RESEARCH BRIEF

Inequality Aversion, Populism, and the Backlash Against Globalization


KEY TAKEAWAYS

✓ Globalization increases growth but the wealthy benefit more
✓ Over time, this rise in inequality causes resentment among voters
✓ In an attempt to reduce inequality, voters will favor politicians and policies that restrict the flow of goods, services, and people across borders
✓ The resulting autarky means that all are less wealthy, but there is less inequality

United States and United Kingdom voters shocked the world in 2016 when they elected a populist president and rejected Britain’s role in the European Union. However, the two results had one thing in common—anti-globalization—that not only fueled the votes but proved a predictor for the surprising outcome.

What was the source of this anti-globalization? Why did two wealthy countries turn their backs on one of the very forces—international trade and finance—that added to their own prosperity? In a new paper, “Inequality Aversion, Populism, and the Backlash Against Globalism,” Booth professors Lubos Pastor and Pietro Veronesi develop a theory that describes how growing income inequality spurred resentment among voters and set the stage for a populist backlash against global integration.

According to their theory, a retreat from globalization is a rational response to rising inequality. And the whole cycle—economic growth that exacerbates inequality, which ultimately quells globalization—is inevitable and only a matter of time. As Pastor and Veronesi frankly state: “Globalization carries the seeds of its own destruction.” The authors draw this stark conclusion from a model that connects rising income inequality with the growth of populism. And there is little that policymakers can do to avoid such a backlash against globalization, the model reveals, short of a massive tax overhaul that would move from a system of redistributive income taxes to consumption taxes.
The size of the pie matters, but so does the size of the slices

Pastor and Veronesi, two finance academics, came to this work on the rise and fall of globalism, in part, because of the connection between financial risk aversion and wealth accumulation (they have also done previous work on asset prices and political cycles, among other related subjects). People’s willingness to take on financial risk correlates to increased wealth, on average and over time, and it’s this propensity that distinguishes the agents in the authors’ model. Those agents who are more risk averse and who, consequently, fall further behind, eventually vote for populist politicians and policies.

The authors define populism as “a political ideology pitching ordinary people, who are viewed as homogeneous and inherently good, against the established elites, who are deemed immoral and corrupt.” The agents in the model are assumed to dislike inequality, but their primary concern is with the elites of society who consume a great deal more than others.

A retreat from globalization is a rational response to rising inequality.

Non-rich agents (who are not poor) naturally care about their own consumption, but they also care a great deal about how much the rich are consuming. These agents are intent on reducing the consumption of elites, even if that means limiting the growth of their own consumption. It’s not the size of the pie that matters, in other words, it’s the relative size of their own slice.

A common feature of populism is anti-globalism, according to the authors, which is perceived as benefiting the rich more than others. This is especially true when globalization is partnered with a highly developed financial system that allows for high risk-and-reward scenarios. It is no coincidence, then, that the two countries that recently experienced a populist revolt—the US and UK—have two of the most sophisticated financial systems in the world, and that those systems have generated vast amounts of wealth for relatively few players (while also benefiting many others to a lesser degree). Populists, likewise, favor politicians and policies that restrict globalization and that favor closed borders, both to people and to goods, according to this research, because such policies hurt elites more than others. In the authors’ model, the election of a populist leads to that country consuming its own products with no cross-border trading and no access to international finance (autarky).
Another feature of the authors’ model is that this shift to populism necessarily occurs during good times and not when a country is in a downturn. The reason is that during a growth period in a globalized economy with income inequality, like the recent lengthy (though gradual) upswing, the gap between the rich and others tends to widen. Also, in a growth period, non-rich agents are also improving and, consequently, they are willing to give up some consumption to more sharply reduce the consumption of the rich. During a recession, on the other hand, the wealthy often take a larger relative hit than others (as in the recent Financial Crisis and Great Recession), and income and consumption gaps are closed.

In summary, the authors’ model makes the following predictions:

• Support for populism should be stronger in countries with higher inequality, more financial development, and a more negative current account balance. They find evidence supporting these predictions by analyzing voting data from 29 developed countries.

• Populist agents are more averse to risk and are likely to place a large weight on consumption inequality. Their more conservative investment and consumption plans make them less susceptible to the negative effects of autarky and, thus, they are more inclined to favor populist policies.

• These agents tend to be less wealthy because of their conservative financial positions and risk-aversion.

• The model also suggests education as a proxy for risk aversion: less-educated agents tend to benefit less from growth under globalization, and have less to lose from the end of globalization.

• The model thus predicts that less-educated, poorer, and anti-elite agents are more likely to vote populist.

Pastor and Veronesi offer one recourse to globalization’s demise: a consumption tax on the purchases of the elites that would serve to subsidize those left behind by globalization. Such a tax could stem a populist tide and keep globalization in place. Other redistributive measures, like income taxes, could slow the impact of globalization but inequality would continue to grow in such an economy and eventually lead to populism.
Conclusion

Globalization is often thought as inexorable and irreversible. However, the authors recount a century of globalization that occurred prior to 1914 that was, in some ways, more expansive than current levels. The onset of World War I, though, and the period extending till after World War II, brought a retrenchment of globalization driven by a number of grievances, including income inequality. Could such a retrenchment happen again? The authors cite literature which suggests that globalization may not be compatible with certain social norms and arrangements that many people find important. Free-flowing goods, services, and migrants may create labor market tensions, but they may also raise other social tensions, including a perceived loss of culture and other norms. Pastor and Veronesi analyze one of those tensions—inequality—and their results suggest that globalization is reversible indeed.

In effect, their model offers the following advice to countries with high inequality and current account deficits, along with sophisticated financial services industries: Get ready—change is coming. As to when such change would occur, the model cannot offer a precise prediction. However, it does suggest that globalized countries that are facing immigration strains, as well as challenges from competing nations, may be particularly vulnerable. When inequality becomes large enough, it becomes unsustainable and will set in motion a process to reduce that inequality, according to the model, even at the risk of destroying wealth.

CLOSING TAKEAWAY

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