Inequality and Political Power

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By David Leonhardt
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In one of our recent Book Chats, Tyler Cowen offered his diagnosis for slow-growing income: a slowdown in innovation. Jacob Hacker and Paul Pierson have a different diagnosis. In their recent book, "Winner-Take-All Politics," they point to government policies that have helped the affluent at the expense of the middle class and the poor.

Mr. Hacker is a professor at Yale, and Mr. Pierson is a professor at the University of California, Berkeley. You can see a video of Mr. Hacker and Mr. Pierson speaking about the book, and read Jonathan Alter's review of the book for The Times. My conversation with the authors follows.

Q. *A common argument, especially from the political left, is that a change in the power dynamic between employers and employees is a central reason for the rise in inequality. Your book explores this theme in detail. I'm certainly open to the argument, but I think it often lacks sufficient granularity. That is, how exactly have deregulation, the decline of unions and a more business-friendly judiciary caused wages to stagnate for many workers? How have these changes led to an explosion of incomes in finance? A growth in the college premium? The connections are not entirely obvious.*

Mr. Hacker: We're certainly not arguing that changes in the balance of power are the only cause of inequality and stagnating wages. The college premium has indeed grown, though it's hard to see how this accounts for the most striking and distinctively American development – namely, the extreme concentration of economic rewards at the very, very top of the economic ladder. Most of those who have a college degree haven't shared in the really big gains experienced by the top 1 percent or top 0.1 percent (average 2007 income: $7 million), which has seen its share of income more than quadruple since the early 1970s.

The big question is whether these outsized rewards could have been distributed more broadly given different economic policies. We're convinced the answer is yes. The key to getting the answer right, we argue, is to look beyond the economics of rising inequality to examine the politics. Much of our book traces how major changes in policies governing finance, corporate governance, taxation, and industrial relations helped fuel the "winner-take-all economy." These changes, we show, directly reflected the declining clout of middle-class voters and unions relative to a much more organized and mobilized corporate sector.

Mr. Pierson: We need to think more broadly about what shapes markets and the distribution of economic rewards. For instance, economists generally err in thinking that unions influence the income distribution mostly through direct negotiations with employers. Instead, we argue the most important role these forces play is to create some organized countervailing pressure in Washington. Cross-national research suggests that strong labor unions are associated with greater government redistribution through taxes and transfers. The United States is one of only a handful of countries where government taxes and benefits have become less redistributive as inequality has grown.

And failure to compensate for rising inequality through taxes and benefits is only the tip of the iceberg. From industrial relations policy to regulation of executive pay to financial deregulation, policy makers either remade markets in ways that encouraged inequality or stood on the sidelines (despite plenty of complaints and clear alternatives) as changes in the market outran existing policy rules. Especially after the financial crisis, it's hard to deny that some of the big policy shifts that enriched those at the top have contributed substantially to the hardships faced by the middle class.

Q. *You date the key change in American politics to the late 1970s, when you argue that corporate America realized it needed to become more aggressive in Washington. "Business must learn the lesson," a Chamber of Commerce official named Lewis Powell (who later became a Supreme Court justice) wrote at the time, "that political power is necessary." The Business Roundtable formed in the 1970s, and the Chamber and the American Enterprise Institute both grew rapidly.*

In several areas, you offer the kind of details that are too often missing from critiques of corporate power — the surprising 1978 defeat of a new consumer-protection agency, the defeat of a bill that would have curbed antiunion practices, the pre-Reagan decline in tax rates that mostly affected the affluent. But there are two areas where I'm interested in hearing more: executive pay and finance.

You write that chief executives' check should be stamped, "Made possible by Washington." How, specifically, has Washington changed executive pay? And how is Washington most culpable for the financial crisis? I don't see how the 1999 repeal of the Glass-Steagall Act — a move that allowed the combination of investment and commercial banks — played a major role. The firms that caused the most damage (Lehman Brothers, Merrill Lynch, A.I.G.) were not combined investment-and-commercial firms.

Mr. Hacker: One reason we stress government's hand in generating extreme top-end inequality is because we think Washington's role isn't limited to passing big new laws. We also have to look at how the enforcement of existing regulations was politically undercut and, even more important, at how policy makers failed to step in as existing laws were rendered obsolete by decades of rapid economic change. A big part of the policy story is what we call "drift" — the deliberate failure to update policies to reflect changing economic realities (despite viable and popular alternatives) due to the pressure of those benefiting from such calculated inaction.

Take executive pay. Not only are U.S. executives much more lavishly paid than they were just a couple decades ago, they are also much more lavishly paid than their counterparts in other successful economies. Moreover, their compensation is often much more weakly connected to performance. As Lucian Bebchuk of Harvard and others have documented, many features of American corporate pay practices seem designed to maximize C.E.O. leverage and minimize oversight— something the corporate scandals of the early 2000s cast in stark light.

Why have these tilted arrangements thrived? We show in our book that corporate managers, who are highly organized, have had reliable friends in Washington. Political leaders supported these practices, and resisted efforts to strengthen shareholders, even as executive pay skyrocketed. The memoirs of Arthur Levitt Jr., S.E.C. head under Clinton, are unambiguous and revelatory on this

point. One prominent example we explore is the political furor regulators generated when they proposed more reasonable accounting standards for grants of stock options, the main technique used to boost (and hide) executive compensation after 1990. Prominent politicians, including Democratic senators like Joe Lieberman, were instrumental in forcing the regulators to back down.

Mr. Pierson: The story of finance is similar. We agree that the repeal of Glass-Steagall itself was not central to the financial crisis. But it was symbolic of a broad reorientation of Washington policy to support a vastly more prominent and aggressive financial sector. Finance expanded much more dramatically in the United States than it did in most other countries. Legislators and regulators encouraged this all along the way, both through a steady removal of regulatory obstacles and through a consistent lethargy in developing effective regulation of financial innovation and evolving practices in the banking sector. The most prominent example is the failure to regulate derivatives, which were central to the financial implosion. Numerous figures, including prominent regulators, sounded the alarm about derivatives. They were beaten back in organized political combat by prominent allies in Washington from Robert Rubin to Phil Gramm.

In short, policy was changed to benefit executives in many cases. But at least as important, it was also allowed to become less effective or even relevant — not because there wasn't a strong case or public support for stronger laws, but because powerful organized interests were pressing political leaders to look the other way.

Q. *How would you evaluate the Obama administration's first two years?*

Mr. Hacker: If we were passing out grades (without grade inflation!) we would give the administration a B. The political system, on the other hand, gets a D. And we would include a note indicating that it's in danger of failing.

The big achievements of the first two years were health reform, financial reform, and a major stimulus package (including additional payroll tax relief in the recent tax deal). All these are major breakthroughs, even if they clearly do not match the scale of the crisis we face. To be sure, the president made mistakes: His economic team was too close to Wall Street, for example, and he over-claimed for the recovery package and didn't leave himself sufficient room for additional action. But we're convinced that the really deep problems aren't with Obama or his team. They're with our political process, which makes meaningful reform that threatens powerful economic interests extraordinarily hard.

Mr. Pierson: The last two-and-a-half years have vividly showcased the basic problems we identified in "Winner-Take-All Politics." First, there is the entrenchment of narrow economic interests, which are very well connected and powerful in both parties. Second, there is the vastly increased role of the Senate filibuster — a huge change in the character of American governance, which essentially makes 60 votes a requirement on all nonbudget legislation. And third, there is the reality that the Republican Party has become both increasingly cohesive and increasingly conservative on economic issues. Actually, we should say "radical" rather than "increasingly conservative" since prominent G.O.P. figures now express many views on economic matters (tax

cuts reduce deficits, slashing spending creates jobs, markets are self-regulating) that are well outside the mainstream consensus of the past 60 years or so.

All three of these developments have badly stacked the deck against economic and political reform. This has become all the more clear in recent months, as Washington has shifted from insufficient concern about the problems in our economy to excessive preoccupation with deficits (even as it extended the high-end Bush tax cuts in the face of consistent public skepticism). So watching all this unfold left us more sympathetic to the administration, but even more deeply concerned about the political process as a whole.