FACULTY
OF ECONOMICS

Chapters in Economic Policy – Supplementary Materials

Set No. 1

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Content

1. Limits of Economic Policy
2. Market Failures
3. Government Failures
4. Political Business and Budget Cycles

Limits of Economic Policy

Part I

Economic Policy Limits

- **The possibilities of economic policy holders are limited by many factors that determine the success of EP measures**

- It is possible to distinguish four basic types of limits that are inherently present at each stage of economic policy planning and decision-making

- **These limits include:**
  1. **Uncertainty and risk**
  2. **Limits of trust**
  3. **Information limits**
  4. **Conflicts of interests**

1. Uncertainty and Risk

- **Decisions on the setting of economic policy instruments are ideally derived from the long-term development of relevant quantitative indicators, taking into account the current context of the economic situation**

- **However, even the best econometric instruments do not allow a precise assessment of the results and impacts of a given economic policy decision**
  - Thus, policy makers always face the risk that the measures envisaged are constructed on the basis of past experience and data that are not fully transferable to the current situation

1. Uncertainty and Risk

- **Uncertainty about the appropriate choice and setting of a given economic policy instrument stemming from limited (often only estimated) information and incomplete data**
- **Every decision, whether private, corporate or government, is exposed to some degree of uncertainty about the end result – i.e. risk**
  - In the case of economic policy, this risk is particularly high, as many economic policy measures affect a large part of the national economy and thus affect many individuals and companies

1. Uncertainty and Risk

- **Together, uncertainty, risk and limited knowledge of transmission mechanisms in the national economy constitute serious limits to the effective performance of economic policy**
- **Many erroneous decisions were made because governments did not take sufficient account of the risks and irreversible nature of economic measures**
- **In particular on serious economic policy issues, it is appropriate to follow the 'precautionary approach' where the government does not implement an economic measure until it has sufficient relevant information to enable it to make a qualified decision**
  - In doing so, the economic policy-maker minimizes the risk of making a wrong decision, which may also be irreversible

Economic Policy and Expectations

- **Connected to the previous point**
- The existence of expectations is one of the limits of conventional economic policy approaches
- **Expectations are one of the most important factors affecting the development of macroeconomic variables**
  - **Examples:**
    - GDP: investment expectations – optimism -> economic expansion
    - Inertia of the inflation rate – inflation acceleration

- **Two basic ways of forming economic expectations**
  1. **Adaptive expectations**
  2. **Rational expectations**

Adaptive Expectations

- **Entities create expectations based only on past experience**
  - Mostly individuals, small businesses

- **The simplest case**

$$X_t^e = X_{t-1}$$

- **Other, slightly more sophisticated case:**

$$X_t^e = \lambda_1 X_{t-1} + \lambda_2 X_{t-2} + \lambda_3 X_{t-3} + \dots$$

Rational Expectations

- **Subjects take into account past experience, present and future**
  - **I.e. all available information**
  - **Subjects behave rationally -> it is costly not to behave like that**
- **Their predictions may not be correct, but on average they are**
- **There are no systematic errors**
- **-> Theory of rational expectations**
  - **New Classical Macroeconomics**
  - **New Keynesian Economics**
- The case of mostly large companies, financial markets

Economic Policy and Expectations

- **The potential existence of fully rational expectations (per se) in the economy significantly worsens (in some situations, completely excludes) the application of a stabilization policy in the Keynesian sense**
  - Because the policy only leads to an acceleration of inflation and does not lead to a sustained increase in output

2. Limits of Trust

- **Confidence that the government (or economic policymakers) will adhere to what they are committed to are key to the effective pursuit of economic policy objectives**

- In reality, this confidence is determined by several factors which are present in varying degrees of intensity in every economic policy decision-making:
  1. **Credibility of the commitment**
  2. **Moral hazard**
  3. **Time inconsistency**

Credibility of The Commitment

- **The economic policy holder's commitment is credible if the policyholder behaves and proceeds as promised and advised**
  - **Breach of this commitment results in government decisions being unreliable, thereby undermining consistency and successful implementation of economic policy**
- **In addition, if the economic policymaker's commitment is non-credible, the expectations of economic agents change**
  - **Example: central bank and inflation targeting**
    - Central bank may lose its reputation
      - Which is one of the monetary transmission mechanisms

Moral Hazard

- **A situation in which an individuals (or group) know that they will not bear the full cost of their actions and behave differently (typically more risky) than if they actually carried the full costs**
  - E.g. moral hazard is well known in the insurance industry
    - Those who are insured against a certain category of risk tend to be more exposed to risk

- **Pelzman effect (1975 – The Effects of Automobile Safety Regulation)**
  - Consequences of the mandatory use of safety belts on US roads

Moral Hazard

- **Pelzman effect (1975 – The Effects of Automobile Safety Regulation) – continued**
  - Contrary to the general expectation that the use of belts will lead to a reduction in the number of accidents, Pelzman came to the opposite conclusion
  - **The number of road accidents increased as drivers drove less cautiously and at higher speeds because of the feeling of greater safety provided by the (mandatory) attachment**
  - **The term Pelzman effect is used to describe a situation where a well-thought-out effort (regulation) degenerates and has counterproductive results**
    - Economic policy is no exception and it also has to deal with the risk of moral hazard in implementing its measures

Moral Hazard

- **Examples of moral hazard relevant to economic policy**
  - **Compulsory deposit insurance in banks (25 000 EUR)**
    - -> it demotivates clients of financial institutions to be interested in the financial soundness of their bank, as clients know that their deposits are bankrupt insured (it reduces clients' interest in the capital stability)
  - **Bail-ins – saving large institutions (banks) – "too big to fail"**
    - These banks are more motivated to make more risky transactions
    - -> another counterproductive results (financial instability)

Time Inconsistency

- **Time or dynamic inconsistency of economic policy**
- **= Certain decisions are optimal ex-ante, but not optimal ex post**
  - Economic policymakers (e.g. the government) are tempted to deviate from their original plans and rules in the future

- **Time-inconsistent behaviour is tempting for central authorities due to possible short-term positive effects**
  - **In the long run, however, such behaviour has negative effects**
  - Uncertainty, loss of confidence of economic agents, creating distrust, possibly contradictory economic effects

Time Inconsistency

- **Examples:**
  1. **Protection of industrial property (patents, licenses, industrial designs)**
     - **Ex-ante (period 1):** protecting this property in order to motivate economic actors to innovate
       (innovation = key to long-term economic growth)
     - **Ex-post (period 2):** violation of the protection – in order to make the objects of protection (or inventions) accessible to a wide range of subjects and to ensure greater social benefit from the invention
     - **-> Destimulating innovative activity – uncertainty, loss of confidence of economic agents, creating distrust, etc.**

Time Inconsistency

- **Examples:**
  2. **Monetary policy – economic stimulus**
     - The central bank will abandon the price stability target in exchange for reaching other short-term targets (e.g. GDP and employment growth)
     - **=> inflation "surprise", fixation of higher inflation expectations, acceleration of inflation**

- **Costs are always the same: uncertainty, loss of confidence of economic agents, creating distrust; -> lower GDP growth, opposite economic effects**

3. Information Limits

- **No economic policy bearer (unlike model examples) is omniscient and does not have all the necessary information at the time of decision-making**
- **Information asymmetry**
  - One of the basic issues of economic policymaking
  - **The situation when an individual or a group has information that is not (easily and cheaply) available to others**
    - **-> One group or individual has an information advantage over other economic entities**
  - Even more pronounced in the environment of modern and technologically advanced economies (abundance of information)

3. Information Limits

- **The aim of the economic policy-maker is therefore not to obtain all available information, but only that which is relevant to the type of economic decision-making**
- The issue concerns also private sector, not only public sector
- **Principal-agent problem**
  - Principal owns an asset (e.g. a company or real estate) and hires an agent to manage it
  - The agent (manager) has much better information about the asset than the principal in that case (day-to-day management)
  - **The agent may exploit the advantage to his benefit if he is not properly motivated and monitored**
  - Possible solution: contractual relationship (salary x company stocks)
    - But even this is always problematic

3. Information Limits

- **Economic policy**
  - **Motivate economic operators to publish information that is important for economic policy management**
  - **Remuneration or promotion on the basis of performance criteria serves as a possible tool to overcome information limits, not only in the public sphere**

4. Conflicts of Interests

- **Economic policymakers should ideally pursue the general interest of the society**
  - Government (or politics it implements) should be an instrument of the will of the people
- **However, government may prefer their own particular interests that do not correspond to maximizing social welfare (general interest)**

4. Conflicts of Interests

- **Reasons for following other interests:**
  1. **Maximisation of (election) votes**
     - Unpopular (usually long-run) policies are harmful to the goal
       - For example, a pension reform
     - Re-election efforts and the political cycle, their holders try to maintain a (parliamentary) majority and also adapt their policies to this goal
     - -> loss of credibility, problem of moral hazard, time inconsistency

4. Conflicts of Interests

- **Reasons for following other interests (continued):**
  2. **Length of the political mandate vs effectiveness lag of EP measures**
     - Some economic policy measures are inherently long-term, and therefore the government may not have the incentive to invest its political capital in them
     - Positive effects of the changes will not be reflected in the next elections
     - Example: education policy

4. Conflicts of Interests

- **Reasons for following other interests (continued):**
  3. **Influence of interest groups on economic policymakers**
     - Interest groups can influence government members to adopt economic policy that favours a given particular interest – which may be in contradiction to the general interest of the society
     - Strong involvement of interest groups in EP greatly reduces the credibility of the government, often accompanied by corruption and loss of effectiveness in the pursuit of economic policies

4. Conflicts of Interests

— **Reasons for following other interests (continued):**

4. **Political party's ideology**
    — A government with a strong ideological base (one party) can enforce policies that have support of "their" voters but polarise the rest of society

5. **Coalition compromises**
    — A coalition made up of ideologically different political parties
    — -> compromise is needed + many topics that target many different votes are being addressed
    — -> increasing the size of public budgets, deficits and overall debt

4. Conflicts of Interests

- **Reasons for following other interests (continued):**
  6. **Societal compromises – polarised society**
     - The same logic as in the previous case
     - -> compromise is needed + many topics that target many different votes are being addressed
     - -> difficult to pursue long-term consistent EP

Market Failures

Part II

Two Basic Policy Approaches

1. **Maximising free market**
   - Idealized liberal (perfectly competitive) world assumptions
   - Automatic balancing mechanisms, perfect market cleaning (supply x demand balancing), wage flexibility and other variables
     - The market itself ensures optimum with its invisible hand
   - They see the role of the state primarily in enabling the market to function effectively – i.e. establishing an institutional framework (rules of the game) and defining and effectively enforcing property rights

Two Basic Policy Approaches

1. **Maximising free market – continued**
   - **This approach draws attention to the so-called government failure**

   - **Liberal supporters believe that the outcome of a market failure is more effective than the situation where government intervenes and seeks to remedy the failure through regulations (government failures)**
     - Others argue that the state should intervene in the event of a market failure and regulate (the next slide)

Two Basic Policy Approaches

2. Great emphasis on the role of government and interventions

- They put much more importance to market rigidities (e.g. downward wage rigidity – deflation problem)
- They reject the perfect self-cleaning of the markets
- Emphasis on stimulating aggregate demand through interventions by government, central bank and other institutions
- They strongly support redistribution processes
- **This approach draws attention to the so-called market failure**
- **However ,this approach is based on the assumption of a perfectly functioning, informed and effective government - the principle of an "enlightened ruler" that eliminates market failure at minimal cost**

Two Basic Policy Approaches

2. Great emphasis on the role of government and interventions – continued

— J.M. Keynes is considered to be the father of the economic policy when understood as a science

— F.D. Roosevelt is considered the first de facto implementer of the interventionist-oriented EP (New Deal)

Typology of Market Failures

1. **Imperfect competition**
2. **Existence of externalities**
3. **Existence of public goods**
4. **Other market imperfections**
   - Asymmetric information

1. Imperfect Competition

- **A market where at least one condition of a perfect market is not met**
  - Large number of sellers and buyers
  - Homogeneous product
  - Zero barriers to entry
  - Free access to information and technology
  - Existence of economies of scale

1. Imperfect Competition

- **The main feature of imperfect competition is that the seller or buyer can somehow influence the price**
  - **This market failure leads to price increases above cost and to consumer purchases below effective levels**
    - E.g. realisation of monopoly profit (long-term economic profit is not zero)
    - High price and low output are a signs of inefficiency linked to imperfect competition

1. Imperfect Competition

- **In an environment of imperfect competition, we encounter three types of market structures:**

1. **Monopolistic competition**

2. **Monopoly**
   - Production inefficient (higher costs than in perfect competition)
   - Dynamically inefficient (weaker incentives to innovate)
   - X-inefficient (pressures on organizational change are again weaker than in perfect competition)
   - **Baumol‘s Contestable Market Theory**

3. **Oligopoly**

1. Imperfect Competition

- **However, imperfections are sometimes due to territorial dispersion or heterogeneous products, this brings benefits to consumers (e.g. lower transport costs, more varied products, etc.) and therefore comparing the efficiency of imperfect markets makes no sense in these cases**
- **Monopoly power may be addressed by microeconomic policy**
  - **Setting prices or rate of return on capital approaching the level of a perfectly competitive market (direct approach)**
  - **Protecting competition (both direct and indirect approach)**
    - Keeping low barriers to entry
    - Breaking a monopoly, etc.
- **However, elimination of monopoly power can be often very questionable – the existence of government failures**

2. Externalities

- **Externality = any activity that affects someone else's well-being by involuntarily bearing costs or profits**
  - Externalities (spillover effects) arise when firms or people incur costs or profits to others without being compensated by the market
- **External costs (negative externalities) or external benefits (positive externalities)**
  - **The distinction depends on the point of view:**
    - E.g. throwing food remains into a pond is a positive externality for fishermen (fatter fish), but for swimmers negative (pond pollution)

2. Externalities

- **Externalities arise as a result of "failure of the law" (social order) – as a result of vague ownership rights or high transaction costs for their enforcement**

- **We distinguish two types of costs – social and private costs**
  - Social include all the effects of one's activities on society
  - Private costs: easier to quantify, concerning one entity

2. Externalities

- **Negative externality:**
  - A factory that not only pollutes the air by burning coal, but also pollutes the river by discharging waste products
- **Positive externality:**
  - A classic textbook example: when beekeeper moves to neighbourhood with an apple orchard
    - Due to the intensive drilling of apple blossoms, the orchard grows the number of apples harvested
    - If the planter refuses to compensate the beekeeper, there is a positive externality

3. Public Goods

— **Their existence is considered to be a market failure due to two basic characteristics of these goods:**

1. **Non-excludability from consumption**
2. **Non-rivalry**

	Excludable	Non-Excludable
Rival	Private Goods "Typical Goods" (Clothes, Food, Flowers, etc.)	Common Goods "Common Pool Resources" (Mines, Fisheries, Forests, etc.)
Non-Rival	Club Goods "Artificially Scarce Goods" (Cable TV, Private Parks, Cinemas, etc.)	Public Goods "Collective Goods" (Air, News, Sunshine, etc.)

Source: Wikimedia Commons (2020): https://commons.wikimedia.org/wiki/File:Features_of_goods.jpg

3. Public Goods

- **Issue of black passenger**
  - Black passenger = a person who is a member of a social group and uses its goods and services without paying for them or participating in their creation
- **For these reasons, there is inaccurate information about consumer preferences --> erroneous decisions by firms in terms of production quantity and structure are made**
- **Again, all 3 types of inefficiency are produced here**

3. Public Goods

- **Economic policy relevance**
- When producing public goods, the state has two options:
  1. **Take over the production itself (e.g. national defense)**
  2. **Allow the provision of public goods to private companies (e.g. public lighting with advertisements)**
- However, non-market of government failures arise in both cases

4. Other Market Imperfections

- **Situations where prices (goods, services, wages, interest) or information (their asymmetry and mobility) differ from the situation in conditions of perfect competition**
- **Asymmetric information**
- **= One side/entity in an economic relationship has better information than the other**
  - E.g. sellers are better informed about the product than buyers
  - Or managers are better informed than business owners themselves (principal-agent problem)
- **Some economists consider the existence of asymmetric information to be the cause of market failure**
  - They can be the cause of unfavourable selection or moral hazard and hinder the allocation efficiency

4. Other Market Imperfections

- **Moral hazard**
  - Arises when someone uses asymmetric information to their advantage at the expense of others, encourages risky behavior and changes the likelihood of loss

- **Unfavourable/adverse selection**
  - A situation in which the customer expects moral hazard from the seller and responds with a behaviour known as unfavorable selection
  - If the customer is aware that he/she cannot recognize the product quality, he / she will automatically **expect a lower product quality from the seller and is therefore willing to pay only a lower price** – sellers are therefore further motivated to offer only lower quality products for the price

4. Other Market Imperfections

- **Unfavourable/adverse selection – continued**
  - **Lower quality → lowering the average quality and price customers are willing to pay, gradually pushing better products out of the market and decreasing quality**

- **The imperfections occur both in the private and public sectors**
  - **However, the scale of the problem is greater in the public sector**
    - Bureuacrat x politician x voter

- **They cause, again, all the types of inefficiencies**

Government Failures

Part III

Government Failure

- **Some authors distinguish between non-market and government failure**
  - Non-market failure, unlike government failure, concerns the microsphere
  - **However, we will not do so**

- **Government failures began to appear for discussion in the late 1970s**
  - After the failure of Keynesian-oriented economic policy
  - **It was the contribution of the public choice theory which pointed out that the government was not "perfect" and there was no "enlightened ruler"**

Government Failure

- **The necessity of government intervention in the natural development of the economy is justified by market failure.**
- **However, market failure does not always justify the government intervention**
  - **The consequences of government intervention are sometimes worse than if the situation they are addressing by the intervention remains unresolved by the government = government failure**

Government Failure

- **The failure is present in any microeconomic and macroeconomic policy of the state**
- **It occurs:**

1. **In a situation where the state tends to produce at unnecessary costs**
   - Originally market things are turned into administrative by state intervention and its regulation
2. **Because of the separation of income from costs/production**
   - When there is a tendency to maximise government budget and the effort to minimise costs is small – it is better to justify an increase (populism, elections)

Typology of Government Failures

- **Government failures include:**
  1. **Interests and abilities of politicians and bureaucracy**
     A. Underutilisation of political capital and shallow relationship of politicians to economic theory and practice
     B. Limited control of bureaucratic apparatus
     C. Limited control of private sector responses/effects
  2. **Time delays in economic policy**
  3. **Problem of political business and budget cycles**
     - Political cycles vs business cycles

1. Interests and Abilities of Politicians and Bureaucracy

A. Underutilisation of political capital and the relationship of politicians to economic theory and practice

- Government failure in the form of non-realization of optimal EP can take two forms:

  1. **Motivation mismatch**
     - Politician is maximising election votes -> political agenda and goals
     - Politicians can also take advantage of the voters' rational ignorance
  2. **Professional disability**
     - Obtaining some knowledge requires costs which are sometimes higher than the gains from the acquired knowledge

1. Interests and Abilities of Politicians and Bureaucracy

A. Underutilisation of political capital and the relationship of politicians to economic theory and practice

- **Underutilisation of political capital**
- Political capital means the possibility of a newly elected government to implement unpopular measures without major social consequences and social tensions, since it is not explicitly required of measurable economic results
- **The under-utilization of this capital is considered to be a government failure, especially at the beginning of the transformation period**
  - **Later, these necessary reforms may not take place or costs will be significantly higher**

1. Interests and Abilities of Politicians and Bureaucracy

A. Underutilisation of political capital and the relationship of politicians to economic theory and practice

- **Relationship of politicians to economic theory and practice**
- Government failure can occur when politicians have a disproportionate approach to economic theory and practice

I. If theoretical approach prevails

- -> It can have a positive effect on the creation of an economic order (institutions)
- -> But persistent adherence to the proclaimed principles and practices of untested instruments can lead to improperly implemented economic policy

II. If practical approach to EP prevails

- The institutional framework is relatively difficult to create
- -> Politicians are influenced by various interest groups

1. Interests and Abilities of Politicians and Bureaucracy

B. Limited control of bureaucratic apparatus

- **Another possible motivation mismatch**
- Bureaucracy maximises its benefits/utility (power, status, prestige, budget, income, etc.)
  - They can employ more people, have more influence and demand higher salaries; the larger the office, the worse it can be
  - If both the budget and the bureaucratic output is be greater than the optimum
    - -> marginal revenues of the service provided will be less than marginal costs
    - -> draining the consumer surplus and generating a surplus of labour and capital resources

1. Interests and Abilities of Politicians and Bureaucracy

C. Limited control of private sector responses/effects

- Government has some idea of what changes will happen in society based on government steps / decisions
- **But people sometimes act differently than politicians expect**
- **The government has limited influence on the consequences of its decisions**
- **Examples:**
  - **Crowding-out effect**
  - **Tax rate(s) increase**

1. Interests and Abilities of Politicians and Bureaucracy

C. Limited control of private sector responses/effects

- **Rent-seeking**
  - This issue concerns mainly interest groups which seek to use the political process to transfer wealth to their advantage and gain a privileged position on the market
  - Government intervention may bring the benefits for them (e.g. regulation, licensing, securing a permanent monopoly)
  - **The rent is then the difference in income without regulation and with regulation**
    - České dráhy is/used to be the example of such monopoly

2. Time Delays in Economic Policy

- **We consider time delays to be a government failure mainly because of inefficiency, which arises from the mismatch of the moment when change is necessary and when it actually occurs**
- **For example, if delays are significant:**
  - Negative externalities (e.g. environmental pollution) may deepen
  - Positive externalities may disappear
  - Or the business cycle may be adversely affected

2. Time Delays in Economic Policy

- **Time delays and phases of economic-political decision-making**
  - **Each economic policy decision (and its effects) consists of several phases and each phase is accompanied by a certain time delay**

1. **Internal time delays = government can directly influence them**
   - A. **Problem diagnosis – diagnostic phase and recognition lag**
     - Identification of economic problem (which is possibly growing) that requires a solution
     - Recognition lag = the collection of the necessary macroeconomic information is done through statistical surveys

2. Time Delays in Economic Policy

1. Internal time delays (continued)

B. Planning phase and planning lag

- The government must plan what approaches it will take to correct the problem
- It must identify all possible solutions to the problem and focus only on those that are consistent with the advocated economic policy concept

C. Decision phase and administrative lag

- Government will choose which specific measures and which tools will be used to eliminate the problem
- The decision may differ from the government's original ideas, depending on how it convinced Parliament, coalition partners, large social groups, supranational institutions, etc.

2. Time Delays in Economic Policy

2. **External time delays =** outside the government's control; mainly associated with the business sector

   A. Decision phase and decision-making lag

   — Economic entities (businesses and households) they become familiar with the content of government decisions and estimate how this will affect their activities

   — Larger businesses can also prepare short-term forecasts, etc.

   B. Implementation phase and production lag

   — Then, the business management decides on the final response to the government measures

   — E.g. decision to reorganize production, shut down some operations, etc.

Public vs Private Sector

- **Indices of economic freedom**
  - Higher freedom -> higher economic growth
  - Strong correlation and even causality to some extent

- **Heritage Foundation**
  - https://www.heritage.org/index/

- **Fraser Institute**
  - https://www.fraserinstitute.org/studies/economic-freedom

Economic Freedom

2020 (2019) – Heritage Foundation

Top 10 Countries

RANK	COUNTRY	OVERALL	CHANGE
1	Singapore	89.4	0.0 —
2	Hong Kong	89.1	-1.1 ↓
3	New Zealand	84.1	-0.3 ↓
4	Australia	82.6	1.7 ↑
5	Switzerland	82.0	0.1 ↑
6	Ireland	80.9	0.4 ↑
7	United Kingdom	79.3	0.4 ↑
8	Denmark	78.3	1.6 ↑
9	Canada	78.2	0.5 ↑
10	Estonia	77.7	1.1 ↑

2019 (2018) – Fraser Institute

OVERALL RANK	COUNTRY NAME	YEAR	OVERALL SCORE
1	Hong Kong SAR, China	2018	8.94
2	Singapore	2018	8.65
3	New Zealand	2018	8.53
4	Switzerland	2018	8.43
5	Australia	2018	8.23
6	United States	2018	8.22
7	Mauritius	2018	8.21
8	Georgia	2018	8.18
9	Canada	2018	8.17
10	Ireland	2018	8.13

Data sources: HF, FI (2020)
https://www.heritage.org/index/
https://www.fraserinstitute.org/studies/economic-freedom

Political Business and Budget Cycles

Part IV

3. Political Business Cycles

- **Political cycle**
  - Usually lasts for 4 years and represents cyclical changes in the size of the government's popularity during the parliamentary term and the related adaptation of "popular" and "unpopular" measures during that period
  - **It is based on the idea that the government (politicians) acts rationally and takes unpopular measures only after the elections; while implementing an "appealing" policy before the elections to maximize voter votes**
    - **-> this affects the business cycle (e.g. higher spending = economic boost)**

3. Political Business Cycles

- **Business cycle**
  - Refer to the basic macroeconomics course

--> The political and business cycle mismatch (PBC) results in a failure of economic policy

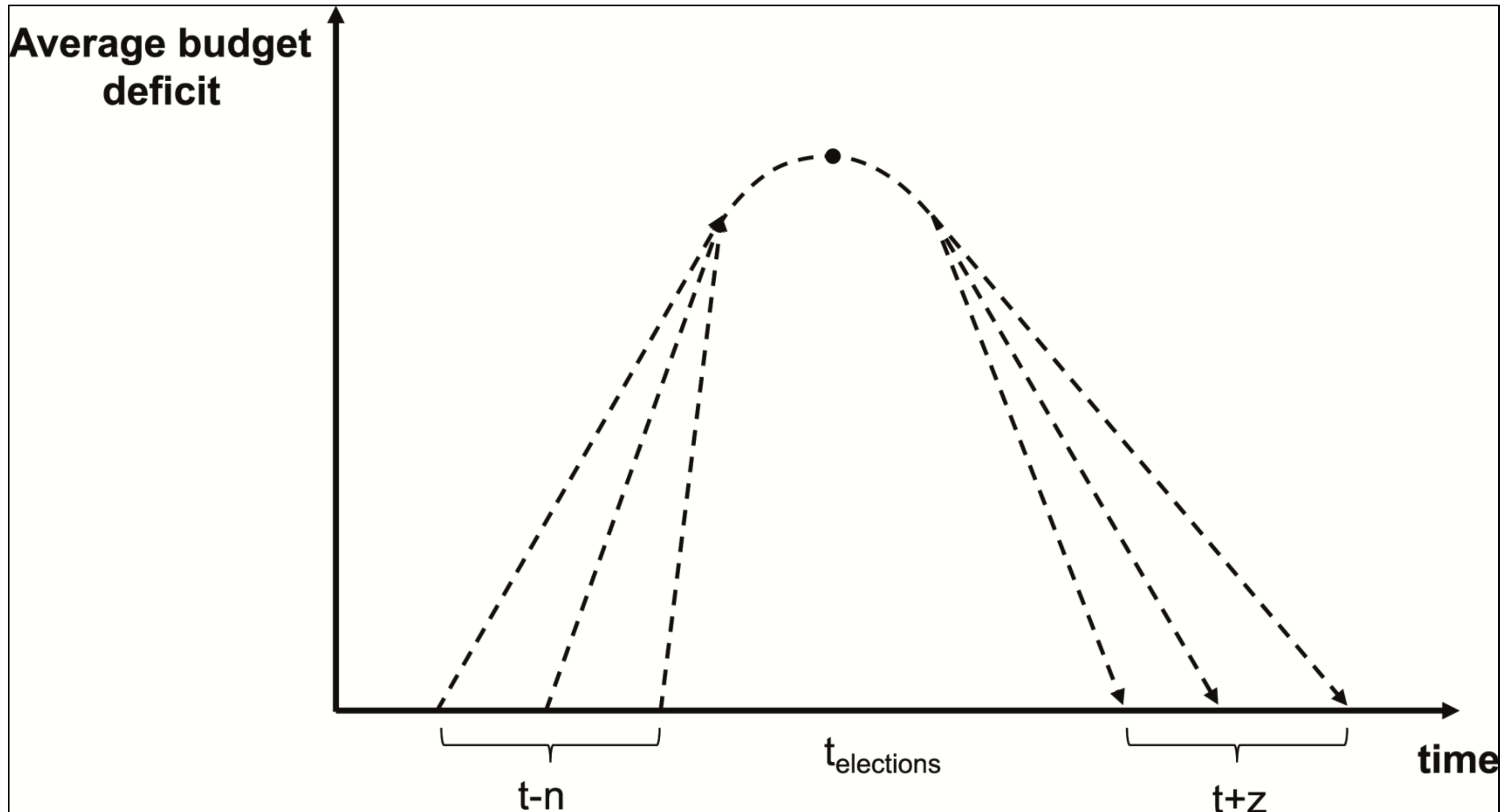
- **The two may be in line – for example, before the elections, the economy is in a recession and needs recovery (and vice versa), then government failure does not occur**
  - However, this situation is usually an exception

3. Political Business Cycles

- **Naturally, the strong assumption that governments directly affect the key macroeconomic variables was relaxed in many papers and economists started working with budget balances** -> **Political Budget Cycles**

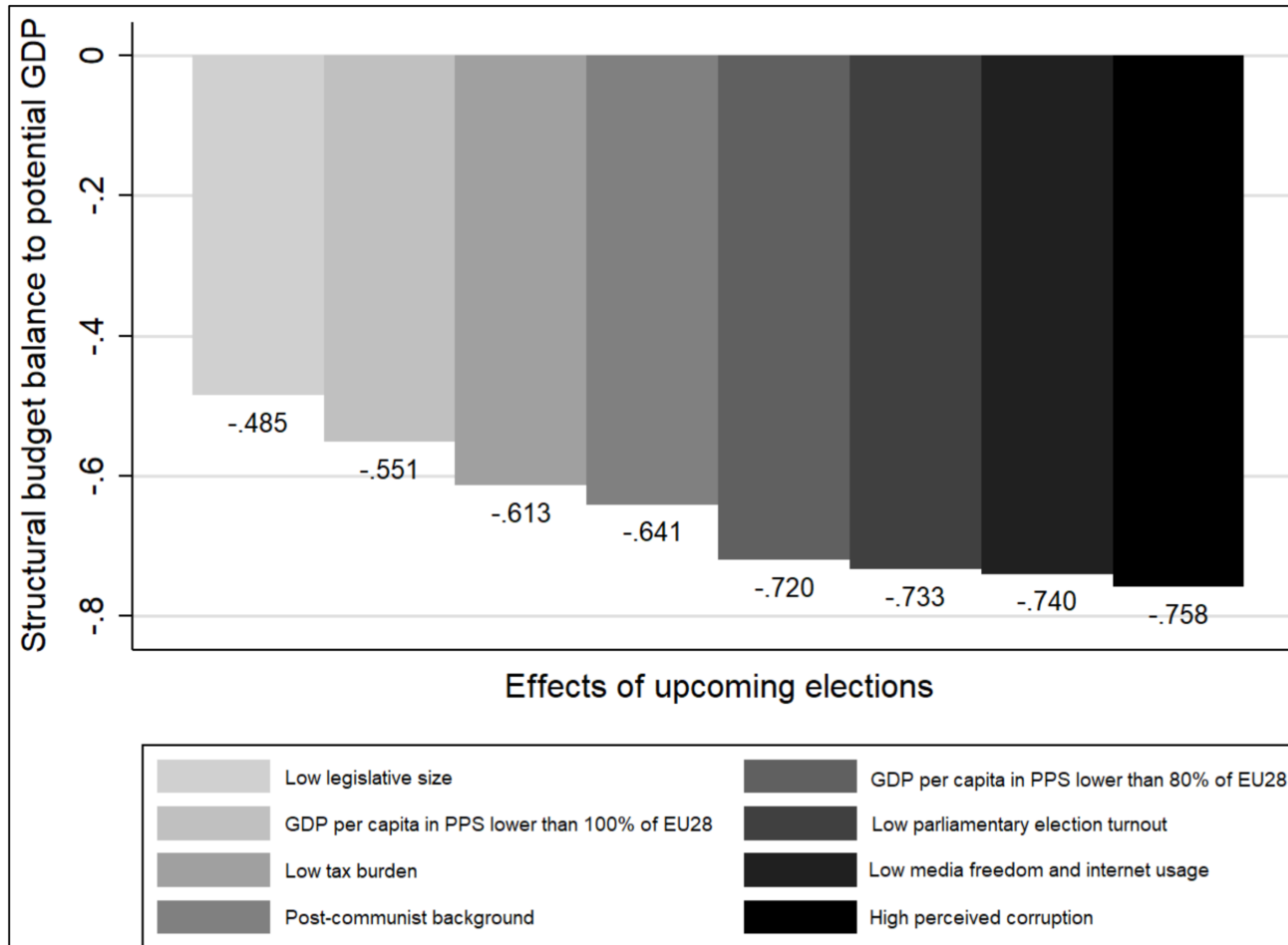
- **-> It consists of the efforts of politicians to influence the election result through the government budget (i.e. expansionary policy)**
  - **This means that before the elections taxes are reduced or social expenditures are increased**
    - **And after the elections the reverse process takes place**

Political Budget Cycle



Source: Bednář (2019): https://akjournals.com/view/journals/032/69/4/article-p523.xml

Research of Bednář (2019)



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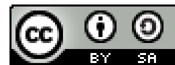
Operační program Výzkum, vývoj a vzdělávání

Národohospodářská fakulta VŠE v Praze



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