The Economics of Political Change in Developed Countries*

Jayati Ghosh

Across the world, people have been watching recent political changes in developed countries with a mixture of bemusement and shock. From the recent anointment of Donald Trump as the Republican candidate for US President, to the rise and spread of blatantly racist anti-immigration political parties and movements in Europe, it is clear that there are tectonic shifts under way in the political discourse and practice in these countries. As these changes have gone from the unthinkable to the depressingly predictable, there are increasingly desperate attempts to understand what is driving them. This is especially the case because – despite all the talk of a shift in global power to some large "emerging nations" – what happens in the developed countries still matters hugely in international relations and to all of us in the rest of the world.

It is now obvious that increasing inequality, stagnant real incomes of working people and the increasing material fragility of daily life have all played roles in creating a strong sense of dissatisfaction among ordinary people in the rich countries. While even the poor amongst them still continue to be hugely better off than the vast majority of people in the developing world, their own perceptions are quite different, and they increasingly see themselves as the victims of globalisation.

But while this is increasingly recognised, the full extent of recent economic trends is probably less well known. A new report from the McKinsey Global Institute ("Poorer Than Their Parents? Flat or falling incomes in advanced economies", July 2016) brings out in detail how the past decade in particular has been significantly worse for many people in the developed world.

The report is based on a study of income distribution data from 25 developed countries; a detailed dataset with more information on 350,000 people from France, Italy and the United States and the UK; and a survey of 6,000 people from France, the United Kingdom and the United States that also checked for perceptions about the evolution of their incomes.

The results are probably not surprising in terms of the basic trends identified, but the sheer extent of the change and the deterioration in incomes still comes as a surprise. In 25 advanced economies, between 65 and 70 percent of households (amounting to around 540-580 million people) were in segments of the income that experienced flat or falling incomes between 2005 and 2014. By contrast, in the previous period between 1993 and 2005, less than 2 percent (fewer than ten million people) faced flat or falling incomes.

The situation was much worse in particular countries. In Italy, a whopping 97 per cent of the population had stagnant or declining real incomes between 2005 and 2014, while the ratios were 81 per cent for the United States and 70 per cent in the United Kingdom. This refers to market incomes, and it is true that government tax and transfer policies can change the final disposable income of households, in some cases improving it. Indeed, for the 25 countries taken together, only 20-25 per cent experienced flat or falling disposable incomes. In the US, government taxes and transfers turned a decline in market incomes for 81 percent of households into an increase in disposable income for nearly all of them.

Similarly, government policies to intervene in labour markets also made a difference. In Sweden, the government intervened with measures designed to preserve jobs, so market incomes fell or were flat for only 20 percent, while tax and transfer policies ensured that disposable income advanced for almost everyone. But in most of the countries examined in the study, government policies were not sufficient to prevent stagnant or declining incomes for a significant proportion of the population, and labour market trends contributed to feelings of insecurity among workers everywhere.

While these changes were evident across the board, the worst affected were less educated workers, and particularly the younger ones among them, as well as women, especially single mothers. The report notes that today's younger generation in the advanced countries is at real risk of ending up poorer than their parents, and in any case already faces much more insecure working conditions.

This material reality is actually quite accurately reflected in popular perceptions. A survey conducted in 2015 of British, French and US citizens confirmed this, as approximately 40 per cent of those surveyed felt that their economic positions had deteriorated. Interestingly it was also such people, as well as those who did not expect the situation to improve for the next generation, who felt most negatively about both trade and migration. More than half of this group agreed with the statement, "The influx of foreign goods and services is leading to domestic job losses," compared with 29 per cent of those who were advancing or neutral. They were also twice as likely to agree with the statement, "Legal immigrants are ruining the culture and cohesiveness in our society," compared to those advancing or neutral. The survey also found that those whose incomes were not improving and who were not hopeful about the future were more likely in France to support political parties such as Front National and in Britain to support Brexit.

One major driver of stagnant worker incomes has been the combination of labour market developments and public policies that have resulted in declining wage shares of national income. The report notes that from 1970 to 2014 – with the brief exception of a spike during the 1973–74 oil crisis – the average wage share across the 6 countries studied in depth (United States, United Kingdom, France, Italy, the Netherlands and Sweden) fell by 5 percentage points. In the most extreme case of the United Kingdom, it declined by 13 percentage points. These declines in wage shares occurred despite increases in labour productivity, as the productivity gains were either grabbed by employers or passed on in the form of lower prices to maintain external competitiveness.

Such declining wage shares are commonly seen to be the result of globalisation and technological changes that have led to changing patterns of demand for low-skill and medium-skill workers. But even here, it is evident that state policies and institutional relations in the labour market matter. In Sweden, where 68 percent of workers are union members and the government has in place policies that enforce contracts that protect both wage rates and hours worked, the median household received a greater share of output that went to wages, and even got more of the gains from aggregate income growth than households in the top and bottom income deciles over the 2005–14 period.

By contrast, countries that have encouraged the growth of part-time and temporary contracts experienced bigger declines in wage shares. Once again, this is especially adverse for the young. According to European Union official data, more than 40 per cent of workers aged between 15 and 25 years in the 28 countries of the EU have such insecure and low-paying contracts, while the proportion is more than half for the 18 countries in the Eurozone, 58 per cent in France and 65 per cent in Spain. This is obviously a concern for the young people who have to experience this, but it is as much a source of unhappiness and anger for their parents who worry for the future of their children.

In the meantime, they can all observe the counterpart in terms of rising profit shares in many of these rich countries. Economic processes and government policies increasingly appear to favour plutocratic tendencies. In the United States, for example, post-tax profits of firms in the period 2010-14 reached more than 10.1 per cent of GDP, a level last reached in 1929 just before the Great Depression. Ironically, in the US this is apparently favouring the political rise of one of the biggest beneficiaries of this process, Donald Trump who is himself emblematic of such plutocracy.

If economic policies do not change dramatically to favour more good quality employment and better labour market outcomes through co-ordinated fiscal expansions, to lift growth in more inclusive ways, things are likely to get even worse. The report projects that even if the previous high-growth trajectory is resumed (an unlikely prospect) at least 30-40 per cent of households would not get income gains over the next decade, especially if technological changes like more automation accelerate. And if the slow growth conditions of 2005–12 persist, the proportion of households experiencing flat or falling incomes could go to as much as 70-80 per cent by 2025.

The unpleasant and even terrifying political fallout of such outcomes is now only too evident. How much more will it take for political leaders to recognise the need for a move away from business as usual to radical change in economic policies?

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