

**POLITICAL BUSINESS CYCLES  
IN EMERGING MARKETS:  
Brazil  
(and Venezuela and Argentina)**

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This paper was initially written to examine whether theories of political business cycles were more or less applicable to emerging market countries. The bulk of research in the area political business cycles has emphasized conditions in developed countries. While this certainly makes sense in terms of ease of collecting data and traditions of democracy, this leaves out second and third-wave democracies. At the same time, evidence from developed countries is hardly inspiring to both proponents of the opportunistic political business cycle and the rational partisan cycle.

This paper argues that extending the logic of political business cycles to emerging markets is likely to produce more robust examples of opportunistic and partisan behavior because conditions and incentives in emerging markets are more propitious for the political opportunism or for the policy shifts expected by the two theories. The paper proposes three hypotheses about what type of evidence should be expected and how political business cycle theories might need to be readdressed so that they can better be applied to emerging market countries (see page 5).

The text of the paper uses exclusively evidence from Brazil in the last fifty years. For this presentation at BRASA, some evidence, in the form of graphs, from Venezuela (1960-1995) and Argentina (1981-1995) is included. The data for these countries are not as extensive as the data from Brazil, but they raise some interesting questions about to what extent one might generalize about political business cycles in emerging markets. Certainly there are considerable differences between Brazil, Argentina and Venezuela, even though all are emerging markets. The most obvious, perhaps, and one of the most pertinent to the current study is that Argentina and Venezuela, until recently, have had very stable and institutionalized party systems, and very well disciplined parties, especially when compared with Brazil (see Mainwaring, 1999).

In Venezuela, inverted political business cycles led to victories of the opposition. But an opportunistic business cycle with a honeymoon from 1963-1968 did not lead to a victory for the party in power (AD). True, the opposition candidate (Caldera of COPEI) won by a margin of 1%, but the victory is difficult to explain given the Brazilian experience. In this case, the stable two party system may have created possibilities in Venezuela that might have been absent in Brazil. In the case of inflation, in both the 1983-88 and the 1989-1993 periods, governments tried to reduce inflation and then inflation rose near the coming elections. This is expected by the opportunistic political business cycle and it is expected given the evidence from Brazil prior to the phase of hyperinflation.

In Argentina, the 1983-89 and 1990-95 periods are clear examples of failed efforts at opportunistic political business cycles. Inflation, tells a different story. The Alfonsín period (1983-89) follows the typical policy of trying to cut inflation before allowing it to rise. But, during the first mandate of President Menem inflation is cut sharply and it decreases throughout his mandate. Despite a failed political business cycle in terms of GDP growth, Menem passed a reelection amendment and was elected despite low growth during the electoral year primarily because he was able to eliminate inflation. In this case, hyperinflation created incentives that encouraged a politician maintaining low inflation prior to an election even at the cost of growth. It should be added that pressure from the Mexican crisis presented a growth or low inflation scenario, and Argentine voters chose the candidate who eliminated inflation. This is quite similar to what happened with President Cardoso in 1998.

There is insufficient time to integrate evidence from Venezuela and Argentina into this paper better. It is believed that the hypotheses made for Brazil still hold for Venezuela and Argentina, although, as mentioned earlier, the party system may temper some of the incentives in these two latter cases. Nevertheless, the expectation is that these countries, as emerging markets, will show more clear evidence of political opportunism and partisan activity than OECD evidence would suggest. The occurrence of two inverted political business cycles in Venezuela during the 1970s is still difficult to explain, but the rest of the data examined seem to support the hypotheses made here.

An additional note should be made. The end of the paper considers the idea of a post 1989 realignment in Brazil. From the partisan perspective, the Center in Brazil has unquestionably expanded and the Left has approximated the Center. This is most obvious if one considers the newly madeover Lula, but it is also true of Anthony Garotinho and Ciro Gomes (see [www.spanakos.org](http://www.spanakos.org) "Real Changes in Brazil"). This has decreased country risk in Brazil and it should increase the possibility of a Leftist presidential victory or a Center-Left governing coalition. This is still unlikely, but it is more possible. Also, changes in fiscal and monetary policy limit the extent to which opportunistic business cycles are possible. The law of Fiscal Austerity and the de facto autonomy of Central Bank governor have weakened the institutional incentives for rampant opportunism.

This year is an electoral year and Brazil should expect interest rates to be lowered and growth to exceed last year. But Brazil is also recovering from contagion from Argentina and a slump in the global economy, so a decrease in interest rates is good policy and an increase in growth should be expected anyway. The Central Bank has been more concerned with these events (and the recent increase in world petroleum prices), than with the idea of making a government candidate more palatable to the electorate (by lowering interest rates at an irresponsibly rapid rate). So 1999-2002 will show a very classical decrease in growth shortly after the reelection of Cardoso (prior to and immediately following the devaluation), which is certainly expected by the opportunistic business cycle. But the government grew faster in 2000 than is expected in 2001 and 2002 (and maybe even for those years combined). Cardoso's reluctance to try to improve the electoral scenario through loosening macroeconomic policy is a result of his policy preferences-ideology (see page 25) and also of changes in the institutional context of Brazilian macroeconomic policy-making. These changes are significant and the incoming government may further consolidate these reforms.

If individual politicians' policy preference and the institutional environment truly consolidate the ideas of fiscal and monetary prudence and avoiding blatant and severe opportunism, the evidence of political business cycles in Brazil will decrease. This may not be especially helpful for the theories considered here, but it will be good for Brazil.

## **I Introduction**

Conventional wisdom holds that politicians will behave opportunistically, kiss babies, shake hands, print money and open schools, especially during an electoral year. That politicians pursue popular policies during an electoral year is logical. Equally logical, however, is that politicians from different parties distinguish themselves. After all, if politicians are all alike there would be no need for more than one political party, and there would be little reason for elections.

Much of the literature of political economy is derived from the idea that rational actors pursue policies that are in their best interest. But there is debate as to whether it is in the best interest of all politicians to pursue the same policies, or if it is not more advantageous to pursue policies consistent with a specific ideology or program. Two basic theories have emerged from these propositions in the previous paragraph: the opportunistic business cycle (OPBC) and the rational partisan cycle (RPC)<sup>1</sup>. The OPBC theory states that politicians will behave opportunistically, and therefore will pursue expansionary politics prior to elections. The RPC argues that politicians from different political parties will choose to pursue economic policies that are consistent with their ideology, and, hence, rational politicians will choose different policies based on their ideologies and constituents.

There has been a considerable amount of research on whether, and to what extent, OPBCs and RPCs exist in OECD countries. Recently, this work has been applied to emerging market countries, where there is already a rich literature that analyzes manipulation of macroeconomic policies for political support. This paper argues that PBC theory is very valid for emerging markets, but that certain expectations must be adjusted, given fundamental differences between emerging

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<sup>1</sup> Consistent with, Dra zen (2000: 228), this paper uses the term Political Business Cycle to refer to all periods in which there is a correlation between economic and electoral cycles. This is distinguished from the model set forth by Nordhaus which is labeled an “opportunistic” Political Business Cycle. Throughout this paper “OPBC” will be used to denote “opportunistic Political Business Cycles.” Additionally, the paper will use the term “Rational Partisan Theory,” to refer to the theories that emerged from the work of Hibbs (1977) Alesina (1987) and others. Originally, called the Partisan Business Cycle by Hibbs (1977), Alesina updated the theory and re-baptized it the Rational Partisan Cycle.

and developed markets. Once these differences are taken into account, and adjustments are made, both OPBC and RPC theories prove to very capable of explaining economic outcomes. Post World War II Brazil is used as to test the following hypotheses:

1. OPBC theories in developed markets find more evidence of inflation being tied to elections, than growth. In emerging markets, the correlation between growth and elections should be stronger than that of inflation
2. RPC theories are less valuable as long as “Left” and “Right” are used to identify political ideologies. When using economic ideologies (“Interventionist” or “Liberal”), the explanatory power becomes very strong. Again, in contrast to developed countries, the correlation with growth is better than with inflation.
3. Conditions of hyperinflation reorders political incentives and encourages preelectoral adjustments, whereas when inflation is moderate to high, incentives to avoid adjustments in the preelectoral period are much stronger. This is an important addendum to OPBC theory which suggests that adjustment should occur early in administration.

## **II Political Business Cycles**

Classical economic theory identifies a business cycle, in which economies experience growth and contraction through a natural process. Political economy literature argues that there is evidence of cyclical movements in economic performance that can be directly linked to political events. The most obvious such domestic event is an election, which can be viewed as an opportunity for the electorate to choose to endorse or reject the policies of the current government for another mandate. It can also be seen as a potentially pivotal period (a mini-crisis<sup>2</sup>) that augments the uncertainty of future monetary and fiscal policies. Two theories of PBCs will be examined here: the first focuses on the opportunistic behavior of all politicians regardless of ideology; the second emphasizes the importance of political ideology and voter support for certain types of programs.

### **The Opportunistic Business Cycle**

MacRae (1977) found that voters are more likely to vote against incumbents when the level of growth is low, and when unemployment and inflation are high. Fair’s 1978 study of elections in the US argued that for every increase of 1 percent in growth, incumbents can expect an additional 1

percent in vote total. Fair also finds that voters have short memories—using the previous year as the basis for their voting decisions—and that the electoral benefit associated with growth was the same for Republican and Democratic governments.

The idea that politicians are office-seeking and, thus, opportunistic, rather than dogmatic, in their policies was formalized by Nordhaus (1975) who argued that there is a clear and observable cycle in which political and economic cycles overlap. Rational politicians, regardless of ideology, he argued, pursue the same policies that optimize support among the electorate in an electoral year.

The basic assumptions that underlie this theory are as follows:

- Fiscal and monetary stimulants lead to higher levels of growth and employment but have an inflationary cost
- There is a gap between the time in which the initial benefits of such expansion is felt, and the time in which the costs are felt
- The memory of the electorate is short, and the government will be punished less for a contraction that occurs in the initial part of its government than for a contraction prior to or during an election year
- Voters are unaware of the future consequences of expansionary politics in an electoral year
- Voters reward politicians who deliver high levels of growth and employment, and low levels of inflation
- Voters are homogeneous or have uniform preferences
- Politicians are rational and they will pursue a strategy to maximize support during an electoral year
- Reelection is a tangible goal for all politicians<sup>3</sup>

From these basic assumptions, Nordhaus argued that the rational politician will try to contain inflation during the first part of his or her mandate, and will pursue higher levels of growth during the latter part of his or her mandate. Pursuit of growth throughout the mandate runs the risk of producing an inflationary environment during the election year, and, potentially, creating the need for a stabilization program. A rational politicians should avoid contractionary policies and entering into a recession, but when it is necessary to curb inflation, this should be pursued in the beginning of the government.

In addition to an OPBC, there is an inverted political business cycle<sup>4</sup> which is characterized by a honeymoon phase in which the new government pursues expansionary policies. However, as

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<sup>2</sup> I am grateful to Felipe Illanes for this observation.

the mandate continues inflation rises steadily and it becomes necessary for the government to show fiscal and/or monetary discipline, and a contraction becomes inevitable. There have been few examples in the industrialized world of IPCs and they have produced electoral defeats for incumbents, most notably US president Carter in 1980.

IPCs appear to be more common in developing countries. Giambiagi and Além argue that this is because developed countries choose adjustment earlier in the administration, whereas developing countries, where social demands are great and more diverse, choose adjustment later, when there are few options. The recent democratization in Latin America exacerbated the pressures and demands on the new civilian governments who were expected to differ from the authoritarian governments that they replaced (2001, 346-7). At the same time, political bargaining meant not challenging many of the fiscal privileges of the military, but it also required giving benefits to constituents who had been excluded under the authoritarian governments. Such political negotiations during regime transitions gave ample incentive for expansionary policies, particularly early in political mandates.

This was compounded by rising inflation during the late 1970s and the debt crisis which, by placing increased pressure upon authoritarian governments, facilitated democratization. Particularly important from the perspective of public finance is that authoritarian governments in Latin America, even those that were growth-oriented,<sup>5</sup> experimented with orthodox stabilization programs in order to reduce inflation and debt. These economic policies further weakened support for authoritarian government, forcing governments to weaken their fiscal stances in order to preserve popularity. Additionally, the electorate responded so negatively to the belt-tightening orthodox programs, which were largely seen as “imposed by the IMF,” that a return to growth was considered fundamental to the survivability of any politician in the newly democratic state. This also

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<sup>3</sup> Some of this is drawn from Giambiagi and Além (2001: 345)

<sup>4</sup> This paper will use IPBC to denote this phenomenon.

<sup>5</sup> This was the case of Brazil.

encouraged a preference for heterodox strategies, when some sort of stabilization program was inevitable.

### **Rational Partisan Cycle**

Despite sharing most of the assumptions of the OPBC—such as the assumption of the inflationary costs of expansionary politics, the goal of reelection, and rationality on the part of the electorate and politicians—the rational partisan cycle challenges the basic assumption of the OPBC, that ideology does not matter. Hibbs (1977, 1987) noticed that the preferences of the constituencies of the two political parties in the US were vastly different, and that this should lead to a difference in policy positions. If the two parties differed in their policy positions and were held accountable to their constituents, the two parties should be expected to pursue different policies while in office.

Hibbs's argument that there is an observable difference, in terms of economic performance, between governments on the Right and Left has been extended to other OECD countries (see Alesina, Roubini and Cohen, 1997). The standard assumptions of the literature which examines the role of partisan identity as a determinant is that politicians on the Left (Right) are more concerned with growth and unemployment (inflation) and, as a result, they pursue different policies. The difference in policies leads to different results and the Right (Left) tends to preside over governments with lower (higher) levels of inflation, growth and employment.

Contrary to the assumption of voter homogeneity fundamental to the PBC, proponents of the RPC suggest that voters and voter preferences are heterogeneous and so it is logical that they should vote for politicians that correspond with their particular preferences (Drazen, 2000: 246). Additionally, voters should reward politicians and political parties loyal to their personal interests and/or projects.

Alesina (1987) observed that uncertainty about which candidate will win elections leads to uncertainty about post-electoral monetary policy.<sup>6</sup> The perception that different electoral results would yield different monetary policies suggests that partisan differences are important. In countries with independent central banks this effect is diminished, although the executive branch is a powerful lobbying force. Uncertainty about future monetary policy is even greater in many developing countries, such as Brazil, where the central bank is not independent.<sup>7</sup>

### **III Adopting theories for Brazil and Other Emerging Markets Countries**

The majority of studies in the area of PBCs use empirical examples from developed countries. Certainly, political manipulation of monetary and fiscal policies is not unique to the developed world, but translating the research agenda to emerging market countries implies certain inherent difficulties or adjustments. Adopting the PBC theories for emerging markets requires reevaluating some of the basic assumptions of the two theories.

The most obvious adjustments come in the assumption of reelection and the idea of elections, since the former is not always a possibility and the latter cannot always be assumed in developing countries. Additional comments will be made regarding specific assumptions of the OPBC and RPC. The evidence for the PBC theories in OECD countries will be considered and this will reveal an implicit assumption: that small incremental changes can be detected and can produce positive results in developed markets. It will be argued that emerging markets require more pronounced changes in order to achieve similar political gains. Finally, these adjustments to PBC theory will be used to explain the three hypotheses set out in the introduction.

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<sup>6</sup> See also Persson and Tabellini, 2000, chapters 15 and 16.

<sup>7</sup> The new economic platform of the Leftist Workers' Party (PT) in Brazil supports the idea of an independent central bank. Yet, PT honorary president and perpetual presidential candidate Luis Ignacio "Lula" da Silva made clear in July of 2001 that were he to win the elections of 2002 he would neither want current central bank president Arminio Fraga in office, nor would he replace him with someone with a similar economic perspective.

## **Assumptions—reelection, elections**

The assumption of reelection that is present in both the OPBC and RPC models, but this assumption is not applicable in many emerging markets, particularly in the Americas, where no reelection or no immediate reelection are common restrictions.<sup>8</sup> In Brazil, immediate reelection was not possible for any executive in the post war period prior to president Cardoso. Political turnover is also very high in Brazil and, for many politicians, reelection (in some office) is not an immediate goal (Ames, 2001: 207). This should present a serious blow to the PBC theories since not only is reelection fundamental to the matching of voter preferences with politician incentives, but reelection serves as a potential constraint on politician behavior.<sup>9</sup> However, the absence of reelection, as a possibility, does not have this affect in Brazil, and in other emerging markets.

Even without the possibility of reelection, there are strong incentives for politicians to leave during a period of economic prosperity because many individuals use elected office as a stepping stone to positions in the private sector. The possibility of reelection, once waiting out a full term, gave presidential hopefuls, such as Kubitschek, incentives that would normally be associated with a system in which immediate reelection was possible. Politicians in Brazil, as in other emerging markets, also tend to linger in politics. Two of the last three presidents<sup>10</sup> have remained very active participants and power-brokers on the national level: José Sarney, was the president of Congress, and Itamar Franco, governor of Minas Gerais.<sup>11</sup>

Another assumption of the PBC models is that there are electoral cycles, and, more basically, that there are elections. Fundamental to these theories is the idea that politicians compete for votes in an environment where voter feedback (votes) will reward/punish the incumbent

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<sup>8</sup> For the sake of brevity, only the electoral rules governing Brazil will be considered.

<sup>9</sup> Elections suffer from a principal-agent problem since once a politician is elected there is little the elector can do to effect the government's policy choices. Reelection reduces the principal-agent problem and it provides incentives for politicians to be more accountable to their constituents. See Drazen's review of the literature (Drazen, 200: chapter 7).

<sup>10</sup> The other, Collor, lost his political rights as a result of his impeachment. Having regained his political rights, he returned to politics in an unsuccessful bid for mayor of São Paulo.

government. Military and authoritarian government and coups were not infrequent in the developing world during the second half of the twentieth century, and, thus, elections should be considered differently than in the case of the established democracies in the developed world.

Democracy in post World War II Brazil was interrupted by a twenty-year interlude of military government, but the military government in Brazil held elections throughout their twenty years in power. Additionally, the military government's legitimacy was based on two items: restoring social peace and economic growth. The first was rapidly reached and so the second became the priority of the military government. The military government, through its use of technocrats, believed that its maintenance of economic growth was its most sacred duty and economic performance was critical for the electoral performance of the government. The economic miracle of the late 1960s and early 1970s was the *sine qua non* of the military government's ability to deliver and its improvement on civilian politics. Economic growth became the central part of military propaganda and economic performance was largely responsible for the support, acceptance or tolerance that citizens showed towards the military regime.

Economic policy-making was never entirely isolated from public approval, nor from political considerations. From the beginning of the military government, the government made the decision to hold and win elections, and, although the conditions for elections were hardly free and fair, the government wanted legitimate electoral victories. Electoral victories were important not only for showing popular support for the regime, but also in terms of the power struggle between the military government and the opposition and between the two principal factions in the military government, the Sorbonne Group and the Hard-Liners.<sup>12</sup> Thus, though the electoral environment

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<sup>11</sup> Additionally, the central role of the state in the economy, and thus as a source of rent, gives politicians considerable incentive to be popular upon leaving office. Now that immediate reelection is possible for executive officers—president, governors, mayors—the incentives are even more powerful.

<sup>12</sup> The Sorbonne Group was the moderate wing of the military government. Its members wanted a brief period of military rule and then a return to democracy. Castelo Branco, its leader, also pursued liberal economic policies and was not threatened by foreign capital. The Hard-Liners (Costa e Silva, Medici) believed that Brazil needed an extended period of military rule. They believed it was necessary for the government to play a fundamental role in production, management and regulation of markets, and they were distrustful of foreign capital. Later, the moderates returned (Geisel and Figueredo) with the intention of a

was suboptimal, from a democratic perspective, the incentives for incumbents to perform were still great, perhaps greater. These incentives should be expected stimulate opportunistic behavior among politicians.

The assumption, specific to the OPBC, that politicians will behave in an opportunistic manner seems consistent with expectations of political behaviors in emerging markets. Politicians must “survive,” to us Ames’s terminology(1987), in whatever environment that they are in. However, political survivability is often more pressing in developing countries. Alesina (1991) identifies three important aspects of emerging market politics that create incentives for politicians to behave opportunistically: high levels of political polarization leads to high levels of uncertainty about the future; when cooperation between politicians is minimal, politicians have short-term horizons; and political polarization leads to delays in stabilization attempts and many failed efforts at stabilization (1991: 41-42). The case of Brazil does not show significant levels of political polarization, but it does demonstrate uncertainty about future policies, short-term political horizons and many delayed and derailed stabilization attempts. As such, it is reasonable to not only expect opportunistic behavior, but to expect a greater degree than might be expected in developed countries where political horizons are less myopic.

The RPC assumes that there are clear and discernable differences in the preferences and policies of politicians on the Right and Left. This tends to be true in developing countries, just as in developed countries. However, although there is a clear and noticeable difference in terms of political preferences, there is not the type of distinction between economic preferences that would be expected in developed countries. The case of Brazil is remarkably illustrative of the tendency in

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slow but genuine process of political opening (*abertura*). They, however, were committed to a heavy government presence in the macroeconomy, although, under Figueredo there was a attempted stabilization program.

many emerging markets to unite domestic industry and labor through nationalist economic policies which are accepted by considerable sectors of the Left and Right<sup>13</sup>.

Due to the confluence of domestic forces which supported import substitution industrialization and state-led growth in developing countries for the better part of this century, at many junctures in the history of many developing countries, both Right and Left have agreed on basic economic preferences such as growth and employment. This was especially the case in Brazil. Part of this can be attributed to the hegemony of the ideology of development (desenvolvimento) (Chaffee: 1998). Part of this can also be attributed to the political economic issues: ISI favored domestic industrialists as well as organized labor. Exporters and unorganized labor, who would have preferred lower levels of inflation, were largely removed from policy-making. Thus, politically connected members of the Right and Left benefited from growth and both contributed to policy-making.

In the case of Brazil, it is also difficult to compare governments of the Right with those of the Left, since there has only been one Leftist government in post-WWII Brazil, and that government was not elected.<sup>14</sup> But this should not discount studying the possibility of a RPC, especially since in many developing countries,<sup>15</sup> as well as in some developed countries,<sup>16</sup> there are long periods of single party dominance. Additionally, from the positions taken by leaders of the Brazilian Left, the tracts designed by their economists, and the programs that they encouraged, it is evident that the Brazilian Left has shared the Brazilian Right's concern with growth, even if it would have pursued different policies.

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<sup>13</sup> Coppedge has an impressive data set that classifies Latin American political party systems according to their ideology (see [www.nd.edu/~mcoppedg/crd/papslaps.htm](http://www.nd.edu/~mcoppedg/crd/papslaps.htm)).

<sup>14</sup> The government in question was that of João Goulart (1961-1964). Goulart was elected vice president and he became president following the resignation of president Jânio Quadros.

<sup>15</sup> Mexico's PRI is the most obvious example, but Venezuela's AD was dominant for much of the time between 1958 and 1992. Joaquín Balaguer, and his PRSC, dominated Dominican politics from 1966-1996, with only a brief 8 years out of office.

<sup>16</sup> The obvious examples are post war Italy and Japan, although single party dominance was considerable, for much of the post WWII period, in countries as diverse as the UK, India, Israel and Greece.

Hegemony of *desenvolvimento* does not invalidate the idea that governments with different ideological positions pursue different policies. Caldas poses that Right and Left in Brazil have both pursued growth with little concern for inflation. However, he argues, one can distinguish governments in Brazil not by Left or Right, but by the economic priorities of particular governments (Caldas, 1999). The assumption is that governments that prioritize inflation, regardless of political ideology, will preside over governments with lower levels of inflation, employment and growth. The reverse should happen with governments that prioritize growth.

This observation is critical, because not all governments of the Right, in the case of Brazil, produce or even aim to produce, the same economic consequences. However, this paper poses that government priorities only partially explain economic outcomes. A better indicator is the degree of government intervention in the macro-economy<sup>17</sup>. Governments that are ideologically liberal—and therefore minimize intervention in the economy—will oversee periods of lower growth, employment and inflation, whereas governments that are more prone to intervene in the economy will preside over periods of higher growth, employment and inflation.

### **Evidence and Tinkering in OECD countries**

Evidence of the incidence of PBCs in developed countries during the post war period is not overwhelming. The most complete empirical studies are only partially supportive of the assumptions of OPBCs and RPCs (Alesina, Roubini, and Cohen 1997; Persson and Tabellini, 2000). Interestingly enough, in developed countries, the correlation between inflation and the Left (RPC) and an increase in inflation following elections (OPBC) is stronger than the correlation between growth and the Left (RPC) and expansionary monetary policy prior to elections (OPBC)<sup>18</sup>. Persson and Tabellini summarize the evidence as follows:

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<sup>17</sup> In order to determine the government's degree of intervention, governments were rated on their use of exchange rate controls, whether they discriminated against foreign capital, significantly regulated the domestic market, whether private production predominated, the degree of openness to trade.

<sup>18</sup> As will be seen, this is the reverse of what is observed in Brazil.

- “Inflation increases shortly after elections; budget deficits tend to be larger during election years; there is also some (not very strong) evidence that monetary policy is more expansionary before elections. On the other hand, real variables, such as growth or unemployment, are not systematically correlated with election dates.
- Output displays a temporary partisan cycle just after elections: on average, newly appointed left-wing governments are associated with expansions, right-wing governments with recession. This cycle tends to occur in the first half of the interelection period and is more pronounced in countries with two-party systems. Inflation displays a permanent partisan cycle: higher inflation is associated with left-wing governments.”<sup>19</sup>

Drazen summarizes the empirical evidence of PBCs arguing “there is some econometric evidence of opportunistic behavior in policy instruments, especially in fiscal transfers, so that, on the whole, the evidence for opportunistic manipulation of macroeconomic policy is stronger than for macroeconomic outcomes “(2000:239).

The empirical results of policies may be so difficult to detect because economies may not be as easy to manipulate for short-term benefits, without leading to uncontrollable increases in inflation in the medium-term. The presence of manipulation of government transfers, for example, may be visible in the US without a significant corresponding increase in inflation because of an inherent stability of the market and because of real, measurable losses for a politician who increases inflation above the Federal Reserve’s targeted rate. But in developed countries where policy swings are more radical, economic performance is more volatile, and the role of foreign investment is more visible, results may differ.<sup>20</sup>

There is an implicit assumption in the PBC theories and that is that government tinkering can be noticeable. Alesina, Roubini and Cohen write that a government on the Right may be associated with a 1.1 percent decrease in GDP, which is quite significant when considering that the average growth rate of the sample is 3.4 per cent per year (Alesian, Roubini, Cohen, 1997: 152). A decrease in 1 per cent in GDP or inflation would certainly be noticed in developed countries, but the same 1 per cent decrease in emerging markets is unlikely to produced similar dividends (costs). For

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<sup>19</sup> (Persson and Tabellini, 2000: 393).

<sup>20</sup> This volatility is also related to external forces (see Spanakos, unpublished).

a number of structural reasons, politicians need to produce larger shifts in order to receive political advantage.

Growth rates can be moderate and produce noticeable improvements in GDP per capita in developed countries because of low population growth rates and relatively equitable distribution of wealth in developed countries. Politicians can thus reap the benefit of lower levels of growth than might be expected, or even demanded, in developing countries. In developing countries higher population growth rates dilutes the effect of growth on per capita income and a more skewed distribution of wealth creates greater and more pressing social demands. Additionally, the variation of the size of the economically active population is smaller in developed countries, which means that moderate increases in employment will be felt in developed countries. Politicians seeking to raise employment figures in developing countries have to contend with a relatively smaller economically active population, and, thus, increases in employment must be greater in order to be felt.

Emerging markets also differ in that cuts in consumption in developed countries affect disposable income, whereas cuts in developing countries lead to a decrease in the consumption of essential goods (Giambiagi and Além, 2001: 348). This is exacerbated by the distribution of wealth and it provides powerful incentives for politicians to delay cuts in spending and stabilization programs. Thus, politicians in developing countries should avoid the post-election contraction proposed by the standard OPBC. Politicians will, rationally, consider the cost of higher inflation during the electoral year smaller than the cost of contracting growth even if it is during the first two years of the electoral mandate. Politicians should also avoid such contractions because stabilization programs in emerging markets rarely have the requisite political support to be successful, or are relaxed once inflation decreases. The result is a history of unsuccessful programs where the painful adjustments were implemented but the eventual gains—lower inflation, return to growth—were not

visible. In such a context, voters and politicians are rationally very wary of contractionary policies<sup>21</sup>.

The implication of these adjustments is that politicians will be expected to be in a more opportunistic manner and to pursue more expansionary policies than might be expected otherwise. This should show a clear preference for growth and less concern with inflation. This is consistent with expectations based on ideology, since a consensus is expected across Right and Left to support domestic business and labor, and to choose growth over inflation. Only governments that are committed to an economic ideology of liberalism should be expected to deviate from this trend.

It is also expected that the environment of moderate to high inflation supports pro-growth preferences. An important change emerges with hyperinflation in the 1980s and 1990s. In an environment where moderate to high inflation is expected and is normalized, the incentives for stabilization during an electoral year are weak. The incentive structure favors a rapid adjustment during the first year of a government, if at all, consistent with OPBC theory. However, incentives shift with hyperinflation because there are no groups (e.g. organized labor) who are adequately shielded from hyperinflation. A stabilization program prior to an election can have such a significant impact on short term price stability, that even if it reduces growth, the reduction in inflation will increase the purchasing power of the voter.

#### **IV Evidence of PBC and RPC in Brazil**

The expectations presented in the previous section, consistent with the three hypotheses in the introduction, will be tested in this section. As predicted, growth is a very strong indicator for both the OPBC and the RPC, and inflation is less strongly correlated. Also consistent with the predictions, economic ideology was significant, and hyperinflation increased the incidence of pre-election stabilization programs. This last element is not expected by the typical OPBC which

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<sup>21</sup> See also Alesina and Drazen's seminal work on the costs and benefits of delaying stabilization programs (1991).

assumes that contraction will be avoided during the run-up to an election. However, the majority of these plans were heterodox and not orthodox, and so they were not strictly contractionary, and the rate of inflation was so high that the cost of contraction was far smaller than the gain from a radical change in price stability.

### **Evidence of OPBCs and Growth in Brazil**

The evidence of OPBCs in Brazil in the post war period is very strong when growth is used as a dependent variable. In truth, there are only five years (1981, 1983, 1988, 1990, 1992) in which the Brazilian economy did not grow, and there are five more years in which growth was less than 2 per cent (1963, 1982, 1991, 1998, 1999). Of all of these “low-growth” years, only two were elections years, one municipal and one presidential. Additionally—and more important than the number of years of positive growth—there is a clear pattern of OPBCs. The following periods show clear examples of OPBCs where growth is low to moderate at during the first half of the mandate and then accelerates during the second part of the mandate (1951-55, 1956-60, 1965-1968, 1990-1994, 1999-). This is consistent with what the OPBC theory predicts.

During the periods 1961-1964, 1979-1984, and 1985-1989, there are observable OPBCs that begin with a honeymoon phase (growth) before slowing and then growing again. The phase between 1969-1974 was one of consistent growth. Clearly, almost all Brazilian governments were committed to growth. The only examples of IPBCs are 1975-1978 and 1995-1998. Although growth slowed between 1975 and 1978—growth was almost 5 per cent in both 1977 and 1978—the economy was hardly contracting prior to the elections in 1979. The IPBC of 1995-98 will be explained shortly.

Growth is strongly correlated to electoral cycles, as the OPBC theory argues. But, as suggested earlier, the variance in growth is far greater than would be expected in developed markets. This variance is assumed to be necessary in order to make the efforts of the incumbent tangible and, therefore, to maximize political gain.

### **Evidence of RPC and Growth in Brazil**

The RPC, whether the Hibbs or the Alesina version, assumes historical evidence of political Left and Right in office. As mentioned, a comparison between governments on the Left and Right would not be fruitful, due to the paucity of the former. But if one compares the government of Goulart (as an example of a Left leaning government) with the rest of the governments of post war Brazil (all Right leaning) there is no clear and consistent difference in terms of economic preferences nor performance. It can also be hypothesized, because of statements of leaders of the Left, that hypothetical Left leaning governments during this period<sup>22</sup> may have differed in some areas, but they would have shared the same economic preferences. Political ideology does not, and would not, produce any clear differences in Brazil since there was consensus about macroeconomic goals and methods. Economic ideology and economic preferences, however, do produce differences especially in terms of growth. As Caldas predicts, governments that prioritized growth show high levels of average growth (6.25 per cent), while those that prioritized cutting inflation show low levels of growth (3.04 percent). Adjusting the hypothesis to include only the first two years of the government, as Alesina, Roubini and Cohen suggest, is consistent with this prediction. The degree of intervention is also very strongly correlated to growth, a finding that is consistent with growth during the first two years of the mandate as well.

### **PBCs, Inflation and Hyperinflation in Brazil**

Although, average growth rates could be explained by government priorities and by economic ideology, consistent with the RPC, inflation proves a little more difficult to correlate. Average inflation for governments that prioritized inflation was 456.44 per cent, compared to 151.85 per cent for governments that prioritized growth. This is not especially telling, although if

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<sup>22</sup> However, if the period is shortened to 1989 to the present, there may be a difference for a hypothetical Left leaning government. This will be addressed in the final section.

the outlier (the Collor period) is removed, the level of average inflation for governments that prioritized inflation is 17.83 per cent, a very significant difference. Examining the first two years, also corrects the Collor period, because all governments that prioritized inflation witnessed a decrease in inflation during the first two years of their mandates. However, the evidence for inflation during the first two years of pro-growth governments is ambiguous. When looking at degree of intervention, the data indicates a clear correlation between inflation and degree of intervention although the Collor period again is problematic. Again, this is corrected when examining the first two years, but the same ambiguity exists with the first two years of pro-growth governments and inflation.

Similarly, the evidence for OPBCs is strong when considering growth, but it is more difficult to analyze in terms of inflation. The OPBC predicts that politicians should try to curtail inflation during the beginning of their governments, before allowing fiscal and monetary policy to loosen prior to elections. But this assumes that there are natural rates of growth and inflation with which politicians tinker. This may be true of the OECD countries—and again the evidence of both OPBCs and RPCs is stronger for inflation in OECD countries—but this is not the case with emerging markets. The existence of high levels of inflation and even hyperinflation provide a different set of incentives.

There are three clear examples of OPBCs (1956-60, 1974-78, 1985-89) in which inflation is lowered during the first part of the government's mandate before increasing during the latter period. There are two periods where there is a consistent increase in inflation (1961-1964, 1979-1984). As opposed to the periods 1956-60 and 1974-78,<sup>23</sup> the rate of inflation for the base year in the 1961-1964 and 1979-1984 periods in which inflation consistently increased was significantly higher.<sup>24</sup> When inflation was moderate, there were incentives to curb it in the beginning of the mandate and then allow it to grow prior to elections (1956-60 and 1974-78). When inflation was already high

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<sup>23</sup> Note, not 1985-89 which is part of the hyperinflationary period.

(1961-64, 1979-84), the cost for cutting inflation—stabilization and, potentially recession—was considered higher than that of allowing inflation to continue to rise.

The cost for cutting inflation in a highly inflationary environment was considered too high for a popularly elected government because stabilization programs were synonymous with economic contraction, a price that few politicians were willing to pay. There was no serious stabilization plan until the military government PAEG program (1965-68). The military government had certain incentives that were not available to civilian governments. It had a longer time horizon, since it decided when and if it would have elections, and, therefore there was less pressure to produce immediate growth. This was not the case with later military governments who were committed to a regular pattern of elections, in which they needed to compete. The military government was not accountable to any specific partisan group, but more importantly it was (viciously) opposed to populist forces whose demands upon the system had created incentives for inflationary policies. The importance of price stability decreased as annual inflation reached 25 per cent during the PAEG years, and in 1969-73 the government pursued pro-growth strategies. These strategies were highly successful, but they also took place within a context of decreasing inflation. Thus, 1969-73, like 1965-68, represented a period of consistent decrease in inflation.

There are two other periods of consistent drops in inflation (1995-98, 1999-). The first of which was the first and only truly successful stabilization plan in the post war period of Brazilian history. As opposed to moderate inflation, hyperinflation generated significant incentives for politicians to cut inflation. A successful stabilization plan in 1994 became the symbol of the Cardoso government who maintained low inflation throughout his two mandates. Previously, a drop in inflation during an election year may have generated some support, but only within certain constituencies, and there were many political actors who benefited from inflation. Once inflation became hyperinflation, the distortions in the economy were such that even actors who previously

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<sup>24</sup> Inflation in 1961 and 1979 was 43.51 and 67.19 per cent, respectively, compared with 26.46 and 33.05 in 1956 and 1974, respectively.

benefited began to incur high costs, while the costs to society as a whole increased rapidly. The Cardoso economic team inherited an annual inflation rate of 2,490.99 in 1993, and by 1995 that rate had been reduced to 23.17 per cent. The radical reduction was essential for Cardoso's popularity.

There had been other stabilization attempts that had short-term success in cutting inflation, but what differentiated Cardoso's plan was that the Cardoso government was not satisfied with maintaining moderate to high levels of inflation, as was the case of the military government. Additionally, Cardoso's goal of reelection required the success of his economic program, which was the fundamental element of popular support for his policies. Price stability was not only ideologically important to Cardoso, it was politically important, which differentiated Cardoso from all other Brazilian presidents. This explains his commitment to a fixed currency regime during the 1998 election during which the real suffered enormous pressures as investors challenged the government commitment to its band.

This also explains the period 1995-1998 which is an IPBC where, during an electoral year, the government barely grew and there was actually deflation. The OPBC theory would caution against such an IPBC. But the maintenance of low levels of inflation, in truth, deflation, in the face of external pressures—the Russian crisis—was critical. The assumption that Cardoso's economic team could resist inflationary pressures gave the president considerable political support even in the absence of growth, and his maintenance of the currency band can be understood as electoral year politics, even if its goal was to curb inflation rather than to induce growth. After all, MacRae (1977), among others, argues that citizens reward governments where growth and employment are high and inflation is low. The experience with hyperinflation and many failed stabilization plans created a premium on low inflation which, in the 1998 elections, was more important than growth.

Although it was not as successful as the Cardoso governments, the period 1990-94 was one in which there was a president who saw cutting inflation as providing political support. Although the Collor/Itamar period did not see an end to hyperinflation, there was a dramatic drop in inflation during the electoral year of 1994, which produced political capital for the incumbent candidate,

Cardoso. The 1990-94 period can also be considered alongside the 1985-89 period. Although inflation remained high during both periods, and it increased at the end of one (1985-89) and decreased in the other (1990-94), there is a clear pattern of attempting to cut inflation prior to elections. This is best understood by examining the Brazilian experience with stabilization programs, but it is also worth emphasizing again the importance of hyperinflation. Both the Sarney and Collor government's began their governments with stabilization programs with the intention of gaining political support as a result of cutting inflation. Sarney's lack of commitment to price stability and Collor's political woes, made such efforts short-term projects. Nevertheless, hyperinflation produced powerful incentives for stabilization programs in election years.

The use of stabilization programs is illustrative of political manipulation. In the pre-hyperinflation period stabilization programs were implemented during the middle of electoral mandates, but were abandoned prior to elections in order to restore growth. This was the case in the failed stabilization programs of 1957-1959 and 1979-1983. The stabilization program implemented in 1964-1967 did not fail, but it was abandoned once inflation was considered to sufficiently low. Additionally, despite contractionary policies, the government expanded the monetary base considerably prior to the 1965 elections. This timing may be considered consistent with what the OPBC theory expects.

The era of hyperinflation witnessed a different form of political manipulation of stabilization programs. During the 1980s and 1990s, stabilization programs were implemented during electoral years. The cost of lowering growth was not a concern, as it was for politicians in earlier eras, because the level of inflation was so high that a positive shock in terms of price stability would generate considerable support. Stabilization programs were also more political feasible because politicians used heterodox strategies, to minimize the pain of adjustment. Like previous efforts at stabilization, the stabilization programs were short-term programs, but now they were being used to secure electoral support, and instead of being abandoned before elections, they failed or were abandoned shortly after elections. The Cruzado plan is perhaps the clearest example

of a stabilization plan that was developed to provide an electoral surge by cutting inflation and producing growth. This was unsustainable in the long run, but the goal of the Cruzado plan was to improve the government's performance in the elections. It was implemented in March of 1986 and by November inflation began to surge upwards.

The 1987 Bresser Plan, which was launched in July, and the 1990 Collor Plan, implemented in April, also followed this pattern of an immediate and sharp cut in inflation and then a return to high levels of inflation, following elections. The January 1989 Summer Plan, differed in that it was incapable of curbing inflation from its beginning, yet it was also an electoral year concoction. The Real Plan, which began in July 1994, began like other election year stabilization programs, however, the drop in inflation continued after the elections and hyperinflation has been conquered.

The evidence suggests that there is clear pressure for Brazilian politicians to behave opportunistically. The only IPBCs show either moderate growth or a conscious response to end a period of hyperinflation. As predicted earlier, politicians do rationally consider the cost of higher inflation during an election year less significant than the potential gains of higher growth. The only cases which differed involved the beginning of a military government, which was responding to levels of inflation that were considered very high, and governments that operated in a hyperinflationary environment<sup>25</sup>. The evidence also shows that economic priorities and (economic) ideology also are very significant.

### **PBCs in Emerging Market Countries**

Expanding the PBC arguments to emerging markets is important but it does require adjustments: dealing with interrupted democratic governments, the dominance of one political group (Left or Right), and the local rules regarding reelection, and the amount of economic

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<sup>25</sup> This hyperinflationary context also eroded international support, lowered credit ratings of Latin American bond and foreign exchange markets, and effected capital flows. This is not insignificant since the foreign sector in the 1950-1970 period was characterized by US Aid and government investments, whereas capital flows from the early 1970s until today increasingly became predominantly private capital. The difference in the interests and the sources of foreign capital is significant (see Spanakos, unpublished).

performance necessary in order to be “felt” by voters. The political economy of state-led growth facilitated the formation of politically significant members of both Left and Right that favored government intervention. Political ideology becomes less important than the RPC theory predicts, however, economic ideology and the economic priorities of the government prove to be quite salient. Also, unsuccessful experience with adjustment programs and structural conditions give politicians clear incentives for being more concerned about growth than inflation. Given these incentives and short-term horizons, politicians rationally choose opportunistic behavior. Thus, when adjusted to meet the realities of emerging markets, OPBCs and RPCs can be excellent explanatory tools.

A critical addition to PBC theories is that of the importance of hyperinflation. Moderate levels of inflation in the period prior to the 1980s, gave civilian politicians little incentive to cut inflation. There is, in fact, a tremendous disincentive since the advantage of cutting inflation from 25 to 20 per cent is far less than the cost of growth sliding from 5 to 1 per cent. In a country that has witnessed more growth in the last century than any other country in the world, with the exception of Japan, the stigma associated with recession is especially pronounced. Anti-inflationary policies may be successful in the short-term but are notoriously unsuccessful in the long run. Thus, cutting inflation during the first year of a mandate may lead to disastrous political results. Finally, an added disincentive is the association that inflation cutting programs have with IMF programs which are generally unpopular and which weaken the political capital of the president who “accepts” the terms of the international financial community. This also explains the incentives to break with stabilization programs, the most clear example being when Kubitschek “broke” with the IMF.

Hyperinflation changes the incentive structure for politicians by giving incentives for politicians to implement inflation cutting programs prior to elections since there cutting inflation from an annualized 2,000 per cent to an annualized 50 per cent, generates significant support. However, lack of popular support for orthodox programs and fear of the length of a recession that may result from the program gives presidents weak incentives to pursue anti-inflationary policies

beyond elections. The programs are generally implemented shortly before the elections so that results will be visible prior to the elections, but following the election the cost of continuing to maintain anti-inflationary policies rises significantly, especially as the choice between growth and inflation becomes more zero-sum.

High levels of inflation and hyperinflation, therefore, effect models of OPBC and RPC in emerging markets. Given high levels of inflation and hyperinflation, politicians tend to behave opportunistically, by avoiding anti-inflationary policies or by producing election year stabilization plans. However, economic ideology also plays a role as the only governments three of the four governments that have been successful in reducing inflation during the first two years of their mandate were governments that pursued liberal economic policies.

### **Post-1989 RPC alignment?**

The hegemony of the *desenvolvimento* ideology was fundamental for support among the Right and Left of state intervention in the Brazilian economy. Nevertheless, the consensus over state-led growth began to unravel during the 1980s and 1990s. Since 1989, trade liberalization has been significant in Brazil, and every government since 1990 has adopted pursued liberal economic policies, although not “purely” liberal. As a result, the government coalition has been associated with liberalism, while much of the opposition, has been associated with structural critiques of liberalism. Namely, since 1989, the center-right government coalitions have adopted liberalism, to some degree, while left of center parties have been critical and have favored an increased state intervention in the economy.

RPC theory suggests that economic liberalism should be accepted by the Right, while the Left should prefer intervention. In Brazil, the Left has indeed adopted intervention, consistent with its position throughout the century. The Right, in Brazil, however, is fragmented between economic nationalists and liberals and prior to stabilization, the association of Right and Left with any

economic ideology would be difficult. Additionally, liberalism has been adopted by the political center (PSDB and PMDB) not simply the Right (PFL).

Since 1989, and certainly since 1994, the Right and Left are adopting what would be expected by the RPC. The last three elections have posed anti-liberal candidates from the Left (Lula, principally, but also Brizola and Ciro Gomes) against pro-liberal candidates from the Center (Cardoso) and the Right (Collor). It is significant that the Center has also adopted liberalism—a moderated form—and that this Center is expanding. Now that there is stabilization, the Center has expanded and the rate of inflation is low and controlled, it is expected that evidence of RPCs may become more visible. Of course, this will only be tested in further elections, particularly the elections of 2002.

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