

Partisanship in the Setting and Coordination of
Fiscal and Monetary Policies

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Abstract. The principal concerns of this paper are with the roles partisan politics have played in the making of fiscal and monetary policies within the OECD countries as well as the extent to which these policies have complemented each other. It is argued that parties of the left pursue fiscal policies that are distinctly different from those pursued by the right. The critical difference is in the way these parties use fiscal policy as a corrective mechanism for dealing with macroeconomic problems: leftist parties adopt counter-cyclical fiscal policies while right-wing parties adhere to pro-cyclical fiscal stances. The paper also examines two arguments regarding monetary policy and how partisan politics influences affect this policy area. The first and most conventional argument sees the formal independence of the central bank from government as a means of negating partisan influences on monetary policy; the second advances the proposition that, regardless of central bank independence, monetary authorities are not politically neutral but instead share views similar to those of parties on the right-hand side of the political spectrum. Empirical analyses, using a pooled cross-section time-series design with data from 14 countries extending from 1961 through 1994, produces evidence in favor of the argument laid out on the role of partisanship in fiscal policy; it also shows little support for the view that central bank independence inhibits partisan influences while at the same time provides support for the thesis that central banks are politically non-neutral. Thus, coordination between fiscal and monetary policies is far less likely to occur when left-wing parties are in power.

Introduction

What roles have partisan politics played in shaping fiscal and monetary policies in the industrial countries in the post-World War II period and to what extent have these policies complemented or contradicted each other? These questions are the central concerns of this paper. In the next section I present an argument about the way in which partisanship works its effects on fiscal policy.¹ This argument is ultimately based on the distinctions drawn by Hibbs (1977) with respect to the preferences of different classes of voters and the reasoned response of different parties that draw their support from these classes of voters. In essence, it is an argument that there are distinctions between parties on the left and right in terms of the fiscal policies that they pursue, but that these distinctions need to be seen in light of the macroeconomic conditions which prompt these parties to use fiscal policy as a corrective mechanism.²

An oft used image of macroeconomic policy is that it stems from a coherent unified actor. Thus, the two principal macroeconomic policy instruments, fiscal policy and monetary policy, are bundled together and described as stimulative, neutral, or restrictive. But this shorthand is a fundamental mis-characterization of macroeconomic policy in that the two elements of such policy are the product of different institutional actors who may or may not coordinate their actions. Thus, the second section also brings monetary policy into focus and highlights the possible roles that partisanship might play in bringing about coordination between this policy and fiscal policy. Here I point out that there are two plausible images of this role. The first emphasizes the independence of the monetary authorities from the government and how this would lead to the absence of coordination between the two policy instruments. The second advances the argument that monetary authorities are more likely to share the preferences and beliefs about the functioning of the economy held by parties on the right. This brings about coordination of the two policies when the right is in power; likewise, the disjunction of preferences and beliefs would lead to non-coordination when parties of the left are the governing coalition.

The third section introduces the broader models of fiscal and monetary policy in which these arguments regarding partisanship are embedded and then takes up the evolution of their empirical utility. These empirical results are supportive of the notion that partisan politics play important roles in the making of both policies. The final section

1 . This argument was originally presented and tested in an earlier paper (Cusack, 1999).

2 . For a comprehensive overview of the literature on partisanship and public policy outcomes, see Schmidt (1996).

of the paper concludes with an overview of the findings produced in this paper and briefly discusses their implications for the coordination of the two instruments of macroeconomic policy.

How Fiscal and Monetary Policies Are Influenced by Partisan Politics

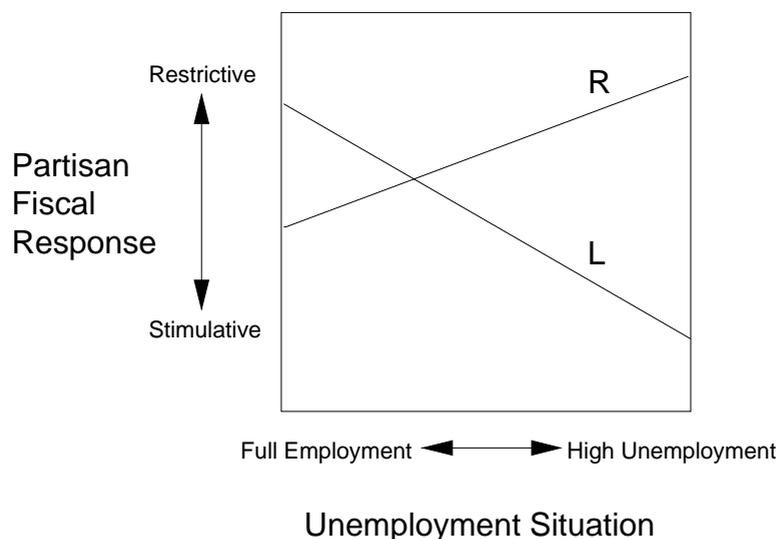
Fiscal Policy. The simplest, widely-accepted, and at the same time quite misleading portrayal of the effect of partisanship on fiscal policy is one that suggests an interventionist and rather profligate approach to economic policy on the part of governments by leftist parties. At the same time, it attributes a non-interventionist and restrictive approach to such policy on the part of governments dominated by right-wing parties. In short, leftist dominated governments are expected to run deficits and rightist dominated governments will produce balanced budgets or surpluses. As I pointed out in an earlier paper (Cusack, 1999), the evidence adduced in support of this claim can be characterized as mixed at best. In that paper I also laid out an argument consistent with a number of points made in previous analyses of economic policy (particularly those by Cowart, 1978; Persson and Svensson, 1989; and Carlsen, 1997) to the effect that at least in the area of fiscal policy this general image is wrong because it fails to take into account the preferences of parties of different ideological hues as well as their constituencies.

The core of the argument is as follows. Parties of the left, as well as their constituents, have an interest in fiscal policy being employed in a Keynesian-like counter-cyclical fashion. That is, such parties should engage in stimulative fiscal policy when unemployment is high, and implement a restrictive fiscal policy when unemployment is low. By engaging in stimulative policy during recession such parties assist their constituents, the unemployed and others likely to bear the greatest risks and costs associated with an economic downturn. In the same way, by carrying out a restrictive policy during booms or near-full employment, such parties assure government's ability to respond adequately to future recessions by minimizing the build-up of debt and the consequent crowding out that would occur through higher interest payments.

Parties of the right have very different interests and, because of this, their policies will differ from those of the left. During good economic times it makes sense for them to run what is in effect a stimulative fiscal policy by cutting taxes without reining back expenditures at the same rate. By so doing, particularly when the tax cuts are targeted at the better-off, they provide advantages to their "natural" constituents while at the same time avoiding the costs of alienating those who would suffer from expenditure cuts.³ In periods of high unemployment, on the other hand, a more restrictive policy than that followed by the left in similar circumstances as well as that which the right itself would follow in periods of full employment has significant advantages for governments dominated by the right. Counteracting the effects of automatic stabilizers helps to weaken those forces in the economy that would be pushing for higher wages and, as a consequence, price increases. By dampening labor militancy, the right then favors a significant parts of the core of its constituency, capital, employers, and those well-to-do secure in their employment. The overall argument is summarized below in Figure 1 where R represents a right-wing government's fiscal response function and L the response function of left-wing governments.

Figure 1

Partisan Based Fiscal Response to Unemployment



3 . Additionally, the uncertainty of retaining office would induce them to follow such a strategy since this ties the hands of a potential successor government on the left from initiating new and costly programs because of the debt management costs that they would inherit upon replacing a right-wing government (cf., Persson and

Monetary Policy. There are at least two plausible contending arguments that can be advanced about how partisanship influences monetary policy. The first suggests that the scope of this influence is contingent on the central bank's relative independence from the government.

An independent central bank is widely seen as vital for eliminating interference in monetary policy by elected officials for short-term political gain. In broad terms, independence can be defined as bestowing the power on the central bank to pursue its goals and simultaneously insuring that its policies are difficult for government to reverse (Blinder, 1999). Granting independence to the central bank is seen as enhancing the ability to achieve long-term social welfare through the lower sustainable rate of inflation that can be promoted by such an institution. Many theoretical and empirical studies have lent support to both the claim that independent central banks produce lower inflation while at the same time imposing no other costs on the economy.⁴ Contradicting a long-held opinion of quite a few economists, it does seem as if there is such a thing as a free lunch.

These claims have not gone uncontested. A leading example of those who argue that the independence of central banks has nothing to do with lower inflation rates is Posen (1993). Some examples of those who point out the negative employment and output consequences of independent central banks include Fischer, 1994; Cornwell and Cornwell, 1998; Hall and Franzese, 1998; Iversen, 1998,1999; Posen, 1998; and Soskice and Iversen 2000. In addition, the consequences of granting independence to a central bank is not an uncontentious issue in term of the implications for accountability and responsibility in a democracy (see, e.g., de Haan, et al, 1998 and Blinder, 1999). Finally, it should be noted that sharp criticisms have also arisen with respect both the logic of the arguments pointing to central bank independence as a means of achieving lower inflation (Forder, 1998a) and to the way in which economists have gone about constructing their measures of central bank independence (Forder, 1998b; and Mangano, 1998).

Svensson, 1989).

4 . The number of published studies on this question which have adduced evidence that central bank independence promotes lower inflation as well as those reporting both that effect and the absence of negative consequences for the real economy are too numerous to cite. For an extensive survey of empirical work on this question up through the mid-1990s, the reader is referred to Eijffinger and de Haan's (1996) paper.

Irrespective of these counter-claims, the proponents of central bank independence maintain that greater independence affords the possibility for central bankers to implement monetary policies that seek to counter the effects of partisan-based fiscal policies being pursued by elected officials in government (Goodhart, 1994; de Haan and Eijffinger, 1996). The advocates of central bank independence note that such independence isolates the bank from partisan shocks and allows the bank to keep its focus on promoting price stability (Alesina and Summers, 1993). At least in terms of economic outcomes, there is evidence that the independence of central banks may combine badly with certain constellations of political parties in government (Way, 2000). More to the point here is the idea that more independent central banks will be prone to counter and not coordinate their monetary policies with the fiscal policies of the political parties in government. One of the starkest ways this reveals itself is through a monetary policy that runs in the direction opposite to that of fiscal policy. Thus, when the government is running a deficit in order to stimulate the economy, the central bank would increase interest rates in order to slow the economy down. Such a policy response can be expected of independent central banks. The opposite holds for less independent central banks. The monetary policy of these institutions should complement the fiscal policy of government. Such banks would accommodate government by loosening when government is seeking to stimulate the economy, tightening when government is seeking to slow the economy by running a surplus. In this first argument, then, partisanship comes through in the coordination of monetary policy with fiscal policy, and this coordination diminishes with the degree of independence of the central bank.⁵

The second argument is that irrespective of the degree to which a central bank is independent, it is not politically neutral. The principal point here is that the preferences of central bankers as well as their beliefs about how the economy works, regardless of who appoints them, are more in conformity with those of political parties on the right, than they are with those on the left. Central bankers are drawn from a relatively narrow pool of possible candidates; often they themselves were bankers in the private sector or else government officials with lengthy experience in (and wide connections to) the financial spheres (see, e.g., Marshall, 1999). The backgrounds of the Board of Governors of the Federal Reserve Bank of the United States, reputedly one of the more

5 . A empirical study which examines both the effects on monetary policy of government fiscal policy and central bank independence, though not in conjunction with each other, is Burdekin and Laney (1988).

independent central banks during the period under study, is instructive on this point. During the period from 1936 through 1999, 59 people have been appointed to the Board at least one time. In terms of their previous primary occupations, 29 were economists, 14 were banking and finance executives, eight were industry executives, two were in banking regulation, three were farmers-ranchers, and three were in education.⁶ The dominance of economists on the Board came about in the latter part of this period. From 1936 until the end of the Eisenhower administration, only one of the 21 Board appointees was an economist. But in both periods, few of these professional backgrounds, particularly main-stream economics in the second period, were generally associated with leftist leanings. Lebaron (1998) reports that of the more than 100 national central bank governors in the mid-1990s, over 70 percent were trained in economics and a very large number of these held degrees from universities in Anglo-Saxon countries. He characterizes them, particularly the governors of European central banks, as "high-minded state functionaries ...[who are]... repositories of the 'common good' and devoted to the defence of a legitimate order enshrined in the financial establishment."

This reveals itself in the selection criteria a government, no matter what its political orientation, is forced to adopt. Cautious and conservative individuals are least likely to draw criticism from financial markets and less likely to provoke instability in those markets. Even those who might have a non-conservative agenda are likely to suppress it as a consequence of the socialization process within the conservative culture of the central bank itself.

On the whole, then, central bankers are not people one might expect to have great deal of sympathy for social democratic and leftist visions of the policies to be pursued and the effects these policies would have on the economy. And in spite of the formal criteria often used in constructing indices of central bank independence, such as turnover rates and terms-of-officeholding, central bankers have a great deal of incentive to adhere to a conservative policy stance given the favor this would find among their potential future employers as well as all of their associates in the financial world. From this one would expect that the response of central banks to fiscal policy is contingent on who is making that policy. Should that policy be the product of a left-wing government, the central bank's monetary policy would lean against the direction being taken in fiscal

⁶ . This information is drawn from various tables available on the Financial Markets Center web site (<http://www.fmcenter.org>).

policy. In the situation where fiscal policy is under the control of right-wing governments, one can expect monetary authorities to coordinate their policy response in line with the direction being taken by the fiscal policy authorities.

In the next section the models used to assess the validity of these two contending visions of the influence of partisanship on monetary policy as well as the argument regarding the effects of partisanship on fiscal policy are laid out and the econometric results are presented.

Models and Related Estimation Results

Fiscal Policy. The basic model of fiscal policy employed here takes the following form:

Fiscal Policy Specification

$$BB_{i,t} = \alpha + \beta_1 BB_{i,t-1} + \beta_2 S_{i,t} + \beta_3 OGAP_{i,t} + \beta_4 CO_{i,t-1} + \beta_5 U_{i,t-1} \\ + \beta_6 G_{i,t-1} + \beta_7 (U_{i,t-1} G_{i,t-1}) + \varepsilon_{1,i,t}$$

The public sector household budget balance (BB , expressed as a percent of GDP), is the measure of fiscal policy in the model.⁷ The variable is the net lending item of the general government financial accounts.

The right-hand side of the equation includes two variables that capture the built-in stabilizers of fiscal policy in all countries. The first of these deals with programs representing transfers to and from the household sector (Cowart, 1978, and Cusack, 1997 and 1999). Downturns in the labor market will increase the number of recipients, particularly in terms of unemployment compensation programs but also social welfare and security programs. Simultaneously, any such downturn pushes program revenues below those anticipated and the combination of these two effects is to move the fiscal balance in a negative direction. Improvements in labor market performance automatically lower the number of transfer recipients and the public outlays going to them, while simultaneously increasing revenues through higher tax receipts generated by the income received by the newly employed. The joint effect of these latter two changes is to move the fiscal balance in a positive direction. To capture the impact of

7 . Detailed descriptions of the variables used in the models presented in this section are presented in Appendix 1.

changes in transfer program costs the variable, S_t , has been introduced into the model and is meant to capture the change in transfer costs based on the change in the size of the pool of eligible recipients and the prevailing level of transfer program generosity.

The second stabilizer variable is the gap between actual and projected economic performance. Both the broad directions of government spending and taxation policies are fixed prior to their implementation. By implication, of course, the same holds for the balance between the two. But all of these aggregates, in the end, are simply plans based on assumptions regarding how well the economy will be doing during the year in which the budget is implemented. As noted in the last paragraph, transfer program expectations can be off the mark because of changes principally in the numbers of people who might unexpectedly gain or lose eligibility for these programs. General revenue collections can also be out of line with expectations and this too will move the fiscal balance in one direction or another away from which it had been targeted. In order to capture this, which in many ways also reflects a kind of built-in stabilizer, a variable, $OGAP$, which is a function of the historical growth rate performance relative to the actual growth rate in the economy is introduced into the model. A positive (negative) score indicates that growth was lower (higher) than might have been expected based on recent trends. With lower than anticipated growth the planned fiscal balance will necessarily be lower or more negative than had been anticipated, and vice versa. Therefore, the expectation is that the sign on the parameter for $OGAP$ should be negative.

Next, because of the argument that the growth of international capital markets and the accompanying ease with which capital can flow across borders has compelled all governments to rein in any tendency to engage in excessive fiscal deficits, a measure of the lack of restrictions of capital flows (CO , or Capital Openness) is also included. This index is based on the data developed by Quinn and Inclan (1997) and takes into account the lack of controls on the capital and current account as well as international agreements constraining the right to impose restrictions on the flow of capital. The expectation on the parameter here is that it would be positive, reflecting the supposed difficulties that would arise for governments running deficits in a context of uncontrolled capital markets.

The impulse that flows from the need to manage aggregate demand the unemployment rate (U) of the previous year is included. The previous year's unemployment rate and not the contemporary year's rate is used because it is reasonable to assume that significant changes in fiscal policy (by implication, changes

in spending programs and tax laws) require some significant time to implement. The role of partisanship enters the equation in two ways. First, the partisan character of government (G) enters alone to capture the effect of the governing coalition's ideology on fiscal policy under the conditions of full employment. Second, the partisan variable is multiplied by the unemployment variable to show the differing responses to unemployment that occur under governments with different ideologically-based preferences. Expectations with respect to the parameters here are the following: the parameter on the interaction of the two constituent terms (U and G), will be negative given that higher values of unemployment combined with higher values of commitment to leftist ideology would invoke greater government response to stimulate demand as a means of reducing unemployment; the parameter on the U term should be non-negative, since it captures the response of extreme right-wing governments to unemployment; and the parameter on the (G) should be positive reflecting the greater fiscal conservatism of left-wing governments under conditions of full employment.

The OECD countries included in this study are Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, the Netherlands, Norway, Sweden, the United Kingdom, and the United States. Australia, Japan, New Zealand, and Switzerland are excluded because of the lack of data (for the whole or part of the period) on one or more of the variables used in the analyses reported in this paper. Greece, Spain, and Portugal are excluded because they were not democracies during part of the period under study. Size considerations led to the exclusion of Iceland and Luxembourg. The time frame was dictated by considerations of data availability. Information on the fiscal variable is available for only a subset of the 14 countries prior to the 1960s. For some of the countries, other data were not available after 1994.

Based on a pooled cross sectional-time series design, the estimation results for the fiscal policy model are reported below. The estimation technique used throughout the paper is OLS with panel-corrected standard errors. Note that in none of the equations presented in this paper do the Lagrange multiplier tests indicate that the errors are autocorrelated (Beck and Katz, 1996).

Fiscal Policy Specification: Estimation Results

$$\begin{aligned}
BB_{i,t} = & -.83 + .91 BB_{i,t-1} - .97 S_{i,t} - .11 OGAP_{i,t} - .02 CO_{i,t-1} + .13 U_{i,t-1} \\
& (1.52) \quad (36.44) \quad (5.38) \quad (3.27) \quad (0.54) \quad (2.40) \\
& + .49 G_{i,t-1} - .07 (U_{i,t-1} G_{i,t-1}) \\
& (3.15) \quad (2.67)
\end{aligned}$$

$$R^2 = .89$$

t-statistics in parentheses

14 countries, 34 years (=476 observations)

The overall fit of the model is quite good and the expectations with respect to the parameters are met in all but one instance. Thus, the parameters on both the automatic stabilization term and the output gap take on negative signs and are statistically significant. The parameter on the lagged endogenous variable is positive, as expected, and suggestive of a rather large amount of built-in inertia, when all other factors are controlled. Unfortunately, the parameter on the capital openness variable is statistically indistinguishable from zero, indicating no directly detectable influence from this measure of exposure to the international economy.

The parameter on the first constituent term, unemployment, has the predicted positive sign and is statistically significant. Controlling for all other influences, then, it points to the expected increasing fiscal restrictiveness on the part of far-right-wing governments when unemployment rises. Similarly, the parameter on the second constituent term, has the expected positive sign and is, again, statistically significant. The sign of the parameter implies that under conditions of full employment, left-wing governments run far more restrictive fiscal policies than do right-wing governments. Finally, the parameter on the interaction of the two variables can be seen as the increment by which the parameter on partisanship (unemployment) is adjusted if unemployment (partisanship) is not equal to 0. The adjustment is greater the greater the value of the conditioning variable. The negative sign on the parameter indicates that the left adopts a more counter-cyclical fiscal stance than does the right. The size of the parameter reflects the magnitude of the difference in those stances.

These results replicate for a lengthier period of time the findings reported in my earlier paper (Cusack, 1999). Partisanship plays a role in fiscal policy making. This role, however, does not conform to the simplistic image to which many analysts and commentators adhere. The left has not used fiscal policy in a profligate manner and the right have not been the consistent guardians of a restrictive approach to fiscal policy.

The picture is more complicated. The left has followed a fiscal policy consistent with the precepts of Keynesianism. It has responded to faltering demand and higher unemployment by stimulating the economy through either tax cuts or increased spending. And when economic conditions pick up, the left runs a restrictive fiscal policy which helps guard the public sector from building up unsustainable debt. Following such a strategy contributes to economic stability and simultaneously affords assistance to the working class, the traditional clientele of the left. The right, in turn, has acted with greater profligacy during periods of full employment and then with increasing restrictiveness in response to higher unemployment. Its policies can be described as pro-cyclical -- a stance that neither helps the economy as a whole nor the working class. At the same time this policy certainly affords favors to the well-to-do, the traditional clientele of the right.

The model and related results presented above are based on the premise that partisan differences in the fiscal policies of the left and right have remained constant over the last three decades. One way of assessing the validity of this assumption is to re-specify the model so that it introduces the possibility of differential effects of partisanship on fiscal policy across distinct periods. The three periods used here run from 1961 through 1972 (period 1), 1973 through 1979, and 1980 through 1994. Stopping the first period at 1972 is intended to allow the supposedly stronger connection between partisanship and fiscal policy that prevailed in the "Golden Age." With the collapse of the Bretton Woods system (in late December of 1971) it is often argued that this linkage deteriorated. Starting the third period in 1980 is intended to capture the strong internationalization effects that supposedly came into play during the 1980s and 1990s. Substantial differences across the three period specific government variables' parameters would indicate that the fiscal stance being adopted by governments under conditions of full-employment have undergone change across the three periods. Likewise, substantial differences across the parameters on the three interaction terms would reveal that the pattern of partisan-based fiscal policy in light of different labor market conditions has undergone change through the three periods. To assess this

three separate government terms, one for each period, and three separate interaction terms (between government and unemployment), again, one for each period, are introduced. The estimation results for the revised model are presented below:⁸

Fiscal Policy Specification with Differential Partisan Effects over
Time: Estimation Results

$$\begin{aligned}
 BB_{i,t} = & -.94 + .91 BB_{i,t-1} - .96 S_{i,t} - .11 OGAP_{i,t} - .01 CO_{i,t-1} + .13 U_{i,t-1} \\
 & \quad \quad \quad (1.79) \quad (36.91) \quad \quad \quad (5.29) \quad \quad \quad (3.10) \quad \quad \quad (0.32) \quad \quad \quad (2.32) \\
 & + .67(P_1 G_{i,t-1}) + .35(P_2 G_{i,t-1}) + .46(P_3 G_{i,t-1}) - .12(P_1 U_{i,t-1} G_{i,t-1}) \\
 & \quad \quad \quad (3.79) \quad \quad \quad (1.81) \quad \quad \quad (2.32) \quad \quad \quad (2.70) \\
 & \quad \quad \quad -.06(P_2 U_{i,t-1} G_{i,t-1}) - .06(P_3 U_{i,t-1} G_{i,t-1}) \\
 & \quad \quad \quad (1.53) \quad \quad \quad (1.95)
 \end{aligned}$$

$$R^2 = .90$$

t-statistics in parentheses

14 countries, 34 years (=476 observations)

With the breakdown of the Bretton Woods system and with the onset of the first oil-crisis, fiscal policy became far less distinguishable in terms of partisan-based preferences than it had been in the previous decade. Smaller partisan-based differences in the response to unemployment emerged. Simultaneously, the partisan-based variation in fiscal stances at full or near-full employment narrowed.

Why has this shift occurred. There are three plausible and not necessarily inconsistent interpretations one might give to this decline in the distinctiveness in fiscal policy across the political spectrum. First, economic interdependence, which has grown significantly over recent decades, is seen as one reason why such differentiation has narrowed. (Garrett and Lange, 1991; Scharpf, 1992). In this view, the ever greater openness of national economies has dictated that fiscal policy not be used as an instrument to manage the economy and thereby restricted the latitude with which governing parties ideological preferences can be expressed in these policies. In brief, international constraints have brought about a convergence in the fiscal policy strategies being pursued by the right and the left. Second, there has been a loss in the rigidity of

8 . Note that the P terms included in the equation represent period dummy variables. Thus, P₁ takes on a value of 1 for the first period, i.e., the years 1961 through 1972, and a zero otherwise. P₂ and P₃ are the period dummies for period 2 and 3, respectively.

the coalitions supporting these parties with their traditional clients' interests no longer being catered to by the strategies that were once pursued. This is especially the case for social democratic and left parties. These parties have had to move to the right in pursuit of significant elements of their previous voter support as more and more of the groups adapt to the changes brought about by the market. Finally, there is the view that the power of ideas has played an important role in reshaping policy strategy. Where once Keynesianism had a least an air of respectability, the rise of monetarism and other neo-classical economic ideas has altered significantly what is seen as the proper role of government in a market economy.

Monetary Policy. In order to assess the possible effects of partisanship on monetary policy I employ a broad basic model of the determinants of the central bank interest rate (specifically, the discount rate, *DR*) based on loosely on the formulation generally credited to Taylor (1993; 1998). The formulation, often described as the Taylor rule, sees nominal interest rates as a function of inflation (*I*) and the output gap (*OGAP*). It is widely seen as a successful simple account of the forces shaping central bank behavior both in the United States (Taylor, 1993;1998) and elsewhere (Clarida, Gali, and Gertler, 1997; Gerlach and Schnabel, 1999). Also added is a third element that a number of analysts (see, e.g., Koselkla and Viren, 1991; Eijffinger, Van Rooij, and Schaling, 1996) have shown to be important in terms of adequately capturing the monetary authorities' reaction function, namely, the current account balance (expressed as a percentage of GDP, *BCA*).

In addition, a fourth element meant to capture the effects of international economic integration has been included (*BUBAFED*). Particularly in the European context this should play a critical role in the monetary authorities reaction function (Oatley, 1999). For the non-German participants in a European Multilateral Currency Arrangement (Snake/ERM) this is the Bundesbank's discount rate during years in which the individual states participated. In the North American context, particularly given the relative size of Canada and its strong dependence on the American economy, the policies of the American monetary authorities should have had a strong impact on Canadian monetary policy. For Canada this is captured the Federal Reserve's discount rate throughout the estimation period. In both cases, members of a European monetary system and Canada, the discount rate to which they are responding is based on the third quarter, i.e., one quarter previous the observation on *DR*.

Given the discussion in the last section on the possible role of partisanship in monetary policy, there are two distinct ways in which the complete formulation of the monetary policy function can be specified. The first treats the role of partisanship as contingent on the independence of the central bank. The second focuses on the peculiar form political non-neutrality of central bank decision makers. The two specifications are laid out below:

Monetary Policy Specification 1 (Partisanship Contingent on Degree of Central Bank Independence)

$$DR_{i,t} = \alpha_2 + \lambda_1 DR_{i,t-1} + \lambda_2 I_{i,t} + \lambda_3 OGAP_{i,t} + \lambda_4 BCA_{i,t} + \lambda_5 BUBAFED_{i,t-1q} \\ + \lambda_6 CB_{i,t} + \lambda_7 BB_{i,t} + \lambda_8 (CB_{i,t} BB_{i,t}) + \varepsilon_{2,i,t}$$

Monetary Policy Specification 2 (Political Non-neutrality of Central Banks)

$$DR_{i,t} = \alpha_3 + \gamma_1 DR_{i,t-1} + \gamma_2 I_{i,t} + \gamma_3 OGAP_{i,t} + \gamma_4 BCA_{i,t} + \gamma_5 BUBAFED_{i,t-1q} \\ + \gamma_6 G_{i,t} + \gamma_7 BB_{i,t} + \gamma_8 (G_{i,t} BB_{i,t}) + \varepsilon_{3,i,t}$$

Across both specifications, the expectations regarding the effects of inflation, the output gap, the current account balance, and the monetary policies of the leading states in the international economy are identical. The parameter on inflation should be positive, with the central bank increasing interest rates as prices rise and lowering rates as prices move downward. Both the parameters on the output gap and current account measures should be negative as monetary authorities move rates upward as signs of overheating are revealed by negative values on each of these indicators. The parameter on the *BUBAFED* variable should be positive as the national central bank seeks to follow the interest rate policies of the Bundesbank or the Fed.

In the specification of monetary policy relying on the argument regarding the degree of central bank independence, the following expectations hold. The parameter on the interaction between the two variables, central bank dependence and the fiscal policy outcome, should be positive. This follows from the increasing need for the bank to accommodate the fiscal policy, the more tightly controlled it is by the government. The parameter on one of the constituent terms, fiscal policy, should be negative since this is the effect that would come about when the other constituent term has a value of

zero, indicating a highly independent central bank. The expected sign on the parameter of the other constituent term, central bank dependence, is zero, given that it comes into play when fiscal policy is effectively neutral, i.e., the budget is in balance.

As to the specification of monetary policy based on the argument that a central bank, regardless of its degree of formal independence, is basically an institution with a conservative bias, the following expectations hold. The parameter on the interaction between the two variables, partisan character of the government and the fiscal policy outcome, should be negative. This is the consequence of policy outcome variable being amplified by the partisan term which would arouse greater non-accommodation on the part of the monetary authorities. With respect to parameter on the budget balance variable, the expectation is that this would be positive. This effect comes into play when the partisan term is zero, signifying a very right-wing government. Under such political conditions, the central bank is most prone then to coordinate its monetary policy with the government's fiscal policy. As to the sign of the parameter on the second constituent term, partisanship, the expectation is that this would be negative or zero. The econometric results for the two specifications using data on the same 14 countries and 34 years as in the analysis of fiscal policy are reported below.⁹

Monetary Policy Specification 1 (Partisanship Contingent on Degree of Central Bank Independence): Estimation Results

$$DR_{i,t} = .95 + .72 DR_{i,t-1} + .14 I_{i,t} - .14 OGAP_{i,t} - .11 BCA_{i,t} \\ + .14 BUBAFED_{i,t-1q} + .03 CBD_{i,t} - .04 BB_{i,t} + .01 (CBD_{i,t} BB_{i,t}) \\ R^2 = .77$$

t-statistics in parentheses

14 countries, 34 years (=476 observations)

9 . Note that the statistical results based on analyses of the two specifications using only 12 countries (that is, excluding Germany and the United States) are nearly identical to the results based on the 14 country data set. The results from the more limited analyses are presented in Appendix 2 of this paper.

Monetary Policy Specification 2 (Political Non-neutrality of Central Banks): Estimation Results

$$DR_{i,t} = 1.12 + .73 DR_{i,t-1} + .13 I_{i,t} - .15 OGAP_{i,t} - .14 BCA_{i,t} \\ + .13 BUBAFED_{i,t-1q} - .06 G_{i,t} + .17 BB_{i,t-1} - .08 (G_{i,t} BB_{i,t})$$

(0.83) (15.57) (3.22) (4.19) (4.39) (4.30) (0.59) (2.36) (2.93)

$$R^2 = .77$$

t-statistics in parentheses

14 countries, 34 years (=476 observations)

In terms of the estimated parameters on the Taylor rule-like elements as well as that connected to the influence of the interest rate policies of dominant nations, expectations are met in the results for both specifications. Central banks adjust their interest rates upward as inflation increases, move them to counter economic growth off the trend line as well as any disequilibrium on the external account, and attempt to follow the policies of central banks in the dominant economies. Differences arise in the results related to partisanship.

In the first specification, where the effects of partisanship are predicted to be a function of the degree of central bank independence, none of the estimated parameters connected to this thesis are statistically significant. This suggests that the monetary authorities' degree of formal independence or dependence with respect to the government is unimportant in terms of the policy these authorities are following.¹⁰ In contrast, the results from the estimation of the parameters in the second specification are supportive of the argument that central banks, regardless of their degree of independence, are not politically neutral. While the parameter on one of the two constituent terms, namely the partisan character of the government, is statistically indistinguishable from zero, the parameters on the other constituent term and the interaction between the partisan color of the government and fiscal policy are statistically significant and take on the predicted signs. Thus, the effects of having a right-wing government is to have the monetary authorities accommodate fiscal policy. When budget balance moves into deficit, the discount rate is lowered. Similarly, if a right-wing government is in power and is running a surplus, the monetary authorities accommodate

10 . A test of this specification using an alternative operational measure on central bank independence was equally unresponsive of the argument that more dependent central banks coordinate their monetary policies with the policies of the fiscal authorities. The alternative measure used is that developed by Cukierman (1992).

the government by increasing interest rates to help further slow down economic activity. On the other hand, the parameter on the interaction term indicates that the fiscal policy of the government meets with ever more non-accommodative behavior on the part of the monetary authorities the further governing coalition is to the left on the political spectrum. We see here evidence of the political non-neutrality of the monetary authorities. They appear to be willing to coordinate policy when right-wing governments are in power. They behave in a contradictory, non-accommodative fashion when left-wing parties hold the reins of government.

The preliminary evidence that has been produced for this paper does not lend any weight to the commonly accepted opinion that central bank independence is needed to counter-act partisan shocks of any sort in order to help assure that excess demand being generated by government does not enter into the economy. Instead, it affords support to a far less technocratic and more political vision of the role that central banks have played in supplying or blocking coordination of macroeconomic policy.

This more political vision of a central bank's role is one where conflict between the bank and the fiscal authority is pre-ordained when the latter is under the control of parties on the left side of the political spectrum. While those parties have shown a willingness to pursue a reasonable fiscal policy strategy, reasonable at least in terms of Keynesian theory, the central banks have countered that with a pro-cyclical monetary policy response, independent of actions they have taken in response to other developments within the economy. One might grant that the size of the monetary authorities' response to left governments' fiscal policy is statistically significant and still argue that it has not been overwhelming in substantive terms. The response, for example, to a moderate left-wing government running a deficit of three percent of GDP only works out to about a small annual increment in the discount rate. Over a three of four year period, however, this is not unappreciable, and certainly has made the problem of fighting unemployment harder.

At the same time, the results do lend support to the argument that monetary authorities have interests and preferences similar to parties on the right-hand side of the political spectrum. These preferences are revealed by the apparent willingness of the central bank to coordinate monetary policy with fiscal policy by accommodating the fiscal strategy of right-wing governments. While the strategy of these right-wing

governments shades toward fiscal irresponsibility during good economic times and harsh restraint during periods of high unemployment, central banks appear to only have made bad situations worse.

Conclusion

This paper has shown that partisan politics have played a role in fiscal policy within the OECD countries. In contradiction to the conventional wisdom, it has been demonstrated that the left has not behaved in a fiscally irresponsible way by persistently and recklessly running deficits. If anything, governments on the left have conducted more conservative fiscal policies under conditions of full or near-full employment than governments controlled by the right. Where the two sides of the political spectrum have differed most importantly is in the responses of their fiscal policy strategies to conditions of high unemployment. Indeed, it is in these situations that the left has been willing to use fiscal policy to stimulate the economy by running deficits and the right has actually acted to dampen demand by implementing a restrictive fiscal policy.

Nevertheless, the magnitude of partisan-based differences in fiscal policy has diminished over the last three decades. While the left continues to take a more conservative stance under conditions of full or near-full employment, the size of its counter-cyclical response to conditions of moderate to high levels of unemployment has attenuated appreciably.

In the other sphere of macroeconomic policy, it has been shown that the conventional view that central bank independence hinders the influence of partisan politics on monetary policy receives no empirical support. But this does not deny that partisanship is tied up with the monetary authorities' own response to fiscal policy. An alternative view of how partisanship comes into play in the setting of monetary policy has been advanced and evidence in support of this view has been uncovered. This alternative view suggests the monetary authorities' preferences are likely to be the opposite of those held by left-wing parties and similar to those of right-wing parties. In turn, this leads central banks to be non-accommodating to the fiscal policies of left-wing governments and accommodating to the fiscal policies of right-wing governments. This set of different response holds regardless of the degree of formal independence of the central bank.

In sum, for over three decades the coordination of fiscal and monetary policies in the OECD countries has been contingent, at least in part, on partisan politics. Monetary policy has been conditioned in part by the fiscal policies of right-wing governments. In other words, central banks have cooperated with governments of the right. On the other hand, these same monetary authorities have not accommodated the fiscal policies of left-wing governments and indeed appear to steer monetary policy in the direction opposite that taken by such governments.

Appendix 1: Data Sources and Index Construction

- BB* This is the budget balance (for general government) expressed as a percentage of GDP ("+" = surplus; "-" = deficit). This is overall balance (net lending) between general government total revenues and expenditures. The fiscal data derive from two OECD sources: *National Accounts, Detailed Tables, Vol. 2* (various years) and the 1999 version of the *Fiscal Position and Business Cycles Diskette*. The GDP data are also taken from the OECD's *National Accounts, Detailed Tables, Vol. 2* (various years).
- BCA* This is the balance on the current account as a percentage of GDP. Data series constructed on the basis of information taken from the OECD's *National Accounts, Detailed Tables, Vol. 2* (various years).
- BUBAFED* For non-German participants in a European Multilateral Currency Arrangement (Snake/ERM) this is the Bundesbank's discount rate during years in which the state participated. For Canada it is the Federal Reserve's discount rate throughout the estimation period. In both cases the discount rate is based on the third quarter, i.e., one quarter previous the observation on *DR* (see below). Information on exchange rate regimes was gathered from the annual issues of the International Monetary Fund's *Annual Exchange Arrangements (and Exchange Restrictions) Reports*. Data were initially coded into four categories including: (1) a "fixed" exchange rate, generally in the Bretton Woods' system, plus a few cases of pegging to dollar or pound after the collapse of the Bretton Woods' arrangement; 2. "EMCA", European Multilateral Currency Arrangement member and participant (Snake + EMS/ERM); 3. "Floating", 4. "Residual", none of the above but linked loosely to some currency composite (including "EMCA") or a composite of indicators.
- CBD* Degree of non-independence from government on part of central bank. This index ranges from 0 to 4 with the lowest value indicating the highest level of independence of the highest value indicating the lowest level of independence. The index is based on Eijffinger, et al's (1993, 1995, 1998) index of central bank independence which is based on 3 criteria: (1) whether the central bank is the final monetary policy authority; (2) whether one or more government officials are the central bank

- policy board; and (3) whether more than half of the policy board appointments are made independently of the government. The original independence index scores (ranging from 1 to 5, from the lowest to the highest degree of independence) for the countries included in this study area as follows: Austria (3), Belgium (3), Canada (1), Denmark (4), Finland (3) France (2 through 1993 and then 4), Germany (5), Ireland (2), Italy (2), the Netherlands (4), Norway (2), Sweden (2), the United Kingdom (2), and the United States (3). Note that Eijffinger et al provide no score for Ireland. My coding for the Irish central bank is based on information provided in Aufricht and Evensen (1967)
- CO* This is Quinn's measure of the lack of restrictions on capital flows. Score ranges from a low of "0", where all elements of the categories of restrictions on current and capital account apply, to a high of "14," where none of these restrictions are in effect. My thanks to Dennis Quinn for providing me access to this data series.
- DR* For each country the interest rate series, unless otherwise noted, is the official Discount Rate of the national central bank at the end of the year. With a few exceptions, all data on interest rates are drawn from the International Monetary Fund's *International Financial Statistics* CD-ROM of May, 2000. The series for Canada is described in the source as the "Bank Rate". The "Money Market Rate" is used for France. The "Treasury Bill Rate" is used for the United Kingdom. The Discount Rate for Ireland in 1992 is not available from the IMF and has been drawn from the 1996 Statistical Yearbook of the Netherlands. The latter is also the source for the Netherlands' data for 1994 through 1996.
- G* This is the government political center of gravity; a low value signifies a rightist government, a high value signifies a leftist government. An index intended to capture the governing parties' collective position on a left-right scale has been constructed and introduced into the model. It represents what Gross and Sigelman (1984) describe as a skyline view of party systems. On the vertical dimension the relative strength of, for example, a party within a coalition government is portrayed while on the horizontal dimension the "ideological - programmatic" position of that party is captured. The general

formula for this measure of the political center of gravity for government takes the following form: $G = \sum_{i=1}^n T_i C_i$ where T_i is

party i 's decimal share of cabinet seats, and C_i refers to party i 's position on a left-right continuum (Gross and Sigelman, 1984). To operationalize parties' positions on the left-right continuum the Castles and Mair (1984) codings of party's placement on a left-right scale have been employed. The Castles-Mair scale is based on expert codings and in organizing the data it has been modified to range from a low of 1 (extreme left) to a high of 5 (extreme right). For purposes of this study, the index, which has been used successfully elsewhere (Cusack, 1997; 1999), has been rescaled by subtracting it from the value 5. Thus, it has a natural zero value (in this case, extreme right) and ranges up to a high of 4 (representing the extreme left). An extensive number of sources were used in collecting information on governing parties. The prime sources included: Paloheimo's *Governments in Democratic Capitalist States*, numerous issues of the *European Journal of Political Research*, *Europa Yearbooks*, and Arthur Banks' *Political Handbooks of the World*.

- I* This is the rate of inflation. This is based on changes in the GDP deflator. Data series constructed on the basis of information taken from the OECD's *National Accounts, Detailed Tables, Vol. 2* (various years).
- S* This is the automatic stabilization response; based on proportional change in unemployed and retired times price adjusted replacement rate. The variable is calculated in the following way: $S_t = RP_t * \Delta DB_t * GE_{t-1}$ where $RP_t = RPC_t / RPC_{t-1}$, and, in turn, RPC is equal to the ratio of the consumer price index to the GDP price index; DB is the percentage of the total population that is either unemployed or in retirement age; and GE is the ratio of the percentage of GDP involved in public transfers (to the household sector) to DB . Data for these variables come principally from OECD sources. Labor force and demographic data have been drawn from various issues of the OECD's *Labor Force Statistics* Data on government transfers to the household sector as well as household and general prices derive in the main from the OECD's *National Accounts, Detailed Tables, Vol. 2* (various issues) and are described in Cusack (1991). Note that because of the practice

of linking expenditures in such programs to movements in a price index, a relative price term is also included within the calculation of this variable.

OGAP This is the outgap gap in real GDP (long-term growth rate minus actual growth rate). Each country's long-term growth rate is based on its observed average annual growth rate from the early 1950s through the mid-1990s.

U This is the unemployment rate using national definitions. Data derive from various annual issues of the OECD's *Labor Force Statistics*.

Appendix 2: Supplementary Estimation Results

Monetary Policy Model. Estimation results on a reduced sample of 12 countries, excluding Germany and the United States, are quite similar to those reported for the entire sample of 14.

Monetary Policy Specification 1 (Partisanship Contingent on Degree of Central Bank Independence): Estimation Results (Excluding Germany and the United States)

$$DR_{i,t} = 1.17 + .73 DR_{i,t-1} + .13 I_{i,t} - .14 OGAP_{i,t} - .15 BCA_{i,t} \\ + .14 BUBAFED_{i,t-1q} + .11 CBD_{i,t} - .03 BB_{i,t} + .01 (CBD_{i,t} BB_{i,t})$$

(2.59) (14.64) (3.09) (3.54) (4.47)
(4.01) (1.29) (0.39) (0.40)

$$R^2 = .75$$

t-statistics in parentheses

12 countries, 34 years (=408 observations)

Monetary Policy Specification 2 (Political Non-neutrality of Central Banks): Estimation Results (Excluding Germany and the United States)

$$DR_{i,t} = 1.17 + .73 DR_{i,t-1} + .13 I_{i,t} - .14 OGAP_{i,t} - .15 BCA_{i,t} \\ + .14 BUBAFED_{i,t-1q} - .08 G_{i,t} + .17 BB_{i,t-1} - .08 (G_{i,t} BB_{i,t})$$

(2.59) (14.64) (3.09) (3.54) (4.47)
(3.98) (0.76) (2.67) (3.10)

$$R^2 = .76$$

t-statistics in parentheses

12 countries, 34 years (=408 observations)

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