5. POPULISM, PSYCHOLOGY AND BANKING POLICY

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This chapter describes the results obtained in Favaretto and Masciandaro (2020) addressing a case of populism called Democratic Rioting, in which citizens – i.e. the poor and the rich – are assumed to be heavily influenced by psychological group dynamics that result from banking shocks. We highlight a display of anger that is channelled through an election instead of in the streets. In turn the anger can be influenced by non-financial news about immigration, welfare plans and housing plans. Consequently after a banking shock the consensus on a myopic populist policy can depend on many issues that have nothing to do with the bailout decision itself. We describe a mechanism that can be applied to the aftermath of both the Great Recession and the Great Depression.

5.1. INTRODUCTION

Populism was thought to be an issue restricted to emerging countries until it became strong and clearly evident in Europe. In fact, populism is sweeping Europe's political equilibria. A report published by a group of leading political scientists in *The Guardian* in November 2018 found that one in four Europeans were voting for populists. Notably, European populist parties received 12.5 million votes and held governmental roles in 2 countries in 1998, while they received 170 million votes and governed in 9 countries in 2018. According to the report in *The Guardian*, the surge of populism has had an impact even in countries where these parties are not in government. Most notably, countries such as the UK, Sweden, Denmark and Germany experienced strong shifts to the right on immigration due to the presence of extreme right populists.

This shift has fostered new enthusiasm and a wide range of research among academics. Populism is not a new phenomenon – the first wave was mostly left-wing and concentrated in Latin America (Dornbusch and Edwards, 1991; Acemoglu et al., 2013), while this wave is mainly right-wing and evident in Europe.

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The definition of "populism" is blurred. Scholars in the fields of political science and sociology have put a great deal of effort into defining the concept (Gidron and Bonikowksi, 2013). In economics, we follow Guiso et al. (2017) in defining populism as a political movement that offers short-term protection to voters. By riding voters' fears or enthusiasm, populist politicians frame themselves as siding with the common people and against the corrupt elite by championing policies that disregard long-term consequences. From a political science perspective, Golder (2016) suggests that populists maintain as central the difference between the "pure people" and the "parasitical elite", both of which are seen as homogenous groups.

This chapter describes the results obtained in Favaretto and Masciandaro (2020) addressing the following question: What do populist parties have in common with the extreme radical parties that emerged after financial crises?

Masciandaro and Favaretto (2020) builds a theoretical model in order to answer this question. In particular, we highlighted the demand for populism, which we view as a political manifestation of anger and frustration. We suggest that populism has some similarities with political movements that became very strong after financial crises in the past. Financial crises seem to unleash emotions that make it easier for extremist and populist parties to be voted into power. Funke et al. (2016), Mian et al. (2014) and De Bromhead et al. (2018) demonstrate that after systemic banking crises, politics tend to become more ideologically extreme and take a hard turn toward the right. Moreover, parliaments become more fractionalized and governments become less solid. We build a model in which angry citizens choose the suboptimal policy championed by the populists, as that choice gives them an emotional benefit.

We discuss a situation in which an economy is hit by a systemic banking shock and an election is used to determine the bailout policy. We describe electoral competition by including a mainstream party and a populist party. The difference between the two platforms is assumed to be given by their proposed bailout policies. The mainstream party is the classical centre-right or centre-left party, which follows moderate economic policies by choosing the optimal bailout policy and has expectations for the central bank's actions. In contrast, the populist party pushes for a sub-optimally high or low policy depending on its political positioning, and that policy is not welfare maximizing.

Citizens decide to vote for the populist party by considering the economic and psychological costs and benefits of this choice. The individual choice is heavily influenced by the respective wealth group: voting for populists entails different psychological benefits and individual costs for the poor and the rich. The psychological benefits depend on anger – when anger is higher, the more expectations differ from a group-specific reference point. For example, the more the poor vote

for populists, the greater the psychological benefit of voting for them. The poor will be more content with this protest vote because it represents a public display of anger, similar to rioting together in the streets (Passarelli and Tabellini, 2017).

We call this Democratic Rioting for this very reason – it discusses a display of anger that is channelled through an election instead of in the streets. This is a behavioural decision, as it is not entirely economic and is driven, at least in part, by emotions. In other words, what other group members do matters to the individual.

The group-specific reference point is influenced by news about immigration, welfare plans and housing plans. For instance, news leading individuals to think "immigrants are receiving benefits to start their lives in my country while I struggle to find a job" moves the reference point and generates fuel for the populist vote. The rich and the poor typically have different reference points that depend on the information they receive. Consequently, a vote on a bailout policy depends on many issues that have nothing to do with the bailout policy itself.

We define self-serving bias as a wedge that changes the reference point, thereby differentiating the indirect utility of voters from the reference point. Indeed, if individuals assign more weight to their group in social-welfare optimization, then their reference point is different from their indirect utility.

In our framework, we assume that the poor have higher self-serving bias and lower variance in the individual costs of voting for populists. Therefore, they have a higher probability of voting for a populist party. The remainder of the chapter is organised as follows. Section 2 reviews the relevant literature, while sections 3 analyses the interaction between banking crises, group behavior and voting on bailout policies. Section 4 concludes.

5.2.   LITERATURE REVIEW

We examine the literature on the political consequences of systemic banking crises (Funke et al., 2016; Mian et al., 2014; De Bromhead et al., 2018) by building a framework of the effect of these crises on voting. Theoretically, there are at least three broad explanations for the populist vote: populism as a consequence of political and economic cycles, populism as a result of trade shocks, and populism caused by inequality and fear of immigrants.

Guiso et al. (2017) use individual survey data from the European Social Survey and consider turnout share to estimate drivers of the populist vote. They find that economic insecurity (defined by combining unemployment risk, financial distress and globalization) and fear of immigrants fuel the populist consensus, with the

first variable being predominant and affecting the second. Algan et al. (2017) use regional-level data on voting in Europe after the Great Recession and find that unemployment is a major driver of the populist vote.

Autor et al. (2016) and Colantone and Stanig (2016) offer examples of the trade-shock explanation. They find that voting patterns are influenced by global competition, especially by decreased wages among unskilled workers in developed countries.

With regard to the inequality argument, Dorn et al. (2018) consider German counties and find that poorer counties and counties characterized by greater inequality have higher proportions of votes for extremist parties. Bischi et al. (2019) use a game-theoretical approach to explain the demand for populism as a function of demand for lower economic inequality and fear of immigrants. In other words, populists capitalize on two long-term trends: rising inequality and the salience of immigration.

Our framework proposes a different theoretical mechanism that links systemic banking shocks and voting in which individual decision making is influenced by citizens' groups. Several papers support parts of our framework.

First, some researchers recognize the fact that populists use short-term solutions that benefit subgroups of the population but are harmful in the long run (Sachs, 1989; Dornbusch and Edwards, 1991; Acemoglu et al., 2013; Chersterley and Roberti, 2016). Second, empirical evidence suggests that poor European citizens vote for populists more than rich European citizens. Moriconi et al. (2018) show that the inflow of less-educated immigrants is positively associated with an increase in votes favouring nationalistic positions and it is stronger for non-tertiary educated voters. At the district-state level, Giebler and Regel (2018) find that the poor vote more for right-wing populists, as they are more likely to be unemployed and have less education. Third, studies from social psychology stress that individual behaviour is affected by group affiliation through group norms, information and identity concepts. Gerber and Rogers (2009) highlight the growing stream of literature on social norm perceptions, which indicates that people carefully consider other people's actions. In fact, beliefs about how other people act, which are called "descriptive social norms", exert a powerful influence on a range of behaviours. Group membership influences individual political attitudes and behaviour.

For instance, the Columbia school (e.g., Berelson et al. 1954) explains individual voting behaviour as the product of group affiliations, such as religion, ethnicity and occupation, and argues that group pressure leads to conformity. Moreover, information about politics is heavily dependent on group behaviour (Huckfeldt and Sprague, 1995). Social-identity theory (Tajfel, 1982) states that group

members are motivated to conform with norms that provide them with an in-group identity.

Other contributions tackle different aspects of populism. Acemoglu et al. (2013) model left-wing populism with a signalling mechanism. Aggeborn and Persson (2017) build a model in which the poor support right-wing politicians because they prefer to consume basic public services instead of a global public good, where the latter is assumed to be offered by left-wing politicians. Frisell (2009) focuses on the supply of populism – how the choice of electoral policy platforms is influenced by politicians' abilities to know public opinion and then, if the remuneration associated with their positions is high, strategically choose a short-term policy rather than a long-term one. From a game-theory perspective, this approach is heavily dependent on information and strategic voting.

Pastor and Veronesi (2018) build a heterogenous agent model in which agents' utility is modelled as averse to inequality. In a setting in which the US is compared to the rest of the world and there are individual-level differences in risk aversion, economic growth increases inequality in both the US and the rest of the world because less risk-averse agents consume a greater share of total output. In this model, globalization leads to populism through the effects of risk sharing. In fact, agents with low risk aversion consume more over time, thereby widening the inequality to a point at which it is beneficial for the majority to halt risk sharing and trade in order to limit within-country inequality. They do so by voting for a populist candidate. This theory implies that populism surfaces in cycles and that it emerges when economic growth is strong, as the loss of income due to autarky has less of an effect on the marginal utility of consumption during expansions. Although this perspective may fit with the vote for Trump, it is less relevant for European populists.

5.3. BANKING CRISES, DEMOCRATIC RIOTING AND BAILOUT POLICIES

The Favaretto and Masciandaro (2020) framework takes stock of features of populist movements. First, we assume that populists enter the electoral competition by supporting short-term policies instead of long-term policies (Guiso et al., 2017). In our setting, this means that populists prefer a sub-optimal level of public spending to save the banking system. Our framework allows for either sub-optimally low or high bailout policies, but we believe that the latter make more sense. Most populist parties choose high public spending in order to reward specific social and economic groups (see, e.g., The Economist, 2018, "Battle over benefits"). Higher public spending is often used to address voters' demands. We assume that this is an attractive policy for angry voters.

Second, we assume that individuals may decide to vote for the populist party by weighing the costs and benefits, both economic and psychological. Individual choice is heavily influenced by the respective wealth group. In fact, the psychological benefits and the individual costs of voting for populists are assumed to differ for poor and rich individuals. The psychological benefit depends on anger, and each individual is angry if its policy expectations differ from the group-specific reference point.

Third, we know that populists tend to publicly blame and target economic and political elites. In our framework, this means that a populist rhetoric motivates each person in the two groups to consider group features. The poor may represent the lower 60-70% of the wealth distribution, while the rich are the elite in terms of wealth. Our key assumption is that the individual's vote is influenced by group behaviour.

Our approach defines populist policy as a short-term, sub-optimal policy. This approach is based on Golder (2016), who suggests that "the precise content of the populist message is context-dependent" in terms of being against the established power structures, and on Guiso et al. (2017), who propose that the left or right orientation of a populist party depends on the political opportunity space. Moreover, our approach is compatible with all types of non-mainstream parties, including populist, extremists and those that are anti-system. This allows us to be as general as possible in building a model for our empirical evidence.

In our framework, an aggregate negative banking shock generates a positive probability of voting for a populist party, assuming that the supply of populism is fixed. A generic populist party offers an alternative to a classical party that represents the optimal policy choice. The extent of the intervention is decided through the electoral competition. We assume that this will be the only policy dimension on which to vote (Persson and Tabellini, 2002).

Monetary and fiscal policy interact but voters only choose the latter. This setup replicates Euro-area populism well. In the Euro area, monetary policy is constrained by an international institution with strong independence (i.e., the European Central Bank (ECB)), while fiscal policies are subjected to the demands of populists, such as the Fronte Nationale in France or the Five Star Movement and the Lega in Italy.

The economy consists of heterogenous agents, the government, the central bank and the banking system. When there is a banking shock, the government designs its strategy based on two decisions: one regarding the bailout amount and the other regarding how to finance it. The central bank is independent and sets the optimal fiscal monetization in line with its inflation goals. The government introduces an income tax to repay debt and interest. The citizens make decisions about

labour and consumption given the tax. The equilibrium choice for the bank bailout policy reflects the trade-off between minimizing tax distortions and smoothing out banking externalities.

The citizens are heterogenous regarding their financial profiles, i.e. they hold different amounts of bank shares, deposits and bonds. We assume that these differences matter only because they induce the creation of two broadly defined groups by wealth: the rich and the poor. We assume that wealth is the only feature that defines the group reference points for political issues.

We assume that the decision regarding the extent of bailout is made by voting and that there is only one policy dimension on which to vote (Persson and Tabellini, 2002). From a generic perspective, we assume that the bailout decision is, by far, the most important political issue on which the two parties battle. The monetary policy decision is made by an independent central bank, which chooses the optimal level of inflation. Differently from Masciandaro and Passarelli (2019), political pressures on the central bank setting cannot arise.

In terms of bailout strategy he populists will present a different policy than the classical party. It should be modelled on the specific populist party and political system, even though we believe that populists usually prefer higher government spending and, hence, higher bailout policies (see, e.g., The Economist, 2018, "Battle over benefits").

Citizens decide whether to vote for the populist party by balancing the costs and benefits of this choice both economically and psychologically. The individual benefit of voting for the populists comes from expressing emotions in a way that has a public impact. Importantly, the individual benefit of voting for the populists increases along with the size of the individual's group. It is an indirect public display of emotions, so the more that is shared by group members, the more it pleases the individual. In the words of Passarelli and Tabellini (2017), "the psychological benefit of a public display of anger is stronger if the emotion is more widely shared" and is related to being treated unfairly.

Why does the psychological bias emerge? It can be caused by news about immigration, welfare plans, or housing plans. The group's bias increases when group participants feel entitled to a better public policy for various reasons, such as when they blame immigration or the other group for getting too much public attention and resources. Th bias acts as a wedge between the indirect utility of voters and their reference points.

Research indicates that such as biases may be caused by immigration. Guiso et al. (2017) find that fear of immigrants affects voting decisions in favour of populists. Dennison and Geddes (2018) find a correlation between the salience of immigration (from the pan-European Eurobarometer survey) and the polling of anti-

immigration parties in most western European countries for data after 2005 (salience is defined as the indication of the most important issue affecting the individuals and/or the country).

Moriconi et al. (2018) find that the inflow of less-educated immigrants is positively associated with an increase of votes in favour of nationalistic positions, and that this association is stronger for non-tertiary educated voters and in response to non-European immigrants. In our framework, this means that the inflow of less-educated immigrants increases the biases of both the rich and the poor, but with a stronger effect on the poor. More specifically, the poor experience a higher level of distress, which increases the probability that they will vote for populists.

Some evidence suggests that the bias may be higher among the poor due to their higher exposure to the presence of immigrants in public spaces. In this regard, Card, Dustmann and Preston (2012) compare attitudes toward immigrants in Europe using data for 21 countries from the 2002 European Social Survey. They use a latent-factor model to account for the composition of local populations and the perceived threats to the compositional amenities that natives derive from their neighbourhoods, schools and workplaces. They find that compositional concerns are two to five times more important for explaining variations in individual attitudes toward immigration than concerns about wages and taxes. Moreover, most of the differences in opinion between more- and less-educated respondents is attributable to heightened compositional concerns among people with less education.

All in all, both the rich and the poor may have a probability of voting for populists that is greater than zero. For this to be true, both groups' anger must be positive. In our baseline framework the poor have a higher probability of voting for populists, as they have a higher bias and lower variance in the individual costs of voting for populists. As seen above, higher bias may be the result of a higher impact of immigration coverage in the media and other information sources.

This scenario is in line with the empirical evidence. Dorn et al. (2018) show that poorer German counties have higher shares of votes for extremist parties. Guiso et al. (2017) and Algan et al. (2017) find that economic insecurity is a dominant driver of populist voting, which is in line with the fact that the poor are more likely to be affected by economic hard times than the rich. In line Funke et al.'s (2016) finding that there is a rise in extremist right-wing parties after a systemic banking shock, we use a banking shock. We describe a mechanism that applies to the aftermath of the Great Recession with a timing similar to the emergence of right-wing parties during the Great Depression, as in De Bromhead et al. (2018). On top of that our setting may incorporate a globalization effect on the poor

through a bigger increase in their self-serving bias, which is in line with the literature on the political effects of trade shocks.

5.4.   Conclusion

Populism in Europe has plenty of explanations: trade shocks, cyclical unemployment, fear of immigrants and demands for redistribution. We propose one more explanation: citizens implementing a democratic riot through a vote that decides the bailout after a systemic banking crisis. The voting decision is behavioural and it is influenced by citizens' wealth groups. In other words, economic and psychological costs and benefits matter for the decision. Populists propose a suboptimal bailout policy. Citizens vote for populists if their group is angry (i.e., if what they expect to receive in terms of a bailout differs from the classical party's optimal policy). The expectation influences the group's reference point, and it acts a wedge between the reference point and voters' indirect utility. This wedge is affected by news about immigration, welfare plans and housing plans. The more such as psychological bias will be relevant the more likely will be an increase in the populistic consensus.

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