

# XXIV INTERNATIONAL CONFERENCE OF THE “GIORDANO DELL'AMORE” OBSERVATORY ON THE RELATIONSHIP BETWEEN LAW AND ECONOMICS

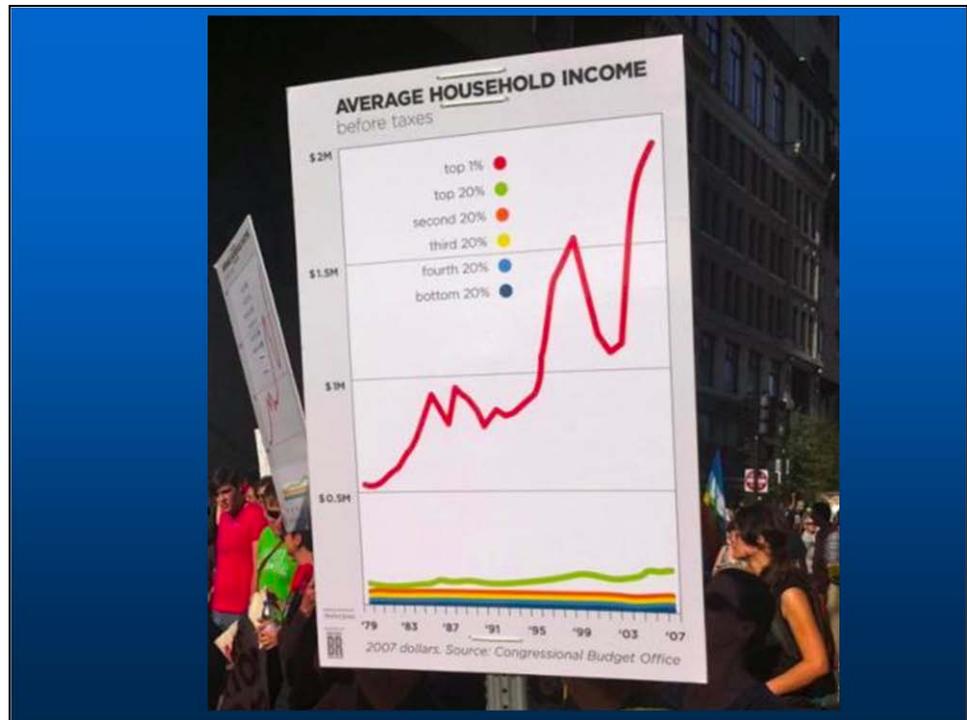
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Good afternoon, I am very pleased to be here. I want to start by thanking my co-author, Paul Pierson, who regrets he can't be here today.

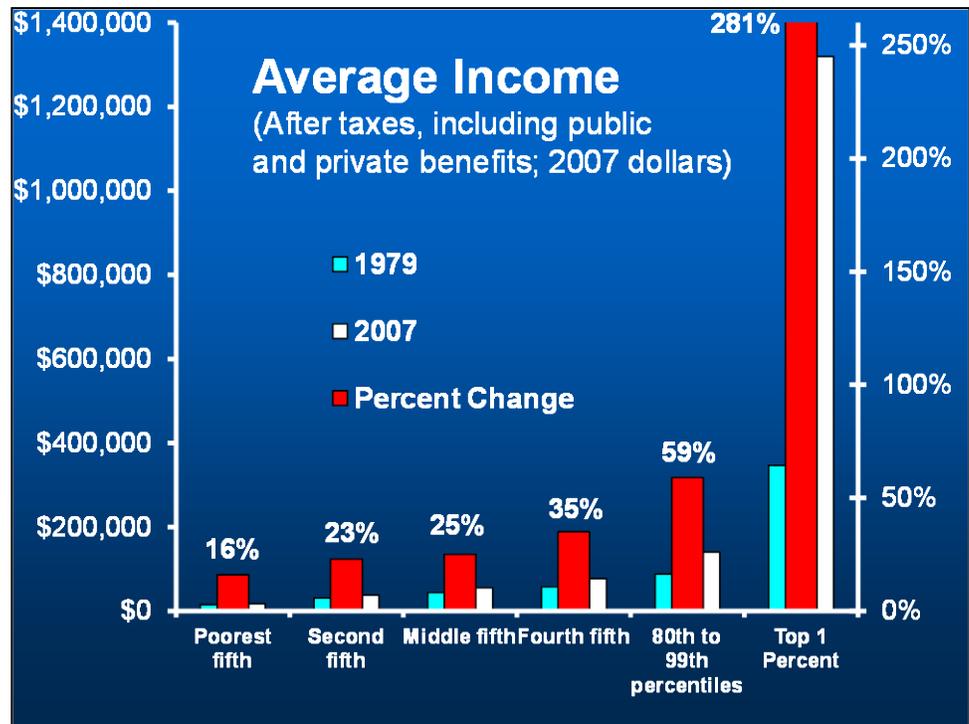
Asking an American to speak about how to tackle inequality might be akin to asking an atheist to speak about world religions. The United States has of course set the standard for economic inequality over the last generation, and right now there are major protests in the United States about the issue.

I mention the Occupy Wall Street protests in part because they have brought a lot of attention to this issue. In fact, I noticed in the coverage of the protests someone holding up a poster with a Congressional Budget Office graph on the changing distribution of income in the United States. I have to warn you that like this protester, I do like statistics. My defence is that I once heard someone say it's the mark of an educated man to be deeply moved by statistics. I hope you share my passion.



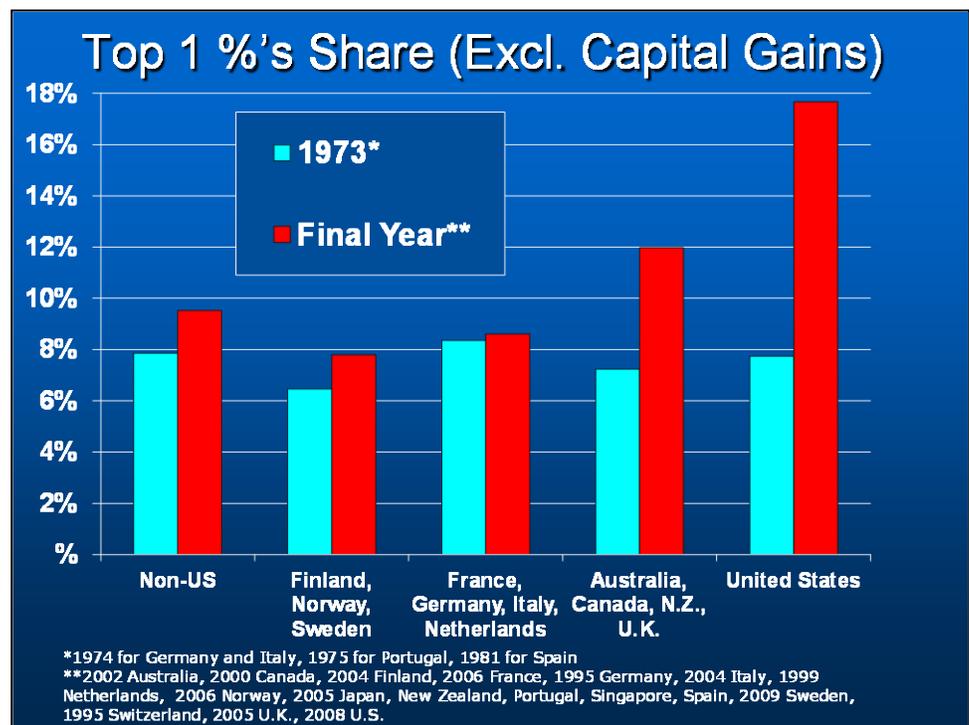
You can sum up the basic puzzle of my book with Paul in this one figure. What the Congressional Budget Office has done is produce a measure of income that includes government taxes and transfers. It also includes employer-provided health insurance and retirement pensions, as well as federal benefits like Medicaid that are close to cash transfers. The CBO measure is close to the best measure that we have of how much income people have. And what the CBO has done is to divide the population into the standard quintiles--the bottom to the top 20%. I've also broken out the top 1%. And what we're going to do is time-travel back to 1979. But we don't have to put on bell-bottoms or anything, we can just go back there right now and look at what the inequality of income looked like back then.

In 1979, as you can see, the top 1% was a lot richer than the rest of Americans; its average income was around \$350,000 a year compared with around \$44,000 a year for the middle fifth. But let's fast-forward to 2007. Now, the top 1% has an average income of around \$1.2 million. So that's a more than 250% increase in real, after-tax income for the top 1%, compared with just a 25% increase for the middle fifth. And in fact, if you take that middle fifth and you say "What proportion



of that increase is due to increased family work hours?" the answer is about two thirds. So most of the gains for the middle came because families were working more hours, not because they were earning more. This is a pretty striking development. But in fact, it understates the true shift, because the gains over the last generation are concentrated not just **at** the top 1%, but **within** the top 1%. It's the top 1/10<sup>th</sup> of 1%, and the top 1/100<sup>th</sup> of 1% that have really done well.

The first thing I want to say in terms of the top 1% is that this is a fairly distinctive US story. Fairly distinctive. It is not unique to the United States and indeed in the last decade or so we've seen the creeping of American patterns to other countries. In 1973, according to the Top Incomes Database, the share of total national income going to the top 1% before taxes and excluding capital gains was surprisingly similar across all these countries. If you go to recent years, it doesn't look as similar. In particular, the "Anglo" countries have seen a large increase in the share of income going to the very top, and the United States stands out even among those countries. So when I start to talk about



American politics and policy I want to make clear that there are elements of American policy that have been broadly emulated in other countries, particularly in the Anglo countries, and so some of these arguments could apply to other countries as well.

The fact that these gains are so concentrated raises some serious questions about the standard way in which we look at rising inequality. For example, it's easy to explain why the top 20% gets ahead due to increased education. It's easy to explain how globalisation and competition from China can hurt those at the bottom. But it's harder to explain why we see such concentrated gains at the very top. In general, when we start to talk about those gains at the top there is a tendency to try to take the arguments that we've developed for explaining the more general broadening of the distribution to explain what's happened at the top. However, I'm going to argue that for the top 1% we should move beyond the kind of standard arguments that focus on skills and technological change and focus more specifically on policies and politics as they have affected the top 1%. I'll make what I hope is a persuasive, or at least plausible, case for that, and I'm going to conclude with some ideas about what the prospects are for a reversal of the political and policy patterns that I believe have created this massive rise at the top.

At the same time I want to make clear that I am not arguing that globalisation or technological change doesn't matter. There are effects of the broadening of competition that in particular have allowed people who have specialised skills that are highly valued in an increasingly global market to do very well. For example, if you think about how technology has changed financial markets, the ability to do billions of trades a day rather than thousands of trades a day means that people who are very smart or very canny or very connected can make a lot more. What I want to argue, though, is that policy has been very crucial in creating the opportunities for those kind of rewards and at the same time that those policies often have resulted in risks or costs for the rest of the society. In other words, I'm going to argue that it's politics that explains a lot of the policy changes that have either mediated or furthered these larger shifts that help explain the rise in inequality.

We have already heard a lot about redistribution at this conference, and in general when we talk about redistribution, we're thinking "What are we doing to help those left behind?" The first thing to say is that the United States doesn't do very much compared with other rich democracies or compared with its recent past. The redistributive effects of federal taxes and transfers in the United States has actually declined over the period during which inequality has skyrocketed. That's a pretty remarkable fact if you think about it. When inequality grows, you would expect that the majority of people who are losing out would use their power at the ballot box to demand more redistribution. Democracy is supposed to create a political pressure that countervails the power of money. Over this period in which we've seen inequality grow, however, the United States almost uniquely has seen a decline in redistribution.

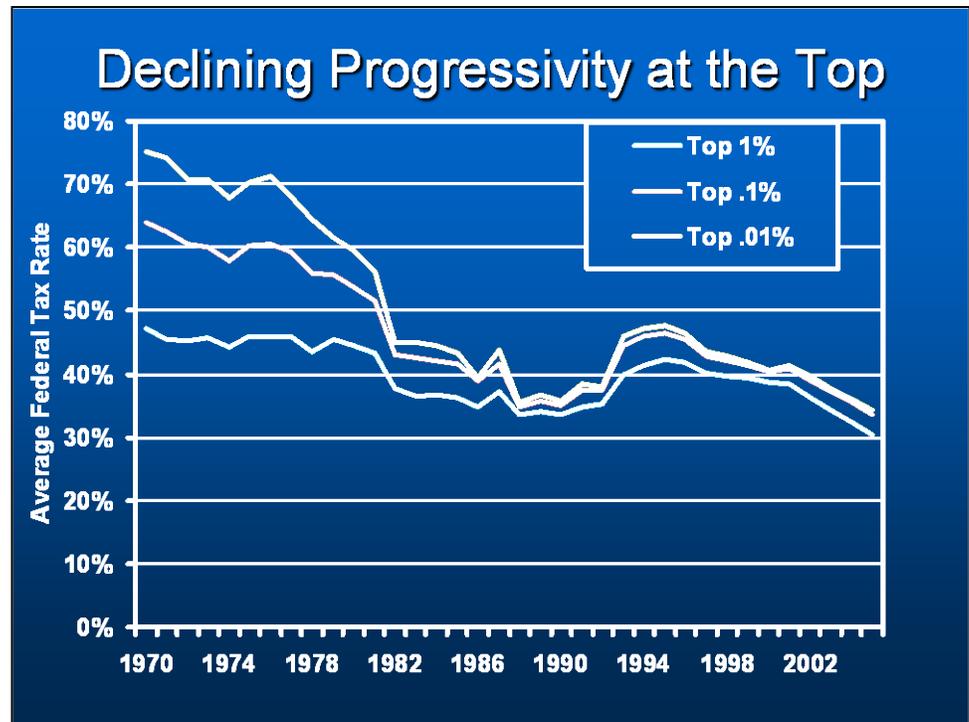
Still, that does not get us very far in explaining why the top 1% has shot into the stratosphere. So I want to make 3 straightforward, and I hope reasonably compelling, arguments.

First: forget about those policies that are focussed on the bottom for a moment. Start thinking about the policies focussed on the top. And what are the most important of those policies? Well in the United States, the most important have been tax cuts for the very, very rich. The United States has seen a massive decline in taxes on the top 1%, but that's not even the big story. The big story is the decline in effective tax rates paid by the top 1/10<sup>th</sup> of 1% or the top 1/100<sup>th</sup> of 1%. This has gotten to the point where Warren Buffett says he pays a lower tax rate than the people who work for him. The top 400 taxpayers in 2007 paid an average effective federal income tax rate of 16.5%. In 1995 they paid about 30%. That difference between 30% in 1995 and 16.5% in 2007 is about \$46 million—for every

taxpayer in the top 400. That is not a trivial change.

The way to look at what's happened in the United States it's that even as there's been a politics of redistributions writ large, there's also been a politics of redistributions writ small—that is targeted benefits for those at the very top. I call these economic smart bombs: They've got payloads of cash for carefully selected recipients, such as hedge fund managers. In the United States hedge fund managers can make

billions of dollars, yet they pay a tax rate on much of their income of 15% because they get the treat the profits from assets under management—other people's money, not theirs—as capital gains, thus paying a lower tax rate. So pay attention to what happens at the top.



The second point is: pay attention to market-making. After all, when we think about what the government does to affect what people earn, we tend to focus only on what it does after those people get their paycheques. But think of how much the government affects the paycheques people get in the first place: rules governing labour unions, governing financial markets, what counts as a conflict of interest, how are contracts written. Those are all things that affect the distribution of income before the government reaches in its prying hands and pulls dollars away and them to someone else.

And what government has done in the United States is shift the market in ways that have allowed those at the top to reap huge fortunes. The greatest example of this is of course financial market deregulation. This graph comes from a paper by two economists. This line shows you the relative wage in the financial sector, and this green line is an index of financial regulation. So what this shows you is that finance professionals earned a lot more than other similarly skilled workers from the early 1900s up to the Great Depression when financial regulations were extremely lax. Then financial regulations were tightened, and the relative wage in the finance sector--how much finance professionals earned relative to what other comparably educated and skilled workers earned--dramatically declined. In recent decades, we've seen financial deregulation that has pushed up incomes in the financial sector, and thereby at the top. One thing that you should know is that that top 1/10<sup>th</sup> of 1% of Americans, the richest one in a 1,000 households, are mostly executives. Six in 10 in the top 1/10<sup>th</sup> of 1% (average incomes \$7 million in 2007) are executives, and about 2 in 10 are financial executives. So when you're talking about what happened at the top, policies governing the financial markets matter a lot. So, too, do policies governing CEO pay. American CEOs earn vastly more than CEOs in other countries; they earn more relative to ordinary workers than they ever have, and over the last generation we've seen a big increase in executive pay. This is not a natural market development either. American rules shaping

corporate governance are incredibly lax and allow CEOs to heavily influence their own pay.

And so I want to bring you to the third argument about how government has helped the top 1%. It is not just that government targeted the top. It's not just that government has shaped the market in ways that have helped those at the top. It's also that over this period in which we've seen major changes in our economy, we've seen our government sit on its hands in ways that are highly beneficial to those at the top. We call this "drift" in the book, and corporate governance is perhaps the paradigm example. What happened in this period was that we saw a decline of labour unions and the traditional organisations that held CEOs accountable, like large pension funds. We saw instead the rise of so-called shareholder capitalism, where decentralised shareholders were supposed to be able to police CEO pay. How has that worked out? Not so well, because it's very hard for diffused shareholders to create real, effective checks on CEOs when CEOs can set their own compensation through compliant compensation boards and through peer benchmarking that allow CEO pay to escalate even higher every year. And this is crucial: In some countries there was an effort to increase the hand of institutional shareholders or others that could put a check on executives' pay. In the United States, the exact opposite happened. In fact, there were deliberate attempts to try and stop efforts to tighten accounting standards and other measures that might have reduced the run-up in executive pay.

I have a great example of this: Arthur Levitt, the chair of the SEC in the 1990s went to the head of the banking committee, Phil Gramm, republican, of Texas, and asked for slightly tighter accounting standards on corporations. This is before the Enron collapse, before WorldCom. And here's what Phil Gramm said: "Unless the waters are crimson with the blood of investors, I don't want you engaging in any regulatory flights of fancy." Well, a few years later the waters were crimson red, but of course then the federal budget was crimson red, our economy was in the tank, and corporate CEOs were still seeing big payouts even as companies go bust.

Those are the three arguments about what happened in terms of policies. The question I want to end with is: How did this happen politically? I won't go into a detailed examination of the shifts in American governance we discuss in the book. I just want to make two simple points.

First, over the last generation in the United States we've seen a fundamental transformation of the balance of political power between those who have effective lobbyists on Capitol Hill—those who have money to burn in politics, who are networked, who have long-term aspiration to change policies—and ordinary working Americans, who used to have labour unions and broad cross-class civic organisations representing them but are now largely adrift. This shift has transformed the ecosystem of Washington, and both parties have had to adapt. For the Republican party, it's meant: "Go for it, the new gilded age has begun." Republicans have been emboldened to move dramatically to the right on economic policy matters. By contrast, Democrats have been cross-pressured. The party has basically found itself torn between the need to raise campaign funds and appease lobbyists, on one hand, and the desire to work with its traditional labour and working-class constituencies, as weakened as they are, on the other hand.

We've had a massive increase in lobbying activity and money in politics. Both parties have had to respond. And this has resulted in polarisation and stalemate that has abetted the drift I was talking about earlier, punctuated by bouts of extremely aggressive, anti-egalitarian policy-making, such as the Bush tax cuts of 2001, where Democrats have been picked off or divided and Republicans have been single-minded. Look at the current debt ceiling crisis. The fight was basically about one party, the Republican party, holding the overall economy hostage to achieve reduced government with no commitment to raise revenues. Right now the federal government is raising revenues at about 15% of GDP, the lowest

level since the Eisenhower administration, and cutting back spending would bring our weakened economy to its knees, as well as hurt many vulnerable Americans. Yet that was exactly what was being pursued with the full faith and credit of the federal government hanging in the balance.

What is the prospect that will see some shift away from the winner-takes-all politics I'm talking about? We come to my second point. To answer that question, we have to look to the past. Historically, what has allowed there to be serious pushback against the kind of extreme inequality that we see in the United States today? Three things: it's required a crisis, it's required a reformist president and it's required a discredited opposition. Many people thought that was what you had in 2008. What we learned with president Barack Obama, when we went from "Yes we can" to "Well, maybe we can't," is that the deep, structural imbalances in our politics are great enough now that even that historical pattern is not going to push forward the kind of comprehensive changes that are needed.

Instead, I think the underlying organisational imbalance that is at the heart of this crisis is going to have to be addressed more directly. That in some sense is what the Occupy Wall Street movement represents. For several years during the economic crisis, the bailout and the efforts to help Wall Street galvanised the public. But it galvanised conservatives, the Tea Party, pushing for smaller government and for more limited redistribution. With the Occupy Wall Street movement and the greater interest in inequality that it has sparked, perhaps we're going to see some galvanisation on the other side of the political spectrum.

What we know from the story I've told is that that is not a change that will happen overnight. We had a 30-year war in which those who wished to make our society less equal pushed consistently, through administration after administration, on policy issue after policy issue, to change the rules of the game in a way that tilted the playing field toward those at the top. It will take years of hard work, of determination, of organisation, of mobilisation, to push back. But I think that the story that I'm trying to tell actually represents a somewhat more optimistic tale than we often hear. For the story is not about broad global trends that are inexorably making our society much more unequal. Those trends are real and there are threats to growth and prosperity and equality that are created by them. And yet, ultimately, the story we're telling is that domestic politics does matter. Political choices matter. Organisation matters. And if there's any hope in this story, it's that we have seen such trends before and we've seen broad movements to push back against them.

I hope that with this book, with this discussion, there'll be some greater pressure to push back. Now.