

Divided We Fall

The Hidden Costs of Political Polarization on Macroeconomic Performance

William Ginn Jamel Saadaoui

Labcorp AI; Coburg University of Applied Sciences; University Paris 8 – IEE, LED

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Research question

Question

What are the dynamic macroeconomic costs of rising political polarization?

- ▶ Outcomes: output growth, capital formation, and government debt as a share of GDP.
- ▶ Coverage: annual panel of 168 countries, 1985–2023.
- ▶ Method: panel local projections estimated with system GMM.
- ▶ Heterogeneity: advanced versus emerging economies, and democracies versus autocracies.

Why polarization is macroeconomic, not only political

- ▶ Polarization increases political uncertainty and can delay policy stabilization.
- ▶ It discourages investment by raising the option value of waiting and the perceived risk of policy reversal.
- ▶ It weakens fiscal discipline when distributional conflict blocks consensus over taxes, spending, and debt reduction.
- ▶ It can damage both democratic and autocratic systems, though through different institutional channels.

Main message

Polarization is a hidden macroeconomic shock: lower output, lower capital formation, and higher debt.

Data overview

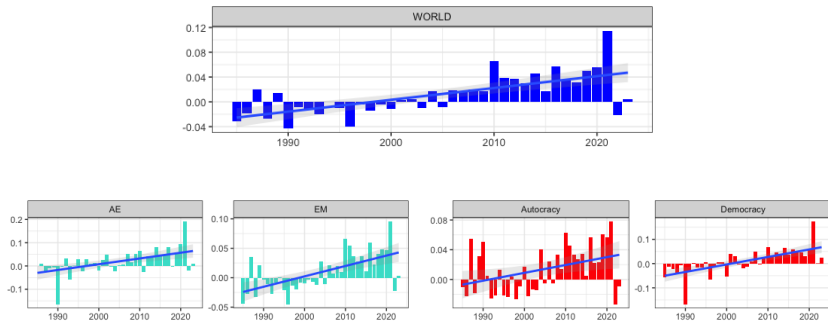
Variables and sources			Descriptive statistics			
Variable	Symbol	Source	Variable	<i>N</i>	Mean	SD
Real GDP	$\ln Y_{it}$	World Bank	GDP growth	5,702	3.49	3.67
Real capital formation	$\ln K_{it}$	World Bank	Capital growth	4,148	4.00	12.90
Government debt (% GDP)	D_{it}^G	World Bank	Debt (% GDP)	1,637	68.91	43.30
Consumer prices	$\ln P_{it}$	World Bank	CPI inflation	5,702	9.99	24.00
Political polarization	POL_{it}	V-Dem	Democracy index	5,702	0.521	0.267
Electoral democracy	D_{it}	V-Dem	ΔPOL	5,702	0.013	0.285
Regime classification	R_{it}	V-Dem				

Sample

Unbalanced annual panel of 168 countries, 1985–2023. Growth and inflation variables are winsorized.

Source: Tables 1 and 2.

Political polarization has risen since the mid-2000s



Source: Figure 1. Original embedded graphics extracted directly from the paper PDF.

Measurement and sample design

- ▶ Polarization comes from V-Dem political polarization scores, converted to latent continuous measures.
- ▶ Higher values indicate that society is polarized into antagonistic political camps.
- ▶ Macroeconomic variables come from the World Bank: real GDP, real capital formation, CPI, and public debt.
- ▶ GDP growth, capital growth, and inflation are winsorized to reduce the effect of extreme observations.
- ▶ Regimes are grouped from V-Dem as democracies and autocracies; income groups follow IMF WEO classifications.

Panel local projections with GMM

$$\Delta \ln Y_{i,t+h} - \Delta \ln Y_{i,t} = \alpha_i + \gamma_t + \beta_h \Delta POL_{i,t} + \nu X_{i,t-1} + \varepsilon_{i,t+h}$$

$$\Delta \ln K_{i,t+h} - \Delta \ln K_{i,t} = \alpha_i + \gamma_t + \beta_h \Delta POL_{i,t} + \nu X_{i,t-1} + \varepsilon_{i,t+h}$$

$$Debt_{i,t+h} - Debt_{i,t} = \alpha_i + \gamma_t + \beta_h \Delta POL_{i,t} + \nu X_{i,t-1} + \varepsilon_{i,t+h}$$

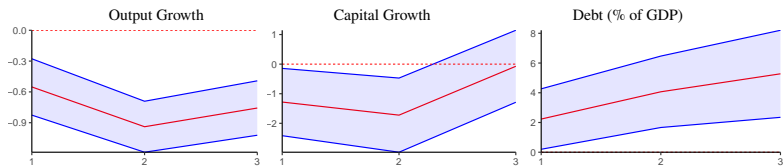
- ▶ Country and time fixed effects absorb persistent cross-country differences and global shocks.
- ▶ Lagged controls include output growth, inflation, democracy, polarization, and the response variable.
- ▶ LP-GMM helps address feedback from macroeconomic weakness to polarization.

Reading the impulse responses

- ▶ Shock: one-standard-deviation increase in the change in political polarization.
- ▶ Horizon: cumulative responses over three periods.
- ▶ Confidence bands: 90% intervals.
- ▶ Interpretation: the plots show how polarization shocks change macroeconomic paths relative to the pre-shock trend.

Aggregate effect: lower output and capital, higher debt

Figure 2: Aggregate Panel LP Cumulative IRF



Note: aggregate panel includes 168, 141 and 82 countries.

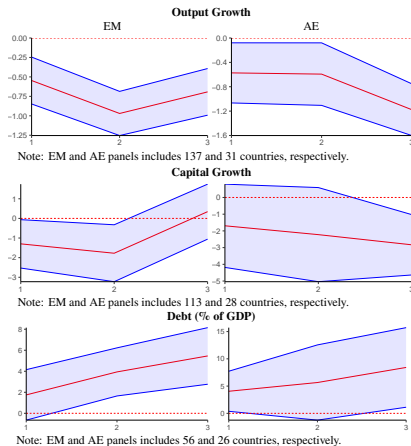
Source: Figure 2, aggregate panel LP cumulative impulse responses.

Aggregate magnitudes

- ▶ A one-standard-deviation polarization shock lowers GDP growth by about 0.6 percentage points on impact.
- ▶ Capital growth falls by about 1.1 percentage points on impact.
- ▶ Public debt rises by about 2.1 percentage points of GDP on impact and continues to increase over the horizon.
- ▶ The debt response suggests that polarization impairs fiscal adjustment as well as private-sector accumulation.

Heterogeneity by income group

Figure 3: Heterogeneous Panel LP Cumulative IRFs (Income Type)



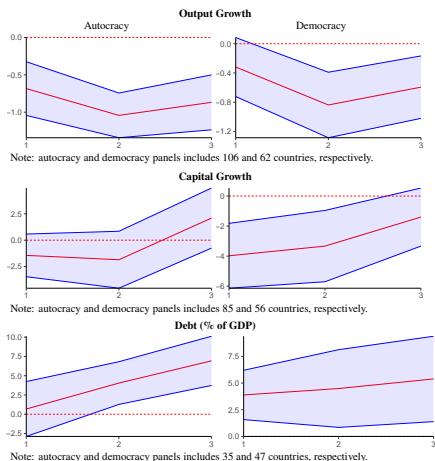
Source: Figure 3, heterogeneous cumulative IRFs by income type.

Income-group interpretation

- ▶ Both advanced economies and emerging markets experience weaker output and capital accumulation.
- ▶ The contraction in capital growth is sharper in advanced economies, indicating a strong investment channel.
- ▶ Debt increases in both groups, with a stronger and more persistent response in advanced economies.
- ▶ The results reject the view that polarization is mainly a problem for weaker or poorer economies.

Heterogeneity by political regime

Figure 4: Heterogeneous Panel LP Cumulative IRFs (Political Regime)



Source: Figure 4, cumulative IRFs by political regime.

Regime interpretation

- ▶ Output growth declines in both autocracies and democracies: approximately 0.6% and 0.4%, respectively.
- ▶ Capital growth falls by about 1.3% in autocracies and about 4.0% in democracies.
- ▶ Public debt rises in both regimes, but autocracies begin to outpace democracies by the third period.
- ▶ Democracies may have better conflict-resolution channels, but they are not insulated from macroeconomic losses.

Mechanisms: why the effects appear

Output

- ▶ Policy uncertainty
- ▶ Gridlock
- ▶ Lower confidence

Capital

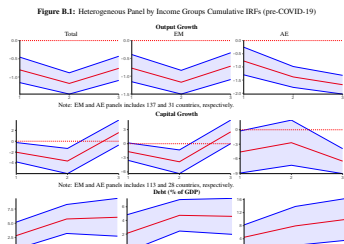
- ▶ Investment delays
- ▶ Higher risk premia
- ▶ Lower predictability

Debt

- ▶ Fiscal conflict
- ▶ Delayed stabilization
- ▶ Weak debt-reduction coalitions

Robustness: pre-COVID estimates

- ▶ The main patterns do not depend on the COVID-19 shock.
- ▶ Pre-2020 estimates preserve the sign and interpretation of the aggregate and heterogeneous responses.
- ▶ The paper reports 18 alternative LP models by income and political regime.
- ▶ Across the complete set of 27 LP models, conclusions remain consistent.



Positioning relative to the literature

- ▶ The paper connects political polarization to classic channels: instability, policy delay, fiscal conflict, and investment uncertainty.
- ▶ It extends country-specific or regional studies to a global panel of 168 countries.
- ▶ It adds dynamic macro responses using local projections rather than static cross-country correlations.
- ▶ It shows that polarization is costly across income groups and regime types.

Policy implications

- ▶ Political dialogue and institutional mechanisms for consensus are macroeconomic stabilization tools.
- ▶ Fiscal rules and independent institutions may reduce the debt consequences of polarization.
- ▶ Investment policy must account for political-risk channels, especially in environments with rapid polarization shifts.
- ▶ International institutions should treat polarization as a macro-financial vulnerability, not only as a governance indicator.

Limitations and extensions

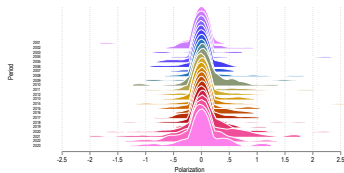
- ▶ The paper estimates average dynamic responses; mechanisms require complementary micro or political-institutional evidence.
- ▶ Debt data availability is narrower than output data, reducing the cross-country sample for fiscal results.
- ▶ Future extensions can separate ideological, affective, and elite polarization.
- ▶ A natural next step is to link polarization shocks to policy uncertainty, sovereign spreads, and private investment decisions.

Conclusion

- ▶ Political polarization depresses output growth and capital formation.
- ▶ It raises government debt, indicating weaker fiscal discipline or delayed adjustment.
- ▶ The costs are broad-based: advanced economies, emerging markets, democracies, and autocracies are all affected.
- ▶ The macroeconomic consequences of polarization may become more severe as polarization rises globally.

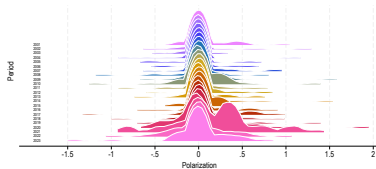
Backup 1: density plots of polarization changes

Figure A.1: Ridge density plot for change in polarization in Autocracies



Data source: V-dem database (Vocacamps).
Higher values mean society is polarized into antagonistic political camps.

Figure A.2: ridge density plot for change in Polarization in Democracies

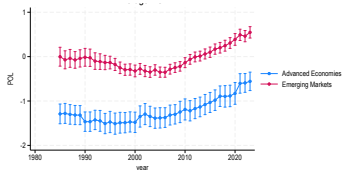


Data source: V-dem database (Vocacamps).
Higher values mean society is polarized into antagonistic political camps.

Source: Appendix Figure A.1 and A.2.

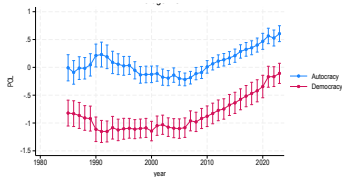
Backup 2: average polarization by income and regime

Figure A.3: Panel graph for Mean Polarization (Country Income)



Data source: V-dem database (V-Demcamp).
Higher values mean society is polarized into antagonistic political camps.
Standard error of the mean are represented in the error bars.

Figure A.4: Panel Graph for Polarization (Political Regimes)

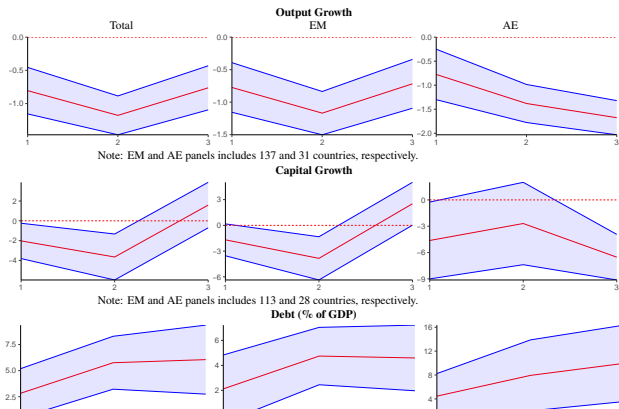


Data source: V-dem database (V-Demcamp).

Source: Appendix Figure A.3 and A.4.

Backup 3: pre-COVID robustness by income group

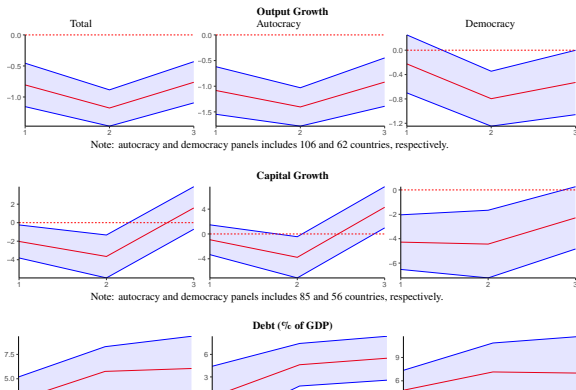
Figure B.1: Heterogeneous Panel by Income Groups Cumulative IRFs (pre-COVID-19)



Source: Appendix Figure B.1.

Backup 4: pre-COVID robustness by political regime

Figure B.2: Heterogeneous Panel Political Regimes Cumulative IRFs (pre-COVID-19)



Source: Appendix Figure B.2.

Backup 5: technical notes

- ▶ The shock variable is the change in V-Dem political polarization.
- ▶ The LP-GMM specification uses country and time fixed effects.
- ▶ Lagged controls include the response variable, real output growth, inflation, democracy, and polarization.
- ▶ Cumulative impulse responses are shown with 90% confidence bands.
- ▶ Country counts vary by response variable because debt and capital data have more missing observations.