

# A Political Economy Theory of Populism and Discrimination

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## Populism as/and “discrimination”

In a recent work on Venezuela, Hawkins (2010) provides an articulated definition of populism consistent with a form of exclusionary politics.

*“Populism is a set of fundamental beliefs about the nature of the political world—a worldview or, to use a more rarefied term, a “discourse”—that perceives history as a Manichaeian struggle between Good and Evil, one in which the side of the Good is “the will of the people,” or the natural, common interest of the citizens once they are allowed to form their own opinions, while the side of Evil is a conspiring elite that has subverted this will.” (Hawkins 2010, p. 5).*

## Populism and crises

- Since the classic work on the macroeconomic of populism of Dornbusch and Edwards (1991), scholars increasingly associates populism with expansive fiscal policies and redistributive measures designed to enhance popular consumption, but invariably at the cost of macroeconomic stability.
- *Populism* associated to *highly distortionary policies* (large fiscal deficits, foreign exchange bottlenecks, high inflation).
- Our result are consistent with Dornbusch and Edwards (1991):
  - The populist leader overspends the technocrat.
  - This relative lack of fiscal discipline distinctive of populist politicians makes, in turn, a fiscal crisis *more likely* to occur *ex ante*.
  - Populists more likely to come to power in bad times.

⇒ Populism leads to fiscal distortions and waste of resources.

## Populism as expression of a cross-cutting coalition

- This feature of populist regimes has been emphasized by Drake (1982).
- It is more transparent in the first part of the 20<sup>th</sup> century when populism incorporated workers and capitalists within broad and multi-class political coalitions backing, among other things, both social reforms and state-lead industrialization. Such coalitions, first emerged at the beginning of the last century following the structural social economic transformations that lead to industrialization and the birth of mass politics, included often large segment of the urban masses, whose interests were not represented by traditional parties, and the industrial bourgeoisie.
- Prominent populist leaders in Latin America included, for instance Perón in Argentina, Cárdenas in Mexico, Vargas in Brazil, and Haya de la Torre in Peru (see for example O'Donnell, 1988, and Roberts, 1998).

# Introduction (continued)

- Kaufman and Stallings (1991) argue that the political goals of populist regimes often “[...] are (1) mobilizing support within organized labor and lower-middle-class groups; (2) obtaining complementary backing from domestically oriented business; and (3) politically isolating the rural oligarchy, foreign enterprises, and large-scale domestic industrial elites. The economic policies to attain these goals include, but are not limited to: (1) budget deficits to stimulate domestic demand; (2) nominal wage increases plus price controls to effect income redistribution; and (3) exchange-rate control or appreciation to cut inflation and to raise wages and profits in nontraded-goods sectors.”
- Furthermore, according to Perrucci and Sanderson (1994, p. 30), “Latin American populism has been characterized as a time-bound phenomenon, part of the political revolution against the old agricultural oligarchy and accompanying import-substitution industrialization.”

# Income distribution

- People differ by both their income and their caste.
- Income: people are either rich or poor.
- The proportion of rich is  $\theta < 1/2$ .
- For any aggregate income shock  $y$ ,
  - poor income is  $\beta y$ ,
  - rich income is  $\gamma y$ .
- We assume  $\beta < 1$  and

$$\gamma = \frac{1 - (1 - \theta)\beta}{\theta} > 1.$$

- Average income is equal to  $y$ .

- A fraction  $k$  of the population is either rich or lowest caste (the Untouchables).
- The remaining fraction  $1 - k$  is allocated to a continuum of castes indexed by  $\lambda \in [0, 1]$ .
- Uniformly distributed over  $\lambda$ ,
- Density =  $1 - k$ .

# Basic assumptions

- $k \geq 1/3$ .
- Let  $\lambda_m$  the decisive caste such that

$$(1 - k)(1 - \lambda_m) = \frac{1}{2} (1 - k + \theta) .$$

- We assume that  $k \leq 1 - \theta$ ,
- This implies that  $\lambda_m \geq 0$ .



- Utility of the poor

$$U_P(C, G) = C + G,$$

- Utility of the rich

$$U_R(C, G) = C.$$

# Publicly provided good

- An *entitlement*  $G$  has to be predefined by the polity.
- Any individual is either granted or denied his entitlement.
- Rationing cost =  $\varepsilon G$  units of the private good,  $\varepsilon < 1$ .
- We assume that

$$0 \leq \lambda_m \leq 1 - \beta(1 - \varepsilon). \quad (1)$$

- $\phi$  = proportion of rationed population.
- All income taxed at rate  $\tau$ .
- Taxes cannot exceed state capacity  $\bar{\tau}$
- Government budget constraint

$$\tau y = G(1 - \phi + \varepsilon\phi).$$

- The number of rationed consumers is

$$\phi(G, \tau, y) = \max\left(\frac{G - \tau y}{G(1 - \varepsilon)}, 0\right) \quad (2)$$

1. The incumbent is in power
2. People vote on entitlement level  $G$
3. An income shock is realized,  $y \sim U[0, \sigma]$
4. An election occurs with probability  $q$
5. The politician in power decides on the procedure for allocating public goods

# Rationing technologies

- *Random technology*: each individual is served with probability  $1 - \phi$ .
- *Caste-based technology*: caste  $\lambda \geq 0$  is served with probability

$$p(\lambda, \phi) = 1 - (1 - \lambda)\phi - \lambda\phi^2, \quad (3)$$

- Rich and untouchables are served with probability

$$p_I(\phi) = (1 - \phi) \left( 1 - \frac{\phi}{2} \frac{1 - k}{k} \right).$$

# Properties of the rationing scheme

- $\frac{\partial p}{\partial \phi} = -(1 - \lambda) - 2\lambda\phi < 0$ ,  $dp_I/d\phi < 0$
- $p_I(1) = p(\lambda, 1) = 0$  and  $p_I(0) = p(\lambda, 0) = 1$ .
- $kp_I(\phi) + (1 - k) \int_0^1 p(\lambda, \phi) d\lambda = 1 - \phi$ .
- $\partial p / \partial \lambda = \phi(1 - \phi) \geq 0$ , and  $p_I(\phi) < 1 - \phi = p(0, \phi) < p(\lambda, \phi)$ .

# Utility: Random scheme

- Poor, random scheme,  $\tau y = G$

$$U_P^T(\tau, y, G) = \beta y + (1 - \beta)G$$

- Poor, random scheme,  $\tau y < G$

$$U_P^T(\tau, y, G) = \beta y + \tau y \left( \frac{1}{1 - \varepsilon} - \beta \right) - \frac{G\varepsilon}{1 - \varepsilon}$$

- In this case,  $\partial U_P^T / \partial \tau > 0$  and  $\partial U_P^T / \partial G < 0$ .

# Utility: Caste-based scheme

- Poor, caste-based,  $\tau y = G$

$$U_P^P(\tau, y, G, \lambda) = \beta y + (1 - \beta)G$$

- Poor, caste-based,  $\tau y < G$

$$U_P^P(\tau, y, G, \lambda) = \beta y(1 - \tau) + p(\lambda, \frac{G - \tau y}{G(1 - \varepsilon)})G$$

- (1) implies that  $\frac{\partial}{\partial \tau} U_P^P(\tau, y, G, \lambda) > 0$  at  $\lambda = \lambda_m$ .

- The *technocrat* sets the tax rate  $\tau$  so as to minimize the rationing level  $\phi$ .
  - $\tau = G/y$  if  $y \geq G/\bar{\tau}$  and  $\tau = \bar{\tau}$  otherwise.
  - Furthermore, technocrat chooses random rationing.
- The *populist* maximizes the welfare of the poor in caste,  $\lambda = 1$ .
  - If  $\phi > 0$ , always picks caste-based rationing technology



# Taxes and utility in the last period: technocrat

- Technocrat sets  $\tau = \min(\bar{\tau}, G/y)$ .
  - Resulting utility levels for the rich

$$U_R^T(y, G) = \gamma y(1 - \min(\bar{\tau}, G/y)).$$

- For the poor of any caste

$$U_P^T(y, G) = \min \left( \beta y + (1 - \beta)G, y \left[ \beta(1 - \bar{\tau}) + \frac{\bar{\tau}}{1 - \varepsilon} \right] - \frac{\varepsilon G}{1 - \varepsilon} \right).$$

- Populist solves

$$\max_{\tau \leq \bar{\tau}} u(y, G, \tau, 1) = \beta y(1 - \tau) + p(1, \phi(G, \tau, y))G.$$

- Interior optimum is such that

$$u'_3 = -\beta y + p'_2 \phi'_2 G = y(-\beta + \frac{1}{1 - \varepsilon} p'_2(1, \phi)) = 0.$$

# Equilibrium rationing and taxation

- This defines an equilibrium rationing level

$$\phi^* = \frac{(1 - \varepsilon)\beta}{2}.$$

- The corresponding tax rate is given by

$$\tau^*(G, y) = h \frac{G}{y},$$

where

$$h = 1 - \frac{(1 - \varepsilon)^2 \beta}{2}.$$

- Solution prevails if  $y > h \frac{G}{\bar{\tau}}$ , otherwise,  $\tau = \bar{\tau}$ .

# Utility under a populist government

## 1. Utility of the rich

$$U_R^P(y, G) = \gamma(y - \min(G(1 - \frac{(1-\varepsilon)^2\beta}{2}), \bar{\tau}y)).$$

## 2. The utility of the poor of caste $\lambda$

$$U_P^P(\lambda, y, G) = \beta y(1 - \bar{\tau}) + p(\lambda, \frac{G - \bar{\tau}y}{G(1 - \varepsilon)})G \quad (4)$$

if  $y < \frac{G}{\bar{\tau}}h$  and

$$U_P^P(\lambda, y, G) = \beta y - \beta Gh + p(\lambda, \frac{(1 - \varepsilon)\beta}{2})G \quad (5)$$

if  $y \geq \frac{G}{\bar{\tau}}h$ .

# Voting over public expenditures, technocrat

- Assume  $q = 0$ .
- Technocrat incumbent, utility of the poor:

$$\begin{aligned} EU_P &= \int_0^{G/\bar{\tau}} \left( y \left[ \beta(1 - \bar{\tau}) + \frac{\bar{\tau}}{1 - \varepsilon} \right] - \frac{\varepsilon G}{1 - \varepsilon} \right) \frac{dy}{\sigma} \\ &\quad + \int_{G/\bar{\tau}}^{\sigma} (\beta y + (1 - \beta)G) \frac{dy}{\sigma}, \\ \text{if } G &\leq \bar{\tau}\sigma, \\ &= \int_0^{\sigma} \left( y \left[ \beta(1 - \bar{\tau}) + \frac{\bar{\tau}}{1 - \varepsilon} \right] - \frac{\varepsilon G}{1 - \varepsilon} \right) \frac{dy}{\sigma} \text{ if } G > \bar{\tau}\sigma. \end{aligned}$$

- In equilibrium  $\frac{d}{dG} EU_P = 0$ , i.e.

$$G = \bar{\tau}\sigma \frac{1 - \beta}{1 - \beta + \varepsilon/(1 - \varepsilon)} = G_T^*.$$

- Crisis probability:

$$P(\bar{\tau}y < G) = \frac{1 - \beta}{1 - \beta + \varepsilon/(1 - \varepsilon)}.$$

# Voting over public expenditures, populist

## a. The Rich

- Rich expected utility

$$\begin{aligned} EU_R^P(G) &= \int_0^{\frac{hG}{\bar{\tau}}} (\gamma y(1 - \bar{\tau})) \frac{dy}{\sigma} + \int_{\frac{G}{\bar{\tau}h}}^{\sigma} (\gamma y - \gamma Gh) \frac{dy}{\sigma} \text{ if } G \leq \bar{\tau}\sigma/h \\ &= \int_0^1 (\gamma y(1 - \bar{\tau})) \frac{dy}{\sigma} \text{ if } G > \bar{\tau}\sigma/h. \end{aligned}$$

- Clearly  $\frac{\partial}{\partial G} EU_R^P(\lambda, G) \leq 0$ .

# Voting over public expenditures, populist

## b. The Poor

- Poor expected utility

$$\begin{aligned} EU_P^P(\lambda, G) &= \int_0^{\frac{hG}{\bar{\tau}}} \left( \beta y(1 - \bar{\tau}) + p\left(\lambda, \frac{G - \bar{\tau}y}{G(1 - \varepsilon)}\right)G \right) \frac{dy}{\sigma} \\ &\quad + \int_{\frac{G}{\bar{\tau}h}}^{\sigma} \left( \beta y - \beta Gh + p\left(\lambda, \frac{(1 - \varepsilon)\beta}{2}\right)G \right) \frac{dy}{\sigma} \text{ if } G \leq \bar{\tau}\sigma/h, \\ &= \int_0^1 \left( \beta y(1 - \bar{\tau}) + p\left(\lambda, \frac{G - \bar{\tau}y}{G(1 - \varepsilon)}\right)G \right) \frac{dy}{\sigma} \text{ if } G > \bar{\tau}\sigma/h. \end{aligned}$$

ASSUMPTION A4 –

$$\varepsilon \leq \frac{h^2}{3}.$$

PROPOSITION 1 – Assume A2 and A4 hold, then

$G = \arg \max EU_P^P(\lambda_m, G) = G_P^*$  is a majority winner.



# Who spends more: technocrat or populist?

- In crisis states, the decisive voter is more likely to be served under a populist  $\implies$  higher marginal utility of  $G$
- In non crisis states, decisive voter is rationed under a populist (who lowers taxes for the benefit of the upper castes)  $\implies$  lower marginal utility of  $G$
- Fiscal capacity less likely to be binding, given  $G$ , under populist  $\implies$  Higher marginal utility of  $G$

# When does the populist spend more?

- Decisive voter in a higher caste
- More income inequality

Proposition 2 – The following holds:

(i)  $G_P^* > 0$

(ii)  $G_P^* > \bar{\tau}\sigma/h > G_T^*$  if

$$\lambda_m \geq \frac{\varepsilon(1-\varepsilon)}{h^2/3-\varepsilon} \quad (6)$$

(iii) There exists  $\tilde{\beta}$  such that if  $\beta < \tilde{\beta}$ , then  $G_P^* > G_T^*$  for any  $\lambda_m \geq 0$ .

(iv)  $dG_P^*/d\lambda_m > 0$ .

## *Corollary*

The populist wins with probability  $G_P^*/\sigma\bar{z}$ , which is higher than the probability of victory of the technocrat when the parametric conditions stated in (ii) and (iii) hold.

# The ex-post decisive voter

- While the rich prefer lower expenditure, they also prefer lower taxes given  $G$
- Therefore they will favor the populist in the election
- This defines a new decisive voter  $\lambda_M > \lambda_m$

$$(1 - k)(1 - \lambda_M) + \theta = \frac{1}{2} (1 - k + \theta) .$$

# Ex-post voting

Proposition 3 – (i) The political support for the populist includes the rich and poor workers with a large enough  $\lambda$ . It is a nonincreasing function of the ratio  $y/G$ .

(ii) If

$$\lambda_M > \frac{1 - \beta(1 - \varepsilon)}{1 - \beta(1 - \varepsilon)/2}$$

the populist wins regardless of the realization of  $y$ .

(iii) if

$$\lambda_M < \frac{1 - \beta(1 - \varepsilon)}{1 - \beta(1 - \varepsilon)/2}$$

there exists a critical threshold  $\bar{z}$ , independent of  $G$ , such that the populist wins if and only if  $y/G < \bar{z}$ .

(iv)  $h/\bar{\tau} < \bar{z} < 1/\bar{\tau}$ . In particular, the technocrat sets taxes at full fiscal capacity for  $y/G$  slightly above  $\bar{z}$ , while the populist sets them strictly below fiscal capacity for  $y/G$  slightly below  $\bar{z}$ .

# Voting on $G$ when $q=1$

Proposition 4 – Suppose voters choose  $G$  expecting the politician in office to be appointed after the realization of  $y$  is known. Then the following hold:

- (i) If  $\lambda_M > [1 - \beta(1 - \varepsilon)] / [1 - \beta(1 - \varepsilon)/2]$ , the populist wins for any  $y$ ; hence, the political equilibrium level of  $G$  maximizes the exp. utility of the caste  $\lambda$  poor if  $P$  is in power with  $\lambda = \lambda_m$ .
- (ii) If  $\lambda_M < [1 - \beta(1 - \varepsilon)] / [1 - \beta(1 - \varepsilon)/2]$ , for given  $G$ , the populist wins with probability  $\bar{z}G/\sigma$  (and vice versa).

## Voting on $G$ when $q=1$ (continued)

Moreover, in case (ii) we have that:

(iia) If  $G \leq \bar{\tau}\sigma$ ,  $\beta \rightarrow 0$ , and  $\varepsilon \rightarrow 0$ , and  $\bar{\tau}\sigma \geq 2\bar{z}$ , there exists a unique political equilibrium such that  $G$  maximizes the expected utility of the pivotal caste, i.e. with  $\lambda = \lambda_m$ , defined implicitly by the equation  $\Phi(G) = 0$ , where  $\Phi(\cdot)$  is the FOC of the expected utility of the pivotal poor caste.

(iib) If  $G > \bar{\tau}\sigma$ ,  $\beta \rightarrow 0$ , and  $\varepsilon \rightarrow 0$ , there exists a unique political equilibrium, corresponding to the upper bound  $\bar{G}$  such that  $\bar{G}$  maximizes the expected utility of *all* castes (i.e., we have a common corner solution for any caste).

- Populists more likely to come to power in bad times.
  - In good times the decisive voter dislikes the populist because he is rationed
  - In bad times this has to take place, decisive voter better served than average under populist
- While the rich side with the low castes when voting on  $G$ , they side with high castes in ex-post elections