

ECONOMIC EFFECTS OF POPULISM

A Dialogue between a Populist and an Economist[†]

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Excerpt from an imaginary dialogue between a populist and an economist.

Populist: Hello, I am very happy because populist vote is on the rise everywhere. Finally, we are winning! Unfortunately, you economists have not understood us. Recently you started writing a lot of papers, but you are not really getting to the core of the issue. You are focusing exclusively on economics.

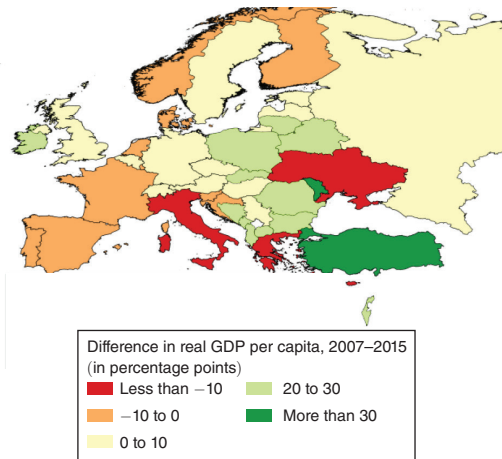
Economist: Wait a moment! The economy can explain a lot. We have revised our understanding of political economy. A few years ago, we just focused on the *aggregate* economy. Parties in power won the elections if the economy was doing well. Therefore, politicians had the incentives to have expansionary fiscal and monetary policy. Shortsighted or misinformed voters voted for parties promising easy policies. This simple idea was called the political economy cycle and explained well what was happening.

Populist: Fine. But now this is not true for the current situation. Look at the map of Europe. Unlike other countries in Europe, Poland did not suffer any economic crises in the last decade, yet populists are in power. On the contrary, Ireland and Portugal suffered a deep crisis and they have

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Panel A. Cumulative change in GDP per capita between 2007 and 2016



Panel B. Right-wing populist parties in national political systems, 2017

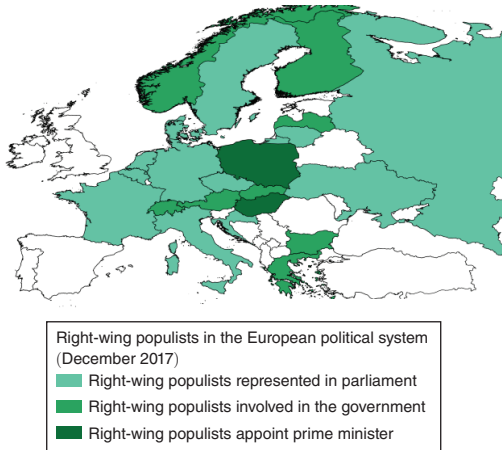


FIGURE 1

no populist party. Switzerland with an enviable economic situation and very low unemployment has one of the strongest populist parties in

Europe. How do you explain this?

Economist: Do not worry. Economists have solutions for every puzzle. In this case, we use what I would call the “factor-proportion model of populism.”

Populist: What is this?

Economist: Simple! In a nutshell, the old Heckscher-Ohlin framework tells us that factor prices change after liberalization, creating some “losers,” such as owners of factors whose price goes down, and some “winners.” The “losers” of liberalization are typically the low-skilled workers exposed to foreign competition or the workers who lose their jobs because of technological progress. They tend to vote for you. Isn’t this so simple? The explanation was already in a model written almost 90 years ago! We just need to find empirical evidence of the Truth. We do not need to read any modern paper of political scientists. We can update Bill Clinton’s 1992 US election saying “it’s the economy, stupid!” to “it’s factor proportion, stupid!”

Populist: So, is it all about trade and globalization?

Economist: Not all, technological progress by displacing disproportionately unskilled labor works in the same way. Workers displaced by technological progress or trade are, with admittedly bad terminology, considered “the losers” of modern times. Economists have shown that technological progress is more important than trade but in the public debate trade plays a bigger role. This is another example of how economists not only look at the facts but also need to explain why perceptions of reality are different.

Populist: Interesting, but your theory does not explain why the so-called “losers” vote for me and do not vote for other parties as they did in the past. Why?

Economist: This could be explained by demand and supply. Traditional parties from left to right have been converging to centrist positions. This happened for historical reasons, including the fall of the Berlin wall in 1989 and the broad economic consensus that followed. As

a result, the political supply shrank and is now unable to address current political demands. In other words, the “losers” cannot find politicians who give voice to their concerns. In some sense, they are twice “losers”: they lost to economic progress and globalization and they lost again because they had no representation. In sum, the factor-proportion theory plus the shrinkage of supply of political parties can explain the surge of populist parties.

Populist: Your theories are elegant and simple, but there is a point I still do not understand. If there is so much demand by the “losers” why didn’t non-populist parties change their platforms to cover our concerns? After all, as they moved to the center in the past, they could move back to the extremes to follow their voters. Political platforms are endogenous and should respond to the demand. I think you are missing something.

Economist: You have a good point. Why can traditional parties not move and cover the political spectrum? What am I missing?

Populist: You are so enamored of your theories that you miss the most important point. My voters have simply lost *trust* in the current establishment, including all pre-existing parties. They realized that they, the People, are separated from this corrupt elite. Political scientists use a nice definition of populism as “a thin-centered ideology that considers society to be ultimately separated into two homogeneous and antagonistic camps, ‘the pure people’ and ‘the corrupt elite’, and which argues that politics should be an expression of the *volonté générale* of the people” (Mudde and Rovira Kaltwasser 2017, p. 6). This definition rightly puts the emphasis on the mistrust of the people toward the elites. Populist leaders give a voice to the “losers.”

Economist: You mean that there is yet another dimension in addition to the left-center-right political location ...

Populist: Yes, and this explains why incumbents do not relocate: they cannot as they are simply not credible as anti-establishment parties. Moreover, we can have populist parties capturing votes at the two extremes of the political spectrum. It would be misleading to think that

there can only be either right-wing populists or left-wing populists.

Economist: Interesting, but your low-trust, anti-establishment explanation captures only the end of the story. I still believe in the supremacy of economic factors. Low trust in political parties and governments is just a byproduct of the Great Recession. Those who were in the opposition during the crisis are lucky.

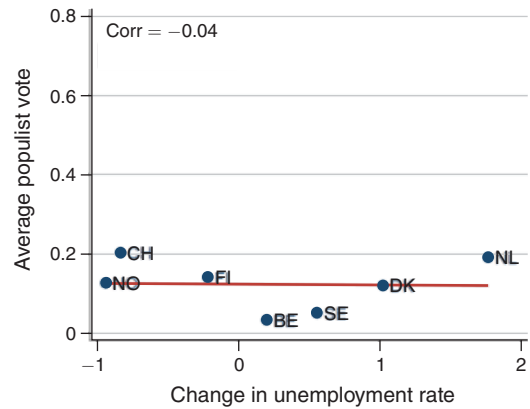
Populist: The crisis has not been beneficial to incumbents, but their credibility loss predates the Great Recession. And this is a key point to understand the effect of economic shocks on support for populism.

Economist: Could you explain your point better?

Populist: In countries with pre-existing low level of trust toward institutions, economic shocks explain well the vote for populists.

Economist: This is interesting. Let me test this using my usual analytical tools. I will bring some hard evidence to this question. I will draw a cross-country plot between economic shocks and populist votes. I will make this plot separately for countries with high and low pre-existing level of trust in political institutions. And the economic shock will be measured as the change in unemployment. For data availability purposes, I will make this plot only for European countries, covering the period 2004–2014. I will use European Social Survey (ESS) to measure vote for populist parties. I will follow the recent literature, e.g., work done by Inglehart and Norris (2016) to classify parties on a populist scale. If your hypothesis is correct we should find that the economic shocks are important *only* when the initial level of trust is low. This is exactly what we find. See Figure 2. *Only* in countries with low level of trust, economic shocks as measured by increases in unemployment are associated with greater likelihood of vote for populist parties. See the upward sloping line on the right panel. In countries with high level of trust, this relationship does not hold. Therefore, both of us are right! Economics matters for populism. But only when political trust is low.

Panel A. High trust in politics



Panel B. Low trust in politics

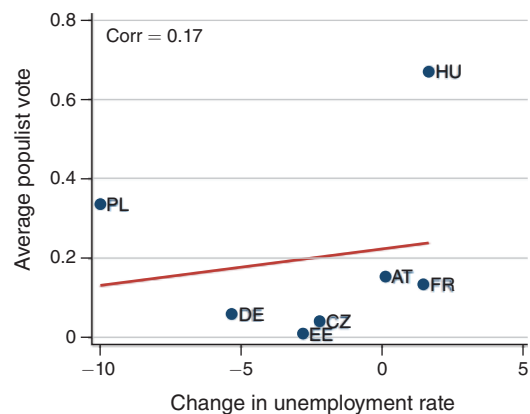


FIGURE 2. AVERAGE POPULIST VOTE AND CHANGE IN UNEMPLOYMENT, 2004–2014

Populist: Hmm ... that's very interesting ... Populism is much more complicated than you economists think. You are showing me a graph where populism depends *only* on economic shocks and you want me to believe it? There are so many things that matter in determining how populism has evolved.

Economist: You are exactly right! That's why we economists develop a more systematic framework and estimate "regressions." We try to account for several possible factors that could determine votes for populists. Here are some of the econometric

details. We estimate the following equation (1):

$$(1) \quad D_{i,c,t} = aUnion_{i,c,t} + \beta Income_{i,c,t} \\ + \gamma Gender_{i,c,t} + \delta Age_{i,c,t} \\ + \mu Education_{i,c,t} \\ + \varphi \Delta Unemployment_{i,c,t} \\ + \sigma Trust \times \Delta Unemployment_{i,c,t} \\ + s_c + v_t + \varepsilon_{i,t}$$

where $D_{i,c,t}$ is a dummy that takes a value of one if individual i in country c at time t votes for a populist party. $Union_{i,c,t}$ takes a value of one if the individual is a member of a union, or any other organization. $Income_{i,c,t}$, $Gender_{i,c,t}$, $Age_{i,c,t}$, and $Education_{i,c,t}$ are indicators for income, female, age, and education. We use two indicators of income: (i) an indicator, “income sufficient” which takes a value of one if the individual responds that income is sufficient, and zero otherwise, and (ii) another indicator, “income difficult,” which takes a value of one if the individual responds to be in a difficult income situation, and zero otherwise. For gender, we use a dummy to indicate that respondent reports she is a female. We also use two indicators for age: (i) a dummy, “young,” which takes a value of 1 if the individual is below 30 years of age, and 0 otherwise, and (ii) another dummy, “old,” which takes a value of 1 if the individual is more than 65 years old. For education, we also distinguish between different categories of education. Specifically, we include two indicators specified as follows: (i) a dummy which takes a value of 1, if the individual has attained secondary education, with 12 or more years of completed schooling, and (ii) another dummy which takes a value of 1 if the individual has attained tertiary education, with 16 or more years of completed schooling.

s_i and v_t denote country and time fixed effects, respectively. Country fixed effects control for all time-invariant country characteristics that may affect individuals’ preferences to vote for populist or non-populist parties, e.g., historical background, culture, or legal system. Time effects capture any time trends in voting behavior that are common across countries, e.g., the global financial

crisis, or a common rise in populism across the globe.

The main variables of interest are $\Delta Unemployment$ and $Trust \times \Delta Unemployment_{i,c,t}$. φ and σ are the coefficients of interest. φ measures how likelihood of voting for populist parties changes with economic shocks at low levels of trust, while σ measures how the reaction of populist vote to economic shocks changes with increasing levels of trust. Table 1 shows the results. Columns 1, 2, and 3 estimate equation (1) for the full sample, precrisis, and post-crisis, respectively.

The responsiveness of populist vote to economic shocks is insignificant before the crises (column 2), but becomes statistically significant only post-crisis (column 3). Note that, in column 3, φ is estimated to be positive and statistically significant, i.e., in countries with low levels of trust, a higher unemployment rate is associated with a greater likelihood of votes for populist parties. σ , on the other hand, is negative and statistically indistinguishable from zero. As trust in political institutions increase, voters tend to vote less and less for populist parties, even in periods of economic shocks. I recognize that the empirical results are not strong in a statistical sense but they are certainly promising, and leave scope for further investigation.

Economists and populists may be in consonance after all!

Populist: I told you! You economists should look more carefully at the credibility of the ruling class. There are too many politicians living off politics rather than for politics ...

Economist: The ruling class is more a subject for sociologists than for economists, as your quote of Max Weber after all indicates.

Populist: So what?

Economist: Anyway, our intuition and my analytical approach found something interesting. We should collaborate more often—and hope you can take a look at a few papers in this emerging literature.¹ There are many other important issues we should address, such as the role of nativism and the rural-urban divide in

¹For example: Algan et al. (2017); Boeri et al. (2018); Inglehart and Norris (2016); Guiso et al (2017).

TABLE 1—DRIVERS OF POPULIST VOTE: HECKMAN ESTIMATES

	2004–2014 ^a	Pre-2010	Post-2012
Union member	–0.07 [0.06]	–0.03 [0.08]	–0.14 [0.03]
Sufficient income	–0.13 [0.04]	–0.12 [0.04]	–0.13 [0.04]
Difficult income	0.04 [0.06]	0.00 [0.07]	0.09 [0.06]
Female	–0.13 [0.04]	–0.14 [0.04]	–0.17 [0.04]
Young	0.03 [0.04]	0.08 [0.06]	–0.06 [0.03]
Old	–0.13 [0.05]	–0.11 [0.06]	–0.15 [0.05]
Secondary education	–0.11 [0.08]	–0.14 [0.11]	–0.05 [0.05]
Tertiary education	–0.46 [0.10]	–0.50 [0.13]	–0.40 [0.05]
Change in unemployment	–0.06 [0.07]	–0.06 [0.06]	0.15 [0.08]
Trust × Change in unemployment	–0.00 [0.01]	0.00 [0.01]	–0.03 [0.02]
Observations	134,077	84,248	49,829

Notes: This table shows the estimations from the second stage of the Heckman 2-step estimation, where the first models participation in voting. The dependent variable is a dummy variable of populist vote (=1 if vote for populist party, and 0 otherwise). The identifying variables used in the first stage includes proxies for lack of political awareness. “Union Member” takes value of 1 if the individual is a member of a union, or any other organization. “Sufficient income” and “Difficult income” take value of 1 if the individual responds to be in a sufficient and difficult income situation, respectively. “Young” and “Old” take value of 1 if the individual is above 65 and below 30 years old, respectively. “Secondary education” and “Tertiary education” take value of 1 if individual has attend secondary and tertiary education, respectively. “Change in unemployment” is the change in unemployment rate in the corresponding country and year. “Trust” takes value from 0 to 10, which higher value indicating higher trust in political party. A full set of country and year fixed effects is included in all regressions. Standard errors clustered at country level.

Source: Authors’ calculations

populist vote. I can already see many graduate students working on this.

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