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Strategic redistribution: The political economy of populism in Latin America

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ABSTRACT

Why do some countries in Latin America redistribute too much ("left-wing populism"), while others allow high levels of inequality to persist or even increase over time ("neo-liberalism")? We argue that when a group's political influence is increasing in its wealth, there is a strategic motive for redistribution: by taking money away from a group, its ability to influence future policy is reduced. Populism arises when the poor respond to this strategic motive, while neo-liberalism results when the rich use their wealth to limit redistribution. Assuming that wealth increases political influence because it enables a group to stage a coup, we find that populism is both more likely and more extreme when the military is biased in favor of the rich. We conclude by discussing the policies of Hugo Chavez in Venezuela and Alberto Fujimori in Peru in light of our findings.

> "[P]opulism is rooted in the distributive political struggles that have characterized Latin America since the beginning of the century. Although such redistributive struggles are ubiquitous in the region, variations in institutional arrangements across countries and time periods determine the extent to which they are expressed through populist policies."(Kaufman and Stallings, 1991)

1. Introduction

Some low-income democracies in Latin America engage in redistribution that is excessive and generates substantial deadweight losses, yet others adopt redistributive policies that are inadequate and allow high levels of inequality to persist or even increase over time. The news media often associate the first of these policies with left-wing *populism*, where very high levels of redistribution typically increase short-run consumption, but at the expense of future output and consumption. These policies are still common in Latin America; those of Hugo Chavez in Venezuela, Evo Morales in Bolivia, and Daniel Ortega in Nicaragua are some recent examples. The second type of policies is often associated with *neo-liberalism*, which generally involves market-friendly policies and the absence of government initiatives to redress inequality. In Latin America, policies of this type were implemented in the 1990s following the Washington Consensus.[1]

It is generally acknowledged that populist and neo-liberal policies have political, rather than economic, goals. However, standard political economy frameworks cannot satisfactorily explain these policy choices. The reasoning behind models of the

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[1] There are many definitions of the term 'populism' and so the concept can be quite vague; see Weyland (2001) for a discussion. In this paper we follow Dornbush and Edwards (1991) and use an economic definition. Other definitions exist; for example, one can think of populist policies as those that are popular, but cannot be implemented. See Conniff (1999) for an excellent discussion of the history of populism in Latin America.

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median voter like those in Meltzer and Richard (1981), Alesina and Rodrik (1994) and Persson and Tabellini (1994), where the tax rate is determined by a median voter who trades off transfers and deadweight losses, would generally predict that higher inequality would result in greater redistribution. This is the opposite of what happens during neo-liberal episodes. Furthermore, populism often imposes substantial deadweight losses on the economy, and it is unclear why this would be optimal for the median voter who chooses policy in these models.[2]

This paper presents a new framework that can explain why the low income democracies of Latin America often implement extreme redistribution policies; for example, through the expropriation and redistribution of land. Our explanation is based on the simple but important observation that money is a central determinant of a group's ability to influence policy. This is particularly true in countries with corrupt militaries, where the rich can enlist the support of military officers for a rebellion, and so wealth provides the rich with more voice over policy than democracy's intended "one-man-one-vote." This has the fundamental implication that redistribution not only re-allocates money, but it also re-allocates the ability to influence policy in the future. This endogeneity means that there is a strategic motive for redistribution: by taking money away from a group, its future ability to oppose policy is diminished. Concern over the relative influence of other groups may thus be a central factor in determining how much redistribution each particular group favors.

One way in which money can affect a group's influence is that it may allow it to drive a government out of office. The threat of doing so can then be used to influence policy. We focus on one specific method for removing governments that is particularly relevant in the Latin American context: the coup d'Etat. Money is required to buy the support of members of the armed forces for such a plot, and many well-known coups have been aimed at removing governments that threatened the interests of the rich, including Pinochet's 1973 coup in Chile and the 2002 attempted coup against Chavez in Venezuela.

Taking into account the importance of wealth inequality in determining political influence introduces two considerations into the policy decision. First, redistribution may be constrained by the opposition of the rich, who may use their resources to enlist the help of the military and threaten a coup. This may force the poor to pursue a low amount of redistribution and potentially give rise to neo-liberalism; we illustrate this with a case study of Alberto Fujimori's government in Peru. Second, the poor will consider the effect of redistribution on the future distribution of wealth, and by implication, on their own future ability to set policy. This can give rise to populism: high redistribution, by reducing the future wealth of the rich, increases the poor's ability to set future policy. We later argue that Hugo Chavez's policy choices in Venezuela can be rationalized in this way.

When inequality is low, the threat of a coup places no constraint on redistribution. In this case the strategic incentive is weak and policy is set largely based on the *base* effect: low redistribution allows the rich to accumulate wealth, which by increasing their future wealth allows for higher redistribution tomorrow. When inequality is high, coups become a genuine concern and redistribution is constrained by their threat. This provides a rationale for redistributing as much as possible (conditional on not triggering a coup): high redistribution lowers the future wealth of the rich, decreasing the threat of a coup tomorrow and relaxing future constraints on redistribution. We refer to the fact that higher redistribution today may allow for higher redistribution tomorrow as the *rate* effect.

In our model, the military's bias in favor of the rich is instrumental in determining whether populism or neo-liberalism will arise. The greater this bias, the lower the level of inequality for which redistribution will be constrained. It also causes the amount of redistribution preferred by the poor to be greater, as they must reduce the wealth of the rich further to keep them from blocking future policy. This potentially gives rise to more excessive populism, which might explain why populism is so common in Latin America, a region where the military has generally had an intrinsic bias in favor of the economic elites.

This paper makes two main contributions. First, it provides an explanation for the extreme redistribution policies implemented by many low-income democracies in Latin America. Populism is puzzling because it is generally very destructive. We show that it is not necessary to rely on the poor being myopic or having bounded rationality to explain these policies: the institutional constraints under which low-income democracies operate may create the incentives for the adoption of populist policies. Second, this paper improves our understanding of the military's potential impact on economic policy, as we show how its bias may affect policy decisions. Although the literature has emphasized other channels (in particular, the role of bribes or campaign contributions), in Latin American countries the threat of a coup is a widely used and very effective pressure mechanism. It is then possible that the failure of many Latin American democracies to adopt better policies is partly due to their corrupt militaries.[3]

[2] Harms and Zink (2003) review the literature that looks at the forces that limit the amount of redistribution in a setting similar to mine: democratic societies where the poor majority have comprehensive political rights. In these papers majority-voting does not provide a good description of how the extent of redistribution is determined, as there are other forces constraining this decision. The authors then explore why in a majority-voting setting the poor may find it in their self-interest to choose a moderate degree of redistribution. More generally, there are a number of issues with using median voter models to analyze representative democracy. For example, Tridimas and Winer (2005) argue that these models are problematic because they do not allow for a distinction between the economic welfare and political influence of different groups. A better set of models use probabilistic voting; as shown by Coughlin and Nitzan (1981), these can reconcile political outcomes with a Nash-type social welfare function. Hettich and Winer (1999) use probabilistic voting models to study how tax policy can be an outcome of democratic choices.

[3] Corruption and rent-seeking can explain a large number of policy outcomes. Anne Krueger (1974) argues that the creation of contestable rents leads to rent-seeking, and that this often presents an obstacle to economic and political reforms that would reduce these contestable rents. Verwimp (2003) argues for a connection between rent-seeking in Rwanda (in particular, through the manipulation of the producer price of coffee) and the 1994 genocide. More closely related to our analysis, McChesney (1987) suggests that political competition, and in particular the need to receive campaign contributions, can induce politicians to create new sources of rents (or destroy old ones). Although it is possible that populist policies allow for corruption or rent-seeking, explanations based exclusively on these two phenomena cannot explain why voters usually support these policies. One alternative would be to follow Congleton (1991), who shows how economic groups can try to persuade voters to support particular policies. Alternatively, Kiss (2012) argues that an incumbent politician may seek to polarize the electorate because that reduces its ability to hold him accountable.