of voters, the economic output is not affected too heavily. Western democracies would provide an example of such a political environment (Alesina et al., 1992).

2.3. Populism

The term populism has attracted widespread interest in recent years as the number of politicians described by the media as populist has risen.

The term has many definitions, but Mudde and Kaltwasser (2017) provide a fundamental and universal approach for understanding the phenomenon. Populism is thus understood as a thin-centred ideology (which means that it has heterogeneous goals, yet has some inherent mechanism) that views society as dichotomously categorised by two opposing groups — the pure people and the corrupt elite.

This approach has several implications, such as anti-pluralism, infringement upon minority rights, and ultimately bypassing democratic checks and balances (Guriev & Papaioannou, 2022). Regarding the economic dimension, populism takes many forms, but protectionism constitutes most instances. In addition, left-wing populists often focus on redistribution programs for the poor, taxing the wealthy and increasing the aggregate output. Right-wing populists, on the other hand, prioritise tax reductions and deregulation of the market, although there are traces of redistributive policies aimed at particular groups. There is also overall agreement on the short-sightedness of most populists' economic policies.

3. Materials and methods

The PBC literature has not formulated a model describing the link between populism and PBC theory. With that in mind, I will analyse populism through the prism of the aforementioned models by applying them to the scenarios in the next section. Other theories not directly associated with populism and PBC may contribute to the analysis. Empirical evidence will supplement the findings. The results of the analysis will be combined into a theoretical synthesis. This approach will prove conducive to formulating the central tenets of PPBC theory.

4. Results

4.1. Nordhaus' model

On the surface, the pure model seems to be effective at assessing the populists' rule — manipulative politicians (or more than average, to be precise) make generous promises in order to achieve power and then inflate the economy in order to gain support — but not for long if the economy is to survive. There are, however, discrepancies between the model and empirical evidence. These discrepancies take different forms depending on the context.

In 20th-century Latin America, more often than not, the following scenario played out (Dornbusch & Edwards, 1991) — populist (in most cases left-wing) took the power, employed redistributive social programs and increased public investment heavily — something that resembles the period before the election, but not after it. It could be explained by the argument that the opportunistic politician needs to signal his ability to satisfy voters' needs. After the first instance of such behaviour, we expect a cycle congruent with the model. However, even accounting for this explanation, we see an overall pattern of expansionary policies at the beginning of the term. After a while, we see a dip in the output and high inflationary pressures. This may be counterintuitive regarding Nordhaus' framework because of the countercyclical macroeconomic moves of the incumbent, which go against the goal of winning elections by the pragmatic usage of governmental tools. Nevertheless, there could be a logic to this course of action — the populist in power may argue that corrupt elites responsible for existing social inequalities launched an attack once again, and the only rescue from that is the incumbent's re-election. This could be feasible, remembering that Nordhaus does not assume rational voters who may use cheaper information from government officials eager to influence and control the media — Hugo Chávez favoured this approach towards the press (Guriev & Treisman, 2019). However, voters still strive to satisfy their immediate needs, so this strategy is unlikely to work. There arises a problem: why would the government engage in expansive macroeconomic policies and put itself into managing the imminent crisis right before the next election?

Apart from answering that question we can find a pattern of a different kind of cycle which comprises the following steps: 1) developing nation is constrained by global institutions as part of economic development plan, 2) the growing inequality and lack of improvement for most inhabitants increase grievances and predispose them towards more radical mindset, 3) populists take advantage of the public mood and win the election, promising alleviation of economic inequalities and bringing about prosperity by re-nationalisation of industries and redistribution of income, 4) the government engages in redistributive and expansive policies financed primarily by the foreign credit; inflation is restricted thanks to price controls and any shortages are compensated by imports, 5) after the period of increased output and reduced inequality the lack of reserves becomes a problem; devaluation, import tariffs and price controls are necessitated, 6) the following crisis of rampant inflation, capital flight and stagnant wages turns the public against the populist who often refuses to concede peacefully, 7) the next government employs restrictive fiscal policies in order to heal the economy; there are lower standards of living and higher inflation because of the economic crisis, 8) unfavourable economic conditions may convince voters to once again vote for the populist — an average voter may not learn from the mistake because of decaying memory and short-sightedness (immediate economic hardships and high discount rate explain this mindset), 9) a process starts again from the step 3. According to Dornbusch and Edwards (1991), a similar process has transpired in Chile, Peru, Nicaragua, and Argentina.

Thus far, we have analysed only one region within a specific period. Though relatively unchanged in Latin America (Cachanosky & Padilla, 2019), populism in modern times takes different forms, as seen in Europe (Rodrik, 2018). Current right-wing populist waves emphasise using trade restrictions and decreasing economic openness as a backlash to growing globalisation and immigration. We see less evidence for the populist cycle which characterised Latin America. Right-wing populists such as Alberto Fujimori in Peru (Roberts, 1995) often espouse market-oriented reforms and others, including Viktor Orbán in Hungary and PiS government in Poland, combine neoliberal and heterodox approaches (Benczes & Orzechowska-Wacławska, 2024) with relatively lower macroeconomic irresponsibility compared to their left counterparts. Even the left-wing populist party Syriza, after coming to power in Greece, abstained from enacting much of their platform and even employed fiscally conservative policies, primarily because of EU restrictions and trade deals (Katsambekis, 2019, pp. 21–46). Therefore, finding a pattern in the modern environment is difficult using Nordhaus' model.

4.2. Alesina's model

The Rational Partisan PBC differentiates between left-wing and right-wing governments. We could apply this dichotomy with one modification — the two competing parties are populist and non-populist. A convincing conceptualisation is that a populist party has widely different inflation and output preferences from the non-populist party, which has moderate preferences, where by moderate I mean close to the status quo, which exists in the original left-right divide. This arrangement can lead to significant economic fluctuations. The additional factor exacerbating the magnitude of fluctuations after the election is that it may be probable that the win of a populist party is not anticipated, as mainstream media and the general public consider support for such parties taboo. Voters sympathising with populists are less eager to voice their preferences in surveys. Moreover, a populist party may need to mitigate some of its radical policies to gain wider support; the opposite holds for the non-populist party, which may radicalise its economic program.

By using Alesina's approach, we could additionally differentiate between left-wing populist parties and right-wing populist parties — the former prefer much higher output for the cost of exorbitant inflation. In contrast, the latter prefers to decrease inflation strongly, which causes a deep recession. This assessment has some empirical support (Funke et al., 2023). It was found that under the populist regimes, both left-wing and right-wing, there is overall lower GDP growth than under different governments. However, under left-wing regimes, there was a spike upwards in GDP at the beginning of the term, which is congruent with the model.

It is crucial to include different types of economic policies preferred by the populists. In Alesina's original model, there is no specification for concrete policies, while in reality, there are many instruments that governments can use. Nowadays, the primary policy standard of the populists, both on the left and the right side of the political spectrum, is increasing tariffs, which diminishes GDP growth (Funke et al., 2023). It could be construed as the model's optimal policy of a given party. However, it is hard to measure the effects because of the narrow policy prescription in the original theory. Suppose we were to treat import tariffs the same as directly inducing lower output. In that case, we can construct the populist vs. non-populist national economy scenario, which fits the model quite neatly. However, other forms of state engagement in the economy, such as state-owned enterprises, are less readily interpreted.

Regarding the rule-based and discretion-based regimes, we can infer that, because of the short-term orientation of populist parties, as they offer quick solutions without concern for the long-term consequences, they exclude the possibility of bipartisan policy commitment. Meanwhile, the rule-based regime can help inhibit the realisation of radical economic platforms. The evidence shows that populists thrive particularly in countries with weak institutional arrangements (Funke et al., 2023), which supports this thesis.

The model used in this section helps to describe the current political climate where populists compete against non-populists. However, the narrow policy choices in the model limit the extent of the analysis, especially if we wish to include policy-mixes such as growth-inducing tax breaks and growth-impeding tariffs.

If we extend this aspect of Alesina's theory, the instruments differ in some respect. Left-wing populists based in Latin America engage primarily in income redistribution by increasing real wages without passing it on to higher prices (Dornbusch & Edwards, 1991). Right-wing populists such as Viktor Orbán or the PiS government (Benczes & Orzechowska-Wacławska, 2024) combine orthodox and heterodox economic approaches, where some populists put more emphasis on the former, among them Recep Tayyip Erdoğan in his early years (Funke et al., 2023). According to Perfeito da Silva (2023), left-wing populist Nestor Kirchner employed stringent capital controls, and right-wing populist Viktor Orbán took control of foreign-owned assets, relocating them back under domestic ownership. The former clashed more with external trade liberalisation, which can point to more pronounced consequences of left-wing populism.

4.3. Other remarks

In recent years, we have seen a transforming political environment — populists are considered viable candidates and have also formed coalitions and majority governments, which reached an all-time high in 2018 (Funke et al., 2023). Having in mind the effects which they have on the economy, it is sensible to ask whether voters act rationally, and if they do, then why do they decide to vote against their welfare in the long run, where they are hurt either by unstable redistribution and spending or by trade tariffs and decreasing openness of the economy.

The possible explanation is the following — as the living conditions deteriorate, not simply because of weak economic conjecture but because of global crisis such as the Great Recession (Guriev & Papaioannou, 2022), voters turn towards more myopic view of the economy — the urgent need to satisfy their basic economic needs dissuade them from forecasting the future outcomes and thus they support the redistributive programs and higher spending; this argument is a paraphrase of Thaler's article (2016). Related to this, Persson and Aggeborn (2017) built a model that explains a given dynamic — voters with lower private income will vote for basic public services and against the global good, such as environmental policies. The demographic shift is another factor influencing the high discount rate of voters. Older voters are not concerned with their future and welcome short-term gains, as they will not bear the long-term costs.

However, this explanation does not seem to account for the support for tariffs as they backfire quickly, and it is hard to identify the immediate consumer benefits. We could explain that with the so-called rational irrationality — a concept developed by Caplan (2008, pp. 114–141). A similar discussion is held by Benczes and Szabó (2022). By combining this phenomenon and the cultural determinants of support for populists, we could explain the willingness to vote against one's own interests.

One can wonder whether there is a breaking point for a biased voter when the adverse effects of political cycles are unbearable. However, the precarious living conditions still predispose voters to support myopic solutions — redistribution and fiscal stimulus or promoting national sovereignty by implementing tariffs. It is also worth stressing the magnitude of economic fluctuations caused by political earthquakes and the role of formal institutions in regulating government's economic tinkering. The larger number of electoral wins for populists in countries with weaker institutions accentuates the importance of institutional arrangements.

4.4. The model

By building upon the implications from the discussion, we can develop the Populist Political Business Cycle. The new political arrangement is characterised by voters satisfying their short-term needs or biased views. There is a populist party and a non-populist one. The former can moderate its stance while the latter can radicalise it. For each election, their rivalry has several possible outcomes:

1. The populist party does not win, and its popularity wanes before it can form a government.
2. The populist party wins.

In the second case, the following can happen:

1. If the populist government can sustain the economy, the economic status quo moves from orthodox (mainstream approach) to heterodox equilibrium (non-conventional approach), which consists of economic nationalism, increased government role in the market and redistribution among selected groups;
2. If the populist government cannot sustain the economy, we will see a pattern similar to the Latin American populist cycle; the country may either remain stuck in populist cycles or move towards a sustainable economy.

The win of the right-wing option is more likely to cause the first scenario, while the left-wing option is more probable to yield the second scenario based on their macroeconomic tools. The institutional context matters in determining if the populist can sustain the economy despite his political orientation and whether he can win in the first place. Major economic setbacks can predispose voters towards satisfying short-term needs. Non-economic factors, such as cultural determinants, can influence the political orientation of a populist and the likelihood of him winning.

The cycle of elections repeats, and the resulting economic fluctuations can be either small, moderate or high, depending on who wins the elections and the party's level of radicalisation.

5. Conclusion

The paper shows that the PBC theory has potential for developing new strands of economics. The concept of PBC itself needs to be reinvigorated, as the general opinion on its existence is still ambivalent. The populist governments and their actions provide an avenue for enriching both concepts and research surrounding them.

The increasing interest in populism warrants new ways of studying its workings and effects on worldwide political orders. The economic aspect was often omitted in the populism literature, and a good way to compensate for this shortage is to develop tools based on theories expounded in preceding sections.

Many questions and important aspects were missed or were not elaborated in the adumbration of the PPBC framework presented in the previous section. For example, it would be beneficial to compare countries with similar economic, institutional, cultural and/or political backgrounds and to analyse the factors influencing the rise of populists in a given region and their preferred policies. Nevertheless, I hope the findings help lay the foundation for developing PPBC. Through the interdisciplinary collaboration of economists and political scientists, we can develop a valuable tool for investigating the economic and political realm. Its effects might take a new breath in many disciplines, including public choice theory and political economy.

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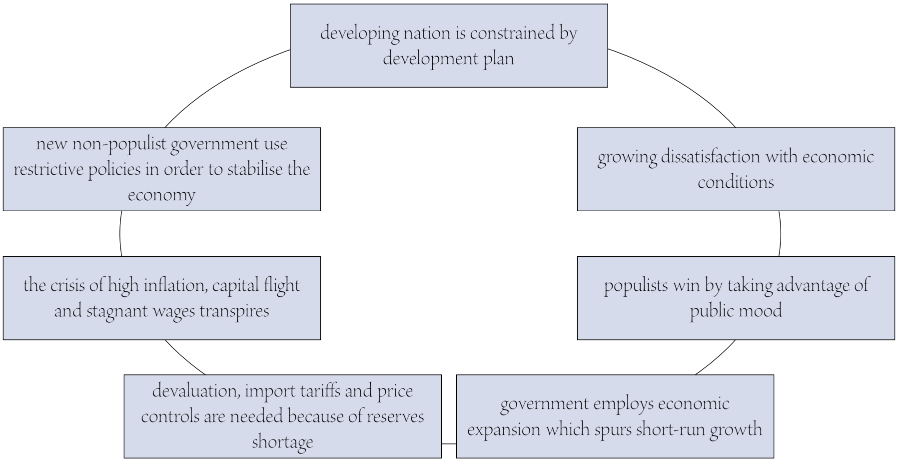
Appendix

Table 1.
Differences between frameworks

Model	Voters	Parties	Pattern of cycles
Nordhaus	Non-rational; look at recent behaviour and cast their votes accordingly	Opportunistic; expand the economy to gain popularity and contract it after winning	Economic booms before elections and busts after the elections
Alesina	Rational; forecasts may be blurred because of election uncertainty	Partisan; determine their preferred level of output and inflation, correcting it with the popularity in mind	Higher output and higher inflation under left-wing parties; lower output and lower inflation under right-wing governments
PPBC	Rationally irrational or rationally ignorant; they vote to accommodate their biased views or to satisfy their short-term needs	Populist and non-populist; if the former wins and it can sustain the economy, the economic status quo becomes heterodox; if it cannot sustain the economy, the Latin American scenario transpires	Pronounced fluctuations under a sustainable populist regime; Latin America populist cycle in an unsustainable regime; mild or no fluctuations under a non-populist regime

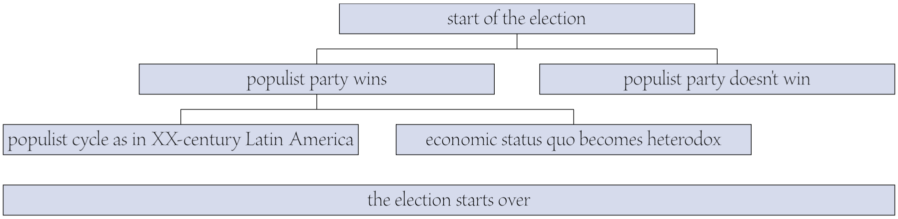
Source: Own preparation based on Nordhaus (1975) and Alesina (1987).

Scheme 1.
Latin American populist cycle



Source: Own preparation based on Dornbusch & Edwards (1991, pp. 7–13).

Scheme 2.
PPBC scenarios for a given election



Source: Own preparation.