

Inequality and Identity Salience*

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1. Introduction

A long-term rise in income and wealth inequality (see, Piketty, 2014) and stagnating real wages and their disconnect with productivity growth since the 1980s in the US and elsewhere in advanced market economies suggest a widening gap between the rich and the poor, falling standards of living for the average citizens, and limited prospects of upward mobility (see Bivens et al, 2014, Bivens and Mishel, 2015, and Machin, 2010).

At the same time, the last few decades have also seen a sustained period of downsizing the welfare state (see, for example, Garrett, 2001) and cuts in both its safety-net aspects and that of fostering investment in human capital through health and education. Arguably, these trends are inter-connected. The decrease in the provision of public goods exacerbate the problem of inequality contemporaneously, but also reduce prospects of mobility, thereby making inequality persistent (see, Kearney and Levine, 2015).

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The global financial crisis of 2008 and the resulting recession added fuel to the simmering political discontent but it was 2015 that marked the arrival of a new era of right-wing populism, xenophobia and isolationism in the form of Brexit and the election of Donald Trump as US President (see, Inglehart and Norris, 2016).

If we extract the common denominator from Brexit voters and Donald Trump supporters, the simmering discontent all over the developed world is over the effect of trade and capital flows, skill-biased technological change, and migration. The outsourcing of jobs to India and China has contributed to a reduction in global poverty over the last three to four decades but it has also created significant pockets of deindustrialization and impoverishment in the Western world (see, Milanovic, 2016). A vast number of Americans, especially from the lower middle class and the working classes, have faced job losses, stagnating wages, and falling standards of living. The financial crisis has only accentuated this trend.

At the same time, the same economic forces have increased the prosperity at the very top since owners of capital and skills have benefited from the higher returns in a globalized economy. Therefore, even though poverty and inequality have declined globally, they have gone up within the US. As Piketty (2014) has documented, the share of national income going to the top 1 per cent has increased from 8 per cent in 1980 to nearly 18 per cent in recent years. In contrast, the hourly wages of middle-wage workers have gone up by only 6 per cent since 1979, while those of low-wage workers are actually down by 5 per cent. With the rich becoming richer and declining growth rates making upward mobility near impossible for the rest, ordinary Americans feel they are worse off even compared to their parents' generation. As a result, they are in despair about their own economic future and that of their children.

A recent International Monetary Fund (IMF) report (Ostry et al, 2016) states that without an adequate safety net, openness and austerity are associated with increasing inequality and, as we saw with the Brexit vote, can undermine growth and openness, the very things that a market-oriented economic agenda is intent on boosting.

According to the economic narrative explaining the rise of right-wing populism one has to understand the politically explosive *combination* of three potent economic forces – falling standards of living, lack of prospects of growth and mobility, and

increasing inequality (see, Ghatak, 2015). Economic hardship or rising inequality or slowdown of economic growth alone can create political discontent. When any two of these three aspects of economic malaise coincide, discontent turns to despair, but there is still a vent through which some steam goes off. For example, economic hardship and rising inequality may still seem tolerable if there is some prospect of economic growth, the benefits of which are expected to trickle down in the form of a higher standard of living in the future.

But when long-term income stagnation for most of the population, and decline for some go together with high rates of income growth at the very top, you have zero sum economics – when your loss is someone else’s gain. Zero sum economics turns despair into rage against the establishment and whips up a perfect political storm, which is what Trump’s electoral victory really is.

In the Brexit referendum, the support for the ‘Remain’ camp typically came from educated and higher-income individuals, while the supporters of ‘Leave’ were less educated and had lower income. In other words, given the unequal spoils of globalisation, those who win voted in, those who lose voted out. There is no doubt that xenophobia and racism played a role in Brexit and plays a role behind Trump’s victory. But these cannot be primary causes since in the last decade we have also had five years of Labour rule in Britain and two terms of Barack Obama’s presidency in the US.

It is not surprising that trade, capital flows and immigration, or from a broader perspective, economic liberalism and globalization will create an anti-establishment wave when the promised trickle-down does not materialize. It is also not surprising that zero sum economics will lead to the politics of division. The puzzle, though, is this: why has the resulting anger taken the form of right-wing identity politics, tapping into xenophobia and isolationism, rather than a more left-wing agenda favouring greater taxation of the rich, expansion of the welfare state, and a tougher policy on corporations? Why did it not fuel the success of a political movement that emphasizes solidarity among the economically disadvantaged, cutting across racial and ethnic lines, like the one that Bernie Sanders led? Why did Trump’s xenophobic, anti-immigrant and isolationist messages, such as building a wall on the Mexican border, banning Muslims from entering the country, and acting tough with China, resonate so much with the disgruntled White majority?

The puzzle becomes deeper if we examine Trump's proposed policies. He wants to crack the whip on US companies so that they do not outsource jobs, strike a tough bargain with China so that it will agree to trade deals that are much more favourable to the US, and stop the flow of immigrants.

None of these are particularly realistic in terms of implementation given how the US political system works, with the Congress and the Senate often being in deadlock and under the influence of various lobbies. Moreover, even if trade and immigration are completely stopped, there is no reason to think that US companies will employ domestic unskilled workers at a higher wage – rather, there will be greater mechanisation and permanent flight of capital. Trump is not talking about raising taxes on the rich, expanding the welfare state to help the less well-off deal with the negative effects of globalization and technological change, or to facilitate mobility by helping their children to acquire the skills and education that will enable them to take advantage of the opportunities that globalization offers. On the contrary, he plans to create more jobs by lowering taxes on the very rich and removing regulations that burden companies, the same trickle-down policies adopted by George W. Bush and his Republican predecessors that created the economic problems in the first place.

This raises the main question that we address in this essay - how come ordinary voters were persuaded by Trump's message despite its patent lack of credibility? We propose a simple analytical framework which addresses how inequality and low growth combine to create a "zero-sum" economic environment. In ethnically or racially polarized societies this naturally leads to the salience of social identities that enable majority ethnic groups to vote for policies that exclude minority groups so that they get a greater share of a dwindling surplus. In contrast, in more ethnically and racially homogeneous societies, this would instead lead to the demand for more pro-redistribution policies that involve greater provision of public goods.

There are several existing explanations for lack of support for redistributive policies even when inequality has been rising (see, for example, Alt and Iversen, 2017). First, there is a social distance argument, namely, as the social distance between the middle class and the poor go up, the support for redistribution from the former falls, and this tendency is accentuated if minorities and immigrants are overrepresented among the poor. Second, there is an argument that there can be a tension between an individual's

social identity (say, national pride) and economic interests and depending on the strength of these identities and their salience, a poor person may not vote for the kind of redistributive policies a purely economic self-interest based argument would imply (Shayo, 2009). Third, there is an argument that the poor are distracted from their economic interests by the use of wedge issues (Frank, 2004). Our argument is distinguished by the attempt to link the salience of the economic vs a social identity of an individual to economic factors.

The plan of the paper is as follows. In the next section (section 2), we discuss the analytical framework with the help of an example. In section 3 we provide a very simple formal model of the core mechanism sketched out in section 2. In section 4, we offer some concluding remarks touching on some of the challenges of reforming the welfare state.

2. The Bus Stop Example[§]

Economic dislocation caused by impersonal market forces inevitably results in a search for visible scapegoats. In a crowded bus, you tend to direct your rage at new passengers who keep on boarding, and want the bus to stop at as few stops as possible, but do not ask why there are so few buses.

Ethnic identity is visible while changes in the global economic landscape are much less so, and it is always easier to blame an identifiable group such as immigrants than the invisible hands of the market.

To develop the crowded bus example further, suppose you are waiting at the bus-stop, along with some people who are visibly different from you. If buses keep on coming, whether you feel positively towards these outsiders or not, you will mind your own business and focus on your journey. Now consider a scenario where buses come infrequently, and when they do, they are terribly crowded. The bus stop will get more and more congested and you are going to get more and more frustrated and ready to vent your anger if you found a target. If everyone around you looks the same, then you are more likely to blame the bus company rather than fight among yourselves.

[§] This is take from Ghatak (2016).

However, if there is a small but visibly different group of “outsiders,” then as a member of the majority group, you might begin to find their presence highly annoying.

If we take the arrival of buses as a metaphor for economic opportunities, so long as the buses keep coming – or as long as there is the prospect of economic mobility -- you do not want to disrupt the system even though you do not necessarily like people who are visibly different from you. But as growth slows down, you are likely to get angrier at visible scapegoats whose ethnic and cultural differences now seem more salient than their class affinities with you. The immigrants then become symbolic of all that is wrong with the “system”.

Not just that; earlier, you may have tolerated the rich driving in cars while you waited for a bus, thinking one day you or your kids will have cars. When that possibility becomes increasingly remote, other than being upset with the “others” at the bus-stop, you also become angry at those driving cars since you feel the whole system is unfair. However, you do not feel there is a realistic chance of winning the fight against the economic elites directly as opposed to against those who are directly competing with you and are visibly different from you.

This highlights the limitations of both a purely economic or a purely social identity-based narrative. After all, if people voted in their economic self-interest, then clearly the policy choices will be much more egalitarian in the US or elsewhere, with greater redistribution and welfare spending. Ironically enough, the whites in the southern states of the US form the staunchest pro-Republican voting-block, even though they are poorer compared to the rest of the country, and benefit more from the welfare schemes disdained by the Republican Party.

This paradox, discussed by Frank (2005) opens up the possibility of an identity-politics narrative centred round the shrinking White Christian majority. The proportion of White Christians have gone down from slightly above to slightly below half the total population over the course of the last decade, but 70 per cent of Republicans are drawn from this group. The most important demographic group supporting Trump are White men without college degrees.

Now as much as one cannot have a mono-causal explanation of voting patterns based on economic factors, one cannot solely rely on an identity-based account in the context of the US Presidential elections. Barack Obama was elected President twice in the last eight years, and no successful Presidential Democratic candidate has won the majority of the White vote since Lyndon Johnson signed the Civil Rights Act. It is perfectly possible to win the election without getting a majority of the White vote, as Jimmy Carter, Bill Clinton, and Obama did.

To understand the outcome of US elections, we should look not at groups whose voting pattern is steady, but at swing voters who move from one party to the other in any given election, energized voters who are more likely to turn out and vote than stay at home, and new voters (first-time voters and naturalized citizens).

This is where the “angry White men” cannot be ignored as an electoral constituency. Exit polls suggest that Trump’s margin of support relative to Hillary Clinton for this group is higher than what Mitt Romney had relative to Obama for this group (see, for example, Yglesias, 2017) . To explain the shift within this group, one has to marry the identity-based narrative with the economic one. In other words, identity and economic fundamentals are not independent. Certain identities become more salient depending on the economic fundamentals and whether social or economic issues will get more weight may depend on the economic situation.

For political entrepreneurs who want to make capital out of this resentment, it is easier to sell a narrative where there are good guys and bad guys, than one that has to do with global reallocation of resources due to lower transactions costs and the IT revolution. That is why Trump’s railing against the elites who have sold the ordinary citizens’ interest off to benefit themselves, and against all those dark-skinned foreigners who are coming in and taking over the country fires up the heartland!

Neither economics nor identity can explain the Trump phenomenon purely by itself. As has been noted, many Trump supporters are not poor or unemployed themselves, and are not direct victims of globalisation, immigration, and free trade. But a careful study by Autor et al (2016) shows that areas that have been more affected by job losses due to Chinese imports chose more ideologically strident candidates in congressional

racism. In the heartland, these tend to be right-wing populists, represented by the Tea-party and now, strong supporters of Trump.

As we noted earlier, it is not one's current economic status that drives political attitudes. Like the stock market, these are driven by expectations about the future. And anxious people often seek solace in cultural identity and crave a strongman. Someone like Trump provide them with a narrative that puts the blame on identifiable external targets, and promises easy solutions, exactly like godmen.

Contrast this with Sanders' message during the campaign. He (correctly) attributed stagnant wages and the loss of US jobs to globalization, capital mobility, and technological change. Rather than railing at immigrants and foreign workers, he proposes to counter this by introducing a fairer tax system that would prevent the very rich like Trump from evading taxes, and redesigning the welfare state to meet the domestic challenges of globalization. Whether one agrees with the specifics of his solution or not, Sanders's view is more complex and appeals more to the educated. No wonder college students and academics were among his most enthusiastic supporters. On the other hand, for Trump's supporters any solution that talks about redistribution or welfare is anathema, given their suspicion that this will benefit immigrants and minorities, and their mistrust of elites and any 'government' solution to their problems. That is why the less affluent whites in the Southern states oppose welfare schemes like Obamacare, even though on average they benefit (on grounds of lower average incomes) from these schemes much more than residents of Democratic-leaning coastal states.

3. A Simple Game Theoretic Model

We develop a simple game that relates to the bus-stop example of the previous section. Suppose individuals are matched pairwise and they can decide whether to engage in conflict or cooperate over how to divide some resource that both value (e.g., getting on board or getting a seat in a crowded bus).

First consider a situation where everyone is identical. If they fight then each has a probability $\frac{1}{2}$ of gaining an upper hand (pushing ahead of someone to board the bus) but it is a costly action. Let B be the payoff associated with the resource over which

conflict is taking place and let c be the cost of engaging in conflict. If one player engages in aggressive behaviour and the other player concedes, then the former gets the full surplus and does not have incur any cost, while the latter gets zero. If both decide to fight, then each has a probability $\frac{1}{2}$ of winning (with the other player getting nothing) but both incurs the cost of fighting, c . If both decide not to fight, then they split the surplus in an even way – each get a share $\frac{1}{2}$ of B – and both avoid the cost of conflict.

In addition, when both players cooperate there is an additional payoff θ which can be thought of as a purely positive psychological payoff from cooperation, or an economic payoff that results when individuals interact positively either in terms of potentially beneficial information being exchanged or enhancing trust and cooperation in other domains.

Player 2 Player 1	Fight	Not Fight
Fight	$(\frac{1}{2}B - c, \frac{1}{2}B - c)$	$(B, 0)$
Not Fight	$(0, B)$	$(\frac{1}{2}B + \theta, \frac{1}{2}B + \theta)$

Game 1: Homogeneous Players

Depending on parameter values this can be one of several possible well-known games, such as the Prisoner's Dilemma (when $\frac{1}{2}B - c > 0$ and $\theta < \frac{B}{2}$), the Hawk-Dove or Chicken game (when $\frac{1}{2}B - c < 0$ and $\theta < \frac{B}{2}$), or coordination (when $\frac{1}{2}B - c > 0$ and $\theta > \frac{B}{2}$). It can also be a game where cooperation is a dominant strategy equilibrium (when $\frac{1}{2}B - c < 0$ and $\theta > \frac{B}{2}$).

If it is a Prisoner's Dilemma game, then cooperation is collectively the efficient outcome but each individual has a selfish incentive to take an action that enables him or her to benefit at the other player's expense. However, if both players choose this action ("fight" in this case), then the overall outcome is suboptimal relative to the one where they cooperated. If it is a coordination game, then the equilibrium where both players cooperate is a better one than one where they both fight.

Assume that the cost of conflict c depends on economic conditions. For example, fighting means your energies are diverted from more productive use. This is a parameter that is affected by overall economic conditions. Suppose it can take two values, \bar{c} and \underline{c} with $\bar{c} > \underline{c} > 0$. Assuming $\theta < \frac{B}{2}$, for a low value of c , namely $c = \underline{c}$, and so long as $\frac{B}{2} > \underline{c}$, both individuals will choose to "fight" and receive a payoff of $\frac{1}{2}B - \underline{c}$ each assuming. On the other hand, if $\bar{c} > \frac{B}{2}$ there is no equilibrium in pure strategies but a mixed strategy equilibrium exists where each player chooses to fight or cooperate with some probability, which means overall welfare is higher than when they always chose to fight.

Analogously, the benefits from both players cooperating (θ) could vary too depending on economic conditions. Suppose it too can take two values, $\bar{\theta}$ and $\underline{\theta}$ with $\bar{\theta} > \frac{B}{2} > \underline{\theta} \geq 0$. Assuming $\frac{1}{2}B - c > 0$, if θ changed values from low to high, then it becomes possible to coordinate on a cooperative equilibrium (as opposed to a non-cooperative one) from a situation when fighting is the dominant strategy equilibrium.

Suppose now that the players are not homogeneous. In particular, they can be members of a group a (e.g., white), which constitutes the majority ethnic or racial group (we will refer to them as the majority group) or group b (e.g., non-white immigrants), which is the minority group. Let N_M be the population size of the majority group and N be total population, and let $q = \frac{N_M}{N}$ be the fraction of the majority which is, by definition, greater than $\frac{1}{2}$. Assume that if two players belonging to the same social group match, then the game is like the one before. But if there is a heterogeneous match then it is as below, with the key difference that now a player belonging to the majority group (for brevity, majority player) has a higher chance of winning a conflict over a minority player, with the probabilities $\frac{3}{4}$ and $\frac{1}{4}$. These probabilities are

arbitrarily chosen, with the important consideration being the former is greater than $\frac{1}{2}$, the latter is less than $\frac{1}{2}$, and that they add up to 1.

We can see that a player belonging to the majority group now has a greater incentive to choose the strategy “fight” when matched with a player belonging to the minority group than before for two reasons. First, he/she has a greater chance of winning. Second, now the minority player may be better off not fighting when attacked (this would be the case if $\frac{1}{4}B - c < 0$).

Player 2 (b) Player 1 (a)	Fight	Not Fight
Fight	$(\frac{3}{4}B - c, \frac{1}{4}B - c)$	$(B, 0)$
Not Fight	$(0, B)$	$(\frac{1}{2}B + \theta, \frac{1}{2}B + \theta)$

Game 2: Heterogeneous Players

The point of introducing this dimension is to show now, for the same parameter values that two homogeneous players do not fight (this is the case if $\frac{B}{2} - c < 0$), now it is possible that a majority player when matched with a minority player will fight (this is the case $\frac{3}{4}B - c > 0$). If in addition $\frac{1}{4}B - c < 0$, then a minority player will not fight back and that would give a majority player a greater incentive to fight, as his payoff will now be B .

A fall in θ and/or a rise in c would therefore more likely precipitate conflict in heterogeneous societies by making social identity more salient to the majority players. Inequality and dwindling economic prospects for the non-wealthy would imply a fall in θ and/or a rise in c . For the same society (in particular, for the same degree of social heterogeneity) no one may have an incentive to fight when economic prospects

are good. This is the case where, in terms of the bus-stop example, enough buses are coming and so people go on with their business without any conflict. In contrast, when overall economic prospects are not great, social identity can become salient in the form of support for majoritarian policies. In contrast, in a more socially homogeneous society, conflict would be avoided and support for more universalistic policies would be higher.

The analysis is admittedly somewhat simplistic. There are many ways in which this example could be developed further. For example, we could introduce investment in human capital and growth. This could introduce an economic heterogeneity – skilled vs unskilled labourers, for example – in addition to social heterogeneity. Another interesting aspect is the difference between developing and developed countries. Is it the case that developed countries growth deceleration leads to rise in populism while in developing countries it is growth that raises expectations and that may unleash populism as in a scramble for the ladder to escape poverty?

4. Conclusion

Clearly, the most important challenge is to reinvent the welfare state in the era of globalisation so that one can balance the gains that trade, markets and migration bring with the losses that some groups suffer. Otherwise, the growing inequality would lead more and more countries to vote for pulling up the drawbridge, as the Brexit vote and the rise of Trump. The result may be less inequality, but it will also be less prosperity for all.

The other major lesson from the Brexit vote and the victory of Trump is that the new class divide is more by education than by wealth or privilege. The rising inequality in the West is to a large extent driven by the rising gap between skilled and unskilled wages. Education is also a key driver of political support for certain key economic policies. There is a surprising convergence of views of the educated elite on certain core policies. For example, the pro-market liberals from the right and the social progressives from the left have, in general, opposed right-wing populism. Indeed,

there was rare unanimity among economists on this issue, cutting across the usual left-right ideological divide.

This means the focus on redistributive policies should focus on higher spending on education and training, which expands equality of opportunity, what is often called pre-distribution policies. This would mitigate the clash of interests regarding the opportunities that globalisation and technological change brings.

Education also tends to produce a more socially tolerant worldview. And, Adam Smith not only extolled the virtues of the market as a source of wealth of nations, he also wrote about the civilising effect of commerce. A culture of cosmopolitanism and social liberalism fostered would help society protect itself from its worst instincts of xenophobia and racism. Adam Smith's focus on trade and Karl Marx's focus on inequality are usually seen as completely antithetical. The policy challenges of the 21st century suggest they may not be so.

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