Week 7: Explaining the Rise of Top Incomes

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Introduction

Last week we noted that the rise in income inequality in the USA is associated with runaway top incomes of the top 1 percent.

But what caused this significant rise in top incomes?

Market-based explanations emphasize apolitical processes of technology and returns to education: skills-biased technological change. These certainly matter in the long run.

But most economic accounts cannot explain:

1. The extreme concentration of income gains at the very top of the economic ladder.
2. The cross-national variation that exists between advanced capitalist democracies.
3. The role of government policy in creating a winner take-all pattern.
4. The change in the collective and organizational landscape of politics.
Table 1
Top-end income concentration: Europe versus North America

<table>
<thead>
<tr>
<th></th>
<th>Total cumulative real income growth per adult, 1980–2016</th>
<th>Share of real income growth captured by income groups, 1980–2016</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Europe</td>
<td>Canada-USA</td>
</tr>
<tr>
<td>Full population</td>
<td>40%</td>
<td>63%</td>
</tr>
<tr>
<td>Bottom 50%</td>
<td>26%</td>
<td>5%</td>
</tr>
<tr>
<td>Middle 40%</td>
<td>34%</td>
<td>44%</td>
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<td>Top 1%</td>
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<td>Top 0.001%</td>
<td>120%</td>
<td>629%</td>
</tr>
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Notes: Income calculated at purchasing power parity (PPP). Twenty-five Western and Eastern European countries are included in the Europe grouping.
Source: Alvaredo et al. (2017: 45–46).
Figure 2.3.1
Top 1% national income share in Anglophone countries, 1920–2015


In 2014, 20% of national income was received by the Top 1% in the US.
Figure 2.3.3
Top 1% national income share in European countries, 1890–2014


In 2014, 11% of national income was received by the Top 1% in France.
Figure 2.3.4
Top 1% national income share in Northern European countries, 1900–2013

In 2013, 9% of national income was received by the Top 1% in Sweden.
Figure 2.3.5
Top 1% national income share in emerging countries 1900–2015

In 2015, 14% of national income was received by the Top 1% in China.
Global Bottom 50% and Top 1% income shares, 1980–2016


In 2016, 20% of global income was received by the Top 1% against 10% for the Bottom 50%. In 1980, 16% of global income was received by the Top 1% against 8% for the Bottom 50%.
Figure E3

top 1% vs. bottom 50% national income shares in the US and Western Europe, 1980–2016: Diverging income inequality trajectories


In 2016, 12% of national income was received by the top 1% in Western Europe, compared to 20% in the United States. In 1980, 10% of national income was received by the top 1% in Western Europe, compared to 11% in the United States.
Theories

Skills-biased technological change
- Returns to education
- Globalisation of trade
- Offshoring/outsourcing

Power-resource and bargaining
- Government policies
- Fiscal/tax policies
- Weakening of left/unions
Winner takes all

Political scientists tend to emphasize the role of the 'median' voter in shaping electoral politics and the process of policymaking.

If this is the case, why then don't the working classes soak the rich?

For Hacker & Pierson the 'winner takes-all ' is rooted in how four different institutions shape outcomes:

- Financial markets
- Corporate governance
- Workplace relations
- Taxation

For Soskice and Iversen (2015), in capitalist democracies, governments respond to the interests of the middle class, and these middle to higher income voters don’t want redistribution downwards.
There are 3 important characteristics of the US winner takes all phenomenon (income gains going to the top 1%).

Gains have been highly concentrated. The top percentile in the US have seen their share of the income rise from 9 to 23.5 percent.

Gains have been sustained regardless of government. Hacker & Pierson (2010) shows that the concentration began with Reagan and continued under every subsequent administration, particularly Bill Clinton.

Gains have not resulted in a trickle down effect. Wages at the bottom have completely flatlined, whilst middle income wages have largely stagnated.
Worlds of welfare capitalism

Piketty also acknowledges the role of politics and institutions (chapter 9) in shaping the cross-national variation in patterns of income inequality.

In the end, he gives priority to the role of different ideas of fair compensation in the USA. His new book is about the role of ideology in capitalism.

But it is important to note that rising top incomes is mostly an Anglo-Saxon phenomenon.

In particular, it is a UK and US phenomenon. Why?
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Discuss

Can the distribution of educational and skills gains cannot explain this outcome of upward distribution?

The macroeconomist, Gregory Mankiw, argues that these variations are purely market-driven and merit-based (I have linked his article ‘in defence of the 1% on brightspace’).

But are they? How would you empirically test this?
Democracy

If voters do not run the show, who does?

To answer this question requires going beyond the voter-politician relationship and analyzing politics as a form of organized combat between competing interest groups.

This perspective gives priority to interest groups over electoral politics:

• Governments do not simply redistribute what markets produce; they actively structure markets in ways that shape economic outcomes. This varies cross-nationally.
• The transformation of policy occurs through drift. Policymakers often don’t change policies because of entrenched interests and political vetoes in the decision-making process.
• Lobbying can often results in non-decisions.
• What governments actually do is a long hard battle between competing organized interests.
• Elections are a side spectacle

Iversen/Soskice (2019) argue that elections do matter, and that voters don’t care about redistribution.
For Iversen/Soskice - capitalist democracy is primarily about generating the conditions for economic growth, and improving the living standards of the middle class.

The working class have grievances, but the new middle class (the expansion of graduates every year) want access to the new economy, and jobs in the advanced sectors of this economy. And they'll vote for governments and political parties that support this.

Hence, their argument is that the new middle classes will vote for policies that complement the underlying logic of capitalist democracy, not democratic socialism.

But what if the middle class is shrinking, not expanding?

This is the conclusion of the OECD:
Politics as organised combat

Organized interests build coalitions of interest within and between political parties in government.
  • They are the crucial actors in the struggle over competing economic choices.

The implication of this analysis is that political parties have become responsive to the concerns of interest groups and less the preference of the median voter.
  • Drift is the cheapest way to abandon the median voter.

Another crucial empirical finding is that voter participation is generally lower when economic inequality is higher (Solt et al 2009).
  • Does low voter turnout increase inequality or is the causal mechanism the other way around?

But by far the most important process of institutional change from the 1970's onwards is the rapid rise in corporate-business lobbying and the decline and weakness of organized labour.
Declining mass membership

In the US, Hacker and Pierson (2010) suggests that change in the four policy arenas has contributed toward winner takes-all inequality:

**Taxes.** Most of these tax cuts for super-high incomes were the outcome of successful lobbying by anti-tax groups and free market think tanks like the Cato Institute.

**Industrial relations.** Private sector unionization had virtually collapsed in the US. Public policies were never updated and governments actively avoided intervening to stem the decline.

**Corporate governance and executive compensation.** Total compensation for the top executives in the US has skyrocketed since the 1980's. This has been fuelled by changes to corporate governance rules.

**Financial de-regulation.** The rise of finance is virtually synonymous with the rise of winner takes-all. In 2005, five hedge fund managers made $500m. FIRE (finance, insurance and real estate) became a huge part of the lobbying and campaign finance world, and actively shaped policies of financial regulation.
Conclusion

Explaining winner takes-all politics requires a perspective that sees modern capitalism and electoral democracies as deeply interconnected.

Governments actively shape and influence markets through a range of public policies. But economic interests actively shape how political authority is exercised.

Economists generally explain rising wage inequalities as the outcome of market and technological forces. Political science explanations give priority to the median voter.

I have suggested it is more related to how organized corporate-financial interests are capable of shaping public policies to advance their own economic interests.

This is 'quiet politics' and cannot be observed in electoral behavior.