

# POLITICAL RISK ASSESSMENT II

## WHERE DOES POLITICAL RISK COME FROM?

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## WHERE DOES POLITICAL RISK COME FROM?

- **Exogenous:** Interstate conflict, regional war, terrorism
  - **Endogenous:** Economic recession & Wealth gap
- Gap between socio-economic and political/institutional evolution
  - Cultural fragmentation (riots, government crises, corruption)
- Internal violence and power struggle (martial law, guerrilla warfare...)
  - Rapid pace of urbanization coupled with religious fundamentalism
    - Ethnic/linguistic fragmentation
    - Fragmented identity and “archipelagos”



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► *Political risk analysis is both an art and a science  
but many types of risk are amenable to rigorous analysis:*

1. How resilient is the political system and its institutions?
2. Is there a tradition of peaceful transitions of power?
3. How robust are the social shock absorbers that provide buffers between citizens and governments? Institutions!
4. What about wealth gaps?
5. What about economic and financial power concentration?
6. Which groups control the engines of growth?

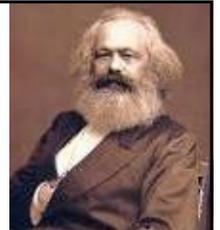
**Ambassador Paul Bremer (US State Department)**  
Harvard Business School Review, 2002

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## MARXIST APPROACH TO ECONOMIC DEVELOPMENT AND CLASS STRUGGLE



- The developing forces of production give rise to increasing conflict with the existing social relations of production = **class struggle**
- The **state** does not represent the interests of 'the people' or a common 'general will'. Nor is it a force which stands above or beyond the clash of class interests.
- The state = Instrument of class rule, nothing but 'a committee for managing the common affairs of the whole bourgeoisie'
- Capitalism will inevitably lead to increasing class polarisation and class conflict

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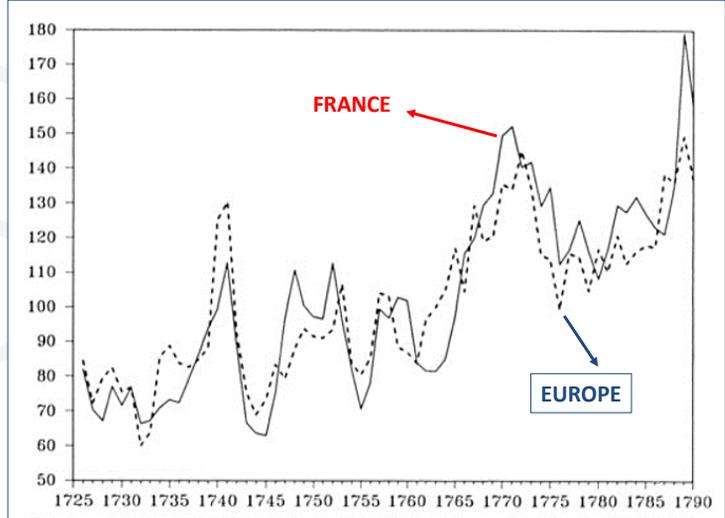
## FOOD STRESS, WHEAT PRICES & REVOLUTIONS: WHAT RELATIONSHIP?

Where does a **revolution** come from?

In the XVIII° century, bread constitutes nearly 50% of expenditures of households in France.

- 1788: bad weather and severe drought
- 1789: Necker's alarmist warnings and urgent imports of wheat
- Very cold winter
- 6 pounds of bread cost 12 « cents » = one day salary.
- Fast inflation will continue until 1795

Wheat price index in France and in Europe 1725-1790

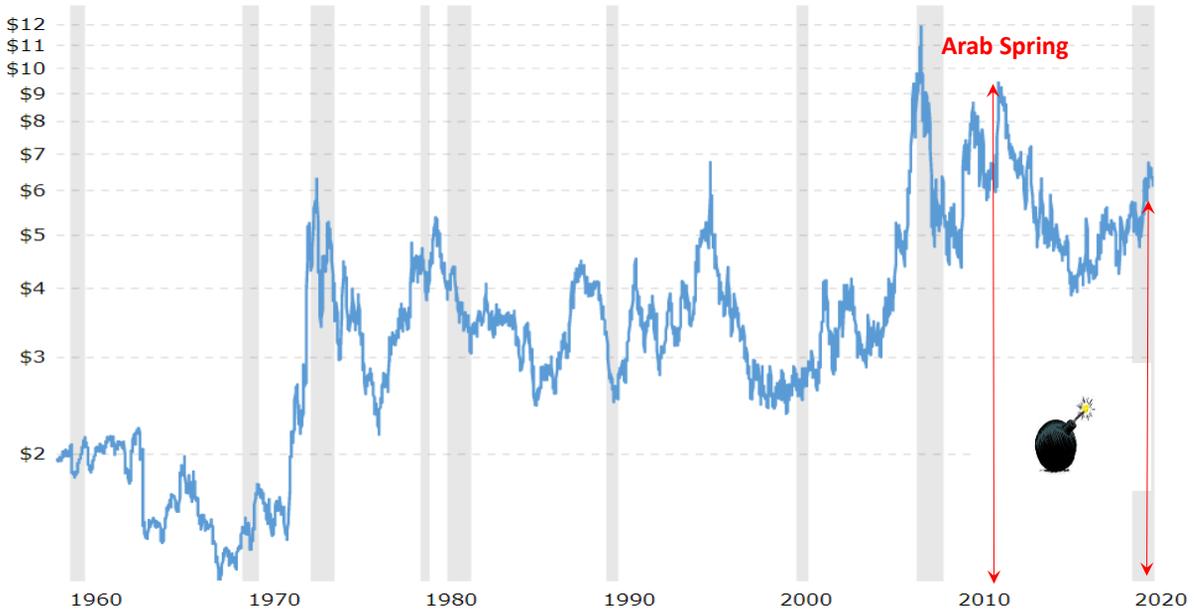


Source: David Weir, Annales, 1991, Vol.46

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## LOOKING FOR THE ROOT CAUSES OF THE 2011 ARAB SPRING? WHEAT PRICES/BUSHELL - HISTORICAL DATA



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## WEALTH INEQUALITY AND INCOME GAPS = ROOT CAUSES OF SOCIO-POLITICAL TURMOIL!

**Table 1:** Inequality outlook

	Income		Wealth	
	Avg. Income (PPP €)	Share of total (%)	Avg. Wealth (PPP €)	Share of total (%)
Full population	12 400	100%	32 300	100%
Bottom 50%	1 300	5.3%	-1 600	-2.4%
Middle 40%	8 700	28.2%	13 500	16.8%
Top 10%	82 500	66.5%	276 700	85.7%
Top 1%	272 000	21.9%	1 777 300	55.0%
Top 10% to Bot. 50% Income gap			1 to 63	
Female labor share			36%	
GHG footprint			7.2 tCO <sub>2</sub> / pers.	
Transparency index			8.5 / 20	

**South Africa in a nutshell :  
one of the most unequal country in the world!**

World Inequality Lab 2023

**Figure 1:**

Top 10% and bottom 50% income shares in South Africa, 1900-2021



**Interpretation:** The Top 10% income share is equal to 67% in 2021. Income is measured after the operation of pensions and unemployment insurance systems and before income tax.

**Sources and series:** see *wir2022.wid.world/methodology*, and Chancel and Piketty (2021).

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[https://wir2022.wid.world/www-site/uploads/2022/03/0098-21\\_WIL\\_RIM\\_COUNTRY\\_SHEETS.pdf](https://wir2022.wid.world/www-site/uploads/2022/03/0098-21_WIL_RIM_COUNTRY_SHEETS.pdf)

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## DANIEL BELL

Sociologist and professor emeritus at Harvard University. Bell was among the original New York Intellectuals, a group of anti-Stalinist left-wing writers. Best known for his contributions to post-industrialism. Masterworks: *The End of Ideology* (1960), *The Cultural Contradictions of Capitalism* (1976) and *The Coming of Post-Industrial Society* (1973)



### The post-industrial society:

- The Cultural Contradictions of Capitalism: Polarization and social tensions between work and consumption pressures: capitalism is inherently **instable**
- Centrality of the new science-based industries & NTIC
- Rise of new technical elites and the advent of a new principle of stratification

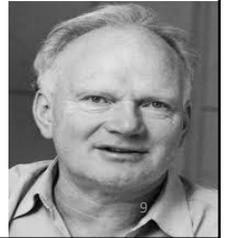
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## ULRICH BECK: "WORLD AT RISK" IN A MODERN SOCIETY

- ▶ Modernization challenges the institutions and structures of traditional societies in the name of individual freedom and autonomy.
- ▶ What began to emerge in the late 20th century was a radical shift in western societies from a culture where meaning and identity were grounded in loyalty to traditional institutions and structures to one in which meaning and identity are grounded in the self as the primary agent of meaning.
- ▶ The paradox in late modern society is that risk might be increasing due to technology, science and industrialism rather than being abated by scientific and technological progress.
- ▶ The **world risk society** is full of hazards and insecurities induced by modernization itself:
  1. Globalization
  2. Individualization
  3. Gender Revolution
  4. Underemployment
  5. Global risks (ecological crisis and the crash of global financial markets)



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## LOOSENING IDENTITY AND SOCIO-POLITICAL FRAGMENTATION: « THE ARCHIPELAGO »\*

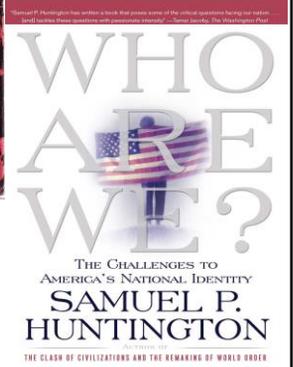
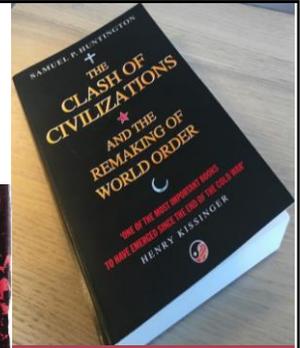
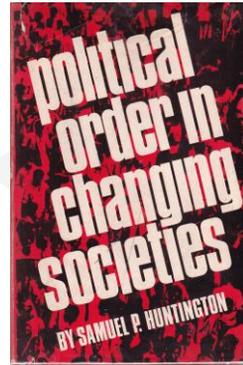
- ▶ Combination of modernization, slower growth, wider wealth gaps, and rapid immigration can produce **eroding national identity and socio-political fragmentation**
- ▶ A « **Nation** » then becomes a « **Country** » where a territory is shared by multiple ethnocultural groups with divergent interests
- ▶ Weakening institutions (parties, associations, unions, religious entities...) are unable to **aggregate diverse socio-political and cultural interests**, hence growing tensions and violence.

\* See for instance: Jérôme Fourquet, L'Archipel Français, Seuil, 2019

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# SAMUEL HUNTINGTON



[http://markweatherall.wordpress.com/2009/10/12/political\\_order\\_in\\_changing/](http://markweatherall.wordpress.com/2009/10/12/political_order_in_changing/)

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## HUNTINGTON AND THE ROOT CAUSES OF POLITICAL TURMOIL

Contrary to the expectations of modernization theory (Kuznet) ,  
**violence and instability stem from:**

- 1. rapid social change**
- 2. Centralized decision-making system**
- 3. mobilization of new groups into politics**
- 4. slow development of political institutions.**

▶ As societies modernize, they become more complex and disordered. If the process of **socio-economic** modernization is not matched by a process of **political and institutional** modernization with political institutions capable of managing the stress of modernization—the result is violence!

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## SAMUEL HUNTINGTON ANALYZING THE ROOTS OF POLITICAL UPHEAVAL

- ▶ Primary problem of politics = **lag** in the development of political institutions behind socio- economic change.
- ▶ Instability = (rapid social change + rising mobilization of new groups into politics) > development of political institutions.



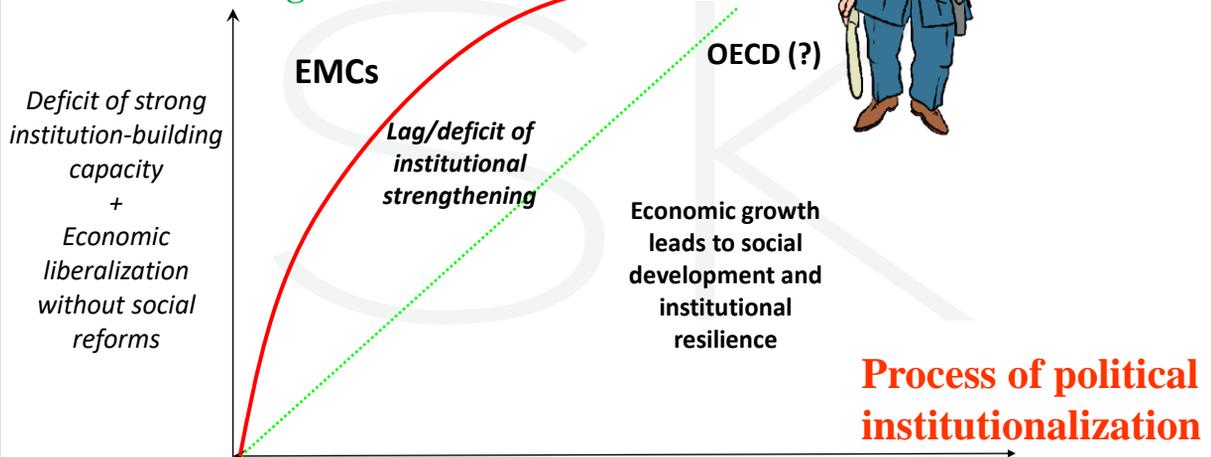
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### POLITICAL DIS/ORDER IN RAPIDLY CHANGING SOCIETIES

#### Process of socio-economic change



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**A DEFICIT IN INSTITUTION-BUILDING ALWAYS LEADS TO SOCIAL UPHEAVAL**



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**MHB: « DEVELOPMENT = ECONOMIC GROWTH  
+ KEY CONDITIONS THAT MAKE IT SUSTAINABLE! »**

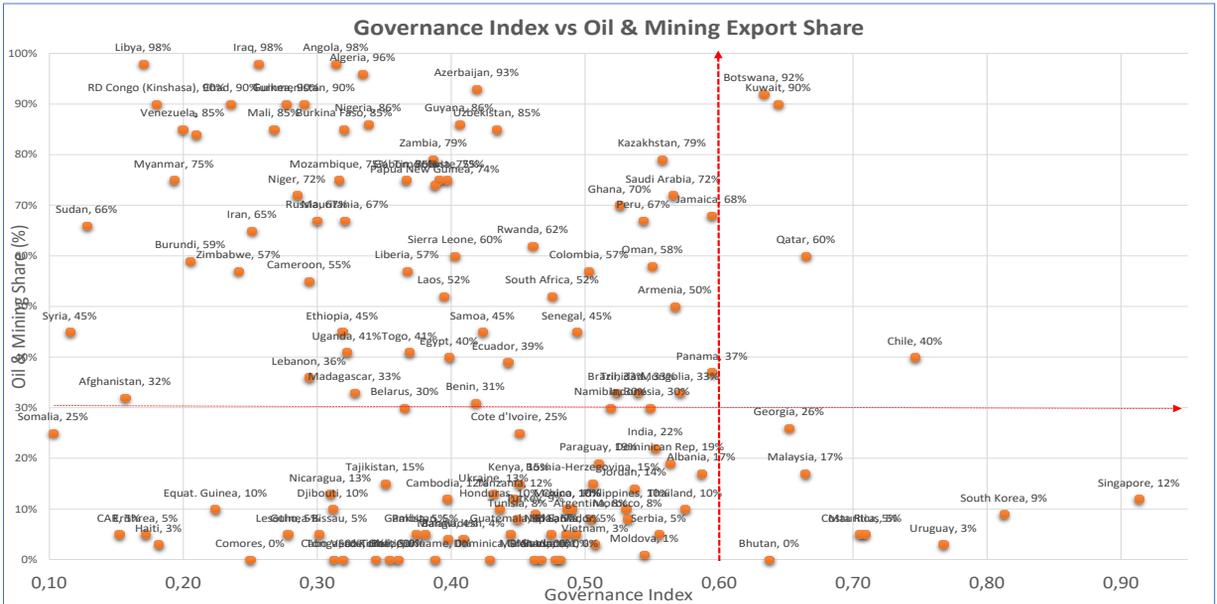
	CHILE	COSTA RICA	Turkmenistan	GABON
GDP/per capita	\$15,000	\$11,000	\$15,000	\$14,000
Life Expectancy	80	81	68	65
Global Peace Index	38/163	28/163	103	83
HDI Rank	43/190	62/190	111	119

	ARMENIA	SRI LANKA	NIGERIA	ANGOLA
GDP per capita	\$5000	\$5000	\$5000	\$5500
Life expectancy	75	77	54	60
Global Peace Index	119	145	136	84
HDI Rank	81	72	161	148



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## LARGE NUMBER OF RICH COUNTRIES WITH POOR PEOPLE



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## WHAT ARE THE DEEP ROOTS OF DEVELOPMENT, POVERTY & AND PROSPERITY?

### Where does development come from?

Geography? Physical capital? Natural resources and Climate? Luck? Human capital and education? Good governance? Repressive regimes? Religion and Culture?

The role of institutions traces back to **Adam Smith** (1750s) and **John Stuart Mill** (1850s)

**Karl Polanyi** (1920s) Primacy of politics: there is no self-regulating economic system: the key inputs into the economy are socially constructed and sustained through the exercise of government's coercive power. Society as a whole becomes subordinate to the market, i.e. "embedded" in the market economy.

**Max Weber** (1930) looks at the emergence of the capitalist market economy during the industrial Revolution and the role of the Protestant Ethics.

**Friedrich von Hayek** (1970s) (Margaret Thatcher and Ronald Reagan): market fundamentalism and neoliberalism: private investment is a better road to wealth and economic co-ordination than government spending programs. Libertarian: Government control of economic decision-making through central planning leads to tyranny!

**Douglass North** (Nobel Prize, 1993) : « Institutions provide the incentive structure of an economy; they shape the direction of economic change towards growth, stagnation, or decline ».

**Engerman & Sokoloff** (1997) focus on the role of natural resources and colonization.

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## HISTORY AND INSTITUTIONS MATTER!

### SOCIO-POLITICAL RISK IS LINKED TO INSTITUTIONAL STABILITY, HENCE TO THE HISTORICAL ROOTS OF DEVELOPMENT

1. Sokolov : [https://www.nber.org/system/files/working\\_papers/w11057/w11057.pdf](https://www.nber.org/system/files/working_papers/w11057/w11057.pdf)  
**Colonial Origins and Comparative Development:** Institutions Matter (while geography may play a small role, majority of the income variation is associated with institutions and colonial origins)  
[https://mpira.ub.uni-muenchen.de/86320/1/MPRA\\_paper\\_86320.pdf](https://mpira.ub.uni-muenchen.de/86320/1/MPRA_paper_86320.pdf)
2. Acemoglu: Colonialism mattered for development because it shaped the institutions of different societies. The **economic impact of colonialism** (extractive institutions, which strip the vast mass of the population of incentives or opportunities, are associated with poverty.)  
<https://cepr.org/voxeu/columns/economic-impact-colonialism>
3. Acemoglu, D, S Johnson and J A Robinson (2001), "The **Colonial Origins of Comparative Development: An Empirical Investigation**", American Economic Review, 91, 1369-1401.
4. Acemoglu, D, S Johnson and J A Robinson (2002), "Reversal of Fortune: **Geography and Institutions in the Making of the Modern World Income Distribution**", Quarterly Journal of Economics, 118, 1231-1294.
5. Acemoglu, D and J Robinson (2012), **Why Nations Fail**, New York: New York.
6. Putnam, R H (with R Leonardi and R Y Nanetti ) (1994) **Making Democracy Work**, Princeton: Princeton University Press.

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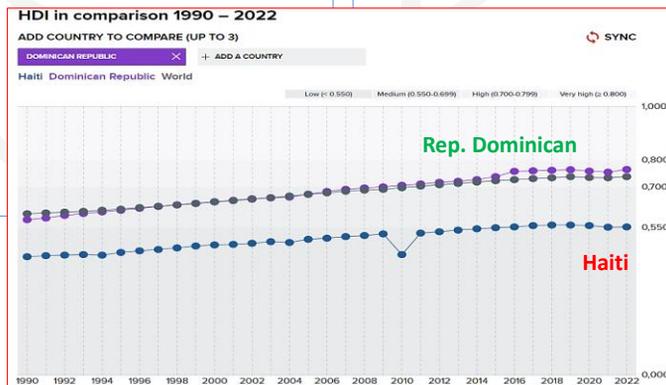
## TWO NEIGHBOR COUNTRIES, TWO POLARIZED TRAJECTORIES

### ▶ Dominican Republic

- Population: 11,2 million
- GDP growth 2024: 5%    Inflation: 4%
- PIB/capita :\$10700    HDI: 92/192
- CPI: 108/180 (Thailande)    public debt/GDP: 33%
- Representative democracy    life expect: 73

### ▶ Haiti: humanitarian crisis

- Population: 12 million
- GDP growth 2024: 0%    Inflation: 45%
- PIB/capita : \$2000    HDI= 158/192
- CPI: 172/180 (Eq Guinea)    public debt/GDP: 25%
- Protracted chaos    life expect: 63



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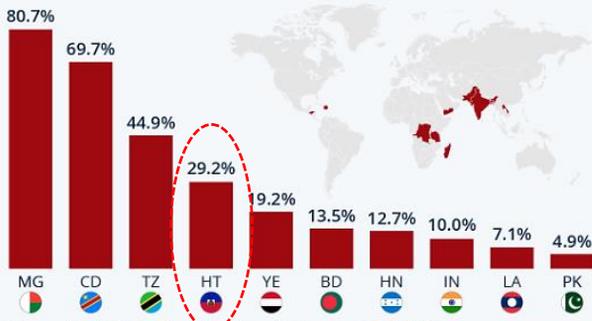
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HAITI AND THE DOMINICAN REPUBLIC SHARE THE ISLAND OF HISPANIOLA WHILE THE ECONOMIES OF THE TWO COUNTRIES WERE COMPARABLE IN THE MID-20TH CENTURY, THE DOMINICAN ECONOMY GRADUALLY IMPROVED OVER THE SUBSEQUENT DECADES. THE REPUBLIC OF HAITI, LONG PLAGUED BY POLITICAL INSTABILITY, IS CURRENTLY THE POOREST COUNTRY IN THE WESTERN HEMISPHERE

### Where People Live in Extreme Poverty

Share of people in selected countries living below the international poverty line\*

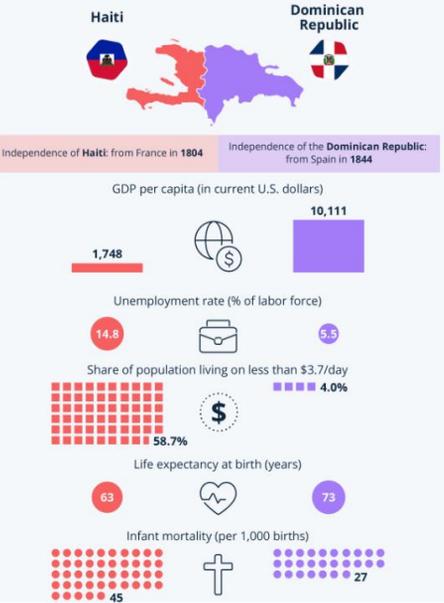


\* Currently at \$2.15 a day. Latest available year: 2018-2019. Bangladesh: 2016, Yemen: 2014, Haiti, Madagascar, DRC: 2012. Source: World Bank

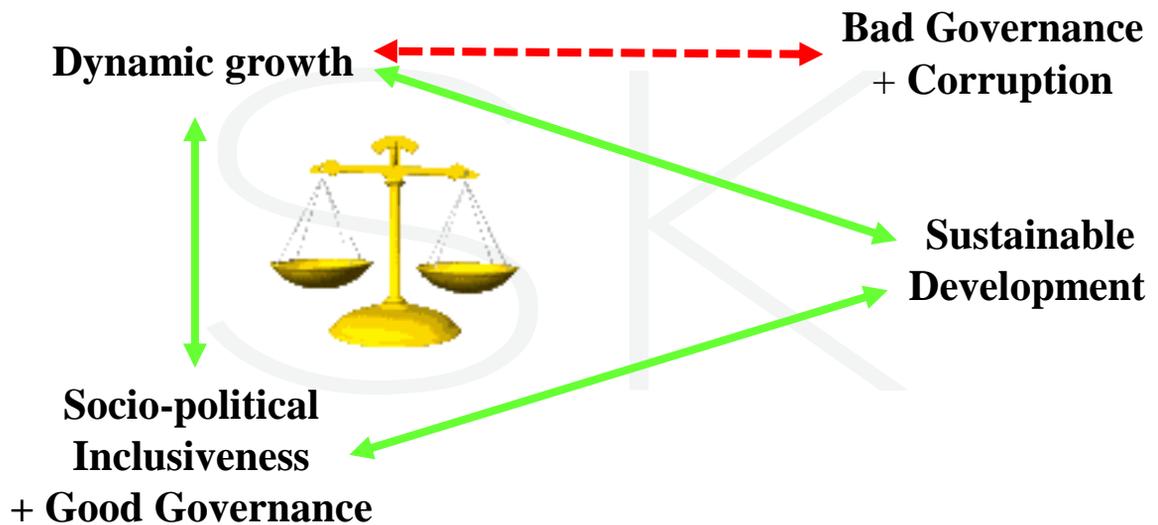
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### Haiti and the Dominican Republic: Contrasting Fortunes

Comparison of Haiti and the Dominican Republic based on socio-economic indicators



### TRILEMMA OF GROWTH AND DEVELOPMENT?



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## POLICY CHOICES, POVERTY, AND SOCIAL REBELLION

What are the root causes of economic growth? What are the ingredients of sustainable development?

### ► Capital investment-driven growth

1. Cross-country differences in income per capita stem from different paths of capital accumulation and technological progress (Hayek, Solow, Cass, Koopmans)
2. Institutions are exogenous, and the key issue is initial and local endowments (climate, culture & religion, geography, raw materials, transportations, techniques and capital goods)
3. Human capital and political stability are crucial to launch growth process

### ► Institutions-driven development

1. Differences in socio-economic institutions are the major source of cross-country differences in economic growth and prosperity (Smith, Stuart Mill, Romer, Lucas, Aghion, North)
2. Institutions provide the rules of the game in social interactions: **socio-political and economic institutions** shape the incentives for investment, production and labor; help define and protect property rights while influencing resource and income distribution! (Acemoglu, Robinson, Johnson, Rodrik)
3. Some ways of organizing societies encourage people to innovate, to take risks, to save for the future, to find better ways of doing things, to learn and educate themselves, solve problems of collective action and provide public goods. Others do not.

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## WHAT ARE THE KEY INGREDIENTS OF SUSTAINABLE DEVELOPMENT? INSTITUTIONS? FINANCING? FIXED AND HUMAN CAPITAL? GEOGRAPHY AND LOCAL ENDOWMENTS?

Do political institutions cause economic growth, or whether, alternatively, growth and human capital accumulation lead to institutional improvement?

Most indicators of institutional quality used to establish the proposition that institutions cause growth are constructed to be conceptually unsuitable for that purpose!

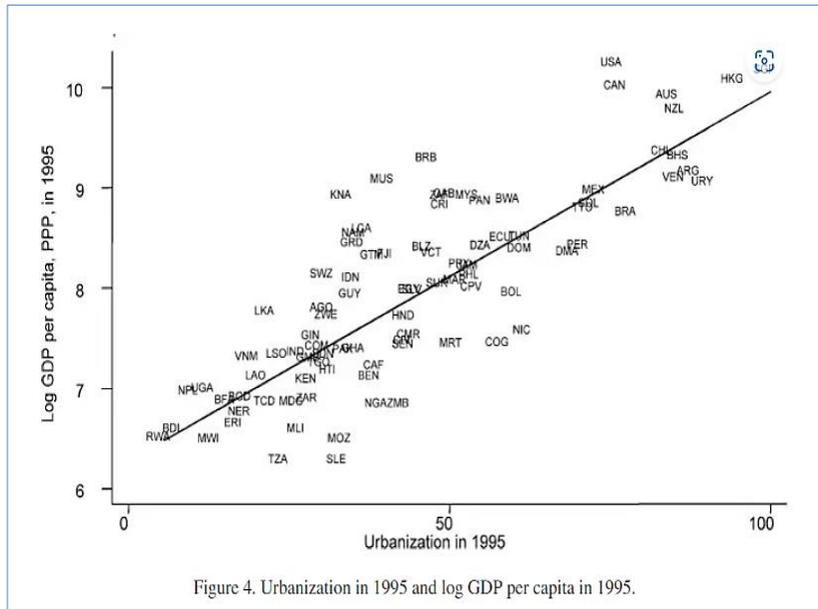
Evidence suggests that :

- a) human capital is a more basic source of growth than are the institutions,
- b) poor countries get out of poverty through good policies, often pursued by dictators,
- c) and subsequently improve their political institutions.

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## RELATIONSHIPS INSTITUTIONS & DEVELOPMENT



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### THE « DEEP » ROOT CAUSES OF POLITICAL RISK I

Since the end of the Middle Age (XIII<sup>e</sup>), humanity aimed at optimizing **individual freedom in an environment of scarcity** of time and resources. Gradually, through the European Renaissance and the Age of the Enlightenment until the Industrial Revolution, a **virtuous couple emerged: market economy & liberal democracy (?)**

**The market takes care of the resource allocation of goods & services, and the democratic framework of the allocation of rights and duties.** Property rights have paved the way to risk taking and investment in the XIX<sup>e</sup>-XX<sup>e</sup> centuries. That couple came out in the North of Italy, in Flanders, in Britain, and later in the US, to reach the whole of Europe after the Fall of the Berlin Wall in 1989. Markets need democracy (innovation, transparency, property rights) while democracy needs markets to boost socio-economic development.

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## THE « DEEP » ROOT CAUSES OF POLITICAL RISK II

**Tensions arising!** Markets are inherently **globalized** since the Industrial Revolution, while democracy is inherently **local** (with a territory and national laws).

Markets aim at satisfying **individual** needs while democracy aims at **collective** well-being!

These tensions are managed by local (Parliaments), regional (EU), and global institutions (UN, Bretton Woods).

Institutions play a key role of transmission channels between people and “elites”. So, democratic institutions create a **framework** to offset the myopia of the markets, and to introduce social and economic transfers to keep wealth gaps under control!

Otherwise, frustration and social rebellion.

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## THE « DEEP » ROOT CAUSES OF POLITICAL RISK III

### The “no-End” of History

Since 2000 (China in WTO), the leadership of the liberal capitalist world is increasingly confined: the West has lost much of its **political, cultural and ideological hegemony** in the face of growing populations and economies elsewhere.

The West believed that **exporting democracy** was the same as **creating a liberal capitalism** in its own image. The West assumed that the end of the Cold War or the modernization of the Chinese economy would cause Russia, China (or India for that matter) to adopt Western political, cultural and economic norms.

The loss of the West’s political leadership and the growing confidence of developing countries to choose their own paths and compete for market share outside the G7, create tensions within and between countries.

The **decoupling of market liberalism and democracy** fuels the risk of global fragmentation and military confrontation!

Globalization has ended and is being replaced by new regional alliances.

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## A FEW FACTS REGARDING DEMOCRACY AND DEVELOPMENT



1. Political regimes have **little** impact on **GDP growth rate**
2. **Economic growth** provides legitimacy to dictatorships (while increasing demand for political change)
3. But, **GDP per capita growth does breed democracy**
4. **Per capita income grows faster under democracy** (due to human capital and because population rises less fast than under dictatorships)
5. Growth is influenced less by the type of regime than by regime instability
6. **Democracy provides a stable political environment, hence a positive impact on sustainable growth!**

Since 1980, of the 124 EMCs that have managed to sustain a 5% growth rate for a full decade, 52 % were democracies.  
What matters is the implementation of key reforms for growth and development.

Feng, Y. Cambridge, 1997- Przeworski, A/ NYU

Ruchir Sharma 2012/Breakout Nations: In Pursuit of the Next Economic Miracles

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## PER CAPITA INCOME GROWTH AND THE QUALITY OF GOVERNANCE

DANIEL KAUFMANN & AART KRAAY, WB 11/2002

Per capita income and the quality of governance are strongly positively correlated across countries. One can separate this correlation into two components:

1. a strong positive causal effect running from **better governance to higher per capita income** and,
2. a weak and even negative causal effect running in the **opposite direction from per capita income to governance**.

The first result confirms existing evidence of the importance of good governance for economic development.

The second result suggests **the absence of virtuous circles**, in which higher incomes lead to further improvements in governance.

That results draws attention to the potential importance of elite influence and state capture in accounting for the negative effects of per capita income on governance, hence evidence of such capture in some Latin American countries.

One observes interactions of culture and formal institutions, hence the role of culture in economic development, with the importance of individualism, cooperation, trust, and various forms of regulation.

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## HOW MOVING FROM GROWTH TO SUSTAINABLE AND INCLUSIVE DEVELOPMENT?

### Assumption n°1

- ▶ Primacy of **human capital for both growth and democratization**: human and social capital shape both institutional and productive capacities of a society.
- ▶ Growth in **income and human capital** causes institutional improvement with better political institutions even with pro-market dictators: **policy choices matter** while institutional quality rises as a country grows richer
- ▶ **Economic growth and human capital accumulation** cause institutional improvement, rather than the other way around
- ▶ institutions have only a second order effect on economic performance.



### Assumption n°2

- ▶ **Democracy** and other checks on government are **key mechanisms for securing property rights and boosting growth**
- ▶ **Robust and stable institutions enhance the pace and quality of economic growth, incl. inclusiveness and better wealth gaps**
- ▶ **Robust institutions and good governance matter!**
- ▶ Democratization and constraints on government are crucial to free market-based incentives

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## ECONOMIC GROWTH + POLITICAL MODERNIZATION IN CHINA?



- ▶ Shenzhen = home to economic reform in China?

PM Wen Jiabao: « *Political reform is a necessary companion to economic modernization: without the safeguard of political reform, the fruits of economic reform would be lost* »

(August 2010)

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## WORLD BANK'S STRATEGY OF INSTITUTIONAL STRENGTHENING

*“To achieve our goal of ending extreme poverty, we must focus on people living in countries that suffer **from conflict and fragility**.*

*Our new strategy aims to address the underlying causes of fragility and invest in the long-term development that helps create the conditions for **peace and prosperity**”.*

(APRIL 16, 2019 World Bank CEO Kristalina Georgieva)

<https://www.worldbank.org/en/news/press-release/2019/04/16/world-bank-group-launches-worldwide-consultations-on-future-strategy-for-fragility-conflict-and-violence>

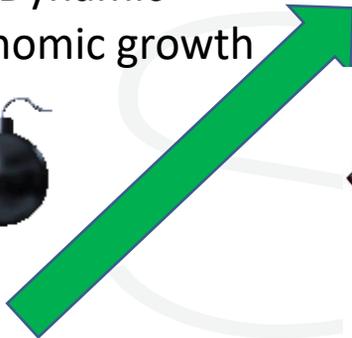
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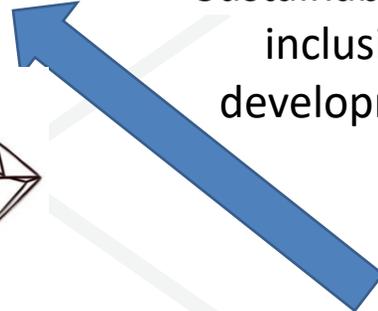
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## THE REQUIRED POLITICAL STABILITY TRIANGLE

Dynamic  
economic growth



Sustainable and  
inclusive  
development



Institutional strengthening

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## INSTITUTIONAL STRENGTHENING, ECONOMIC DEVELOPMENT AND POLITICAL STABILITY: CHALLENGING TRIANGLE!

### ► Chile's President Bachelet:

links between democratic strengthening, economic growth  
and social protection



► « In Latin America , there are countries where people are uneasy about the process of economic liberalization, because structural economic reforms were not accompanied by the social policies that were necessary! The problem has not been with open economies per se but rather the lack of action in addressing poverty and social injustice »

Interview by McKinsey Quarterly, 2007

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**Transforming economic growth into inclusive development and stable socio-political environment requires fighting Corruption and strengthening Institutions!**

### The corruption equation:

$$C \text{ (corruption)} = M \text{ (monopoly)} + O \text{ (Opacity)} + D \text{ (discretion)} + LI \text{ (loose institutions)} - A \text{ (accountability)}$$

Fighting corruption requires eliminating monopoly, reducing discretion and promoting transparency and the rule of law while increasing accountability standards and practices. (Robert Klitgaard)

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## 2025: DOWNWARD TREND OF GLOBAL CONDITIONS FOR FREEDOM AND DEMOCRACY

1. growing signs of a democratic recession spreading to the core of the world's liberal democracies, i.e., Europe and the United States.
2. long-term secular declines in confidence in governments and trust in political institutions
3. illiberal populist demagogues get elected to the presidency (Hungary, USA, Turkey...)
4. declines in the stability of democracy in less well entrenched liberal democracies (e.g., South Africa, Botswana, Mongolia, Brazil, Thailand, Turkey, Tunisia, Bangladesh)

5. rising power of Russia and especially China, and growing tendency of autocrats worldwide to identify with these powerful autocracies as models.
6. Democratic rollbacks in countries with the weakest structural and historical conditions for sustaining it (EMCs, deeply ethnically divided countries, countries with no prior experience of democracy, and countries living in bad neighborhoods: periphery of Russia)
7. The global financial crisis as well as growing wealth gaps lead to a trust decline in the equality promises of democratic systems, both economic, financial and socio-political.

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## RISING POPULISM AS A RESPONSE TO DECLINING TRUST IN DEMOCRACY

1. Anti-institutionalist: Populism stems from a crisis in social mediations: institutions are no longer trusted
2. Anti-elitist, condemning the corrupt dominance of established elites whose interests do not align with the majority of the people.
3. Plebiscitary, favoring mass mobilization of the popular majority, and a direct relationship between the populist leader

4. promoting deep economic and institutional reforms that break up monopolies, redistribute power and income, attenuate injustices, and invite new grassroots forms of political participation
5. People believe that they are being ripped off by the political and economic "establishment"
6. populist politics is always dancing with the devil. All forms of populism, even progressive, democratically inspired, harbor an intrinsic tendency to become a runaway train!

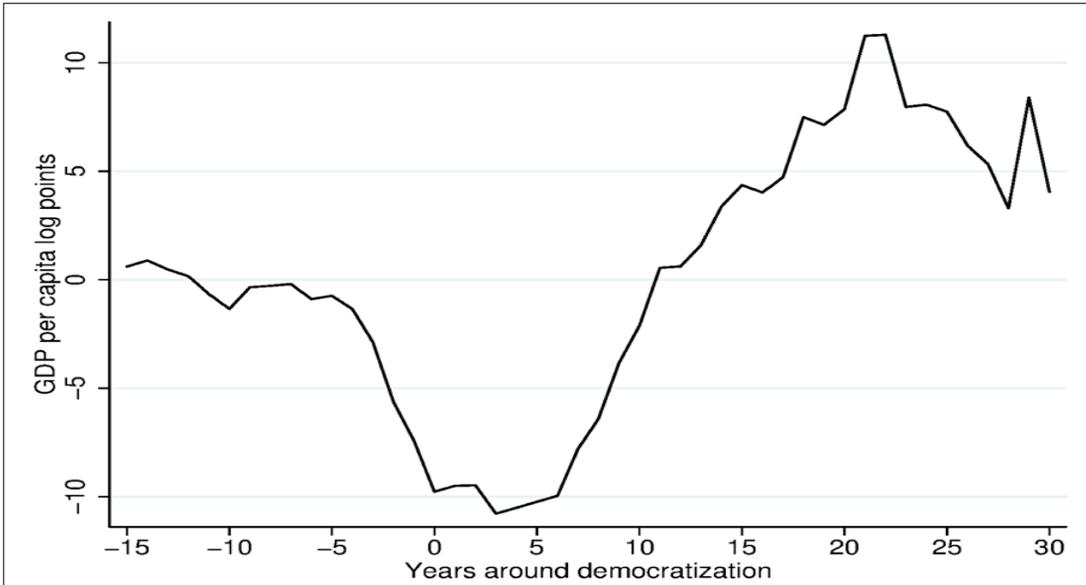
Source; Stanford, Diamond Democracy

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**DEMOCRACY BREEDS GDP PER CAPITA GROWTH WHILE ECONOMIC GROWTH LEADS TO DEMOCRACY  
(ACEMOGLU & ROBINSON)**

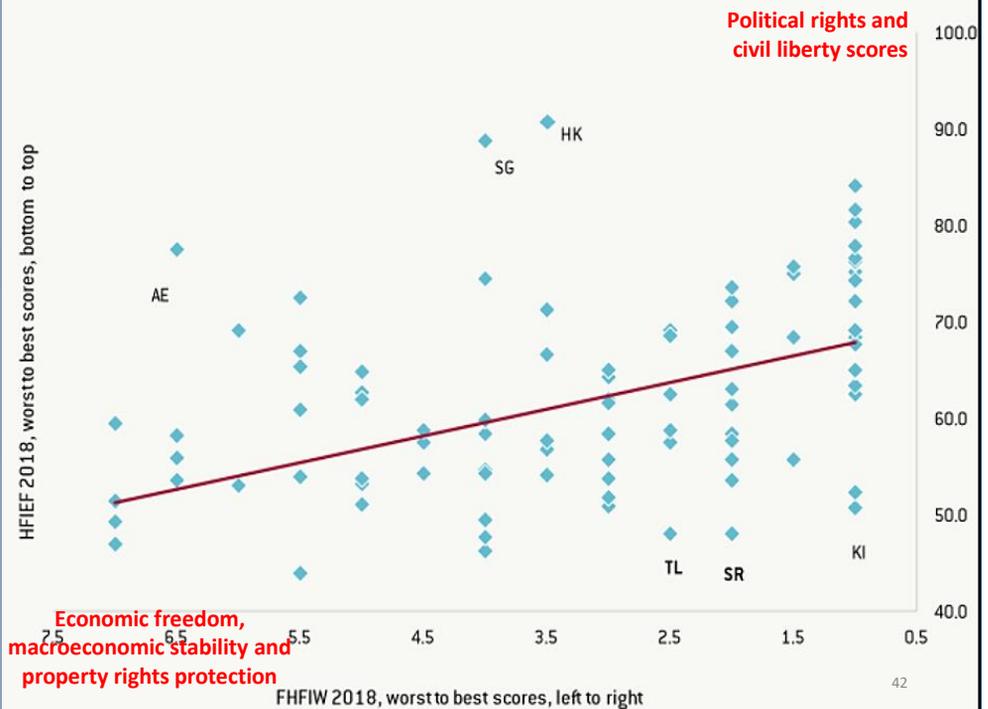


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**IS THERE A CORRELATION BETWEEN POLITICAL FREEDOM & ECONOMIC FREEDOM?**

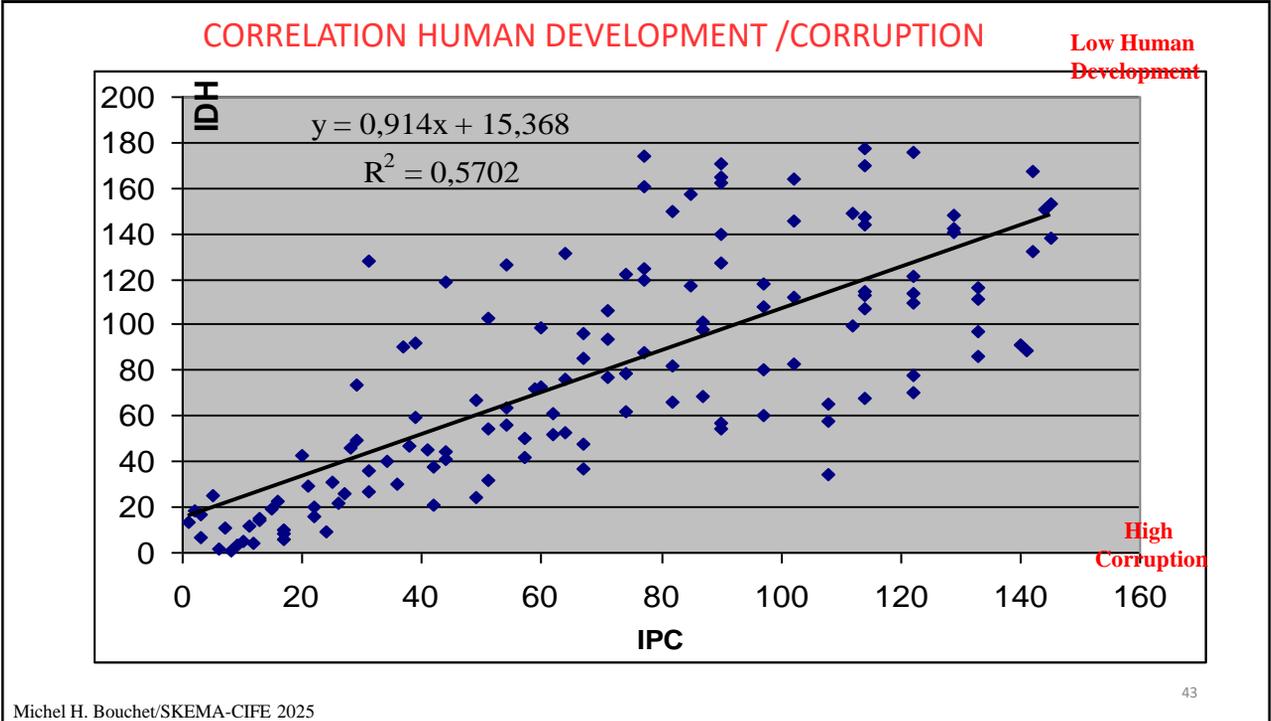


Source: Bruegel, 2018

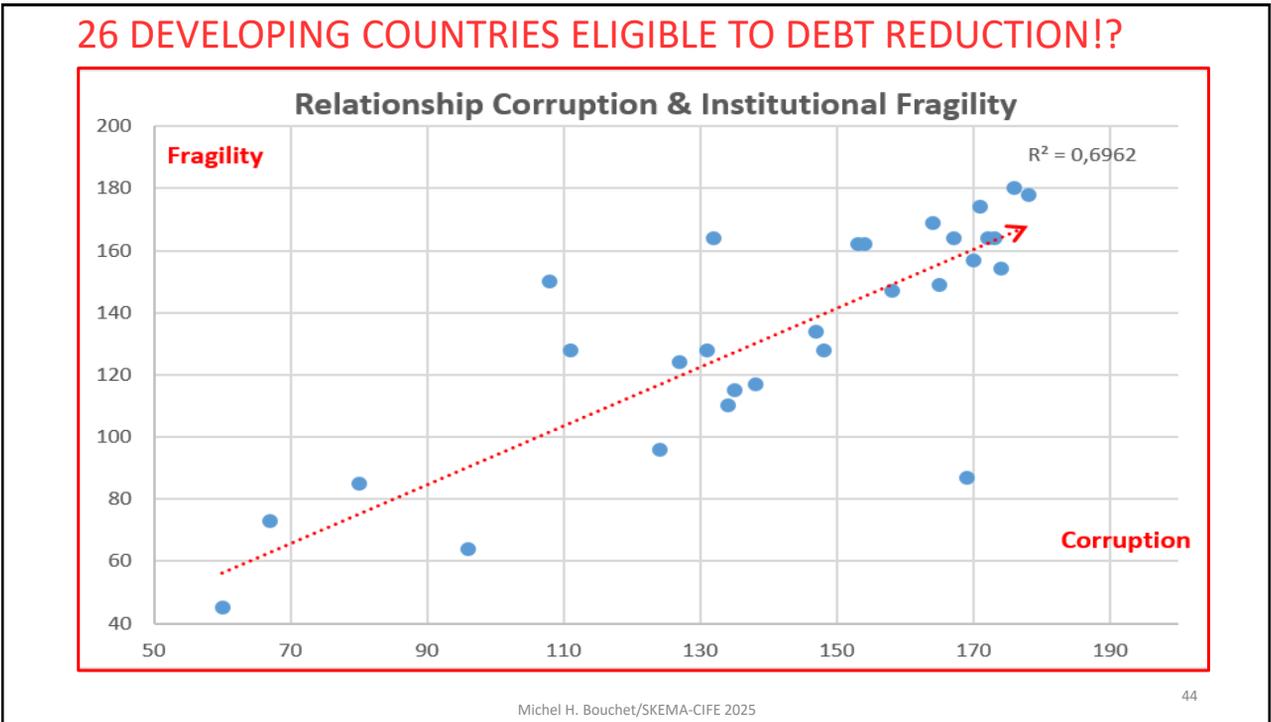
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