



The Paradox of Endogenous Nationalism and the Role of Quantitative Easing

By Massimo Morelli
Bocconi University and CEPR

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This article argues that the role of the ECB (especially through quantitative easing) has been crucial in keeping the populism wave at bay – what we could call the ECB levee. But global fiscal policies are necessary to avoid the long term flooding of liberal democracies by such waves, because the causes of the waves are not just a temporary shock but structural problems that cannot be faced by monetary policy alone.

1. Introduction

As argued in Guiso et al (2017), perceived economic insecurity is a key driver of voters' and parties' drift towards populism in Europe, directly as well as indirectly, through the changes it induces on voters' participation and trust in institutions.¹ The three main drivers of pockets of economic insecurity are typically considered the immigration threat (see e.g. Laitin, 2018), the globalization threat (see e.g. Autor et al, 2016, Rodrik, 2017, and Colantone and Stanig, 2019) and the automation threat (see e.g. Acemoglu and Restrepo, 2017). The great recession certainly caused real harm and by itself reduced confidence in the ability of traditional parties and institutions to respond adequately (see e.g. Judis, 2016). However, as shown in Guiso et al (2019), the incomplete architecture of the European Monetary Union played a crucial role: within Europe the globalization shock and each of the economic crises that followed influenced the populist wave only through the interaction with the Euro dummy, whereas in the presence of such an interaction term neither of the crises in isolation, nor the globalization threat as typically measured, remain significant.

The most likely reason for the particularly strong effect of these crises on political outcomes in the Euro zone is that voters do perceive each state's lack of control on the typical policy instruments employed in response to such shocks. In the Euro zone, one can mention both monetary policy and fiscal policy, given that monetary policy is centralized in Frankfurt and fiscal policy responses are curtailed by austerity principles and rules.² It is not surprising that, when voters lose confidence in the current parties and governments and blame the European constraints and the Euro, there could be a wave of populist euroskepticism.

The wave of populist movements and populist parties has been pronounced especially at the level of individual countries, but even in the European elections of 2019 the traditional parties maintained control only by a few votes. In this article I will first argue that without the Draghi quantitative easing the populist wave would have been even bigger, and could have put Europe in danger. I will then discuss some of the understudied dangers of populism for future policy makers and how the scope of policy making may need to change. In particular, I will argue that European or global solutions should replace, whenever possible, national level policy making, particularly in view of the fact that expansionary monetary policy cannot be maintained to permanently supplement the shrinking fiscal space of individual states. In summary, the point made by this article is that quantitative easing has been essential by creating the fiscal space necessary for individual states to resolve some of the pressing problems that created the populist wave in the first place. However, given that the fundamental trends in absence of expansionary monetary policy are trends of shrinking structural fiscal space at the national level, a more structural change in the direction of centralized fiscal policy capacity is necessary in the near future.

The populist parties almost always emphasize the protection of their country's people, and hence often nationalism is an essential part of their rhetoric and of their social identification strategy vis a vis voters. This *functional* nationalism wave makes it more difficult to go in the global governance direction that would instead be

¹ For most of the quantitative analysis conducted in Guiso et al (2017) the definition of populism adopted has been the standard one in political science – see e.g. Mudde, 2004, Mueller, 2016, and especially Van Kessel, 2015, who provided also the expert identification of populist parties for the relevant time period in Europe. All these standard definitions emphasize the anti-elite rhetoric and the flagging of the virtues of the people as the main characteristics of populists. However, the results continue to hold even when using more continuous measures of populism and when considering the definition offered by the Encyclopedia, which adds to the characteristics above also the tendency to pander to the people's fears, offering protection policies that may be long run unfeasible.

² Guiso et al (2019) also argue that another potential reason for the role of the Euro dummy interaction effect is the fear of relocation of firms, which indeed took place primarily from Euro zone countries to non Euro zone European countries in the aftermath of the great recession.

desirable from the fiscal policy angle mentioned above. It is in this sense that, as I propose directly in the title, endogenous nationalism is a paradoxical trap, pushing us in the opposite direction with respect to where we should be going.

2. Shrinking Structural Fiscal Space and Political Crisis

In this section I want to argue that without the external (crucial) monetary supplement, as the one provided by quantitative easing, many countries would now be experiencing a significant shrinking of their fiscal space. This trend is unavoidable if governments' tax revenue will remain almost exclusively composed by income taxes and value added taxes. I will argue that all the recent structural and technological changes in the economy determine populist reactions precisely due to the simultaneous effects that they have on the shrinking of the structural fiscal space.

That technological change is making the labor share in national income fall is by now an established fact (see e.g. Karabarbounis and Neiman, 2014). Certainly technological change that favors automation (Acemoglu and Restrepo, 2019, Aghion et al, 2019) is the most often discussed mechanism. Combining figures regarding the falling labor share in national income with figures on the prevalence of labor incomes as the main source or base for tax revenues in general, we could easily obtain a picture of structural shrinking of the fiscal space for a given fixed monetary policy. The accumulation of public debt and the consequent needs to service the debt further reduce the possibility to use the shrinking fiscal space for welfare policies, the very type of policies that make liberal democracies politically sustainable. This contrast between shrinking tax revenues on one hand, due to both the falling share of labor income and capital tax competition (making national governments unable to effectively tax capital), and growing expected welfare needs and economic insecurity on the other hand, has created this strait-jacket feeling and induced a drop in trust towards the institutions of liberal democracies, as discussed in Guiso et al (2017, 2019).

Clearly the great recession and the consequences of global competition created *greater needs* for redistribution and welfare policies, but these greater needs have been accompanied by the above mentioned *shrinking* national budget net availability for such policies. This contrast would have certainly led to even wider discontent and populism than we have observed had the ECB maintained a standard independent monetary policy.

To see why a shrinking fiscal space is related to *all* the causes of populism being exacerbated, consider a world where a government finances public spending and/or redistribution using a linear tax system. It can be shown that the system remains viable if the tax rate satisfies three types of constraints:

1. First of all, the tax rate $\tau \in (0, 1)$ must have a *lower bound* $\underline{\tau}$, the minimum necessary to make the state function. Such a lower bound is (1) increasing in the welfare needs of the people; (2) increasing in total unemployment; (3) decreasing in growth; and (4) increasing when the labor share of national income decreases or automation increases leaving fewer labor income earners as tax base.
2. The tax rate must then satisfy a *firms' participation constraint*, which leads to an *upper bound* $\bar{\tau}$, which can be shown to be (1) decreasing in the equilibrium wage rate and (2) increasing with automation and the falling labor share phenomenon.
3. Finally, the viability of the system requires a *labor supply constraint*, leading to a second upper bound $\hat{\tau}$, which can be shown to be (1) increasing in the wage rate and (2) decreasing in the welfare needs for the people.

Intuitively, when the equilibrium wage is high the binding upper bound is given by the firms' participation constraint, whereas when the market wage rate is low the binding upper bound is $\hat{\tau}$. It is equally intuitive that the *structural fiscal space* (which equals $\bar{\tau} - \tau$ when the wage is high and equals $\hat{\tau} - \tau$ when the wage is low) is lower when growth prospects go down. Thus, if we assume that a *political crisis* can emerge (for example taking the form of stronger and stronger populist movements) when the structural fiscal space becomes *empty*, it can be shown³ that

Proposition: A political crisis is the more likely

- the lower is the wage (for example due to global competition);
- the lower are growth prospects (the great recession effects);
- with larger population of workers (fear of immigration);
- for higher subsistence needs;
- and for higher role of capital (robots).

Since *all* the above conditions did materialize in the 21st century, the populism wave can be viewed as due to the perceived necessity to break away from one or more of the constraints among those creating the empty fiscal space. Both the low wages due to globalization and the perceived threat of immigrants are easy to blame for the shrinking structural fiscal space (even though much less relevant quantitatively than the other factors), and hence anti-immigration and protectionism populist stances emerged.

The fact that the 1929 US crisis did *not* lead to a populist consequence whereas the great recession of this century did, does not need to be explained in terms of the size of the economic crisis. The difference is rather due to the fact that the evolution of all the conditions in the above proposition determined a political crisis due to shrinking fiscal space, which made a solution like the Roosevelt new deal unfeasible. More generally, when people perceive that redistributive policies can be advocated within the fiscal space, redistributive politics remains central, whereas the left-right dimension and the redistribution demands lose impetus (replaced by nationalism) when the fiscal space is perceived to be empty (or in any case very small).

3. Fiscal Union Desirability Implications

Since quantitative easing did allow a substantial reduction of interest payments and hence temporarily larger fiscal space, the structural shrinking of fiscal space discussed above (in the absence of the monetary expansion life-line) is not yet a priority discussion in Europe, but it should be.

A recent report of the European Fiscal Board noted that EU fiscal rules further increased the pro-cyclicality of fiscal policy, and emphasized the lack of instruments for crisis management and resolution and the missing central fiscal capacity. Fiscal rules and constraints may be helpful in terms of mitigating the spillovers of debt accumulation, but the political risk generated by pro-cyclical fiscal policy was not adequately taken into account. The cost of not having counter-cyclical policy measures in place is political, but the consequences of a political shift towards populism can also be economic, especially if, as I will argue, the necessary supranational policy measures become even harder to put in place due to the inherent nationalism of most populist parties.

³ Proofs available upon request.

The original Maastricht compromise neglected the importance of macroeconomic imbalances as a source of fiscal and political risks;⁴ inequality within countries and across countries is a second source of populist reactions that could be reduced by a form of fiscal union;⁵ third, the cultural clash consequences of economic integration without political or institutional integration are inflated by (and multipliers of) populism, and can be reduced by a form of fiscal union.⁶ In addition to these three considerations, namely that most forms of fiscal union could reduce volatility, inequality and cultural clashes, which are all sources of populist reactions, a fourth reason of fiscal union desirability is that a centralized European fiscal policy could, perhaps even more crucially, tax capital and asset returns and partially avoid the capital tax competition constraints, which could much reduce the concerns of fiscal space shrinking due to the falling labor share phenomenon. Finally, I will argue below that a way forward will be to link trade policy and fiscal policy agreements, and this would be easier to do at the European level given the importance of the EU commission for negotiations in the WTO.

4. The Nationalism Trap

Given the perception of a policy strait-jacket for countries in the Euro-zone in the absence of a fiscal union, the frustration with the imposed constraints contributed to the ballooning of various forms of nationalism and euroskepticism. Perhaps in the absence of the Draghi monetary expansion nationalism could have triumphed even in European elections.⁷ But the problem in Europe is not at the level of European elections: 2019 European parliament elections had the highest turnout in twenty years. The democratic system of the European Union encompasses 500 million people and transcends borders, hence by design it pushes in the direction of reducing the salience of national differences.

The problem is instead obviously at the national politics level: it is in national elections that the populist rhetoric and the general resentment can give rise to nationalist governments that could then block or undo European level policies that would make it possible to increase the fiscal space. The trap goes as follows: structural shrinking of fiscal space → resentment and populism → protectionism and nationalism → more difficult European and global cooperation, where these would instead be the channels through which fiscal space could be recreated.

The ECB levee created by quantitative easing weakened the strength of the populist wave, but it covered the truth, namely that we need to recreate structural fiscal space for welfare policies. This can be done either through a more centralized countercyclical European level fiscal policy or, more generally, introducing new ideas about how to tax capital and asset earnings rather than solely the shrinking labor share of national income. The problem is how can politicians and parties find it compatible with their political goals to shift attention from national level policy making to European level policy making and global governance problem solving. Political economists can probably all agree that political incentives to accept independence of monetary policy are much higher than the political incentives to relinquish national control of fiscal policy: electoral campaigns typically employ promises to targeted groups of voters, and fiscal policy allows to target much more effectively than interest rate policies or money supply.

⁴ See e.g. Luque et al (2014) for a volatility based argument for fiscal union desirability.

⁵ See e.g. Morelli et al (2012) for an optimal taxation and constitutional design argument for fiscal union desirability.

⁶ See e.g. Guiso et al (2016) for a cultural clash reduction argument for fiscal union desirability.

⁷ President Ursula von der Leyen has been (s)elected just by a handful of votes, and hence the marginal value of the ECB policy has probably been pivotal

On top of this general political incentive problem that makes it hard to go for global policy advocacy, the shift towards nationalism and the greater salience of the nationalism vs globalism cleavage reduces by itself the demand and supply of redistribution, which used to be the most important political and economic dimension to make a liberal democracy viable.⁸ As argued e.g. by Gennaioli and Tabellini (2019) and Besley and Persson (2019), we witness in many countries a shift of social identification that makes the nationalism vs globalism cleavage much more salient than the traditional left-right cleavage. However, I argue that the emergence and increasing relevance of the global vs national dimension is not exogenous: once parties, be they new or old, decide to pander to popular fears of immigration, globalization, etc, by offering more protection from immigrants and global competition, the nationalism dimension is boosted by the supply side of politics.⁹

It is a strategic choice by right-wing parties to emphasize the external threats, in order to attract some of the poor and economically insecure who otherwise on the economic dimension would go left. Moreover, moving towards nationalism helps the rich because it distracts the people from asking more redistribution. Nationalism is the cheapest form of populism to supply, and it actually favors the economic elites while attacking the political redistributive elite.

Thus, the shift of demand and supply towards nationalism has the double implication of (1) increasing distance between domestic political incentives and the necessary shift towards global policies and (2) shrinking demand and supply of redistribution, which further weakens the support for liberal democracy institutions.

One interesting question could be why protectionism and anti-immigration nationalist policies have gained momentum so much even though the other factors contributing to the shrinking structural fiscal space described in my proposition above are probably more important. There are multiple answers for example on why the important economic consequences of technological change and automation do not translate into immediate political consequences: First, the automation process just started, and there are varying levels of information and varying beliefs about how many jobs will actually fall; second, even if politicians were fully aware that automation is by far the greatest threat, they wouldn't know how to use this fact to their advantage in a political campaign, because blocking technological innovation is obviously much less palatable than closing borders or markets; third, for the policy of closing borders or markets the identity and nationalism card can be used to unify the people previously divided in the distributive conflict, and hence the short-run election objectives of politicians make them go in that direction. This should contribute to the explanation of why nationalism is a prevailing response to the recognized problems of political and fiscal feasibility of alternatives.

If the automation process indeed will happen to be the largest threat to labor and to tax revenues at the national level, the nationalism direction will further exacerbate the trap. Less fiscal space implies wanting to close borders and protect national industries, but doing so when at the same time the economy becomes robotized and tax revenues go down implies even smaller fiscal space, a vicious circle.

⁸ The standard sketchy representation of a liberal democracy involves two pillars: the free market pillar and the welfare-redistribution pillar, since the creation of more winners and losers by free markets requires some safety net for the losers. If redistribution disappears even from the political debate then it should be intuitive that the "losers" may want to turn against the system, become extremists, or support nationalist policies like border protection or protectionism in general. As shown in Pastor and Veronesi (2018), there is evidence that protectionism can be perceived as a substitute to redistribution for the losers from globalization.

⁹ See Morelli et al (2020) for a new supply side theory of populism as simplistic commitment (of which nationalism policies are clear examples) and Gennaro et al (2020) for the connections between political and economic competition conditions and the strategic supply of populist rhetoric.

The necessity of a shift towards global policies obviously goes far beyond the advocated possibility of a fiscal union at the Euro-zone level discussed in the previous section, because one of the key determinants of the necessity of more global policies is the reduction of tax competition race-to-the-bottom problems, which are only mildly affected by a shift from national to European level of fiscal policy. If in a nutshell the problem is the labor falling share of national income combined with the capital tax competition constraints making it hard to go beyond labor income taxes, then the question boils down to what global policies can be thought of that could eliminate the taxation free riding of multinational companies.¹⁰ Policy makers and politicians who do not fall in the nationalist trap should then evaluate possibilities such as the one to which now I turn.

5. Issue Linkage Ideas

Trade sanctions and even export embargos are often used as threats against violations of treaties on peace, human rights, or even environmental agreements. These are all forms of issue linkage, in the sense that cooperation on one issue is facilitated by using punishment threats on other issues. Consider the important fact that (1) trade involving multinational companies is around 75 percent of total international trade, in volume and net profits especially (even more so considering the effective zero taxes paid by Amazon and alike); (2) most countries definitely benefit from membership in the WTO. Then, the global taxation necessity can be linked to WTO membership: for example, if calculations indicate that setting a corporate sales tax or capital tax at level x could rebalance and compensate for the structural shrinking of the fiscal space on the labor income dimension, then setting such a tax at level x could be added for conditional continuation of WTO membership.¹¹ As Linao (2000) puts it, "...if the linked policies are not independent and if these policies are strategic complements, then linkage can sustain more cooperation in both issues." I believe that facilitating free trade while avoiding the backlashes of populism on protectionist policies on the one hand, and obtaining more fiscal space for each nation in order to reduce the attractiveness of populist strategies on the other hand, are highly complementary, and hence linking the issues of trade and capital taxation is a must do in the future.

I note that given that trade policies are already decided by the Commission in Europe, a form of fiscal union could allow the EU to be much more effective also in terms of issue linkage like the one proposed. Compared with other forms of issue linkage already exploited in practice, for example linking environmental or labor policies, taxation issues might even be easier to link with WTO rules.

6. Conclusion

This article in a nutshell suggests that central bankers and any believer in the market economy and the desirability of liberal democracies should worry about the structural shrinking of fiscal space in the absence of expansionary monetary policy, rather than focusing exclusively on the ability of monetary policy to supply a temporary life-line.

The nationalist consequences of the populism wave due to policy strait-jackets have reduced the demand and supply of redistributive policies, but restoring the possibility (perhaps through fiscal unions and issue linkages) of effective compensations for the losers of technological change and globalization is key for the survival of capitalism and liberal democracy.

¹⁰ See Morelli (2019) TED talk on this issue and related desiderata.

¹¹ Issue linkage is used in multiple ways in international treaty design. It has been advocated on many domains of international negotiations, see e.g. the early contribution of Tollison and Willett (1979).

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About the author

Massimo Morelli is Professor of Political Science and Economics, Bocconi University, department of Social and Political Sciences, with secondary affiliation in the department of Economics. He is Fellow of Society for the Advancement of Economic Theory, Research Fellow at Centre for Economic Policy Research (CEPR), Innocenzo Gasparini Institute for Economic Research (IGIER), and Carlo F. Dondena Centre for Research on Social Dynamics and Public Policy. His research interests are in game theory, mechanism design, political economy, governance institutions, development economics, behavioral and public economics, comparative politics and international relations.

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