Income Inequality and Political Instability

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1. Introduction

Income inequality is often regarded as an inevitable phenomenon which is caused by the competition for resources in the market. However, given inequality is a fundamentally political issue, it may also have political consequences in the form of rising social discontent and political instability (Parvin, 1973). Establishing a point where income inequality triggers political unrest has long been a challenging task for scholars. Numerous empirical studies have focused on various political and economic factors including political regime type, economic growth, and inflation rates as the main determinants of political instability (e.g., Blanco and Grier, 2009; Miljkovic and Rimal, 2008; Gasiorowski, 1998). Yet, the role of income inequality and its combined impact together with other factors such as the quality of institutions on political unrest remains relatively unexplored. The aim of this research is to investigate to what extent and under what conditions income inequality causes political instability. It examines the effect of income inequality on political instability through two hypotheses. First, we argue that there is a causal link flowing from high income inequality to political instability. Second, we contend that this relationship is conditional upon institutional quality. Our regression results obtained from panel data for an unbalanced sample of 180 countries over the period from 1996 to 2019 confirm the negative relationship between Gini index and political stability when the representative countries had low institutional quality.

This research makes several contributions toward the understanding of the cause-and-effect chain of income inequality and political instability. First, it suggests that income inequality can be of two types depending on the functioning of markets in different countries: market-induced and non-market-induced. The former manifests itself in countries where competitive and well-functioning markets co-exist with higher institutional quality while the latter arises in countries with dysfunctioning markets and lower quality of institutions. Such classification of income inequality has not been used in the literature to the best of our knowledge.

Quality of institutions including protection of property rights, rule of law, control of corruption and safeguard of human rights shape market outcomes. This is supported by the findings of various cross-country empirical studies (Hall and Jones, 1999; Acemoglu et al., 2001; Rodrik et al., 2004). Therefore, income inequality in countries with high institutional quality is considered as market-induced, and it is less likely to cause political instability. On the other hand, income inequality in countries with low institutional quality is deemed as a distributional outcome of mostly non-market forces. The subversion of rule of law can result in unequal allocation of power in society which will put individuals who hold positions of authority in a more advantageous position over others. Income inequality is one of the direct consequences of such inequality of opportunity.

The second, and more important, contribution of this study is that income inequality may bring about a different effect on political instability depending on its underlying cause. This cause is determined by the quality of institutions. Thus, political stability can only be shaken by the joint impact of income inequality and institutional quality when all other things are held equal. Evidence from this research has important policy implications. To maintain political stability in countries with severe income inequality and weak institutions, it is not enough to implement redistributive policies only. Efforts to ensure political stability should be more directed toward reforming economic and political institutions.

2. Data and Methodology

The general form of the panel data model that we will estimate looks as follows:

$$Pol\_st_{i,t} = \beta_0 + \beta_1 * Gini_{i,t} + \beta_2 * Inst\_qual_{i,t} + \beta_3 * Gini_{i,t} * Inst\_qual_{i,t} + Controls_{i,t} + \varepsilon_{i,t} .$$

The control variables of our model include GDP per capita growth, degree of political competition, share of population using the internet, inflation rate, and the rate of unemployment.

As our dependent variable we use the index called Political Stability and Absence of Violence from the Worldwide Governance Indicators (WGI) of the World Bank. As our measure of income inequality, we use the standardized Gini index obtained from the latest version of the UNU-WIDER World Income Inequality Database (WIID). (Additionally, though not reported here in the proposal, we use an alternative measure of income inequality called the Palma ratio, which we obtain from the WIID.) We construct the variable institutional quality by using the WGI's five governance indicators, namely, Voice and Accountability, Government Effectiveness, Regulatory Quality, Rule of Law, and Control of Corruption. For that, we take the normalized average of the mentioned five indices, so that our institutional quality index takes on the values between zero and one.

The data on political competition comes from the Polity5 Project of the Center for Systemic Peace. The data on the percentage of population using the internet originates from the International Telecommunication Union's (ITU) World Telecommunication/ICT Indicators Database. Additionally, we use the data on annual inflation rate (based on consumer prices) originating from the International Monetary Fund and the data on total unemployment rate from the International Labor Organization.

We estimate our model using the fixed effects (within) estimator that allows us to account for country-specific time-invariant factors. (The Hausman test based on our preliminary regressions also suggests that the fixed effects estimator must be preferred to random effects.) To be able to give a direct causal interpretation to the potentially destabilizing effect of income inequality, we may use the two-stage least squares (2SLS) approach at a later stage of our research. This, however, is dependent on us being able to find a valid instrument for income inequality.

3. Preliminary results

Our preliminary results suggest that the effect of income inequality (i.e., the standardized Gini index) on political stability is conditional on the quality of institutions: at low levels of institutional quality increased Gini is associated with higher political instability, while this destabilizing effect fades away with improvements in institutional quality. This is true both when we use the contemporaneous values and the lagged values of the Gini index, institutional quality and their interaction as the explanatory variables.