Summary of Doctoral (PhD) Dissertation

POLITICAL BUDGET CYCLES

Fiscal cycle effects in the state expenditures in new democracies – comparative analysis of Hungary and Poland

Ágnes HALÁSZ

Supervisor: Dr. habil. István BENCZES

UNIVERSITY OF DEBRECEN
Doctoral School of Economics
„*Competitiveness, Globalisation and Regionalism*” Doctoral Programme

Debrecen, 2014

Table of contents

1. Acknowledgements

I would like to express my gratitude to all those people who have been involved in my PhD studies in several ways. Many warm thanks goes to my Mother and Sister, who always helped and encouraged me on my way, stood by my side and were patient as well as supportive with me in the periods of difficulties as well.

My warm thanks goes to three persons without whom I would not have been able to accomplish this dissertation. First of all, my sincere thanks go to my supervisor, István Benczes, I am absolutely convinced that without his support and encouragement I would not have been able to fulfill my purpose. I would also like to thank István Mustó, who persistently encouraged and advised me and whose infinitely friendly supportive personality gave me so much strength on my way. Finally, I thank my previous supervisor, László Csaba who helped me to find *my puzzle*.

Furthermore, my thanks go to my fellow PhD student and friend Ágnes Orosz, as well as István Horváth, Mónika Kotschyné Kiszely and Anna Marosi.

2. Research antecedents and motivation of the dissertation

The political economy of budget deficit and state indebtedness comprises extensive literature. Different economic schools find various factors and reasons behind the deficit. Explanation of the classical theory builds on the Wagner law, whilst the public choice school, hallmarked by James, finds fiscal illusion determinant. The Keynesian models focus on the role of automatic stabilizers, while Robert Barro explains the budget deficit with the tax smoothing theory based on neoclassical economics. The new political economy called for the widening of the mainstream and emphasised the necessity of including political and institutional constraints into the analysis of fiscal policy [Benczes – Kutasi, 2010:180]. New political economy explains the deficit bias of politicians inter alia with the budget deficit as a result of cycles created by policymakers [Benczes-Kutasi, 2010:217]. The phenomenon is well known as political budget cycles (PBC) in the economics following the research of Kenneth Rogoff and Anne Sibert [1988, 1990].

The relevance of the topic is largely driven by the heterogeneous empirical results. This is further strengthened by the fact, that while in some countries (e.g. Hungary) it became trivial in common knowledge that at election times politicians pursue fiscal policy preferring voters, this process has not generally been proved in economic literature either theoretically or empirically. Taking this into consideration, the PhD thesis aims to test the empirical realization of the controversial theories competing with each other in the pattern of two post-socialist transition countries, namely Hungary and Poland.

The motivation, as well as the relevance of the thesis, stem from various factors. On the one hand, different theories of fiscal cycles have been empirically proved only partially and along with strict model conditions so far. On the other hand, research mainly focused on the group of developed and developing economies, whilst the emerging markets – like the Central and Eastern European (CEE) countries – typically remained out of focus, not to mention case studies on these countries. Finally, fiscal performance of CEE economies shows significant differences with various deficit biases. Thus the question arises, whether one might also find cycle bias behind deficit bias.

Since the change of regime the Hungarian public finances have developed rather unfavourable: amid rather strong volatilities, general government balances approximated some 6% of average budget deficit in terms of GDP over the period between 1990 and 2010. While in the early nineties it was the failed stabilization, from the new millennium it has been the welfare turnaround that threatens budget positions. Financial indiscipline and massive indebtedness was generally typical to all Hungarian governments irrespective of their political affiliation. Nevertheless, cyclical evolution of the budget balance apparently was peaking around years when parliamentary elections were held in Hungary. That is, incumbent politicians change economic policy so that they favour special groups of voters for the sake of improving re-election, prospects. The influential papers by Adi Brender and Allan Drazen found that budget cycles are more typical in the less developed, new democracies since voters in such countries do not have enough experience with political incentives and manipulation. Within new democracies, the authors confirmed an expenditure side cycle in the case of post-socialist transition countries. However, PBC gradually disappears over time. As electors learn how democratic institutions operate, politicians cannot manipulate them any more and consequently, PBC will vanish. Drazen showed some estimated four election cycles are necessary for this so-called learning-by-doing process. This theory, however, does not seem to be strengthened by the Hungarian pattern: PBC did not vanish in the case of Hungary. Moreover, it strengthened throughout the 2000s and was the strongest in 2002 and 2006.

On the other hand, re-testing the theory of Brender és Drazen in CEE countries as new democracies can be considered as well-founded 20 years after the change of regime, since their paper was published in 2003 when post-socialist economies only had 13 years of democratic experience.

3. Research questions and hypotheses of the dissertation

With regards to the foregoing, the PhD dissertation is drawing up the following research questions:

1. Can the apparent contradiction of the Hungarian pattern to the theory of Brender and Drazen be confirmed by the in-depth analysis of the budget positions as well?
2. If political budget cycles in Hungary can empirically be confirmed, the question arises, whether the Hungarian case is unique in the sample of new democracies or there may be other countries in the region not following the implications of the model.
3. And finally, what are the underlying reasons behind the possible differences in a relatively homogenous group of countries?

Based on the research questions, the following hypotheses can be composed:

Hypothesis 1: The patterns of Hungary and Poland as new democracies show diverging empirics with regards to political budget cycles for the period of 1989 and 2011. Based on the deep analysis of the budget processes, we assume that the Hungarian case study confirms PBC. Meanwhile, the cyclical development of the Polish budget balances in the nineties was typically not the result of fiscal cycles. Following these heterogeneous empirical results, not just the CEE economies en block, but also a smaller group of these e.g. Visegrád countries as new democracies cannot be actually considered as a homogenous group of countries in terms of fiscal cycles. As a result of this, one might not conclude general statements on political budget cycles.

Hypothesis 2: To understand the development of fiscal cycles in new democracies the consideration of context conditionality is inevitable. Ultimately the emergence of PBC in a country depends on the overall combined effect of several factors – political, economic and institutional etc. The time factor itself or the experience of voters do not have the sufficient explanatory power.

Hypothesis 3: The financial engagement of international institutions – especially the IMF – as well as the external economic and financial processes basically affect against the undisciplined fiscal policy and cycle bias as long as adequate enforcement mechanisms are also called for life in parallel.

Hypothesis 4: There is a negative correlation between economic development, social welfare and the political budget cycles. The higher the living standards are in a country, the smaller the fiscal cycles are.

Hypothesis 5: As for institutional factors, budgetary institutions - especially their quality – are determinant in political budget cycles: hard and strict fiscal institutions decrease the possibility of PBC. On the contrary, institutions of the political system e.g. election system play a much smaller role.

Hypothesis 6: No direct positive link between political instability and fiscal cycles can be identified. The fragmentation of political life and political polarization do not explain PBC, if in times of political turbulences the continuity of reform process and consistency in the reform process is maintained.

Hypothesis 7: To understand why new democracies show divergent results regarding fiscal cycles, it is necessary to analyze the timing and applied method of macroeconomic stabilization.

4. Applied methodology of the dissertation

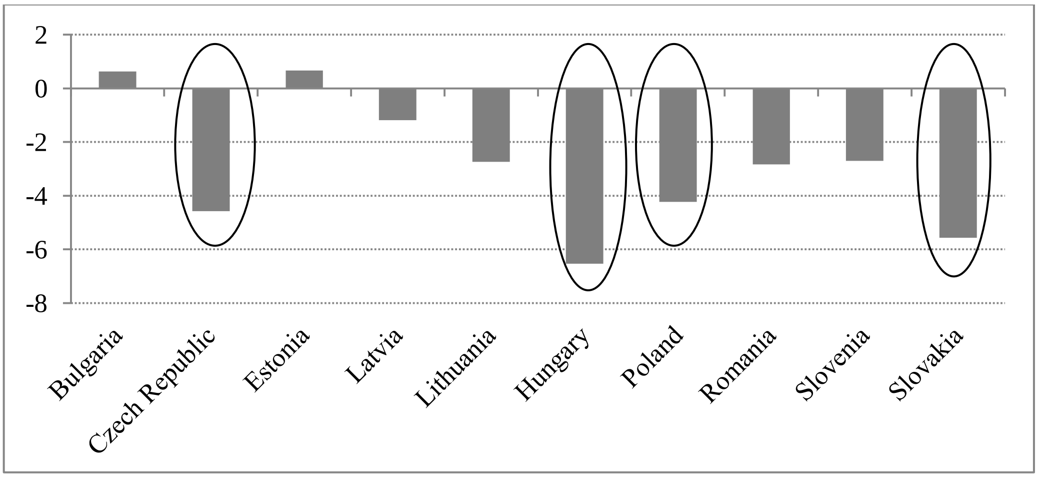
In order to draw up the methodological parametric of the dissertation, first the definition of the political budget cycles need to be determined since following the theoretical background the empirical analysis of the dissertation is based on these cycles. To identify fiscal cycles we call the definition used by Benczes and Kutasi for help saying: political budget cycles are regularly returning periodical fluctuation in the governmental fiscal policy caused by parliamentary elections. Its effect can particularly be followed up in the evolution of budget balance and/or state debt, as well as the structure of state revenues and expenditures [Benczes – Kutasi; 2010:224].

In the dissertation we focus on the state expenditure side, thus reject analysing the state revenues and tax policy. The reason for that is the greater relevance of the expenditure side cycles, furthermore empirical studies until now mainly confirmed PBC typically in state expenditures in developing and emerging economies. Along with these conditions, the following definition is composed: we define as political budget cycle the systematic deterioration in the overall budget deficit and the state expenditures perceived 1 or 2 years prior to the ordinary parliamentary elections that is followed by a systematic improvement in the overall budget deficit and the state expenditures 1 or 2 years after the elections. Furthermore, we consider as typical PBC the phenomenon of the so-called pork barrel spending. Namely a change in economic policy prior to elections preferring special group of the voters thus resulting in targeted expenditure growth.

After having clarified the main definitions, we are signing and justifying the countries empirically analyzed. Since we focus on the post-socialist CEE transition economies, thus a relatively small group of pattern, for testing the hypothesis we chose the comparative and descriptive methodology of case studies. Justification of the Hungarian case study has been already demonstrated. When selecting the other country we base on the condition that a potential cycle bias might be signalled by the deficit bias as well. Consequently it is worth opting for a country where undisciplined fiscal policy is experienced. In the first round we are narrowing the heterogeneous group of post-socialist countries as new democracies to gain a relatively more homogenous aggregation. For this we chose EU membership as an explanatory factor since those economies fulfilling the accession criteria might serve as a more homogenous group with regards to the convergence process and institutional factors.

In the next round we are examining the fiscal stance of those democracies joining the EU in 2004 and 2007. *Figure 1* represents the average budget balances for the period 1995-2007. Visegrád countries being front-runners in transition show the strongest deficit bias, within – as expected – Hungary in the worst position.

Figure 1: Average budget balances in the new EU countries for the period 1995-2007 (in per cent of GDP)

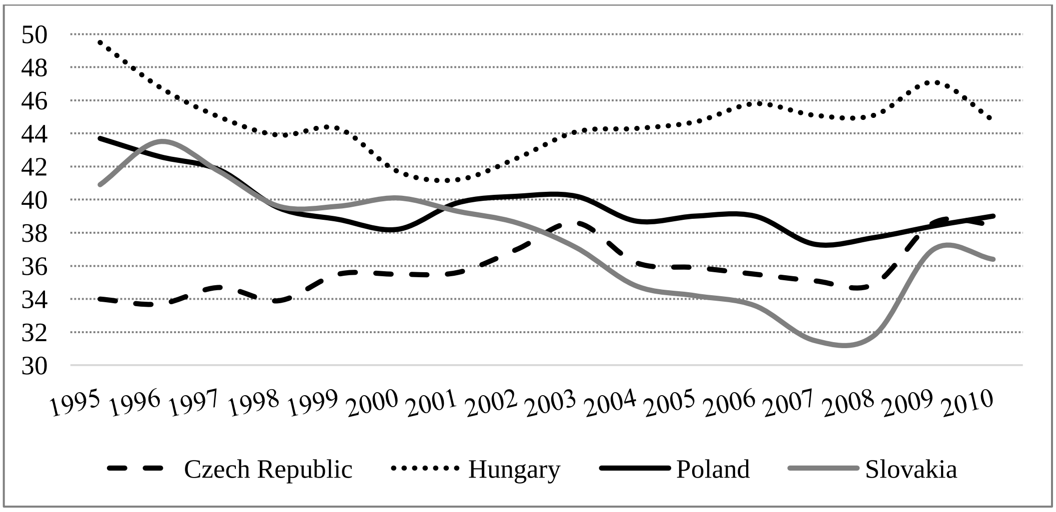


Note: in case of Bulgaria 1998-2007 average data are presented.

Source: Eurostat

Consequently we are further narrowing the EU member CEE economies to the Visegrád countries. In order to make the final choice, we are examining the rate of redistribution as well. Since the budget deficit can be considered rather as a flow indicator, thus might be relatively high without state expenditures being outstanding. *Figure 2* is presenting the current state expenditures (excluding interests paid) in terms of GDP.

Figure 2: Current state expenditures in Central Europe in 1995-2010 (in per cent of GDP)



Source: EC [2012]

Relatively unfavourable position of Hungary is again well perceptible. Slovakia significantly decreased the redistribution rate from a high rate thus reaching the smallest state by the 2000s. Similarly, the Czech Republic is characterised by a low level, and although a slight growth can be seen until 2003, that was followed by a declining trend. Aside from some temporary periods, the second largest state in the region is seen in Poland. Consequently, the second case study is provided by Poland.

In order to strengthen comparability and transparency, the same vertical and horizontal dimensions are used in the case studies. The horizontal dimension is embodied by the time factor. The initial point is the change of regime, while the research is closed with the last parliamentary election. Thus in case of Hungary this is the period between 1990 and 2010, while for Poland 1989-2011 is examined. The whole period is divided into 4 sub-periods. The first one starts from the change of regime and lasts until the stabilization. The second one comprises the recovery after the stabilization until the millennium. Afterwards, the pattern of the two economies becomes separated, since in Hungary the period between 2000 and 2006 provides the welfare turnaround, along with economic slowdown increasing state expenditures result in the deterioration of budget positions. Meanwhile in Poland, the economic slowdown is determinant. With regards to this, the last analyzed period of adjustments in Hungary started in 2006 already, while for Poland it dates from 2008 with outbreak of the global crisis.

Since the dissertation is focusing on the expenditures side of the general government, vertical dimension is embodied by the structure of the state expenditures. In order to be consistent, we use the ESA-95 budget statistics of the European Commission. The *compensation of employees (D1.)* is analysed in sub-chapter Public earnings and employment, while *Social transfers in kind and social transfers other than in kind (D62. and D63.)* are examined in sub-chapter named Social transfers. In the latter one old age benefits, family benefits, and pharmaceutical subsidies and in the case of Poland the relevant unemployment benefits are analysed. With smaller emphasis, but also *state subsidies (D3)* are considered in the dissertation. *Gross fixed capital formation (P.5.),* as well as *intermediate consumption (P.2)* is not subject of the research since they cannot clearly be considered as election cycle factors. State investments, particularly infrastructural ones might mean productive expenditures items. Irrespectively, they might become PBC factors; the negative effect of this, however, cannot entirely be distinguished from the positive effect on potential GDP, especially in emerging economies.

5. Structure of the dissertation and main empirical findings

The PhD dissertation consists of six main sections. The *first chapter* includes the motivation of the research as well as the main research questions and hypotheses, and the applied methodology.

The *second chapter* comprises the theoretical framework and the literature review. Two basic models serve as a pillar for political business/budget cycle (PBC) theories. One is the opportunistic (and free of ideology) model of Nordhaus [1975]. The other is the so-called partisan model established by Hibbs [1977, 1979]. These basically say in electoral periods incumbents who wish to maximize the possibility of remaining in office in the short term, heat the economy up by using active economic policy and cool it down afterwards by restrictions. The 'golden age' of the traditional PBC models does not last long due to the lack of demonstrative empirical evidence and exaggerated simplifications of conditions. Instead, these models provide a strong foundation for the subsequent evolution of PBC theories e.g. rational PBC models [Persson – Tabellini, 1990] or the moral hazard type models [Persson – Tabellini, 2003; Shi – Svensson, 2002a, 2002b]. A real separation from the tradition, thus a clear breakthrough in the PBC theory was particularly hallmarked by the work of Kenneth Rogoff and Anne Sibert [1988, 1990], who reject the Phillips curve and instead, focus on fiscal policy when explaining PBC. In this sense, they applied a new phrase for the phenomenon, calling it "political budget cycles" for life thus referring to cyclical fluctuations in fiscal policy in times of parliamentary elections.

According to this theory, incumbents temporarily execute fiscal expansion in order to improve their own re-election prospects. They continue behaviour like this because voters are self-seeking as well, thus they are maximizing profit in case of both private and state products and services. As a consequence budget deficit increase is perceptible. Following the elections, however, fiscal restriction is realized to improve budget positions. Research results overall and in general indicated the trend that Rogoff's model can be verified typically in less developed and developing economies, whilst the pattern of developed and industrialized countries showed no political fiscal cycles in connection with election periods[1].

[1] See: Ames [1987]; Block [2002a, 2002b]; Alt – Lassen [2006a, 2006b]; Brender – Drazen [2003]; González [2002]; Mink – de Haan [2005]; Schuknecht [2000]; Andrikopoulos et al. [2004]

In their much-cited large-scale study Brender and Drazen [2003] confirmed this result. They found that political budget cycles are typically seen in the less experienced, so-called new democracies, like the post-socialist CEE countries, whilst in the developed more mature democracies the authors did not find any PBC. Specifically, in the CEE economies they confirmed significant PBC in the overall general government balance driven by the state expenditures. Nevertheless, fiscal cycles are gradually disappearing even in the new democracies as voters learn how democratic institutions and political manipulation operate. For this so called *learning-by-doing* process approximately 4 election periods are needed according to the estimation of Drazen [2000]. Since the researchers were able to prove tendencies for a homogenous group of countries empirically, rather than the clear presence or absence of the PBC, economists stated to focus more on the institutional factors, especially the quality of institutions when explaining different empirical results. Robert Franzese [2002] in his comprehensive study found that the theoretical concepts of the different PBC models become empirically determined only when economists recognize and consider the *context conditionality* of the cycles. This contextual change will form the ability of politicians to manipulate, according to Franzese and Jusko [2005]. As a result, the quantity, frequency and content of the political and economic cycles depend on three main factors:

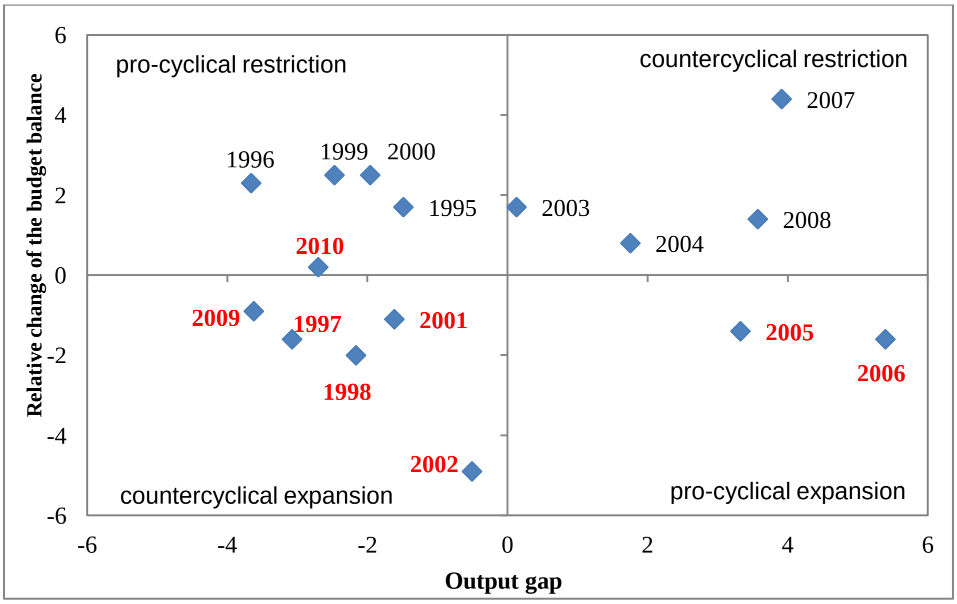
1) *The variations in the international and domestic contexts*: International institutions might influence the development of domestic economic policy, e.g. smaller budget deficit is observed in those developing countries, where IMF programs materialized. [Schuknecht, 1996]. These programs typically mark fiscal and macroeconomic stabilization as a condition of the financial aid, thus limiting the ability of politicians to pursue discretional fiscal expansions. Similar external effect might come from the accession conditions and rules of European Union and the EMU.
2) *The variations in the political and economic contexts:* This group includes explanatory factor of the PBC like economic development and standard of living or welfare. This is strengthened by the fact that fiscal cycles were confirmed by the poorer, developing countries but were not by the sample of developed, industrialized economies. Furthermore, the researchers in the differences between the political and election systems investigated cycle bias as well [Persson et al.; 2002a, 2002b, 2003, 2007].
3) *The variations in the institutional, structural and strategic contexts:* The diversity of the factors forms the opportunities and activity of political decision makers. Several study focus on the stability of the democratic institutions and quality. This is usually

measured by factors like fiscal transparency, fiscal rules and institutions that limit politicians in their discretional decisions.

The value added to the theory of context conditionality lies partly in the possibility it provides to explain different empirical results. Furthermore, it also serves as a framework for the grouping of the main individual explanatory factors of the fiscal cycles and complex analysis. On the other hand, this theory anticipates that several factors, local and global, national and international playing a role in fiscal cycles shape the discretional fiscal policy all together.
In the first section, we showed that the fiscal performance in both Hungary and Poland overall developed unfavourable and has been characterized by great volatilities since the change of regime. In the theoretical overview we saw that it is often political budget cycles and the pork barrel spending that stand behind this phenomenon.
In *section 3* and *section 4* the Hungarian and Polish case studies present the budgetary processes in deep details trying to answer the question whether there is cycle bias behind deficit bias in the two new democracies.
The structure of the two case studies is the same, based on the vertical and horizontal dimensions introduced above. The third and fourth chapters contain four subsections respectively, presenting the budgetary processes between 1989/1990 and 2010/2011 with special focus on the state expenditures.
In *section 3.1* we presented that during the period between the change of regime in 1990 and the stabilization in 1995 the general government balance gradually deteriorated in Hungary in which the systematic delay in executing the adjustment and the strengthening welfare state both played a role [Kornai, 1993]. In the period analysed, the pattern of the 1994 parliamentary election showed fiscal cycle elements especially in the case of pensions and pharmaceutical subsidies and to lesser extent public wages as well.
In *section 3.2* one might see that election cycles strengthened in Hungary during the period of recovery after stabilization between 1995 and 2000, by testing the pattern of the elections in 1998. The yearly budget in 1998 was indeed an election year budget including rising pensions and wage as well as growing agricultural and investment subsidies [OECD, 2000:64]. Further PBC was found in the pharmaceutical subsidies as well.
The *section 3.3* presents that the real turnaround of fiscal cycles, however, was perceptible in the millennium. Despite the weakening economic growth in connection with global processes as well as the spending commitments to meet NATO obligations and EU accession demands the period between 2001 and 2006 saw a welfare turnaround and deterioration in budget

positions never seen before [Benczes, 2007]. The government pursued fiscal laxity in different forms prior to the elections in 2002: pensions and family benefits were increased and a massive public sector wage growth was implemented in certain areas. Furthermore, a comprehensive housing program was launched [OECD, 2004]. Nevertheless, in the deterioration of the fiscal balances not just the usual vote-buying actions played a role, but it was further enhanced by a temporary – as we called –- inverse PBC of the new cabinet after elections in 2002. Approaching the elections in 2006, political budget cycles strengthened again in Hungary, main subjects of which proved to be again social transfers (old age benefits, family allowances, pharmaceutical subsidies) as well as public sector wages. As a consequence of PBC, the general government deficit increased to a level never seen before *(Figure 3).*

Figure 3: The effect of cyclical factors in the general government in Hungary



Note: Axis X refers to the output gap (%), axis Y refers to the relative annual change of general government balance in terms of GDP (percentage point); years of a parliamentary elections and the year prior to the elections are indicated by red colour.

Source: EBRD, EC, AMECO database, own construction

Typical fiscal cycle is further strengthened by the fact – as shown in section 3.4 – that after the elections held in 2006, the new government immediately reacted to the stance of budget positions and implemented a severe adjustment [CP, 2007].

In the last election pattern of 2010 no PBC was actually found. However, it is shown in details, that both political and economic reasons played a role in this. On the one hand, the high level of domestic and external state debt coupled with a massive drop of risk taking appetite on global money and capital markets resulted in the drying-up of financial resources. To manage the problem, the government made an agreement with international institutions on a rescue package. However, the conditions of the credit facility and the severe economic recession in 2009 made further adjustments inevitable. On the other hand, in early 2009 a new government stood up for the 1 year remaining until the next election that aimed to stabilize public finances thus had no political intention to pork barrel spending.

Section 4.1 analysing the presence of PBC in Poland comprising the period between 1989 and 1993. As for public wages we did not find any fiscal cycles, the measure of the stabilization package, the so-called penalty tax (*popiwek*) influenced the wages thus prevented discretional decisions until 1992 [OECD, 1992]. The Constitutional Court, however, attacked further planned savings of the government in 1992. As for social transfers, pension expenditures significantly increased in Poland in the early nineties, in which – similar to Hungary – the high number of beneficiaries flowing into the disability and early retirement schemes played an important role. On the other hand, the large-scale benefits increased the state expenditures as well. This is proved by the soaring rate of old age pensions. Although the government had the intention to curb the rise of expenditures, no substantive decision was made. Nevertheless, clear and significant PBC was not found either.

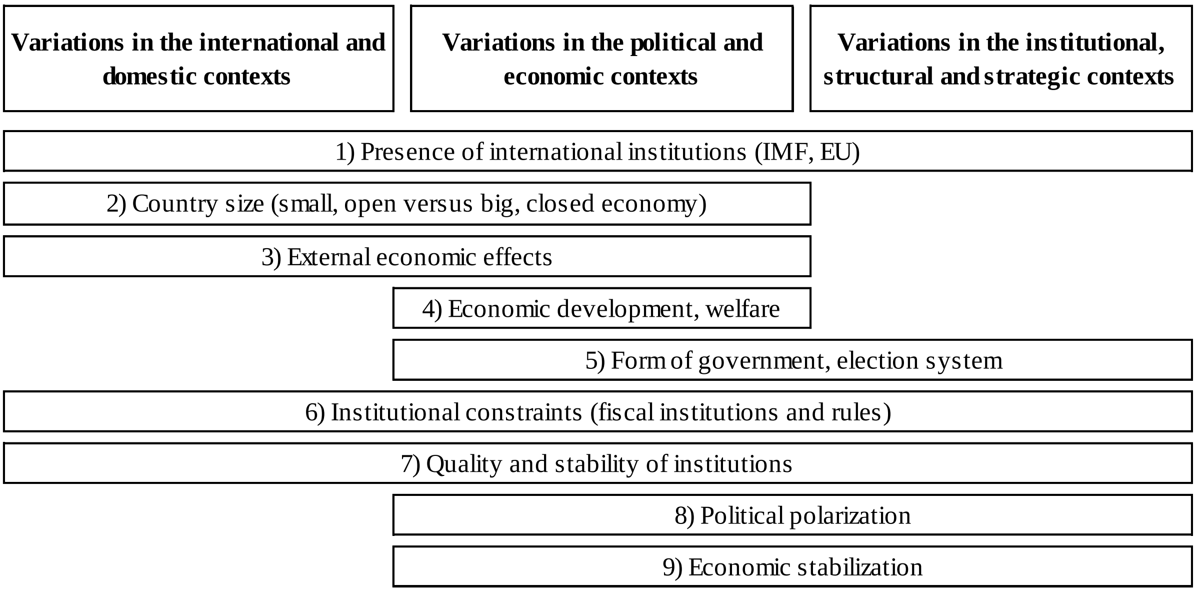
Section 4.2 presents the period between 1993 and 2000, and parliamentary elections were held in 1997 in Poland. The budget of 1997 cannot be considered as an election year budget. Despite the fact that some main areas like education or health care gained supplementary resources, and pensions were increased as well, no uncontrolled pork barrel spending was seen. Furthermore, countercyclical effects might be identified, namely the government launched the socially unpopular pension reform 6 months prior to the elections. The favourable economic prospect also contributed to this development [EIU, 1996: 16].

Section 4.3 comprises the longer period between 2000 and 2008. Similar to Hungary, the millennium brought an economic slowdown to Poland as well, due to the global economic deceleration, the evolution of internal economic cycles and fiscal laxity. Approaching the elections to be held in 2001, government parties lacked the necessary willingness to execute adjustment. Slight PBC might be identified in the pattern of 2001 elections especially in the case of public wages. On the other hand, however, the government postponed the indexation of some social benefits in 2000 by one year, and the necessary collateral was created by the decrease of other expenditures (e.g. slowing down the wage increase of teachers, moderating family benefits). These measures are definitely against the political budget cycles. Substantive

reaction to the unfavourable stance of public finances was fir perceivable in 2003 when the so-called Hausner Plan aimed to decrease state expenditures – especially social transfers – massively until 2007. As a result, in the sample of the election year of 2005, no PBC was confirmed, the overall period was devoted to the adjustment. Political changes and turbulences as of 2006 hardly affected economic policy. Budget of 2007 developed favourably supported by the higher tax revenues, but expenditures remained moderate as well.
Section *4.4* presents the Polish crisis management. Favourable positions of public finances in the preceding years turned for the worse in 2008 and in one year the budget deficit doubled due to the crisis. With regards to budgetary expenditures, the period between 2007 and 2012 might be divided into two phases, where the effect of the global crisis seems to be more determinant cycle factor than the PBC. Between 2007 and 2009/2010 social transfers and public wages increased. Afterwards, from 2009, however, the same expenditures as well as the overall general government deficit declined gradually. This development was supported by the expenditure cut implemented in 2009 and also by the comprehensive consolidation plan announced in early 2010. At the same time, these developments also mean that no election cycle elements can be found either in state expenses or in the overall budget balance in Poland in the election pattern of 2011.
Chapter 5 of the dissertation includes the comparison of the Hungarian and Polish case studies. The diverging empirical findings of the two Visegrád countries out of the four suggests, that new democracies cannot be considered as a homogenous group of countries with regards to political budget cycles. Consequently, the last research question of the dissertation is more than justifiable: *What are the underlying reasons behind the possible differences in a relatively homogenous group of countries?*
In order to answer the question, we base on the institutional factors, especially the theory of context conditionality by Franzese and Jusko presented in *section 2.5.* Previously we determined that contexts give the opportunity to frame and group the individual explanatory factors of PBC used in the literature. As a first step we made this grouping, the results are presented by *Figure 4.* At this point we need to state that the extent of potential explanatory factors of fiscal cycles is not finite. It is reasonable that countless other effects might be identified, thus the group of factors considered in the comparison section of this dissertation needs to be limited. We based on the factors that were already analysed by economists in the PBC literature. Our aim is not to identify potentially new explanatory factors, but to test the factors already applied in the case study of two new democracies. We only introduced one new category, namely the macroeconomic stabilization method. We believe, the analysis of

this element is inevitable in transition economies. Finally, despite the fact that the context conditionality determines three main groups, most of the explanatory factors cannot be completely and exclusively classified in one group. These have their effects through several channels, consequently it is definitely worth making engravings in a way presented by *Figure 4*. Taking these conditions into consideration, in *section 5* we briefly analyse the potential effects of the explanatory factors of fiscal cycles. Finally, *chapter 6* includes the main results and theses of the dissertation.

Figure 4: Classification of the explanatory factors of the fiscal cycle effects based on the contexts



Source: own construction based on Franzese and Jusko [2005]

6. Theses and main results of the dissertation

Thesis 1*: Deep analysis of the budget processes in Hungary and Poland confirmed that the two new democracies show diverging empirics with regards to political budget cycles for the period of 1989 and 2011. Following these heterogeneous empirical results, not just the CEE economies en block, but also even a smaller group of these, e.g. Visegrád countries as new democracies cannot be actually considered as a homogenous group of countries in terms of fiscal cycles. As a result of this, one might not conclude general statements on political budget cycles. To understand the development of fiscal cycles in new democracies, the consideration of context conditionality is inevitable. Ultimately the emergence of PBC in a country depends* *on the overall combined effect of several factors – political, economic and institutional etc. The time factor itself or the experience of voters do not have the sufficient explanatory power.*

PBC literature generally focused on one or two explanatory factors when trying to catch out the existence or lack of fiscal cycles in one economy or a group of countries. This applied method led to heterogeneous empirical results that did not allow making general conclusions. This evidence was further strengthened by the Hungarian and Polish case studies in this dissertation, at the same time the theory of context conditionality was justified as well. Namely, fiscal cycles are shaped by a number of factors, being it global or local, international or national, political or economic.

Thesis 2*: The financial engagement of international institutions – especially the IMF – basically affect against the undisciplined fiscal policy and cycle bias as long as adequate enforcement mechanisms are also called for life in parallel. External economic and financial processes have similar disciplining force, especially for open countries deeply integrated in the global economy.*

Both the Hungarian and Polish case studies have confirmed empirical results so far on the effect of international institutions. Especially IMF credit programs limit discretional budgetary policy significantly. The role of the European Union as an external anchor is dual. On the one hand, the Hungarian pattern showed, that the EU membership itself does not affect budget discipline positively. The underlying reason is the lack of proper enforcement. On the other hand, testing the rules of the Stability and Growth Pact remains limited since none of the countries are members of the euro zone. Similarly, the external economic and financial processes mean disciplining effect on the cycle bias. Especially in Hungary, external effects played a role in the volatility of the budget balances, for as much as it was typically international economic and financial processes that forced governments to adjust, after times fiscal expansions induced by PBC.

Thesis 3: *No unequivocal direct connection can be identified between economic development, social welfare and political budget cycles. If the members of the society judge their own income position as negative, they might increase the demand for state paternalism, which in turn strengthens fiscal cycles.*

Our initial hypothesis saying that economic development and social welfare affect against political budget cycles could not be clearly proved in the pattern of Hungary and Poland. Both per capita income and employment rates, thus the number of households living on state transfers, overall developed similarly in Hungary and Poland. Consequently, economic indicators did not justify the divergent pattern of fiscal cycles in the two economies. On the other hand, since income inequalities are the strongest in Poland, this fact would have predestined the presence of PBC rather in Poland, based on our hypothesis. This contradiction might be explained with the divergence between the actual inequalities and the perception of the society. If people see high income inequalities, be it reasonable or not, they might increase the demand for state paternalism which in turn strengthens fiscal cycles.

Thesis 4: *Institutional factors of the political system like the election system has not been confirmed as an explanatory item of political budget cycles in the pattern of Hungary and Poland. On the contrary, the quality of the budget institutions affects PBC significantly. Hard budget institutions and rules like reliable and conservative economic forecasts, as well as mid-term, reform-oriented and prospective fiscal planning enhance fiscal transparency thus decrease fiscal cycles. Like procedural rules, the adaptation of hard budget constraints through numerical fiscal rules moderate the cycle bias of policymakers.*

Budget institutions play a significant role in fiscal cycles. With regards to this, the advantage of Poland compared to Hungary is spectacular in all three phases of the budgeting process. In the planning phase Poland is a frontrunner regarding both the reliable economic forecast and the medium term budgetary projection. In Hungary, budget process was generally characterized by a kind of *stop and go* approach in economic policy without prospective thinking but high volatilities in fiscal outcomes. Meanwhile, in Poland the nineties already saw a commitment to the comprehensive strategic *budgetary* planning. Such programs were the *Strategy for Poland* as of 1994, the *Package 2000* or the *Hausner Plan*. Fiscal discipline is further enhanced by the numerical fiscal rules in Poland (e.g. debt rule). Meanwhile, in Hungary practically no deficit or other debt rules limited the discretional ability of the governments until 2008, when the global crisis made the changes necessary. Creditable and strategic budget planning as well as hard budget constraint massively contributed to the improvement of fiscal transparency in Poland, despite the fragmented general government system facing severe structural problems. Similar positive tendency cannot be observed in Hungary owning only four sub-segments in the general government.

Thesis 5*: Countries with lower level of institutional confidence face stronger political budget cycles. The weaker confidence for the democratic institutions and thus the future, the higher social demand for the state paternalism is identified. This process increases the possibility of* *emergence and solid survival of fiscal cycles. This also means, that the role of informal institutions in PBC is determinant.*

Significant negative correlation was identified between institutional trust and fiscal cycles in the dissertation being strengthened by both case studies. The connection stems from the fact that countries with low level of institutional trust show a stronger demand for state paternalism thus higher state transfers which in turn generates demand for pork barrel spending and political budget cycles. Consequently, the reinforcement of social trust into democratic institutions in parallel weakens the possibility of fiscal cycles. The adoption of hard budget constraints facilitates the improvement of fiscal transparency, by which a positive circle comes into being, that results in growing institutional trust and declining fiscal cycles.

Thesis 6: *No direct positive link between political instability and fiscal cycles can be identified. The fragmentation of political life and political polarization do not explain PBC, if in times of political turbulences the continuity of reform process and consistency in the reform process is maintained.*

Political stability does not automatically bring fiscal stability as well and *vice versa*. This is perfectly reflected by the Hungarian and Polish cases. With regards to both the number of parties in parliament and the stability of governments, Hungary is clearly over-performer in the region. In Poland on the contrary, short-lived and unstable governments were following each other and political platform was characterized by massive fragmentation and polarization with government crisis and early elections at least until the millennium. Despite this, populism in Poland typically took place at the level of rhetoric, whilst continuity in economic policy was basically maintained. This soon led to the political disillusion of the Polish voters and contributed to the shortening of the so-called *honeymoon period*. Between 1991 and 1993, despite the unstable political environment and social unrest, stabilization and reforms did not halt. Meanwhile, in Hungary the opposite was seen mainly in the case of restrictions and reforms from the second half of the nineties. In 1998, after the elections, the new government revised several measures of stabilization as of 1995. Similar events were observed in 2007 as well with regards to the health care reform, when the opposition finally led a referendum and the withdrawal of several measures.

Thesis 7: *To understand why new democracies show divergent results regarding fiscal cycles, it is necessary to analyze the timing and applied method of macroeconomic stabilization.*

Underlying reasons are of political, economic as well as social type. The more drastic the stabilization is, the smaller the possibility of the emergence of PBC.

In the post-socialist countries, the reforms to be implemented during the political and economic transition included the macro-economic stabilization as well. Despite the fact, that both Hungary and Poland were frontrunners in reform process after the change of regime, they chose a different way regarding the stabilization. In Hungary adjustment was delayed until the mid-nineties, while Poland launched the shock therapy in 1989 already. Underlying reasons are various, political, economic and social as well. Namely, Poland faced a much severe initial economic situation at the beginning of transition, consequently the decision on the transition strategy was more critical than for Hungary, which was much more stable. The economic imbalances in Poland resulted by the duality of hyperinflation and shortage made the radical way of transition necessary. Further argument for the shock therapy compared to the gradual reform became the possible danger of losing political capital coming from the openness of the society to changes. Those times the willingness of the society to accept a radical program was relatively high due to the massive and unsustainable circumstances. These unfavourable initial conditions in Poland made a prompt adjustment inevitable that in turn contributed to the change of the attitude of the society regarding the role of the state. Meanwhile, opposite developments were seen in Hungary. Attempts were made to decrease the level of state expenditures, these, however, faded due to the lack of political will, direct economic pressures and social resistance. Namely, in Hungary no such enforcement mechanism was working like the shortageflation in Poland. Instead of the adjustment, and decreasing the rate of redistribution, Hungary saw increasing paternalism and the spreading of the political and social illusion that the market transition might be fulfilled without any significant consolidation. When talking about premature welfare state, one might speak about the illusion of welfare state, which characterized Hungary in the early nineties. These processes made the society assume that the entitlements of the socialist period are still available automatically and for free following the change of regime as well. Any kind of state measure aiming to change this attitude encountered massive resistance since it might have carried the message, that the government is not competent. Meanwhile, in Poland the disillusionment of the society came about rather early, in which the economy shock caused by the Balcerowicz Plan as well as the political developments – namely the difference between the political rhetoric and the actual realized economic policy – both played a role. All these processes resulted in the shortening of the period of the well-known *honeymoon* effect in Poland. Unlike their Hungarian counterparties, the Polish voters experienced in a very short period of time that political communication prior to the parliamentary elections often remains only promises.

7. Conclusion and further potential research lines

In this PhD dissertation we analysed the political budget cycles in deep details in the case study of two new democracies, namely Hungary and Poland. It was stated, that the two countries show strongly diverging empirics with regards to fiscal cycles despite the fact that they started the same way after the change of regime and both were leader countries in the transition process. According to our results in the Hungarian pattern significant political budget cycles were confirmed that were strengthening with time. Meanwhile, we proved that in Poland the cyclical evolution of the budget balances in the nineties was not the result of the cycle bias of politicians and pork barrel spending. The underlying reason for this kind of divergent empirical results was identified in the combined effect of several – political, economic and institutional – factors.

Our results assign new potential research lines and questions as well. First, the question automatically arises: what pattern of PBC can be found in other countries in the region. Second, the dissertation left the question open to be answered whether the diverging empirics of Hungary and Poland at the same time lead to the rejection of the *learning-by-doing* process. Or one might keep the theory of Brender and Drazen with the new condition that the time needed for this process is different in the countries. Finally, it needs further investigation to decide whether the explanatory factors of PBC might be ranked in some way and primary factors can be identified that influence political manipulation more in the new democracies compared to the old ones.

8. References

Alesina, A. – Roubini, N. [1992]: Political cycles in OECD economies. The Review of Economic Studies Vol. 59. No. 4. pp 663-688.

Alesina, A. – Sachs, J. [1988]: Political parties and the business cycle in the United States, 1948-1984. Journal of Money, Credit and Banking Vol. 20. No. 1. pp 63-82.

Alt. J. – Chrystal, K.A. [1981]: Electoral cycles, budget controls and public expenditure. Journal of Public Policy Vol. 1. No. 1. pp 37-59.

Alt, J. – Lassen, D.D. [2006a]: Fiscal transparency, political parties, and debt in OECD countries. European Economic Review Vol. 50. No. 6. pp 1403-1439.

Alt, J. – Lassen, D.D. [2006b]: Transparency, political polarization, and political budget cycles in OECD countries. American Journal of Political Science Vol. 50. No. 3. pp 530-550.

Ames, B. [1987]: Political survival: Politicians and public policy in Latin America. Berkeley, University of California Press.

Andrikopoulos, A. – Loizides, I. – Prodromidis, K. [2004]: Fiscal policy and political business cycles in the EU. European Journal of Political Economy Vol. 20. No. 1. pp 125–152.

Benczes, I. [2007]: Trimming the sails. Budapest, CEU Press.

Benczes, I. – Kutasi, G. [2010]: Költségvetési pénzügyek. Budapest, Akadémiai Kiadó.

Block, S.A. [2002a]: Political business cycles, democratization, and economic reform: the case of Africa. Journal of Development Economics Vol. 67. No. 1. pp 205-228.

Block, S.A. [2002b]: Elections, electoral competitiveness, and political budget cycles in developing countries. Harvard University, Center for International Development Working paper No. 78.

Brender, A. – Drazen, A. [2003]: Where does the political budget cycle really come from? CEPR Discussion Papers No. 4049.

CP [2007]: Convergence Program of Hungary 2007–2011, Government of the Republic of Hungary, Budapest, 2007. December.

Drazen, A. [2000]: Political economy in macroeconomics. Princeton University Press, Princeton, N.J.

EC [2012]: European Economy, Statistical Annex, spring, European Commission, Brussels.

Economist Intelligence Unit [1996]: Country report Hungary, 1996. December. London.

Fábián, Gy. [1999]: A magyar választási rendszer kelet-közép-európai összehasonlításban, Politikatudományi Szemle Vol. 8. No. 3. pp 107-126.

Franzese, R.J. [2002]: Electoral and partisan cycles in economic policies and outcomes. Annual Reviews of Political Science Vol. 5. pp 369–421.

Franzese, R.J. – Jusko, K.L. [2005]: Political-economic cycles. In: Wittman, D.– Weingast, B. [ed.]: Oxford Handbook of Political Economy. Oxford University Press. 545-564.

Gonzalez, M. [2002]: Do Changes in Democracy Affect the Political Budget Cycle? Evidence from Mexico. Review of Development Economics Vol. VI. pp 204-224.

Hibbs, D. A. [1977]: Political parties and macroeconomic policy. The American Political Science Review Vol. 71. No. 4. pp 1467-1487.

Hibbs, D. A. [1979]: The mass public and macroeconomic performance: the dynamics of public opinion toward unemployment and inflation. American Journal of Political Science Vol. 23. No. 4. pp 705-731.

Kornai, J. [1993]: A szocialista rendszer. Heti Világgazdaság Publ., Budapest.

McCallum, B.T. [1978]: The Political Business Cycle: An Empirical Test. Southern Economic Journal, Vol. 44. No. 3. pp 504-515.

Lewis-Beck, M.S. [1988]: Economics and elections: The major western democracies. Ann Arbor: University of Michigan Press.

Mink, M. – de Haan, J. [2005]: Has the stability and growth pact impeded political budget cycles int he European Union? CESIFO Working Paper No. 1532.

Nordhaus, W. D. [1975]: The political business cycle. The Review of Economic Studies Vol. 42. No. 2. pp 169-190.

OECD [1992]: OECD Economic Surveys, Poland, Paris.

OECD [2000]: OECD Economic Surveys, Hungary, Paris.

OECD [2004]: OECD Economic Surveys, Hungary, Paris.

Persson, T. [2002a]: Do political institutions shape economic policy? Econometrica Vol. 70. No. 3. pp 883-905.

Persson, T. – Tabellini, G. [1990], Macroeconomic Policy, Credibility and Politics. Harewood, London.

Persson, T. – Tabellini, G. [2002b]: Political institutions and policy outcomes: what are the stylized facts? Download: 2012-06-16. http://people.su.se/~tpers/papers/tp020816.pdf

Persson, T. – Tabellini, G. [2003]: Do electoral cycles differ across political systems? Innocenzo Gasparini Institute for Economic Research Working Paper No. 232.

Persson, T. – Roland, G. – Tabellini, G. [2007]: Electoral rules and government spending in parliamentary democracies. Quarterly Journal of Political Science Vol. 2. pp 155-188.

Rogoff, K. [1990]: Equilibrium Political Budget Cycles. The American Economic Review Vol. 80. No. 1. pp 21-36.

Rogoff, K. – Sibert, A. [1988]: Elections and macroeconomic policy cycles. Review of Economic Studies Vol. 55. No. 1. pp 1-16.

Schuknecht, L. [1996]: Political business cycles and fiscal policies in developing countries. Kyklos Vol. 49. No. 2. pp 155-170.

Schuknecht, L. [2000]: Fiscal policy cycles and public expenditure in developing countries. Public Choice Vol. 102. No. 1-2. pp 115-130.

Shi, M. – Svensson, J. [2002a]: Conditional political budget cycles. CEPR Discussion paper No. 3352.

Shi, M. – Svensson, J. [2002b]: Political budget cycles in developed and developing countries. Download: 2012-06-16.

http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.202.8595&rep=rep1&type=pdf

Tufte, R.E. [1978]: Political control of the economy. Princeton University Press, Princeton, New Jersey.

9. List of publications related to the dissertation

a) Politikai költségvetési ciklusok: fiskális ciklushatások az állami kiadásokban Lengyelországban. (*Political budget cycles: fiscal cycle effects in the Polish state expenditures*) Competitio Vol. 13. (2014) No. 2.

b) Politikai költségvetési ciklusok a magyar államháztartásban. (*Political budget cycles in the Hungarian general government*). Köz-gazdaság, Vol. 9. (2014) No. 2.

c) Fiscal cycle effects in the pattern of the Hungarian state expenditures. Society & Economy Vol. 36. (2014) No. 2. pp 263-283. Akadémiai Publ., Budapest.

d) Political budget cycles: an empirical analysis on Hungary. In (eds: Benczes István) „Crisis in the West and the East: Economic governance in times of challenge”, 2014, pp 184-204. Political economy of globalization series, Wiener Verlag für Sozialforschung, Wien.

e) Politikai konjunktúraciklusok (*Political business cycles*). Köz-gazdaság, Vol. 5. (2010) No. 4. pp 87-103.