Northern Trust

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- **The Perils of Populism**
- **Why Economies Go Underground**
- **What Goes On At Home Doesn't Count**

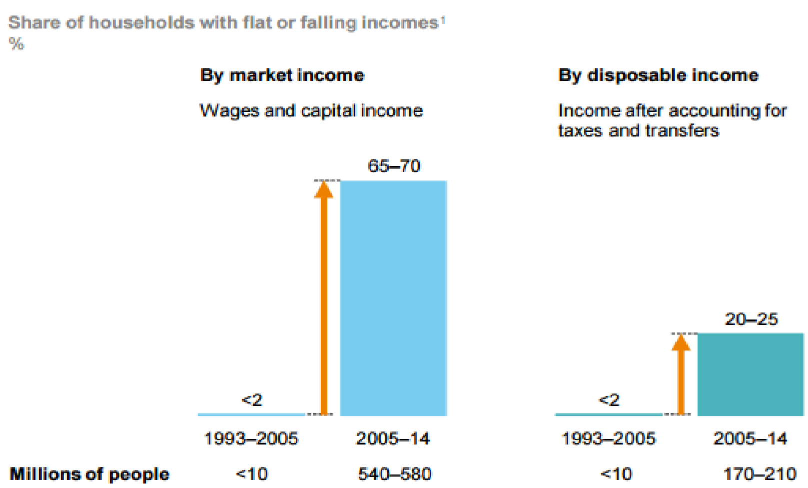
I was never popular in high school. I was a math geek whose standard attire was a t-shirt and jeans that did not go below my ankles. (High-waters, they used to call them.) The toughs took my lunch money, the cool kids ostracized me and the girls ignored me. I didn't gain acceptance until I went to a college where being a nerd actually made you popular.

Unfortunately, the pendulum has shifted in the other direction. The "educated" are presently under siege as a populist wave washes over the globe. It may be fair to say that the learned few who govern have lost touch with common sentiment over the past decade. But the population's complete detachment from educated points of view could be an unfortunate overcorrection.

Populism is not new, and its current incarnation is certainly not its most extreme expression. Wikipedia describes populism as "a political position which holds that the virtuous citizens are being mistreated by a small circle of elites...the elites are depicted as trampling in illegitimate fashion upon the rights, values and voice of the people."

In an economic context, elites are communities of politicians, intellectuals, or capitalists whose actions are perceived as detrimental to the common good. Populism tends to rise when the fortunes of a few are improving while the fortunes for many are not.

Outcomes between classes have diverged importantly during the past decade. A recent study by the McKinsey Global Institute reviews the evidence in some detail.



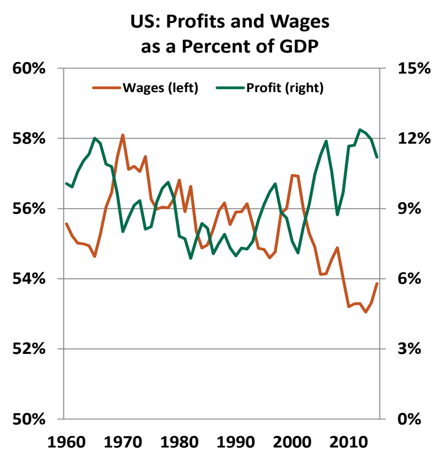
Source: McKinsey Global Institute

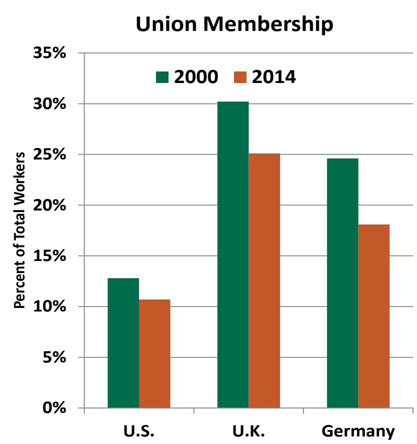
During the decade ending in 2005, a rising tide seemed to be lifting all boats. Peripheral eurozone countries enjoyed growth and stability thanks to falling interest rates; the United States experienced "the great moderation" and rising asset prices enriched everyone to a certain degree. The advancing use of household credit allowed for the monetization of wealth to support consumption, which supported higher lifestyles.

Inequality of fortune has risen sharply since the global financial crisis.

Since the global financial crisis, however, the dynamic has become much less democratic. Economic growth since 2009 has been slower and more uneven across nations and regions. Unemployment has lingered for many countries and communities. Asset prices in some places have returned to record levels, while others have languished. Overall, a surprisingly large fraction of households reported to McKinsey that their incomes have fallen over the last ten years, even when public support is included.

Other evidence illustrates the growing distance between the fortunate and the less so. A large fraction of national income, as represented by gross domestic product (GDP), is divided between corporate profits and wages. These shares typically reverse directions as an expansion progresses, but the current business cycle has seen the wage share languish.





Sources: Haver Analytics, OECD

One explanation for this might be declining rates of union membership. Collective representation has been receding for many years in many countries, largely as a result of an economic transition away from manufacturing. This makes it much more difficult for rank and file workers to grab what they view as a fair share.

Those who feel disadvantaged are much more likely to have negative opinions about immigration and trade. They are more skeptical about their governments and the financial markets. They resent the assistance granted to banks in 2008, even though the support likely kept things from getting much worse and preserved savings for millions of households.

The disaffected are angry about their circumstances and are anxious to express their discontent. Some take to the streets; others vent at the ballot box. Those who are upset are thought to have higher rates of voter participation; this may have been a factor in June's Brexit referendum, and was certainly a factor in the U.S. presidential primaries.

So much of what is driving the movement is visceral. Against such emotion, it is very difficult to introduce studied reflection to the discussion. Former British Home Secretary Michael Gove, who was pushing for the United Kingdom to leave the European Union, became particularly agitated when asked if any economists saw prospective benefit in the departure. “People in this country have had enough of experts,” he replied.

Passion is good, but informed passion is better.

Nonetheless, objective evidence should not be ignored, as it apparently was by many Brexit voters. (It bears repeating that one of the top Google searches in the United Kingdom the day after the referendum asked, “what is the EU?”) International trade has produced immense benefits for those countries who participate: global commerce has created jobs, and it has brought lower prices to consumers. Immigration is accretive to economic performance over time, and essential for countries seeking to sustain demographic balance. Purely redistributive tax policies diminish the incentives for businesses to start and grow. (And they may drive existing businesses to other locations.)

It is certainly proper and desirable for citizens to question the existing order. And there are certainly policies that have the potential to aid economic growth and allocate its proceeds equitably. We’ll be discussing these at some length in the months leading up to the U.S. election in November. But we will try to look at things dispassionately.

Populist movements are often led by charismatic leaders who mobilize latent discontent with rhetoric that is not always be deeply rooted in reality. Economists are not naturally charismatic, so we have a hard time selling our arguments. Once again, nerdiness is a disadvantage.

In The Shadows Of An Economy

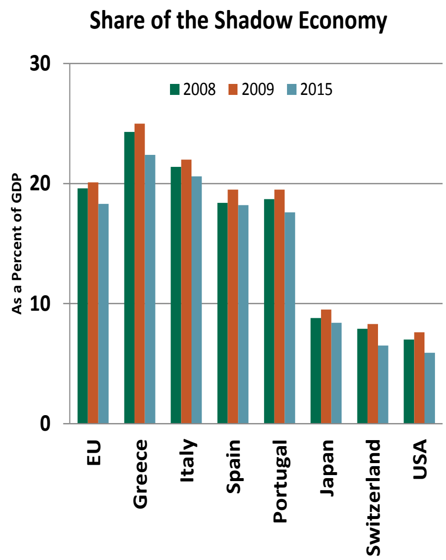
Asha offers some reflections after her recent trip to Greece.

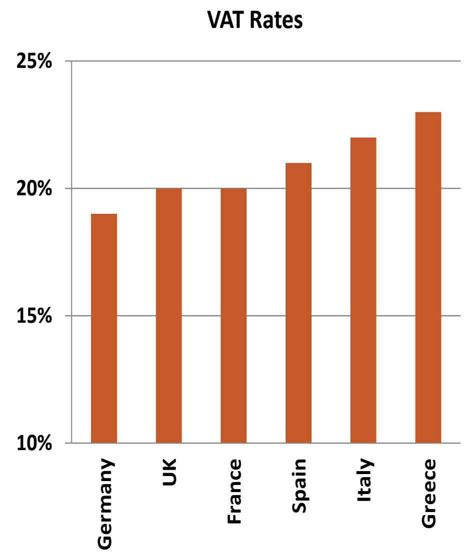
During a recent visit to Athens, it was a challenge on occasion to get a table for dinner at a restaurant. This was a bit of a surprise as the Greek economy is still in a deep recession, with a significantly high unemployment rate. How does one reconcile this contradiction? Summer tourists are only a partial explanation as it was still early in the vacation season. Conversations with Greek residents yielded a common culprit – a thriving underground economy is fueling the economic engine and filling the tables in the *tavernas.*

The underground economy, also known as shadow/parallel/informal/black economy, includes illegal transactions and unreported activity from the legal production of goods and services. Typically, the latter is used to measure the size of the underground economy.

A plumber fixes the clogged kitchen sink, but the cash payment is not reported. Costs of a doctor’s visit or repairs of a car are higher when a receipt is required. These are stories of underground economic activity I gathered from relatives and friends. By implication, the underground economy lowers tax revenue, which is one among many reasons for Greek budgetary pressures.

Measuring the size of the underground economy is difficult, and the share of underground economic activity varies across countries. Friedrich Schneider’s research indicates that the eurozone countries of Greece, Italy, Spain and Portugal have significantly large shadow economies, while the United States, Japan and Switzerland are at the low end.





A parallel economy is eternal but the size of it can be changed.

There are several reasons for the existence and growth of a shadow economy. Taxes and social security contributions raise the cost of labor in the official economy. Employees and employers tend to move to the parallel economy to avoid these costs. The Greeks love to sip frappé and watch life go by, and Greece's high tax burden was the subject of many of these conversations.

The picture is incomplete without mentioning other factors that drive the shadow economy. Studies show that onerous regulatory environments encourage the growth of the shadow economy. Countries that are heavily regulated tend to have a higher share of the shadow economy as a percent of GDP.

High levels of corruption offer opportunities to support a parallel economy. Regulations of new businesses, land zoning decisions and public investment contracts are fertile grounds for corruption and off-the-books transactions. In addition, tax compliance is higher if citizens get valuable public services in exchange for honest tax payments. This did not seem to be the case in Greece.

The underground economy's absorption of labor distorts the official unemployment rate. Employment and income generated in the formal economy will be lower than the actual levels and will send an incorrect signal to policymakers. Those who work in the parallel economy are deprived of benefits from social programs such as social security and health benefits in the United States and similar arrangements in other countries.

Sustained economic growth combined with the strength of public institutions, tax morale, positive views about government agencies, and solid governance are factors that should reduce the size of the parallel economy. For now, the Greeks have a long way to go before economic activity moves above ground.

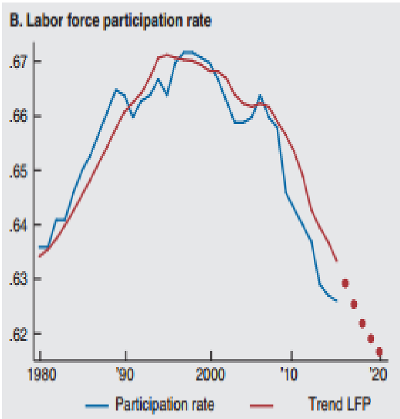
Looking for Lost Output

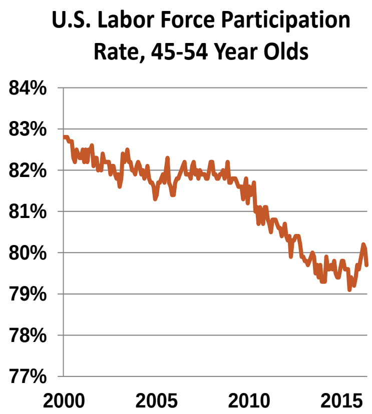
The rules for measuring the size of the economy have some curious twists. One is that if you marry your gardener, gross domestic product (GDP) falls, because a service you were once paying for is now done within the household.

Work done within the home does not count toward GDP.

I've been wondering whether this textbook example might, in some modest way, explain why GDP growth has been sluggish during the current expansion. No, there haven't been more marriages of homeowners and gardeners; but many families may be doing more for themselves.

One of the post-recession themes in the United States has been the decline in labor force participation. Two perspectives on this are shown below. The left-hand panel, from the Federal Reserve Bank of Chicago, shows the overall history in blue and the "trend" in red. The "trend" reflects the path that participation will take as members of the baby boom transition into retirement. The gap between the lines represents people who have stopped looking for work.





Sources: Federal Reserve Bank of Chicago, Haver Analytics

The second chart looks at the participation rate for prime-aged working men and women, which has fallen by 2% since 2008. This may seem small, but it represents about 2 million people.

Those who stay home are much more likely than full-time workers to mind their own children instead of dropping them off at a day-care center. There is time to care for aging relatives, saving the cost of home health aides or nursing homes. The temporarily idled have the opportunity to do their own repairs and cook their own meals.

As you might imagine, it is very difficult to measure whether the rising number of home workers has limited reported rates of economic growth. Research from the Bureau of Economic Analysis finds little evidence of increased household production since the crisis ended, but the study relies on very sketchy data. Our search for the missing GDP goes on.