

BLOG POST 24.03.2017

Rethinking reforms in times of slow growth and rising populism

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Governments are puzzled how to respond to the conflicting demands of reforming the economy and increase growth on the one hand and to cater to disappointed voters who feel left behind on the other hand. This blog post traces the success of populist parties in the polarization of labour markets and a crisis of trust in democratic institutions. Established parties can address the concerns of voters by focussing on reforms that promote equity and efficiency at the same time.

The Jacques Delors Institut – Berlin organized a workshop on “Rethinking reforms in times of slow growth and rising populism” at 16 March 2017 in Berlin. This blog post is based on the presentations and interventions of the speakers at the workshop.

Many advanced economies have still not fully recovered from the recession and growth rates remain low. While many argue structural reforms are now needed more than ever to adapt to structural change and speed up the recovery, governments fear the electoral backlash. In recent months, voters in different countries have voiced their disappointment in elections and referenda. One unifying demand among protest voters has been that governments should take better care of their citizens. Many of them feel threatened by the abstract forces of globalization.

Understandably, governments are puzzled how to address two suddenly conflicting demands: to reform the economies and increase growth on the one hand and to cater to disappointed voters who feel left behind on the other hand.

1 Why do people turn to populist parties?

A dominant theme of populist campaigns is the promise to “take back control” and to promote the interest of the silent majority against national elites and supranational institutions. Two narratives help to understand the perceived loss of agency in today’s globalized economy.

First, **labour markets have become more polarized** in major European economies like Germany, France and the UK, which resulted in greater labour market risks for the middle class. In the 60s and 70s, the interests of the lower income groups such as industrial workers, and those of the upper-middle class were reconciled. They struck a deal based on social protection and redistribution on the one hand and openness to trade and migration on the other hand. Today, this deal seems broken. As a consequence of off-shoring, mid-skilled industrial workers were pushed down in the low-income service sector where unionization is weak. Subsequently, the political power of the lower middle-class crumbled. According to this narrative, voters of populist parties want better social protection, less income inequality and secure jobs in the manufacturing sector instead of low-paid service sector employment.

The second narrative traces populism back to **the global economic crisis** that started in 2008 and fundamentally **undermined people’s trust in democracy**. Particularly in Southern Europe, the experience of losing the power to decide over economic policy and the budget to supranational institutions or even to market sentiment, harmed trust in mainstream parties and institutions that were responsible for negotiating the financial assistance programmes.

Populists exploit these narratives to pin the blame on the abstract forces of globalization or the EU institutions who prevent the people from exercising their sovereign will and subject them to elitist values as well as the rules of free markets. Easy solutions that focus on national interests only and that ignore any tradition of reconciling different interests in society become increasingly appealing.

2 What do voters of populist parties hope for?

Right-wing populists cater to two types of disappointment: economic insecurity and a perceived loss of agency, often mixed with a loss of cultural identity. Paradoxically, neither those whose jobs are at risk of off-shoring, nor the poorest income groups (the first and second decile in the income distribution) form the voter base of right-wing populists. Instead, **right-wing populism appeals to those who are afraid to lose their social status** at some point in the future and who lost trust in the social safety net. The fact that perceived inequality in society is often much higher than actual inequality adds to the fear of a hard landing. For mainstream parties, this is bad news because it means they are fighting a subjective fear rather than a measurable risk.

Despite their frustration with the political establishment, voters of populist parties are very optimistic that the politicians they vote for can deliver on their promises. Almost 90% of voters in favour of Leave in the Brexit referendum, expected that Britain will be able to negotiate trade agreements that better fit the country's needs and only about 20% thought that Britain might lose access to the EU's single market.¹

While easy solutions seem to be a successful campaign strategy, populists in government may disappoint voters. In Greece, for example, about 70% of Syriza's voters are disillusioned with Alexis Tsipras' government after two years in office. Many of them no longer believe that debt relief will happen and have consequently lost trust in the government.² Disillusioned voters of populists are however more likely to disengage with politics altogether, than to reengage with established parties.

3 What are the right policies to promote growth and fight populism?

On the one hand, economic growth and particularly productivity growth is necessary to provide high levels of social security and public goods in a fiscally sustainable fashion. On the other hand, structural reforms that aim to promote productivity, particularly in the labour market, have led to political backlash. Governments are in a dilemma when they seek to adapt their economies to structural change.

There may be two ways for mainstream parties to undertake productivity enhancing reforms without further playing into the hand of populists. First, reforms could **strengthen social safety nets** not through financial compensation but **through up- and reskilling**. Second, governments could **shift the focus of structural reform from labour to product markets**, where many high-income professions have managed to protect vested interests that harm efficiency and stand in the way of equitable market outcomes.

¹ Owen, Erica, & Walter, Stefanie. (2017). Open Economy Politics and Brexit. Insights, Puzzles, and Ways Forward. Review of International Political Economy, 24(2).

² Public opinion surveys conducted by Stefanie Walter, Elias Dinas, Ignacio Jurado, Nikitas Konstantinidis and Eri Bertou in September 2015 and early March 2017.

Today's rapidly adjusting global value chains seem at odds with the desire for a high level of job security. To make up for this loss of social protection, advanced economies need to be productive enough to afford a high quality safety net when people lose their jobs. Attractive retraining schemes are key to reassuring workers that they will find a suitable and well-paid job, even when their previous job is relocated or replaced by technology.

In the euro area, structural reforms in response to the economic and financial crisis have so far focused more on labour than on product markets. This is not necessarily the smartest economic choice. The IMF found that during downturns, labour market reforms have adverse effects in the short to medium term, while product markets have immediate positive effects.

However, political resistance against product market reforms has been strong and effective. The energy sector in Greece is one example: For a long time, the sector resisted reforms that would strengthen competition. This ensured very high wages for a few, but resulted in higher energy prices for all. Reforming insolvency procedures to shorten notoriously long court cases in countries like Italy is a second example, where tackling vested interests could boost economic growth without hurting low-income groups. There are many more product markets, especially in professional services, where high-paying professions benefit from the status quo and manage to prevent reforms. To break this resistance is politically challenging but could do a lot to boost economic growth.

4 What role should the European level play?

The European institutions are in an uncomfortable position when it comes to fighting populism. They are the target of resentment but they lack the competences to tackle the problems. Redistribution, social protection and labour market regulation are national responsibilities.

A recent European Commission White Paper on the future of the EU explores ways to close the expectations-delivery gap, for example by “doing less more efficiently”. In the past, the EU demanded social protection on the one hand, but left very limited budgetary leeway on the other hand. However, simply retreating from social policy will not necessarily help the image of EU institutions, since budgetary rules still impact the ability of member states to provide social protection. There is no easy way out, without an overhaul of the economic governance framework that would grant social inclusiveness greater priority.

At the same time, member states can communicate more clearly that the European level is the only level, at which sovereignty can be exercised in a world with transnational challenges such as migration, security or corporate taxation. Simply barricading behind borders will neither result in prosperity, nor make the problems go away.