Understanding Populism: Inequality by the Numbers

By Pushan Dutt , INSEAD Professor of Economics and Political Science

The populist surge of 2016 was a long time coming, as data on income inequality demonstrates.

The victory of Donald Trump was a seismic shock, completely unanticipated by pollsters, political experts, talking heads on TV, and yes, even academics like me. Suddenly the two major superpowers, the United States and Russia, are led by men deeply sceptical of the existing international system of rules and alliances, who promise a return to some mythical golden past, and who have cleverly exploited people's insecurities in a rapidly evolving world. Throughout Europe, right-wing populist parties are making plausible bids for power.

In UKIP's role in Brexit, the rise of Geert Wilders in Holland, Italy's Northern League, Marine Le Pen in France, the close elections in Austria, and Viktor Orban in Hungary, we see at least some of Trump's populist instincts – contempt for the traditional political elite, scepticism of globalisation and big corporations, and an anti-immigrant stance bordering on xenophobia.

The rise of the populists has led to reams of newspaper articles and analyst pieces. Much of this is purely speculative, with overconfident assertions, some based on slicing and dicing noisy data from exit polls. The irony is, most were written by people who were utterly confident of a Hillary Clinton victory and/or that Brexit would be voted down. I was wrong on both Brexit and Trump v. Clinton so do take everything I say henceforth with dollops of salt.

A false dichotomy

Two ostensibly contrasting schools of thought have rapidly emerged. One ascribes populism's ascendancy to a cultural backlash towards progressive values, centred amongst the urban elite. The other attributes it to rising economic insecurity made salient by the increase in income and wealth inequality over time. Both arguments are plausible. In the former, the majority in many countries have developed a minority complex. They feel threatened by rapid cultural changes as compared to the past when their group was even more dominant, both economically and culturally. This has allowed for the emergence of "political entrepreneurs" who cleverly appeal to our lizard brains by generating fear of the "other." The immigration crisis in Europe has made their task much easier.

The second is more of a slow-moving problem produced by decades of stagnant incomes and a declining share of the pie for both the unskilled and the middle and lower classes, who have been left behind by globalisation (rise of trade and outsourcing, FDI, global supply chains, global capital flows) and in the skill race (automation via rise of machines, knowledge economy). The problem is exacerbated by a decline in unionisation, especially in the U.S., and by the fraying of safety nets following austerity policies post-global financial crisis.

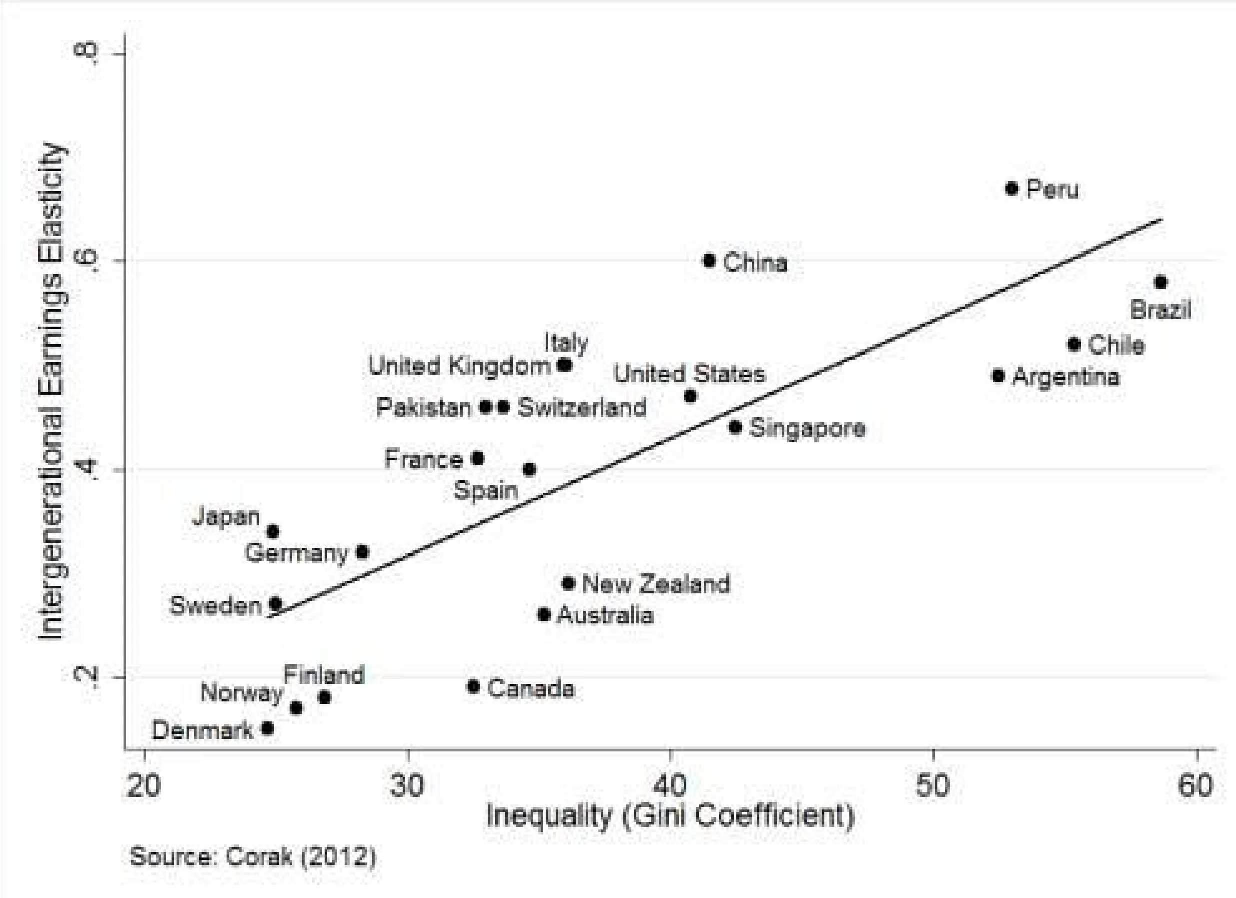
Of course, these two arguments are neither mutually exclusive nor independent. In fact, rising inequality is likely to manifest itself in a cultural backlash over time.

The (un)desirability of inequality

A more fundamental question is whether we should care about inequality in the first place. For instance, if the richest 1% experience an increase in absolute incomes while the rest have constant incomes, then this is what economists dub a Pareto improvement and a desirable outcome – some people are better off while others are no worse off.

A useful dichotomy is inequality of outcomes vs. inequality of opportunities. Economists worry far more about the latter than they do about the former. If someone is smarter than me, better trained and educated than me, works harder than me, is more ambitious than me, then I have no reason to complain if they earn more than me. On the other hand, if the other person earns more simply because their parents were richer than mine, then we have inequality of opportunity, in which a child's destiny is determined at birth. Essentially, we do not want to live in a world with no inter-generational mobility across income ranks.

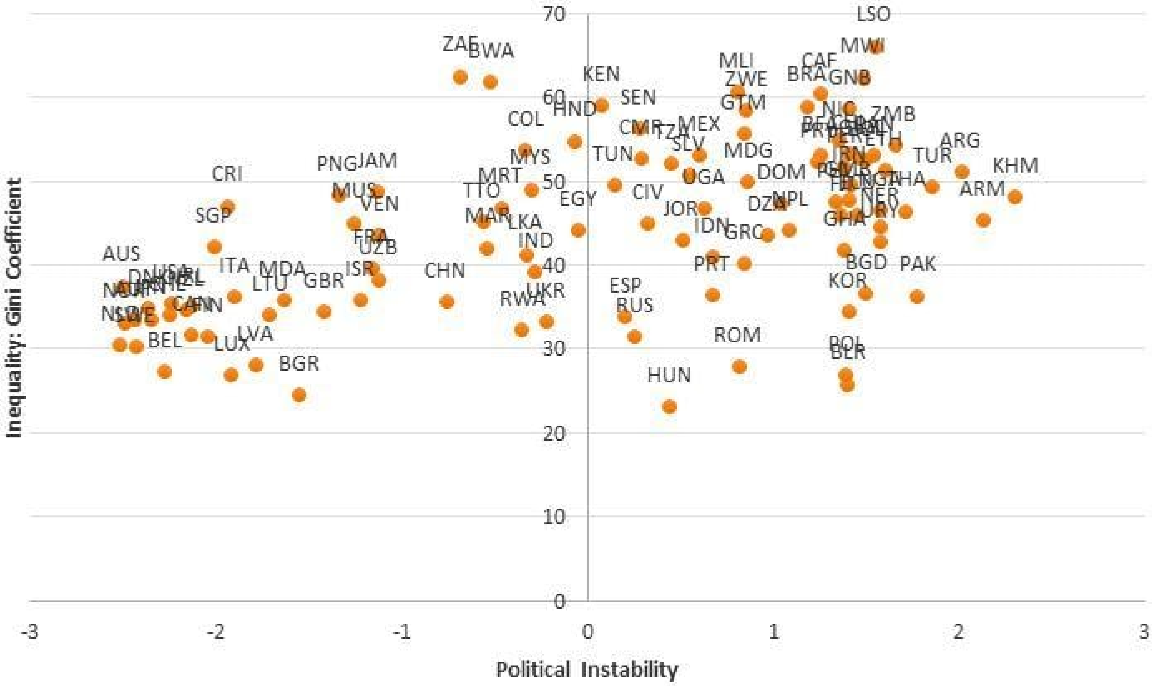
The curve from Miles Corak (2012) below, dubbed The Great Gatsby Curve, shows how inequality and inter-generational inequality are related. The horizontal axis measures inequality; the vertical axis summarises the relationship between your income and your parents'. A score of zero means that we have perfect equality of opportunity – kids of rich people earn as much as the kids of the poor. The U.S. has a score of 0.4 which means that, on average, parents pass on 40 percent of their economic advantage to their kids: If you earn $100,000 more than me, then on average, your kids will earn $40,000 more than my kids. There is a strong positive relation between the two – countries that are more unequal in outcomes also demonstrate low inter-generational mobility. Amongst advanced economies, the U.S. scores highest on this measure. So, in the land of the free…there is little freedom of mobility!



Pernicious influence of inequality

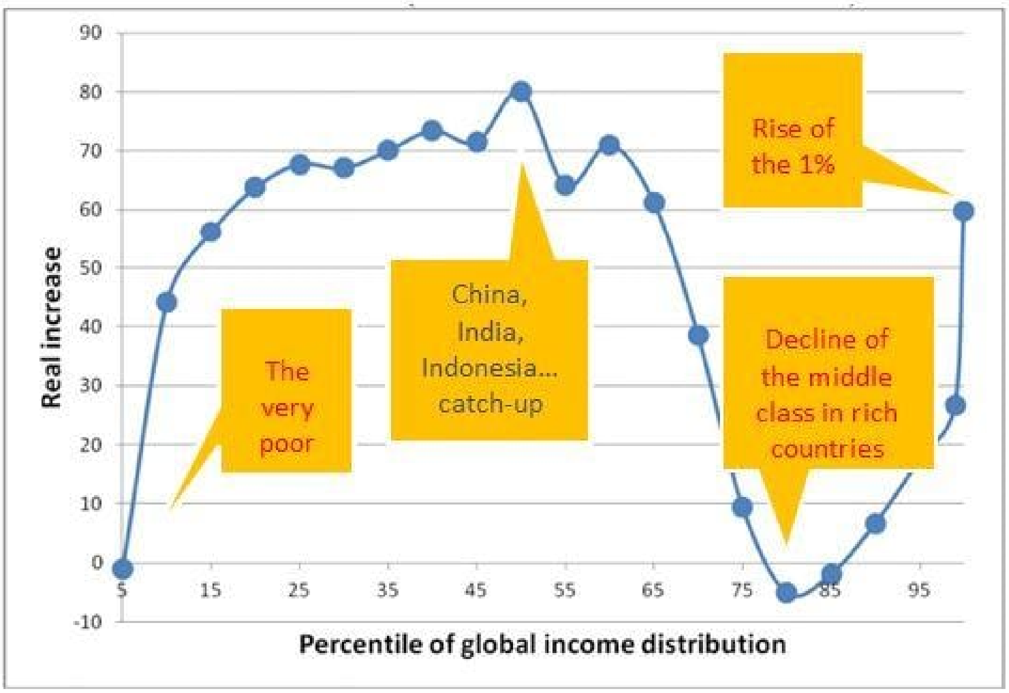
Inequality can lead to policies that hurt long-term growth. Today we see a backlash against globalisation both in the U.S. and in the United Kingdom. The world may well see a resurrection of protectionist policies, especially in advanced economies where higher tariffs transfer gains from capital owners and skilled workers (the beneficiaries of globalisation) to unskilled workers (those left behind). This follows from standard trade models and there is **empirical evidence** that pressures for protectionism are higher in more unequal countries. The efficacy of such protectionist policies is questionable – such policies may create jobs for robots in advanced economies via automation rather than for humans.

Inequality also leads to political instability. My **prior work** shows that countries with high levels of inequality tend to oscillate between democratic and autocratic regimes, as seen in the graph below. This creates tremendous volatility in policies, deterring investment and eventually economic growth.



No simple solution

The elephant in the room is clear from the next graph from Branko Milanovic; it shows the change in real income between 1988 and 2005 in real terms for the world as a whole. On the horizontal axis, citizens of the world are ranked from poorest to richest while the vertical axis shows the increase in real income. It is nicknamed “the elephant graph” because one can dimly see the outline of an elephant with its tail on the left and an upright trunk on the right.



As earlier, it's easy to see that the richest 1% have done well for themselves. The segment that has done even better (in percentage terms) is the one in the middle – this is essentially the rise of India and China that has lifted vast swathes of their population out of poverty. When we celebrate market economies, globalisation, and highlight businesses as a force for good, we are essentially focused on these countries and on this segment of the global income distribution. But after the global median, the gains rapidly decrease, becoming almost negligible from the 75th–90th global percentiles. These are the Trump voters, the Brexit voters, the hollowed out of the middle class left behind by the twin forces of technology and globalisation. Interestingly, those at the very bottom of the global distribution have done poorly as well. For these countries, **poverty alleviation** should be the key focus.

This helps highlight the complexity of the challenge faced by the world and by different countries.

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