

# NEW MACROECONOMICS AND POLITICAL SCIENCE

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■ **Abstract** We review the use of macroeconomics in political science over the past 40 years. The field has been dominated by new classical theory, which leaves little room for economic policy and focuses attention on what democratic governments can do wrong in the short term. The resulting literatures on political business cycles and central bank independence are large and sophisticated, but they fail, we argue, to account for most of the observed variance in economic policies and outcomes. In the past decade, mainstream macroeconomics has moved away from new classical approaches toward New Keynesian theories with greater scope for macroeconomic policy. These new approaches, with little impact so far in political science, are reviewed and their implications drawn out. Instead of explaining short-sighted government behavior in an economy with little scope for economic policy, the key question for political science may be why governments often pursue longer-run objectives in an economy with considerable scope for economic policy.

## INTRODUCTION

In Keynesian economic theory, which dominated political economy until the late 1970s, there was considerable scope for politics. Two approaches that are now largely forgotten dominated in the discipline's journals. One was Hibbs' (1977) partisan model, in which the political left and right seek to maximize the distributive interests of their core constituencies subject to a long-term Phillips curve trade-off. The second approach was the neo-corporatist literature on incomes policies, in which governments try to increase the sustainable level of employment by offering unions expansionary fiscal and social policies in return for wage restraint (Cameron 1984, Flanagan et al. 1983).

The Hibbsian and neo-corporatist approaches produced a rich literature on macroeconomics in political science, but they were more or less wiped out by the rational expectations in economics and the rise of new classical theory (Friedman

1968, Lucas 1977). When economic agents have rational expectations, and markets are perfectly competitive, any trade-off between inflation and employment is essentially short term. This completely derailed existing work in political science, and the field was substantially taken over by new classical economists. Instead of focusing on what governments do to affect the medium- and long-run direction of the macro economy, and the consequences for different groups, the focus became what they do in the short run to ensure their own reelection. Politically induced business cycles replaced the effort to understand enduring cross-national differences in unemployment and distribution (Alesina 1989, Alesina et al. 1997, Cukierman & Meltzer 1986).

The new classical attack on Keynesian macroeconomics was accompanied by a reassessment of the role of groups and political parties in fiscal policy. Public choice theory implied that fragmented democratic governments would tend to overspend and run excessive deficits (Grilli et al. 1991). With each party seeking to maximize spending on its own constituency, there is a common pool problem confounded by the shortsightedness of governments. Because new classical economics implies that public spending and investment crowd out private spending and investment, the result is a misallocation of resources between the public and private sectors.

Whereas democratic governments were generally seen as benevolent in the Keynesian framework, they now came to be viewed as bad for macroeconomic efficiency. Correspondingly it became commonplace to argue that macroeconomic efficiency would be maximized by delegating policy-making power to independent experts, especially independent central banks (Barro & Gordon 1983, Cukierman 1992). This argument contained both the prediction that countries with independent central banks would perform better, and the prescription that if governments followed the advice they would improve performance. But despite the willingness to draw grand institutional implications from the theory, and although many governments appeared to follow the prescription in the 1980s and 1990s, new classical economics had little to say about the causes of institutional design. Instead, they offered what we call a depoliticized “economists’ narrative” of the rise of restrictive policies: Realizing their own role in creating the economic problems of the 1970s, governments learned from economists to behave more responsibly in the 1980s.

Most political scientists working in the macroeconomic field bought into the assumptions of new classical economics in the 1990s. A majority drew the conclusion from rational expectations that the effects of democratic politics on the macro economy can only be temporary and largely negative. The previous focus on the role of (partisan) governments in affecting employment and output, partly as a result of the effects of fiscal and monetary policy on union behavior, took the back seat to the study of the time-inconsistency problem, in which shortsighted politicians concerned with popular support induce business cycles around elections. We argue that this is mistake for three reasons.

First, the inability of governments to affect the real economy beyond the short run is an implication not of rational expectations but of the assumption that markets

are perfectly competitive. When there are rigidities in price and wage setting, or when wages are collectively bargained, rational expectations are perfectly compatible with macroeconomic policies affecting production and employment (Carlin & Soskice 2005).

Second, we do not believe that political business cycle (PBC) theory and public choice approaches to fiscal policy provide much leverage in understanding the economic history of advanced democracies since the Second World War. To a far greater extent than recognized in these theories, governments pursue medium- and long-term goals that not only reduce the impact of elections, but also provide a much more credible alternative to the economists' narrative to explain the changes in macroeconomic regimes during the 1980s and 1990s.

Third, major shifts in economic theory during the past decade bring to the fore old questions about the role of political parties, political institutions, and the interaction between governments and unions (Mares 2006). Ironically, political scientists seem to believe that political science can contribute little to the study of macroeconomic policy making, while economists now grapple with questions about government policies for which political science may have the answers. In this essay, we sketch the frontiers in the new political economy of macroeconomics, and we suggest where political scientists are likely to make significant contributions.

The review is divided into five sections. First, we consider the rise of new classical economics in the 1980s and how it undermined any serious political economy of macroeconomics. Contrary to a common view among political scientists, the critical assumption of new classical economics is not rational expectations but the notion of perfectly competitive and flexible product and labor markets. As discussed in the section on New Keynesianism, modern macroeconomics almost universally accepts rational expectations, but there is a widespread abandonment of the assumptions of perfect competition and instantaneous price adjustments. This has given rise to a vibrant New Keynesian research program, which enables political science to bring partisan politics and the role of labor-market institutions back into the analysis. Next, we provide a brief analysis of the recent economic history of advanced industrial democracies in light of the concepts and theories discussed in the previous sections. We argue that the key issue is not time inconsistency but policy coordination. We conclude with some ideas about the implications for the study of macroeconomics in political science.

## KEYNESIANISM AND THE NEW CLASSICAL CHALLENGE

From the end of the Second World War through the 1970s, policy makers and macroeconomists in most advanced economies subscribed to a coherent set of Keynesian views (Hall 1986, 1989). As these views were honed in forecasting models and textbooks, two relations became central: First, employment (and conversely unemployment) was determined by aggregate demand, comprised of

government expenditure and private expenditure (consumption and investment); the government could affect unemployment by fiscal policy operating on consumption and/or by monetary policy operating on investment. Keynesians assumed that governments would pursue counter-cyclical policies by running deficits during recessions and surpluses during booms. Second, inflation depended inversely on the rate of unemployment; there was a long-term trade-off between the two, defined as the Phillips curve, with a reduction in unemployment implying a rise in inflation. This relation was commonly seen as operating through union-wage bargaining. The ability of unions to bargain (money) wage increases depended on unemployment as an inverse measure of labor-market tightness, and wage increases fed through into inflation. This implied that unions, if they chose not to exploit their bargaining power fully, could reduce the inflation rate associated with any given unemployment rate.

The most influential application of Keynesian macroeconomics in political science is by Hibbs (1977). Hibbs based his argument on the Phillips curve, and the logic was as straightforward as it was original. He argued that the optimal choice in the trade-off depends on the interests that parties represent. Because the constituencies of left parties tend to have insecure jobs and low savings (perhaps debt), they are more concerned about unemployment than inflation compared with the constituencies of right parties, who tend to be in more secure labor-market positions and have higher savings. With this simple conjecture, Hibbs used politics to explain a striking variance in inflation and especially unemployment across countries.

Some of the literature on neo-corporatism, which was prominent in the 1970s and early 1980s, incorporated Hibbs' ideas into a broader institutional argument. In countries with highly centralized unions and wage-bargaining systems, governments could encourage unions to adopt farsighted wage moderation by reassuring their members that jobs and future income were protected by counter-cyclical macroeconomic policies and high levels of social protection. Given their association with unions, left governments were in a particularly strong position to accomplish this combination of wage restraint and full employment (Cameron 1984, Lange & Garrett 1985). In countries with more fragmented unions, on the other hand, accommodating macroeconomic policies were likely to encourage militancy and result in inferior economic performance. In this context, right-wing policies to impose wage discipline might be more effective (Lange & Garrett 1985). This result was in broad agreement with Calmfors & Driffill's (1988) argument that a "hump-shaped" relationship existed between centralization and unemployment: Either complete decentralization or complete centralization would produce the best employment performance (although they did not consider the role of macroeconomic policies).

The focus of both Hibbs and the neo-corporatist literature was to explain differences in real economic variables, especially unemployment, and much effort went into understanding cross-national differences. But developments in macroeconomic theory in the 1970s and 1980s threw the Keynesian economics that

underpinned these arguments into disarray (see Alt & Chrystal 1983 for a review of this literature). Friedman (1968) was the first to provide a systematic critique of the Phillips curve. At the heart of the problem, he argued, was a blurring of nominal and real wages. If governments engineered a rise in demand, it was true that some workers who had been searching for better-paid jobs would now be able to find them. But this is only because the rise in their nominal wages exceeded their inflation expectations based on past inflation. Once the nominal wage inflation translated into equivalent price inflation, workers would realize that real wages were no higher than before and thus update their expectations of future inflation. Unemployment would therefore revert back to its previous level unless the government produced another demand shock. Each time this process is repeated, the Phillips curve becomes steeper, and in the long run it turns vertical. This is the point where the unemployment rate reaches its equilibrium, which Friedman called the natural rate of unemployment. Today it is more common to talk about the equilibrium rate of unemployment, which does not assume that all unemployment is voluntary.

Friedman delivered his American Economic Association presidential address (Friedman 1968) just before the rational expectations approach was applied to macroeconomics. The term rational expectations was largely interpreted as closing down any possibility of changing unemployment except possibly in the very short run. Suppose that employees do not determine their inflation expectations retrospectively but instead ask what inflation would have to be if unemployment were below equilibrium unemployment. In that case, wage inflation has to be greater than expected price inflation to raise the expected real wage; however, because price inflation then has to equal wage inflation to restore profit margins, price inflation has to be greater than expected price inflation. That implies that the only consistent forecast of inflation is infinite if unemployment is below equilibrium. With rational expectations, there consequently would not be even a short-term employment effect of government policies.<sup>1</sup> In a few logical steps, therefore, new classical economists ruled out any beneficial role of the government in the macro economy. In sharp contrast to the optimistic view of Keynesians, the focus of the new economics subdiscipline of political economy that developed through the 1980s was on governmental failure, in particular on the failure of democratic governments. Most political scientists seem eventually to have accepted this approach. Yet, ironically, as described below, mainstream modern macroeconomics has moved some distance from the new classical model toward what is often referred to as New Keynesian macroeconomics. This may enable political scientists to take a more positive approach to the role of democratic governments.

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<sup>1</sup>There are important conditions for this result to hold, among them the uniqueness of the equilibrium rate, complete information, instantaneous price adjustment, and common knowledge of all these factors including the rationality of participants.

## Time Inconsistency

To understand how new classical economics transformed the understanding of the government's role in the economy, it is useful to briefly recount the Barro-Gordon model of inflation (Barro & Gordon 1983). This model brings out clearly the problem of time inconsistency, which is critical to all new classical models of the politics of macroeconomics. We then turn to the enormous literature on central bank independence and political business cycles (PBCs) that builds on new classical economics.

In the Barro-Gordon model, unemployment at any moment in time is equal to the equilibrium rate of unemployment plus some positive function of the difference between the actual rate of inflation and the expected rate of inflation. Governments can use their control over monetary policy instruments to set the inflation rate, and they are assumed to care about both unemployment and inflation. In most PBC models, democratic governments are not differentiated on how much they weigh these goals, but it is assumed that their target rate of unemployment is below the equilibrium rate.

Because governments dislike inflation and cannot affect the equilibrium rate of unemployment, it may be expected that they would simply announce an inflation target of zero and stick to it. But it is easy to show that this would not be an equilibrium. If people believe the announced policy, it is no longer in the government's interest to follow through on its promise. Because economic agents expect no inflation, zero inflation would require the government to set unemployment equal to equilibrium unemployment. But the government prefers a lower level of unemployment and so would reduce unemployment below the equilibrium level. This is the time-inconsistency problem in monetary policy making. Because it would therefore not be rational for people to expect zero inflation, inflation expectations are raised to the point where the government's utility from a small additional increase in employment is exactly equal to the disutility from the associated rise in inflation. At that point, expected and actual inflation are identical, and inflation will always be greater than zero if the government's inflation target is zero.

The time-inconsistency problem implies that the fundamental issue in macroeconomic policy making is an incomplete contracting problem between the government and voters. And like other incomplete contracting problems, this problem has an institutional solution. In this case, it is the delegation of policy-making power to an independent central bank with a utility function that targets equilibrium unemployment (Cukierman 1992). The time-inconsistency problem will disappear because the central bank has an incentive to stick to a low inflation target (it does not care about unemployment), which economic agents will therefore come to expect. There will be no effects on unemployment. Delegation to conservative central banks is, in the words of Grilli et al. (1991), a free lunch.

## Political Business Cycles

In the Barro-Gordon framework, democratic governments produce unnecessarily high inflation, but because people have rational expectations and markets adjust

instantaneously, there is also no possibility for politically induced business cycles. In models with adaptive expectations, such cycles can occur because governments can temporarily exploit a short-term Phillips curve trade-off to boost their reelection chances (Nordhaus 1975, McRae 1977). Yet because most contemporary models assume rational expectations, a different mechanism is needed. That mechanism is incomplete information, which can generate cycles in policy instruments and inflation. If combined with nominal wage and price contracts, incomplete information can generate short-term cycles in both policies and real outcomes.

The key implications of incomplete information for macroeconomics were developed by Lucas (1977). As in the Barro-Gordon model, economic agents will completely discount macroeconomic policies designed to increase aggregate demand because these policies will only raise inflation. But economic agents may not be able to distinguish this effect from price increases that result from relative changes in demand for particular goods. The model thus identifies a “signal extraction” problem, where the true source of price increases is only known retrospectively.

The specific sources of uncertainty vary in different models and have different implications for the effects of politics. Pure PBC models assume there are differences in government competence (Rogoff & Sibert 1988). Voters obviously prefer competent governments, but since competence is not directly observable, incompetent governments can try to “signal” their competence by cutting taxes and printing money before an election. Voters may not be able to tell whether lower taxes are in fact the result of government efficiency. When deficits and seigniorage cannot be distinguished from competence, the result may be what in game theory is called a pooling equilibrium: Incompetent governments mimic competent ones, and voters cannot tell the difference. In this world, governments on average cut taxes and spend more around elections than is socially optimal. The moment the inflationary consequences of these policies become evident, however, expectations are changed. Cycles in *real* outcomes are therefore unlikely, and they do not seem to appear empirically (Drazen 2000).

Alesina’s (1989) partisan PBC model assumes that governments have partisan preferences as in Hibbs’ model, and there is incomplete information because people cannot predict with certainty who will win the next election. Inflation expectations will therefore be somewhere between inflation under a left and a right government (weighted by the probability of each side winning). If, in addition, nominal wages are temporarily fixed by wage contracts, the election will also affect employment as firms hire workers at a lower real wage under left governments and dismiss them as a result of higher real wages under right governments.<sup>2</sup> These effects persist only as long as it takes to renegotiate contracts, so at the end of their terms left and right governments leave no mark on the real economy. Inflation, however, will be higher under left governments.

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<sup>2</sup>Strictly speaking, this is a deviation from the perfect competition assumption in the new classical model, but Alesina’s model is otherwise in this tradition and is usually treated as such.

There are some obvious questions one can raise about Alesina's model. For example, it is not clear why contracts are not set to expire on election day or why they are not negotiated in real terms. Another issue, and to us a more important one, is the role of partisanship. Hibbs' partisan argument, which Alesina adopts, implies that parties maximize the utility of their constituents. In the Alesina model, that presumably means that the preferred post-election policy for workers would be one that satisfies their inflation expectations (so that wage contracts remain optimal). Yet left parties are assumed to pursue policies that increase inflation above the expected level. If they instead stuck to workers' preferred policy (as in Hibbs), it is not clear that the time-inconsistency problem would arise in the first place. As we argue below, parties that care about employment may be far more interested in designing policies that can reduce the equilibrium level of unemployment than in policies that generate brief bursts of employment (which are inefficient from the perspective of their core constituents). However, because new classical theory assumes a unique equilibrium rate of unemployment, it has nothing to contribute to the analysis of this topic.

The PBC literature offers many variations on these general themes. The main contributions of political scientists have been to add institutional context to PBC models. Franzese (2003) and Clark (2003) have argued that election cycles are more likely when the central bank is relatively dependent. Clark & Reichert (1998) likewise suggest high capital mobility and fixed exchange rates constrain the policy-making autonomy of governments, which dampens monetary cycles [though cycles may occur in fiscal-policy instruments instead, as recognized by Clark (2003)]. In a similar vein, Way (2000) proposes that partisan cycles are dampened by central bank independence.

Much of the newest literature on the effects of central bank independence on inflation centers on the importance of the broader institutional context. Such effects depend on the wage-bargaining system (Adolph 2004, Franzese 2003, Hall & Franzese 1998, Iversen 1999), on economic openness (Romer 1993), and on the strength of the financial sector (Adolph 2004). More independent and conservative central banks are found to be strongly associated with lower inflation, especially in closed economies with powerful but uncoordinated unions (Franzese 1999, 2003). But it remains unclear to what extent independence or conservatism is itself a reflection of the preferences of the government and of society more broadly (Posen 1993).

Much effort has gone into testing the PBC arguments, and there is no lack of methodological sophistication in the literature. Most findings, however, are mixed and substantively fairly weak. In one of the most comprehensive attempts to test PBC theory, Alesina & Roubini (1992) and Alesina et al. (1992) find no persistent differences between the left and right in terms of real outcome variables such as growth and unemployment using a sample of 18 OECD countries between 1960 and 1987.<sup>3</sup> Yet, output growth and employment do tend to rise temporarily after

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<sup>3</sup>They do find inflation to be slightly higher under left governments, but the effect is not statistically significant for the sample as a whole.

a shift to a left government. For countries with a clear distinction between left and right governments (8 out of the 18 countries), the effect peaks after about six quarters, with a 1.3% rise in growth and a 1.5% drop in unemployment. For the sample as a whole the results are weaker, and in the country-by-country regressions only three cases exhibit statistically significant effects at the 5% level (see Alesina et al. 1991). No differences between the left and right are visible after 8–9 quarters.

These results are clearly consistent with rational partisan PBC theory. They are also, however, consistent with a standard Keynesian counter-cyclical model of macroeconomic policies. If government turnover is more likely after a negative economic shock—as economic voting implies (Lewis-Beck 1988)—and if left governments care more about unemployment, then a left shift in the government will tend to be associated with a counter-cyclical expansion of output and employment. Cusack (1999) has found strong evidence that left governments respond more aggressively to output shocks than right governments.

In terms of election-induced PBCs, Alesina & Roubini (1992) find evidence of postelection increases in inflation, but they can find no pre-election increases in growth or employment. These results are interpreted as consistent with models of rational cycles in monetary instruments but not with Nordhaus's adaptive expectations model. A little mischievously, one could ask whether they are also not inconsistent with the rational partisan PBC model as this model assumes fixed nominal wage contracts. Such contracts should cause real cycles whenever nominal cycles occur.

The most recent test of PBC theory (Adolph 2004, ch. 7) examines the post-Bretton Woods period up to 1998. Following an estimation strategy very similar to Alesina & Roubini's, but with additional control variables, Adolph finds that the peak temporary effect on unemployment occurs after 10 quarters and is in the order of 0.5%—about one third of the effect reported by Alesina and Roubini. Testing a variety of different specifications, Adolph also finds no interactive effects between partisanship and central bank independence, although rational PBC theory predicts such effects. Instead Adolph finds that partisanship has notable effects on the long-term rate of unemployment when labor markets are intermediately centralized—a finding magnified when central bank independence is high. These results are more in the spirit of Hibbs and the neo-corporatist literature. Below we return to the critical question of how governments can affect the equilibrium rate of unemployment.

Leaving aside the quantitative evidence, there is some anecdotal evidence that governments have occasionally engineered significant reflation. The best example is perhaps what happened after the socialist government of Mitterrand came to power in France in 1981. Honoring a strong pre-electoral commitment to reduce unemployment and expand social services, economic policies under the new government raised inflation and caused three large and rapid currency devaluations. Then policies were abruptly reversed to bring prices under control and recommit France to the European Monetary System. This sequence of events fits well with the predictions of Alesina's model, but it is hard to think of similarly clear examples among advanced democracies, and it is not hard to think of counterexamples.

One such counterexample is the German experience under the social democratic Schröder government. Although the last three elections have been close—the last a virtual tie—and unemployment is high, the social democratic government has pursued restrictive fiscal policies. Germany is doubtless concerned not to break the Stability and Growth Pact too flagrantly. But, as suggested by Soskice et al. (1992), we suspect that governments are more farsighted and more concerned with reputation than standard PBC models allow. Although Alesina recognizes that governments are partisan, parties in this and other PBC models are supremely concerned with the short term. We do not believe that this is generally true. Indeed, the interesting puzzle may be why there is so little evidence for widespread and significant political manipulation of the economy.

### Political Fragmentation and Deficit Spending

Another prominent argument about the economic role of governments in democratic societies often used in conjunction with the new classical time-inconsistency problem comes from public choice theory [originating with the seminal work of Buchanan & Tullock (1962) and Olson (1965)]. It is loosely similar to the neo-corporatist amendment to Keynesianism, except that political parties and groups play an unambiguously negative role. There are several related arguments, but the basic idea is that when there are many parties in government, especially when the parties have distinct preferences and government turnover is high, no one will look after the collective interest. The result is excessive spending, deficits, and delayed stabilizations (Alesina & Drazen 1991; Alesina & Perotti 1994; Bawn & Rosenbluth 2006; Franzese 2002, ch. 3; Grilli et al. 1991; Weingast et al. 1981).

The simplest argument is that multiple parties produce a common pool problem where all parties spend on their own constituencies, while discounting the cost of such spending on the constituencies of other parties. By financing some of this spending through borrowing, some of the costs will fall on future governments. The relationship to new classical macroeconomics is that deficits and excessive spending will not affect economic output because higher interest rates and public spending in an economy with perfectly competitive markets and rational expectations will crowd out private investment and spending. Compared with the socially optimal levels, however, public investment and spending will be too high.

In the widely cited empirical study by Grilli et al. (1991), fragmentation is linked to political institutions, especially as to whether the electoral system is (multiparty) PR or (two-party) majoritarian. They conclude that “deficits are much larger in representational [PR] democracies” (p. 352). Their data, however, can easily be challenged. Countries such as Norway and Sweden, which are PR and have consistently run surpluses, are left out, and fiscally conservative PR countries such as Germany and Switzerland are misclassified as majoritarian.<sup>4</sup> If the latter are

<sup>4</sup>In the case of Germany, the reason for the misclassification seems to be that half of the representatives are elected in single-member districts, but this ignores that the other half is chosen to ensure the overall result is proportional. Switzerland also has a very proportional electoral system.

reclassified as PR, the relationship disappears, and if Norway and Sweden are included, the relationship reverses. In a detailed empirical analysis, Franzese (2002, p. 175) concludes that “evidence regarding the debt impacts of multiple-constituencies is mixed at best,” although he finds evidence that fragmented governments are slower in adjusting debt levels.

We discuss below why there might be no relationship between proportional representation and loose fiscal and monetary policies. One reason is that multiparty governments can adopt fairly straightforward budgetary procedures, as convincingly explained by Von Hagen & Hallerberg (1999) and Hallerberg (2004). Another is that parties in such governments have an interest in monitoring policy decisions by making such policies more transparent. This is achieved through fixed exchange rates, independent central banks, and other institutional devices (Bernhard 1998, Bernhard & Leblang 1999). We think these arguments are exactly right, but they are not completely clear about the microlevel incentives that drive parties to accept constraints on their behavior. As we show below, shortsighted governments prefer to retain flexibility.

## NEW KEYNESIAN MACROECONOMICS

This section outlines some of the main propositions of mainstream modern macroeconomics, often referred to as New Keynesian macroeconomics and associated with such economists as Ball, Blanchard, Bernanke, Svensson, Mankiw, Romer, Clarida, Gali, and Gertler.<sup>5</sup> Unlike new classical models, New Keynesian ones assume that markets are not perfectly competitive and that prices and wages take time to adjust. It is noteworthy that although these models imply that governments can have a strong effect on the real economy, they are rarely used by political scientists. We think this is a mistake and encourage political scientists to take the insights of modern macroeconomics on board.

The first subsection sketches out the so-called three-equation model. This model is at the core of modern central bank practice and graduate macroeconomics. The large forecasting models used by central banks, international organizations, and governments are disaggregated forms of the model. It explains how economies respond to demand and inflation shocks, with monetary policy playing a key role. We then turn to an analysis of equilibrium unemployment in a New Keynesian framework. Finally we reassess the politics of economic institutional choice, especially the decision to impose independent central banks on governments, in light of the insights from the theory.

### The Three-Equation Model

In the three-equation model, the first equation determines aggregate demand or economic activity. Aggregate demand depends on three major factors: the real

<sup>5</sup>For a detailed discussion of the foundational work, see Carlin & Soskice (2005), on which this section builds.

rate of interest, controlled by the central bank; fiscal policy, controlled by the government; and exogenous private-sector expenditure. Leaving fiscal policy aside for the moment, this equation says that aggregate demand depends positively on exogenous private-sector expenditure and negatively on the interest rate. The lag structure is important: There is usually assumed to be an average lag of a year before interest rates affect demand. This is the broad assumption made by the Bank of England and the assumption built into a widely used version of the three-equation model referred to as the Ball-Svensson model (Svensson 1997). This equation is called the IS or aggregate-demand equation. Because unemployment is closely inversely related to the level of economic activity, we can also think of the equation as determining unemployment.

The second equation is the short-run Phillips curve, which determines inflation. Excess demand in the labor market, the difference between unemployment and equilibrium unemployment, takes about a year to impact the rate of inflation. It pushes up inflation relative to what wage and price setters expect the rate of inflation to be. The logic here is that excess demand for a particular good or service leads the relevant price setter(s) to try to raise its expected relative price, by increasing its price faster than the expected rise in the general price level; repeated throughout the economy, the general price level rises faster than its expected increase. Empirically there is strong evidence that the expected increase in inflation is simply its pre-existing rate. Hence inflation rises faster than its pre-existing rate if unemployment is below equilibrium, and it rises more slowly if there is excess aggregate supply. Combining the IS and Phillips curve equations shows, for example, that a cut in the interest rate in 2001 reduces unemployment in 2002 which in turn raises inflation relative to its existing rate in 2003.

The third equation is the monetary rule, sometimes called the Taylor rule, and it shows how the central bank sets current interest rates to respond to the deviation of inflation from the target and to the deviation of unemployment from equilibrium. It therefore closes the model. Imagine that in 2006 inflation rises above the bank's target rate. The central bank responds using the Taylor rule by raising the interest rate. Via the IS curve, the higher current (2006) interest rate dampens activity levels in 2007, pushing up unemployment and creating excess supply in the labor market. Using the Phillips curve, we can see that inflation then begins to fall in 2008, as a result of the excess supply in the labor market in 2007. How fast it falls depends on how wage increases respond to the excess supply.

Alternatively, using the 2001 example, inflation is not a problem, but unemployment has risen above equilibrium. The central bank therefore responds to this excess supply in the labor market by cutting interest rates in 2001, thus aiming to eliminate the excess supply in 2002. (That is the theory; in fact, monetary policy was insufficiently powerful to do this; we return to this issue below.) The matter is not quite so simple; the excess supply in 2001 reduces inflation in 2002 below target inflation, so the interest-rate cut in 2001 has to push unemployment in 2002

below the equilibrium rate to boost inflation in 2003 to restore it to its target rate. In fact this illustrates the complicated forecasting activities in which central banks are more or less continuously engaged.

In this model the central bank restores the economy to equilibrium in a period of years. If the economy is in equilibrium, fiscal expansion is more or less self-defeating in the short to medium term. If the government uses fiscal policy to expand activity and reduce unemployment, this would be effective for at most a year, for by then the interest rates the central bank would have raised in response would have come into operation.

**DEPOLITICIZATION OF DEMAND MANAGEMENT** Demand management is depoliticized in this standard version of the three-equation model. The government's role is quite limited. Monetary policy governs demand management. The government cannot (by the assumptions of the model) influence monetary policy because that is controlled by an independent central bank. If the government attempts to boost activity above equilibrium by using fiscal policy, the central bank will treat this as a demand shock and raise interest rates concurrently. (There are two possibilities depending on the time lag between fiscal policy and economic activity. If the lag from fiscal policy is the same as that from monetary policy, then there will be no effect on the level of activity either currently or subsequently. The only effect of the expansionary fiscal policy will be to increase interest rates sufficiently to reduce interest-sensitive private expenditure by an amount equal to the fiscal expansion. If fiscal policy operates faster than monetary policy, economic activity will expand in the short run and will contract after a year or so.) One implication of this is that any attempt to discover electoral cycles will be of limited effect.

But note that the primary cause of depoliticization is the unexplained existence of an independent central bank and the concomitant assumption that the independent central bank has three goals: (a) to minimize inflation fluctuations around a low inflation target, (b) to minimize unemployment fluctuations around equilibrium unemployment, and (c) to assign a relatively high weight to minimizing inflation relative to output fluctuations.

As discussed below, even given an independent central bank, politicians may not have their hands so completely tied behind their back as the above makes out. However, a more fundamental question we address below is why governments should have set up independent central banks in the first place. Why should governments have given up power in this critical area, if they really valued the ability to produce pre-election booms? Why should they not take the power back again? If the lag structure of the three-equation model is correct, governments could have a very significant effect on the real economy, and it is unlikely that they would set up independent central banks if they had target unemployment rates below the equilibrium rate. This is a key political problem in the model that economists have no solution to.

## Equilibrium Unemployment

New Keynesian economics also explains the determinants of equilibrium unemployment and why it may be different from full employment—i.e., why there may be involuntary unemployment. This is highly relevant to our understanding of the choices governments face. A critical component is that prices and wages are set by agents instead of being the result of competitive market clearing; prices are set by businesses, and wages are set either by businesses (efficiency wages) or by union negotiation. Because businesses and unions are partial monopolies, they typically do not set market-clearing wages or prices, thus allowing the possibility of involuntary unemployment and excess capacity.

Here we present a simple model of equilibrium. There are a number of different sectors in the economy, and in each a union independently sets its expected real wage, that is the wage in the sector divided by the expected general price level. Because the bargaining capacity of a union depends primarily on the level of economic activity (or inversely, unemployment), the expected real wage unions can effectively demand increases with the level of economic activity. (At any expected real wage, the actual level of unemployment will be higher than the voluntarily chosen level of unemployment.)

At the same time, businesses set their prices relative to their cost of production to get whatever profit markup their market will bear. Assume businesses in each sector are identical, and suppose labor is the only cost of production and productivity is 1. To get the markup  $\mu$  on costs the market will bear, businesses set the price  $P = (1 + \mu)W$ . This implies that the real wage businesses “set” via their pricing is  $W/P = 1/(1 + \mu)$ ; the higher the markup, the lower the real wage. We might think of this as the real wage businesses impose on the economy, and we can call it the business real wage.

The economy is in equilibrium when the bargained expected real wage is equal to the business real wage. Because the bargained real wage decreases as unemployment rises (i.e., the level of economic activity falls), there will be some unique unemployment rate at which the bargained expected real wage is equal to the business real wage. This is the equilibrium rate of unemployment. Three implications follow. First, the higher the bargained real wage is at any given rate of unemployment (the stronger the bargaining power of unions), the higher the equilibrium rate of unemployment will be. Second, the lower the business real wage is, the higher the equilibrium rate of unemployment will be; the business real wage may decrease because of a higher markup or because of increased nonwage costs such as an increased price of energy. In both cases, union bargaining power has to be decreased to make the bargained real wage equal to the business real wage. The third implication is that the equilibrium unemployment rate is above full employment.

It is not difficult to see that, if unemployment falls below the equilibrium rate, inflation will rise, and vice versa. Suppose, from equilibrium and a rate of inflation of 2%, that unemployment is reduced. This implies that the bargained real wage will rise, leading unions to set nominal wage increases above their view of the

expected rate of inflation, enabling them to increase the expected real wage. As noted in the three-equation model, the expected rate of inflation is usually taken in practical terms to be the pre-existing rate of inflation, in this case 2%, embodying the idea that wages and prices only adjust slowly. How much wage inflation rises depends on real wage rigidity. By definition, the greater the real wage rigidity, the less responsive bargained real wages are to the difference between actual and equilibrium unemployment. One ballpark empirical measure is that a 1% rise in unemployment above equilibrium raises wage inflation by 1% above expected price inflation. Thus if unemployment falls by 1%, wage inflation rises by 3%. But the business real wage has not changed. Therefore a 3% rise in costs requires a 3% rise in price inflation. If unemployment remains 1% below equilibrium, inflation rises 1% per annum. The consequence is that below equilibrium, unemployment implies steadily rising rates of inflation.

The analysis of equilibrium unemployment suggests a framework to analyze income policies and wage moderation more generally. If unions can agree to wage moderation, then the bargained real wage at any given rate of unemployment will decrease, and hence the equilibrium rate of unemployment at which the bargained real wage is equal to the business real wage will fall. The larger the number of independent unions, the harder this becomes. If  $N-1$  unions agree on wage moderation, where  $N$  is a large number, the gain to the  $N$ th union from free riding on the general moderation and demanding higher bargained real wages will be great, and the incentive on the part of the other  $N-1$  unions from retaliating (by stopping moderation) will be limited.

If unions can agree to moderate their bargaining jointly, then equilibrium unemployment will fall. But unions may be concerned that governments will use the fall in unemployment equilibrium to reduce inflation. This is because the three-equation model provides no guarantee that the authorities will cut interest rates or boost fiscal policy in such a way as to cut unemployment in line with the fall in equilibrium unemployment. Thus governments have to develop bargains with unions: In exchange for wage moderation, governments agree to use Keynesian aggregate-demand policies. Wage moderation may be exchanged for other benefits. In some of the social pacts of the 1990s in the run-up to European Monetary Union (EMU), unions were prepared to accept a reduction in inflation to meet the conditions for EMU membership they valued.

There is, however, an important intermediate case of neither complete decentralization nor complete centralization, which covers many real cases. When there are a few large industry unions that are not coordinated at the peak level, wages bargained by each union will have some effect on the whole economy, but only the portion of wage increases that affects employment conditions in the union's own industry will be internalized. This situation leads to high unemployment (Calmfors & Driffill 1988). Yet in a New Keynesian model this depends on macroeconomic policies because the effect of each union's wage demand on the real money supply, and hence employment, depends on whether price increases are being accommodated and whether wage setters are capable of adjusting their behavior accordingly.

If policies are nonaccommodating, and wage setters can anticipate this, the effect of each union's wage increase on the real money supply will be greater and the incentive to moderate wages will therefore be higher (Scharpf 1991, Iversen 1998, Soskice & Iversen 2001; for a contrasting view, see Hall & Franzese 1998). In this situation, which broadly corresponds to the conditions in Germany up until the beginning of the EMU (Hall 1994), accommodating macroeconomic policies will actually increase medium-term unemployment. There is thus a reason for governments to resist such policies if they can look beyond the short term (Scharpf 1991).

## The Politics of Institutional Choice Revisited

The Barro-Gordon analysis of time inconsistency takes the case of a "bad" government, a government that prefers an unemployment rate below the equilibrium rate, at least when inflation is at the government's preferred (low) rate of say 2%. Only if the inflation rate is at some high level, say 5%, will the government choose the stabilization of inflation over below-equilibrium unemployment. As demonstrated above, in a world of rational expectations and instantaneous price and wage adjustment, wage and price setters know that only if they set expected inflation to 5% will the government choose equilibrium unemployment and hence validate 5% inflation. In such a world it would behoove the bad government to agree to an independent central bank, for once it is in place the central bank would lead inflation expectations and actual inflation to fall to 2% while unemployment remained in equilibrium. The bad government would unambiguously be better off with the independent central bank.

From this theoretical basis a depoliticized economists' narrative of central bank independence arose:

1. From the end of the Second World War through the 1970s, governments practiced Keynesian demand management without the awareness that there was a unique equilibrium rate of unemployment. Consequently inflation rose gradually as a result of growing union power, and it rose sharply when OPEC used its power in the 1970s to raise the real price of energy. This is an example of government-demand management targeting a full employment rate of output now above the equilibrium rate.
2. The intellectual breakthrough of economists in the early 1980s, described above, shows the real nature of the problem and how the government can solve it by setting up a new institution that can commit to the equilibrium rate of unemployment, most obviously an independent central bank.
3. Governments realize the problem and the solution, set up independent central banks, and install depoliticized demand management. Inflation falls. Under the assumptions of the new classical model, this is a free lunch for the bad government.

If markets were perfectly competitive and future inflation fully anticipated (as in the Barro-Gordon model), there would be little point in the government insisting

on monetary policy autonomy.<sup>6</sup> But as seen in the three-equation model, the real world is not like that. Imagine that the bad government has produced the outcome of 5% inflation and equilibrium unemployment. Now the government is presented with the option of setting up an independent central bank. If the independent central bank is set up (assuming the government does not intervene and that wage and price setters believe it will not), it will at once (year 0) raise interest rates. In a year's time (year 1), unemployment will be pushed up. There will be no effect yet on inflation. Thus in year 1 the bad government is unambiguously worse off with the same rate of inflation and higher unemployment. Inflation falls in year 2. But the bad government is still unambiguously worse off. Here is why: When the bad government had to choose the rate of unemployment subject to the Phillips curve with inflation expectations of 5% (before the independent central bank was established), it chose the equilibrium unemployment rate. Thus, on the standard assumption of a curved indifference curve, the government prefers equilibrium unemployment and 5% inflation to any other point on the 5%-inflation-expectations Phillips curve. Hence it prefers equilibrium unemployment and 5% inflation to whatever other point on the same Phillips curve the independent central bank may have chosen to be at in year 2.

So the bad government is certainly worse off for two years after setting up the independent central bank. Given real wage rigidity, implying that the Phillips curve is relatively flat, and that inflation is only falling slowly at any given rate of above-equilibrium unemployment, it is plausible that the bad government would be worse off for a considerably longer period of time. To verify this requires empirical research; as far as we are aware, none has been done in this vein. But the conclusion seems clear: If governments are bad, as assumed by new classical economics, the assumption in New Keynesian economics that central banks are independent would never hold.

## A BRIEF ANALYTICAL HISTORY OF MACROECONOMIC POLICIES

In this section we try to bring the theoretical models and issues covered in previous sections alive by interpreting them in light of the postwar economic history of advanced industrial democracies, especially in Western Europe. Loosely speaking, we use postwar economic history as a testing ground for the theories we have described. Our biases are already obvious because we do not think new classical economics, and the public choice and PBC literatures, provide much leverage in understanding this history. Even for the period when most economies ran into deep trouble, the economists' narrative simply does not describe what happened.

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<sup>6</sup>This is essentially the situation covered by Clark (2003), who concludes that even short-sighted governments would choose an independent central bank with fixed exchange rates.

## The Rise of the Keynesian Welfare State

Following the devastation of the Second World War, international financial institutions were not prepared to finance the enormous costs of reconstruction, and the bulk of investments had to come out of domestic savings.<sup>7</sup> Such savings, in turn, required wage restraint and higher profits (Eichengreen 1997). Convincing unions to hold back consumption, and employers to invest the profits, therefore held the key to economic growth. The logic was simple but its practical application was not.

For this to happen, individual unions had to be convinced not to free ride on wage restraint and investment in other sectors, and labor as a whole had to be persuaded that the higher profits enabled by wage restraint would be reinvested and not consumed. Likewise, employers had to be reassured that their investments in human and physical capital would not be subject to holdup by shortsighted unions and governments. With such a complex set of collective action and commitment problems, the social choice image of shortsighted and opportunistic politicians eager to guarantee their own reelection, while using the public purse to reward their core supporters, did not bode well for the economic future of Europe. But this gloomy prediction never materialized, and democratic governments in fact came to play a key role in the economic success of Western Europe.

They accomplished this, we argue, largely because they kept their sights on medium- and long-term economic goals and did what they could to make sure unions and employers did the same. By expanding social insurance while penalizing conspicuous consumption through taxation, at the same time rewarding the reinvestment of profits through subsidies and low interest rates, governments played a key role in reassuring unions that if they held back wages, the resulting increase in profits would generate handsome returns to their members in the future (Eichengreen 1997, Flanagan et al. 1983, Katzenstein 1985, Stephens 1979). Social insurance made the “investment” in wage restraint less risky, and counter-cyclical macroeconomic policies were designed to maintain the highest possible level of employment consistent with stable prices and international competitiveness in the fixed-exchange-rate environment of Bretton Woods. This is consistent with the discussion of wage moderation above and far closer to the Hibbsian and neo-corporatist accounts than to the new classical one.

At the core of this bargain was a complex set of institutions, especially centralized wage bargaining, that facilitated macroeconomic coordination, overcame collective action problems, and empowered governments to assume a supporting role by providing unemployment, health, and retirement benefits that reduced workers’ uncertainty about the future (Eichengreen 1997). Contrary to popular notions, the expansion of the welfare state, coupled with counter-cyclical macroeconomic policies, was associated with a decline in industrial conflict (Korpi & Shalev 1979). These policies also encouraged workers to invest in firm- and industry-specific

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<sup>7</sup>This section builds on Iversen (2005, ch. 2).

skills because they provided an insurance against the risks of income loss in the event of redundancies (Eichengreen & Iversen 1999). In this manner, governments facilitated the expansion of highly effective vocational training systems that helped firms compete successfully in the international economy.

Politically, coordination was facilitated by well-organized interest associations, responsible and programmatic political parties, and political institutions that facilitated compromise. Another important component of the continental European success story appears to have been that unions and employers in the exposed manufacturing sector were the largest, best-organized, and politically most influential actors. Because unions and employers in this sector had a strong incentive to reach wage settlements that would maintain international competitiveness, economy-wide wage moderation was easier to accomplish (Swenson 1989, 1991). This is a condition that may well be missing in many Latin American cases, where large nontraded sectors have played a more central political role (Frieden et al. 2001, Bloomberg et al. 2005) (see below for more on this contrast).

For our purposes, a central question is how governments could be relied on to pursue long-term macroeconomic policies, contrary to the focus on time inconsistency and common pool problems in the PBC and public choice literatures. It was helpful, to be sure, that the extreme left and right had been thoroughly discredited by the war, leading mainstream parties to emphasize compromise and economic growth. Farsightedness and compromise were also facilitated in some countries by proportional representation, which meant that parties could safely pursue their constituents' interests without fear of losing the next election, while governments would have an interest in getting broad legislative support for legislation that had to be approved by the social partners.

Equally important, the phase of mass mobilization early in the century had gradually given way to a more or less "frozen" party system characterized by stable voting blocks (Lipset & Rokkan 1967). No particular group could reasonably aspire to become hegemonic in a PR electoral system. This reduced the incentives of parties to try to buy off each other's constituencies through populist tax cuts and deficit spending. In turn, elites' emphasis on growth, distributional justice, and consensus building encouraged voters to judge government performance on precisely those dimensions. Research on economic voting shows that voters consider performance across several quarters and often behave in a manner that suggests they can forecast the effects of current policies on future performance (Clarke & Stewart 1994, Lewis-Beck 1988). Policies seen as quick fixes, such as exchange-rate devaluation, are frequently discounted or punished by electorates (Bernhard & Leblang 2002), and in countries where political institutions make it difficult to pinpoint the responsibility for economic policies, people simply refrain from voting on the current state of the economy (Powell & Whitten 1993).

From the unions' perspective, proportional representation and center-left coalitions helped ensure that future governments would not move radically against their interests, thereby reducing future uncertainty. Insofar as parties owed their electoral success as much to the efforts of highly centralized organizations of capital

and labor (the latter in particular) as to their own industriousness, governments had an incentive to consult and involve labor organizations in the preparation of new legislation and to seek their consent in its implementation. This secured the consent of powerful unions but also limited policy flexibility. In effect, the existence of disciplined mass organizations outside the political system enabled mainstream political parties to credibly commit to the consensus policies of postwar Europe.

In addition to these domestic institutional conditions, the international trade and monetary regime gave governments a limited but important measure of fiscal and monetary policy autonomy by cushioning currencies against speculative attacks and by permitting governments to restrict and direct the international flow of capital. Likewise, the General Agreement on Tariffs and Trade (GATT) provided the basis for an expansion of trade, but by bringing down trade barriers only gradually it allowed many exemptions to help European countries build their own industries into effective competitors with U.S. counterparts (Ruggie 1983).

It is in this political-institutional environment that we should understand the Keynesian consensus, the rise of neo-corporatist theory, and Hibbs' conjecture about the role of partisanship. In countries where the political-institutional conditions for class compromise were best approximated during the 1960s (including centralized wage bargaining, proportional representation, and frequent center-left governments), unemployment also tended to be the lowest. By contrast, in countries such as Britain, Canada, and the United States, with fragmented unions, majoritarian institutions, and a preponderance of right governments, unemployment tended to run higher. Hibbs' idea that these differences reflected distinct choices in the Phillips curve trade-off is more doubtful. Although Hibbs' data indicate that inflation is slightly higher in countries dominated by the left, it varies within a tight band; 10 out of 12 countries exhibit inflation between 2% and 4%. Apart from whether there is a negative long-term empirical association between unemployment and inflation, most economists believe that there is no long-term exploitable trade-off. It is also noteworthy that Germany combines the lowest unemployment rate with the third-lowest inflation rate in Hibbs' data. As discussed below, Germany in fact became a role model for other continental European countries in the 1980s.

The main differences across countries are on the unemployment dimension, and these differences are far too large and stable to be explained by short-term business cycles. Nor is it easy to explain them as a cost of strong unions or fragmented party systems. Again, countries with large, centralized unions and proportional representation (Scandinavia being the most obvious example) were successful in maintaining full employment. Viewed in a broader comparative context it is obvious that the new classical framework simply leaves most of the observed variance in unemployment unexplained. In this respect, Hibbs and the neo-corporatist literature of the 1970s and 1980s offered far more convincing accounts. Countries in which the government relied on compromises with centralized unions and employer associations made full-employment policies feasible because such policies were backed by cooperative wage and price setting. Where governments could not

rely on such compromises, either because these organizations were too weak or too fragmented, there was less scope for reducing unemployment without causing accelerating inflation. Equilibrium unemployment, in other words, diverged.

In economics, Keynesian theory seemed to provide a good account of relation in the first two decades after the Second World War. Though governments relied on a more intricate system of coordination with unions and employer associations than acknowledged by the theory, for the most part governments acted in a responsible and counter-cyclical manner. Indeed, whereas left governments responded more aggressively to slumps, they were more prone than right governments to run surpluses during booms (Cusack 1997, Huber & Stephens 2001). Mainstream parties thrived because strong unions and employers associations provided financial and organizational support and, most importantly, industrial peace. Politicians, in turn, nurtured the institutions of centralized bargaining by granting representational monopolies to the peak associations of capital and labor, rewarding unions for their restraint and attending to their distributional interests.

This is mainly a pre-1970s story, and the subsequent explosion of militancy, inflation, and debt discredited both Keynesianism and its intellectual cousin, neo-corporatism. Still, the crisis and reversal of macroeconomic policies are no vindication of new classical theory. To the contrary, we argue, the experience of the 1980s and 1990s shows the capacity of governments to adjust to a radically new set of economic realities and to convince unions, employers, and voters to do the same.

## The Turnaround

The reasons for the world economic crisis of 1970s and the reversal of macroeconomic policies in the 1980s are many and complex. The oil-supply shocks in 1973 and 1979 played a role, as did the notable slowdown of productivity growth, which was itself partly a result of a secular shift toward services (Appelbaum & Schettkat 1995, Baumol 1967, Iversen & Wren 1998). In addition, skill-biased technological change increased demand for those workers whose wages had been held back by solidaristic wage policies and the indexation of wages that typically accompanied centralized coordination. This placed an enormous strain on centralized wage bargaining where it existed and spurred inflationary pressures everywhere (Iversen 1996, 1999; Pontusson & Swenson 1996). The tightly coupled wage systems created in the 1950s and 1960s, with governments being guarantors for everyone getting a piece of the growing pie, were highly sensitive to wage pressure in any part of the system. And such pressure was now building up, starting with the rising demand for skilled workers.

In the face of rising inflation, the full-employment commitment of governments only exacerbated the problem. Although the end of Bretton Woods gave government some additional external flexibility to restore employment levels, the French experience in the early 1980s illustrates that it was not easy to use this flexibility beyond the short run. To the contrary, it added to the markets' perception that

governments had lost an anchor to protect the economy against the tide of inflationary pressures. At a superficial level, therefore, it may seem that the new classical predictions had come to pass. Without an external monetary constraint, it was time for governments to hand over the reins to an independent central bank and to balance their budgets. Many governments did indeed heed that advice, but as argued above, new classical economics provides no insights into the causes of these changes. Governments suffering from shortsightedness could never arrive at long-term solutions.

Instead of saying that shortsighted governments created the economic problems of the 1980s and then somehow solved them with long-term institutional solutions, we think it is far more promising to hypothesize that the shift in policies was enabled by the willingness and ability of governments to address economic problems in a medium- and long-term perspective. The massive reforms in economic institutions, and the shift in the macroeconomic regime, signaled a shift toward a new political-institutional equilibrium, and governments played a proactive role in this shift. This does not mean that no mistakes were made or that these mistakes did not contribute to the economic difficulties. This in fact is what we should expect in a New Keynesian world, where significant gaps can develop between expectations and the real economy. In retrospect, expectations about real wage growth and the possibility for restoring employment to prerecession levels during the 1970s turned out to be vastly out of line with underlying economic realities. But that was hardly apparent to anyone at the time, including economists.

The monetarist turn in policies during the 1980s, and the institutional changes that accompanied this change, appeared in a number of different guises across Europe, but their origins are widely attributed to Federal Reserve Chairman Paul Volcker in the United States and Prime Minister Margaret Thatcher in the United Kingdom. Thatcher's objective was not simply to stabilize prices and change inflation expectations, but to break the backs of the unions, and they were motivated by ideological rather than economic objectives (Hall 1993). Clearly, these were not shortsighted attempts to win over the British voter. In fact, the policies were highly unpopular, and the Conservatives remained in power only because the opposition was divided (Garrett 1993). But the idea of having an unforgiving monetary regime was not a novel neo-liberal invention. It had been practiced in Germany for decades before the monetarist turn in the United Kingdom in the 1980s, and in Germany large unions had always played a key supporting role.

In the German case, as we have argued, the rationale for having an independent, anti-inflationary bank was not to break the unions, but to ensure that they understood their responsibility in maintaining full employment and a competitive economy. In this respect the monetary regime was spectacularly successful in the 1980s, with low unemployment and highly competitive firms taking a disproportionate share for the global market (at one point the Federal Republic of Germany, a medium-sized country, was the world's largest exporter). In Sweden, for reasons completely unrelated to new classical economics, the Rehn-Meidner plan had always called for conservative fiscal policies to force employers to innovate and to resist excessive wage pressure. But with the end of peak-level coordination

in the 1980s and 1990s, this was not enough to secure stable prices, and Sweden, as well as other countries, began to look for a “German” solution to the growing macroeconomic problems. Unlike Britain and the United States, Sweden sought to preserve an essentially consensus-based industrial relations system, not to replace it with market-determined wages. Just as corporatist solutions had never taken root in the Anglo-Saxon countries, neo-liberal ideas never played much of a role in continental Europe.

For many countries, taking “the German cure” meant essentially adopting the Bundesbank as a surrogate for national central banks. This was accomplished by anchoring national currencies to the German one, either directly or through the European Monetary System. Also, in countries where deficit spending had been a problem, budgetary processes were centralized and rationalized—usually by concentrating budgetary powers in the finance ministry, making the budget more transparent, and imposing an *ex ante* hard budget constraint (Hallerberg 2004, Von Hagen & Hallerberg 1999). By aggressively signaling to the market, and to unions, that macroeconomic policies were now targeting inflation and balanced budgets rather than full employment, governments made a sharp policy break from the past. But it probably did not mark a sharp break in the underlying goals of governments. The overriding objective continued to be the lowest possible long-run equilibrium level of unemployment consistent with a strong competitive position in world markets.

The simultaneous policy shifts through monetary integration across Europe, however, seem to have had some unintended consequences that may be partly responsible for currently high levels of unemployment, especially in Germany (see Soskice & Iversen 2000). By effectively creating a common currency and a single European monetary policy maker—first the Bundesbank and then the European Central Bank—wage setting and unemployment became partly decoupled. National unions can only have a small impact on the European real money supply and therefore will not have a strong incentive to restrain themselves on that account. As long as the Bundesbank set monetary policy and targeted German wages, German unions continued to have such an incentive, but with the creation of the European Central Bank this incentive disappeared. Instead, governments (especially the German government) have tried to use restrictive fiscal policies to maintain discipline in the labor market. Such policies, however, produce a European-level collective action problem because they undermine any coordinated effort to maintain aggregate demand at a level consistent with a higher equilibrium rate of employment. Paradoxically, while Germany is struggling with high unemployment, it is running large trade surpluses.

## RETHINKING THE POLITICS OF MACROECONOMICS

A critical question regarding macroeconomics in general, and for political scientists working in this area in particular, is how governments are able to follow medium- and long-term economic objectives despite short-term electoral incentives. Although they sometimes fall for the temptation to seek an electoral advantage by

spending or inflating the economy in close elections, we see time inconsistency as a relatively minor issue in the explanation of the pattern of macroeconomic policies and outcomes—at least for advanced democracies (it may be different in new democracies, as we discuss below). The current high-unemployment situation in Europe is a striking example of the puzzle because whereas New Keynesian economics implies that governments could use fiscal policy to significantly reduce unemployment, and PBC theory implies that they would, governments for the most part do not. The key question for political scientists studying macroeconomic policies in advanced democracies is therefore not why governments continuously jeopardize macroeconomic stability, but why they so often refrain from doing so.

As suggested above, part of the answer may go back to Hibbs' notion of class parties. Political parties are embedded in a broader social, economic, and organizational context that makes it highly problematic to view them as short-term vote-maximizing machines in the Downsian tradition. Parties grew out of social divisions, they developed mass organizations with institutionalized decision procedures, and they are often formally or informally linked to organized interests such as unions, farmer organizations, or employer associations. Although this is widely accepted in the modern party literature (see such diverse contributions as Kitschelt 1994 and Aldrich 1995), the macroeconomic literature tends to adopt a simplistic version of Downs to conceptualize the role of parties. In general, parties are likely to be far more concerned about the medium- and long-term welfare of their core constituents than acknowledged in standard PBC models.

The extent to which parties follow long-term policy goals, as opposed to short-term electoral objectives, is likely to be conditioned by the structure of political institutions. Presidential and majoritarian systems make winning elections a necessary condition for governing. This means that in addition to party organizations constraining their leaders, the temptation to engage in “short-termism” has to be tempered by concerns over losing a reputation for sound macroeconomic management. Reputational effects, in turn, are increased or decreased in proportion to the expectation that a party (or president) can win the next election. Where electoral contests are close, governments have an incentive to maintain as much policy flexibility as possible or to adopt easily reversible policy commitments (Bernhard & Leblang 1999). If electoral prospects are not good, parties have an incentive to design fiscal policies in a manner that does not fully internalize the costs of debt and that constrains the ability of future governments to pursue their preferred policy (Alesina & Tabellini 1990). Parties may also want to constrain future governments by delegating monetary authority to independent central banks, and by cutting taxes and running deficits, the government can limit the ability of the opposition to spend on their own constituencies in the future (Persson & Svenson 1989). This may be especially true of right governments keen on limiting the overall size of the government (Cusack 2001). The point is that the behavior of governments, even when it is entirely driven by narrowly selfish interests and even when the expected life span is short, may be motivated by long-term partisan considerations. Short-termism in the new classical sense of time-inconsistent policies may

be restricted to close, high-stakes elections. These tend to be associated with majoritarian systems, where parties also have few incentives to associate themselves with the long-term interests of particular constituencies.

In multiparty PR systems, the electoral motive shrinks in importance because government participation is only weakly related to electoral success. In these cases, therefore, parties may be even better able to attend to the interests of their constituents. However, this is precisely the situation in which the common pool problem is supposed to be most severe and undermine the incentives of parties to adhere to responsible policies (Grilli et al. 1991). But we do not think recent economic history supports the latter view. Taken as a group, PR countries had an average deficit of  $\sim 0.5\%$  of gross domestic product in the period from 1950 to 2003, whereas the figure for majoritarian countries was 1.5%. It is only when one considers recent and relatively short periods that the opposite picture emerges. There is also no relationship between number of parties and deficits, and inflation has not been higher in PR systems. How, then, do we explain the capacity of multiparty PR systems to control deficits and behave responsibly in monetary policy?

The answer may be quite simple. Parties that want to participate in government want to spend money on their own constituents, but they do not want other parties to spend on theirs. Consequently there is a collective interest in limiting the total budget size and making sure coalition partners stay within that budget. Von Hagen & Hallerberg (1999) have identified some of the key institutional mechanisms that enable this, and Bernhard & Leblang (2002) have convincingly argued that fixed exchange rates and independent central banks help provide information about whether government partners are keeping their part of the bargain. Reputation may also be important to the story. All parties will prefer coalition partners that have a reputation for staying within the limits of the collectively agreed budget. Participation in future governments may therefore depend on responsible fiscal behavior in the current one. Again, this is more likely to be true if coalition bargaining, rather than electoral success as in majoritarian systems, determines who gets into government.

Finally, it is probably important whether the electoral market is stable and segmented or unstable and fluid. Following Lipset & Rokkan (1967), it is a standard argument in political science that the European party systems have been frozen for long periods of time—many cases dating back to the 1920s. To a considerable extent this is still true. If support for parties is fairly entrenched, and the number of swing votes limited, the costs of trying to buy votes using macroeconomic policies will be high. Especially in a PR system, there may be few occasions where parties feel compelled to push the macroeconomic levers to pick up a few additional votes.

Yet, the sensitivity of voting to macroeconomic conditions clearly varies with the entrenchment of the political system. It is reasonable to expect that new democracies are more prone to PBCs than old and established ones. This may explain one of the puzzles in the literature on exchange rates, where scholars working on Latin America often emphasize volatility and manipulation, whereas European scholars emphasize the role of exchange rates in stabilizing expectations. At least

part of the reason appears to be that whereas exporters on both continents want fixed exchange rates, the intense competition for voters in the nontraded sectors of Latin American countries tends to drive up the real exchange rate, which in turn causes exporters to call for postelection devaluations (Frieden et al. 2001, Bloomberg et al. 2005). In Europe, by contrast, pegging the currency has been seen by exporters as a means to reduce the real exchange rate because it is used as a commitment device by governments to punish wage militancy in the nontraded sector (Iversen 1999). Differences in macroeconomic policies may therefore partly reflect the competitiveness of the political system.

In summary, the challenge for those interested in the political economy of macroeconomics can be described as a need to replace the economists' narrative of government policies with a political science narrative. This narrative would recognize the emerging New Keynesian consensus that governments can have significant short- and medium-term effects on the economy but at the same time explain why governments fall for the temptation to manipulate the economy for short-term political gains far less frequently than PBC theory leads one to expect. On the basis of existing work, we have hinted at the political institutions (especially electoral systems) and economic institutions (especially wage-bargaining systems) that may help account for this puzzle, but research in this area is still to be done. What is exciting from a political science perspective is that for the first time in decades, political scientists seem to be better positioned than economists to make the key contributions.

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