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Business Political Capacity and the Top-Heavy Rise in Income Inequality: How Large an Impact?*

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Jacob Hacker and Paul Pierson's article significantly advances the debate on the top-heavy rise in income inequality in the United States. Their account of that rise is the most compelling I have seen. Yet I'm not sure it is right.

Their explanation is depicted in Figure 1. Both steps in this hypothesized causal chain are plausible. And Hacker and Pierson are correct that the over-time correlations between business political capacity and policy and between policy and the income share of the top 1 percent are quite strong. Moreover, I am convinced that these correlations reflect causal effects. For each step, however, I have some doubts about the *magnitude* of the causal impact.

Figure 2 offers an alternative hypothesis. Business political capacity plays a role here too, but in this explanation the increase in that capacity is not what matters. Instead, American political institutions and a shift in perceptions of U.S. economic strength amplify the impact of corporate mobilization and political effort on policy. Shifts in the political culture and strategy of the Republican party also have an important effect on policy. Changes in technology, economic competition, and corporate governance practices contribute, together with changes in policy, to the rise in winner-take-all economic outcomes.

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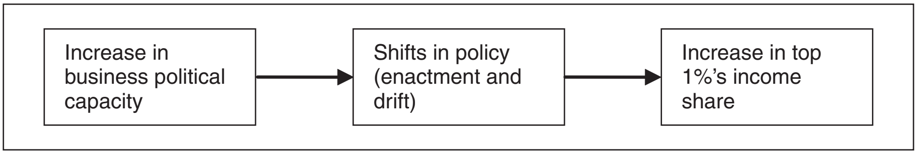

Figure 1. Hacker and Pierson's explanation of the rise in winner-take-all economic outcomes in the United States since the late 1970s

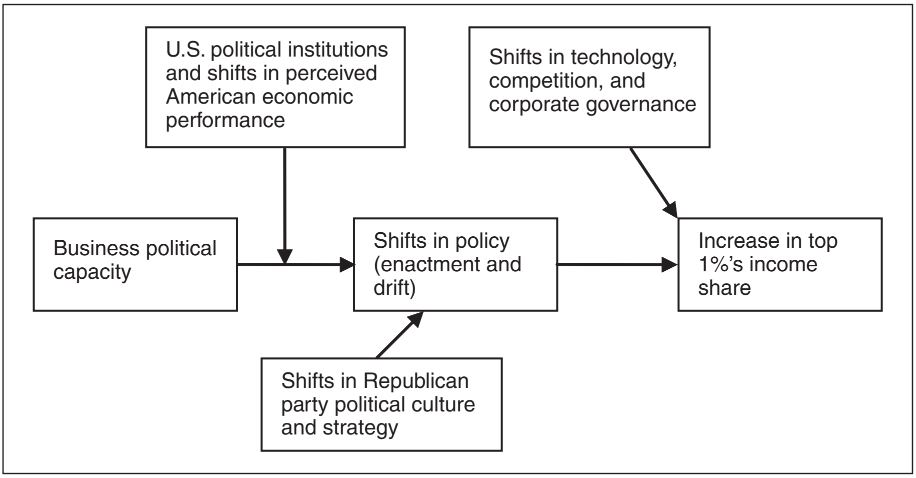

Figure 2. An alternative explanation

Hacker and Pierson's explanation is more parsimonious. But is it better supported by the evidence? I organize my discussion around the three policy arenas that are (rightly) central to Hacker and Pierson's account: executive compensation, finance, and taxes.[1]

Executive Compensation

Executive compensation has risen sharply since the late 1970s. Hacker and Pierson follow Piketty and Saez in attributing about half of the rise in the top 1 percent's pretax income share to this. The culprit is stock options. As a survey in *The Economist* put it, "Options were handed out in astonishing quantities. Indeed, the story behind the growth of [executive] pay in the 1990s is really the story of the option."[2] At their peak in the year 2000, stock options accounted for more than half of total executive compensation at publicly owned U.S. firms.[3] Options are tied to the future stock price of the company. But when the entire market goes up, as was the case in the 1980s and 1990s, it carries most companies with it. As a result, executives in many firms saw the value of their stock options skyrocket, regardless of how the firm was performing relative to its competitors.

In Hacker and Pierson's account, options were able to produce enormous gains for corporate executives because prior to 2005 they did not have to be expensed; that is, firms were not required to subtract the options' (likely) value from reported earnings. In 1993 the Financial Accounting Standards Board (FASB) decided to mandate expensing. But according to Hacker and Pierson, business opposition blocked this proposed shift:

> Managers, especially in the rapidly growing tech industry, mobilized opposition against the change. Led by Senator Joe Lieberman, Democrat of Connecticut, elected officials moved quickly to block the proposed reform. By overwhelming margins, the Senate passed a resolution expressing its disapproval. Facing clear indications that action would lead elected officials to strip FASB of its authority, the regulators backed off. This is a clear and important example of drift—where organized political action effectively prevents the updating of policy in response to changing market outcomes that were advantageous to the wealthy and powerful.[4]

This is one of a number of instances of policy drift to which Hacker and Pierson attribute importance. The existing rules made possible enormous increases in executive compensation, so an intentional lack of policy change amounted to endorsing and encouraging this development.

Was the increase in business mobilization since the mid-1970s a major factor here? And how large a role did the lack of policy change play in producing skyrocketing executive compensation? Let me sketch an alternative story.

Political institutions. The American political system is especially conducive to drift. The U.S. government has an array of veto points: its executive-legislative separation of powers, its bicameral legislature, the committee structure in both houses of Congress, and the filibuster option in the Senate, among others. Many comparative and historical students of American policy making would therefore expect drift to be the norm. Corporate interests might well have been able to block this proposed change—and others, such as undoing the favorable tax treatment of hedge funds—even without the increase in their organization and political influence.

Perceptions of U.S. economic performance. As Hacker and Pierson note, business interests were unable to block a number of new economic and social regulations between the mid-1960s and the mid-1970s.[5] But it does not necessarily follow that the rise in business mobilization explains business interests' enhanced success in ensuing years. Something else changed dramatically beginning in the late 1970s: the perception among the public and among policy makers of the health of the American economy. In the late 1960s and early 1970s there had been considerable confidence in the state of the economy and its likely future course.[6] By the late 1970s that was gone. Stagflation and a surge in imports turned optimism to worry. Though views about the condition of the economy of course ebb and flow with the business cycle, arguably the underlying pessimism continued at least until the later years of the 1990s boom. In this context, policy makers in both parties were likely to have been more willing to entertain the pleas of business interests than had been the case from 1965 to 1975.

Shift in corporate governance practices. Hacker and Pierson note that corporate governance practices shifted sharply in ways conducive to a rise in the compensation of top executives. I am not sure, however, that they give this sufficient due. During the 1980s and 1990s prevailing thinking about firm governance moved steadily toward the notion that high-level executives are critical to the success of the firm and should be rewarded appropriately.[7] At the same time, shareholder focus turned toward companies' short-run profit performance, and this accentuated the perceived importance of the CEO.

Heightened competition. Since the late 1970s the economic environment for many U.S. firms has been characterized by growing competition. This is a result partly of internationalization, partly of deregulation, and partly of technological and other changes that lowered barriers to entry. Coupled with the just-noted shifts in corporate governance, this contributed to a more extensive search for quality leadership and to a willingness to pay more for it.[8]

Other contributing factors. Four are worth noting. One is an unintended consequence of a policy change that aimed to limit increases in executive compensation. In 1993 the newly elected Clinton administration changed the tax rules for executive compensation, capping the amount that could be deducted at $1 million unless it was "performance-based." But corporate accountants quickly figured out ways to classify pay above the threshold as performance-based.[9] Perhaps more important, the change encouraged firms to accelerate the shift toward compensation via stock options.[10]

A second is the rise in stock values. Absent this, the heavy use of stock options for executives would have yielded less of a rise in compensation. Since 1980, compensation for top executives in U.S.-based firms has tracked the market capitalization of those firms, and stock values more generally, very closely.[11] Policy surely contributed in some ways to the run-up in share values in recent decades. But was it a key influence? And were business interests a driving force behind the relevant policy decisions?

A third is CEO free agency. For most of the twentieth century it was common for CEOs to have worked for their company for several decades. Beginning in the 1980s boards grew more willing to hire from outside, partly on the assumption that a person with prior CEO experience would be more effective, or at least have the appearance of being so. This gave current CEOs a credible exit threat. As with athletes in professional team sports, free agency has contributed to bidding up the price of executive talent.[12]

Fourth, given the growing market in executive talent, a simple process of benchmarking and leapfrogging can generate a sizeable rise over time in the average compensation package.[13]

Other countries. Examining the causal influence of business political capacity on policy drift involves tracing the degree of business mobilization, examining business interests' activity in and around the policy process, and thinking through a counterfactual in which that capacity is lower. Counterfactuals are useful but also speculative. As a complement, we can consider evidence from other countries. This, too, is hardly a foolproof analytical strategy; nations differ in too many ways for us to realistically believe that we can effectively control for potential confounding factors. Still, comparison can help.

Are there countries in which business political capacity was weaker than in the United States and in which policy makers did enact a new rule such as expensing of CEO pay? That would be useful supportive evidence for the Hacker–Pierson hypothesis, but I don't know of any such cases. The United Kingdom might count as one, but only barely; its regulation was altered in the early 2000s, a few years before the FASB mandated expensing in the United States. Stock options have been far less prominent in other affluent countries than in the United States. However, this appears to be due less to policy differences than to the limited capital-market orientation in other nations. Concentrated ownership and block shareholding reduce the utility of stock options as an incentive device.[14] This began to change a bit in the 2000s, but sharp differences remain.

Expensing of stock options. Finally, let me return to the principal issue in Hacker and Pierson's account: the FASB backing away from requiring expensing of stock options in the early 1990s. Here Hacker and Pierson rely on the account of Arthur Levitt, then chair of the Securities and Exchange Commission (SEC). But according to Levitt, there is more to the story:

> I, too, was lobbied hard to oppose the FASB proposal. During my first few months in Washington [in 1993] I spent about one-third of my time being threatened and cajoled by legions of businesspeople who wanted to kill the proposal. I met with numerous CEOs, each of whom wanted to impress upon me the importance of stock options as a human resources tool. . . . It's not that I was unsympathetic to the arguments that stock options helped motivate employees. But I believed that options had real value and that the FASB was correct to insist that companies properly account for them as an expense. Arguments otherwise did not sway me.
>
> Politics did, however. The controversy dragged on through the November 1994 elections, which put the Republicans in charge of the House of Representatives and vaulted Newt Gingrich, the conservative lawmaker from Georgia, into the Speaker's chair. It appeared the country had taken a sharp turn to the right, and regulation of any sort, even accounting rules proposed by a private-sector body, would come under close scrutiny. I came to the conclusion that the FASB rule would not survive in this atmosphere. I worried that, if the group continued to push for the stock-option rule, disgruntled companies would press Congress to end the FASB's role as a standard-setter. To me, that would have been worse than going without the stock-option rule.
>
> In retrospect, I was wrong. I know the FASB would have stuck to its guns had I not pushed it to surrender. Out of a misguided belief that I was acting in the FASB's best interests, I failed to support this courageous and beleaguered organization in its time of need, and may have opened the door to more meddling by

> powerful corporations and Congress. . . . I may also have been wrong about the political scene. By mid-1995, the country began to swing back to the center because of what many voters viewed as extreme positions taken by Gingrich and his House Republicans. The FASB might have been on solid ground, after all.[15]

Levitt's story can be read in two ways. One is to focus on the power of corporations to get the Senate to scare a regulatory body away from a change that might have made a big difference in subsequent developments in executive compensation. The other is to emphasize the contingency of the outcome. What would have happened if Levitt had stuck to his initial preference and not advised the FASB to back down? What if the timing had been slightly different?

How much did the lack of an expensing requirement contribute to the run-up in executive compensation? It is hard to tell. On the surface it seems to have mattered a great deal. An alternative view is that it mattered very little. After backing down from requiring full expensing in the early 1990s, the FASB did, in 1995, require that companies calculate the value of executive stock options and report that information in the footnotes to the annual report. It might be that whether the reporting comes in the footnotes of the annual report or in the text, as required beginning in 2005, makes little difference to the performance of the firm's stock. There is some evidence that this is indeed the case.[16]

Finance

Hacker and Pierson view developments in the financial sector as "the central chapter in the chronicle of winner-take-all inequality."[17] Part of the story, they say, is technological innovation, which facilitated creation of new financial instruments, enabled widespread securitization, and allowed a dramatic rise in trading of both traditional and new instruments. The other part—the part that fits with their explanation—is "the gradual shredding of the post–New Deal rulebook for financial markets."[18] They cite a recent study, by Philippon and Reshef, which concludes that deregulation is responsible for roughly half of the recent rise in the pay premium in finance relative to other sectors.[19] And they attribute much of the deregulatory enactment to business influence.

I have two concerns.

The impact of rising business political capability on financial deregulation. A number of the key deregulatory decisions were made during the second half of the 1990s: the relaxation and then repeal of Glass–Steagall in 1997 and 1999, the repeal of the separation of banks and insurance companies in 1999, and the exemption of derivatives and some other instruments from oversight by traditional regulatory agencies in 2000. In Hacker and Pierson's account, the fact that these occurred during a Democratic presidency is strong evidence of the impact of business influence. I am sympathetic, but I wonder about the extent to which Clinton administration officials were open to arguments favoring financial deregulation at that particular moment because of the apparent change in the nature of the economy and because of its success. That was the heyday of the Internet boom and glorification of the "new economy."[20] It also was the only period during the past generation in which real wages and incomes rose in the lower third of the distribution.[21] Paradoxically, then, while perceived economic decline likely made policy makers more receptive to business demands in the 1980s, a perception of economic success may have had the same effect in the late 1990s.

The effect of deregulation on compensation growth in finance. Hacker and Pierson follow Philippon and Reshef in concluding that deregulation is a key cause. The over-time correlation between financial regulation and high-end pay in finance is negative and quite strong. But this leaves open the question of the actual causal impact. After all, extensive deregulation occurred in the 1970s and 1980s in other economic sectors, such as telecommunications and transportation. This did not produce the escalation of incomes that occurred in finance. Of course, these industries are different from finance. But that is the point: what mattered is not just deregulation but the particular characteristics of finance.

A number of other things changed beginning in the late 1970s that contributed to enhanced opportunity for outsized compensation in finance. Global integration of financial markets expanded the pool of potential investors. Technological innovation, particularly in the form of computerization and digital communication, enabled and encouraged creation of a multitude of new financial instruments.[22] Heightened competition coupled with growing short-termism by owners enhanced pressure to generate new sources of revenue and helped to justify increased reward for doing so.[23] As with executive compensation, here too it is likely that free agency and rising payouts begat a process of benchmarking and leapfrogging that accelerated the rise. Financial deregulation certainly contributed to the upward movement in payouts within the sector, but I am not convinced it was the driving force.

Tax Cuts

Tax changes have mattered. Hacker and Pierson note that according to Piketty and Saez, reductions in the effective federal tax rate on the top 0.1 percent account for about one-third of the rise in their income share.[24] The same is true for the top 1 percent.[25]

The two tax changes that made a big difference are the 1981 Reagan cuts and the early-2000s Bush cuts.[26] Were they a product of the rise in business political capacity? That surely had an impact, but one can tell a different story centered on shifts in Republican party culture and strategy rather than corporate political influence.

The Reagan tax cuts. Arguably, Ronald Reagan's commitment to tax cuts owed as much to the populist anti-property-tax revolt of the 1970s as to business demands.[27] And as Hacker and Pierson note, ideas mattered too. Reagan firmly embraced the tax cut agenda only when persuaded by Arthur Laffer, via Jude Wanniski and Jack Kemp, that tax cuts for the affluent could "pay for themselves" by increasing economic growth and thereby the pretax incomes of the rich.

How, if not for business support and pressure, did the 1981 tax cut package get through the Democrat-controlled House of Representatives? The Democratic party at that time still had a strong conservative southern wing, especially in the House. These "boll weevils" were receptive to a tax cutting message, particularly in the context of the deep economic crisis of the late 1970s.[28] Reagan's tax-reduction message not only played well with the conservative constituents of many of these congressional representatives; it offered a simple and bold plan that made a clear break with the recent past. Moreover, it provided a win–win solution to economic malaise: keep more of your income and that will help the economy to boot. The attempted assassination of the president in March of 1981 substantially boosted his popularity among the public, making it more difficult for middle-of-the-road Democrats in the House to oppose his principal domestic policy objective. Finally, the administration allowed House Democrats to load up the tax cut bill with all sorts of goodies.[29]

The success of California's Proposition 13 in 1978, Reagan's consecutive election victories, and the 1981 tax cut enshrined tax reductions firmly in Republican party political culture.[30] Just as a generation of Democrats conceptualized theirs as the party of the New Deal following FDR's political successes in the 1930s and 1940s, newly emerging Republican leaders and activists were deeply influenced by the events of the late 1970s and the 1980s. This was furthered by George H. W. Bush's loss to Bill Clinton in 1992, following his decision to renege on his "no-new-taxes" pledge.

The Bush tax cuts. Though tax cuts were part of George W. Bush's campaign platform in the 2000 election, their prominence in his early policy agenda increased dramatically shortly after the election. An election poll by Bush staffer Matthew Dowd suggested that, despite the closeness of the 2000 election, fewer Americans were truly "independent" than many academics and pundits believed. When Dowd conveyed this finding to Karl Rove, Bush's chief electoral strategist, Rove decided to orient the new president's policy agenda around a strategy that would maximize support among the Republican base rather than appeal to independents and centrists.[31] Given their centrality to the Republican party worldview, it is no surprise that tax cuts became a centerpiece of that strategy.

Why did Congress pass the Bush tax cuts? Here earlier work by Hacker and Pierson is very helpful.[32] The Republicans held the House of Representatives. This was a relatively partisan group, and much more ideologically coherent than the Democratic majority in the House had been twenty years earlier. After the failure of the "Contract with America" in the mid-1990s and the disputed 2000 presidential election, they were ready to advance a tax cutting agenda—especially when the budget surplus allowed it to be portrayed as relatively cost free. The Senate was split evenly between the two parties, but the Republicans were able to win over a few conservative Democrats. Throughout the process, Republican leaders utilized a variety of clever design and marketing tactics to obscure the true fiscal cost and distributional impact of the proposed tax cuts. These tactics, assisted by the change in political climate following the September 11, 2001, terrorist attacks, proved effective in securing additional cuts in subsequent years.

Organized business interests surely played a role in the Reagan and Bush tax cuts. But their impact may have been less substantial than Hacker and Pierson suggest.

Conclusion

Jacob Hacker and Paul Pierson have identified a key piece of the explanation for the surge in top-end incomes in the United States. My aim here has been to suggest an alternative hypothesis and to highlight some seemingly supportive evidence. Is this alternative explanation a better one? I am not sure. A good bit more empirical work remains to be done.

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Notes

1. I don't address the fourth arena: industrial relations. This has a peculiar analytical status in the article in that the argument applies to neither step in the hypothesized causal chain. It is an attempt, instead, to explain the rise in business's (relative) political capacity.
2. "Special Report on Executive Pay," *The Economist*, January 20, 2007, 8.
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25. Lane Kenworthy, “How Much Do Presidents Influence Income Inequality?” *Challenge* 53 (2010): 90–112, figure 11.
26. Hacker and Pierson mention some pre-Reagan tax cuts, such as a reduction in the capital gains rate enacted in the late 1970s. And their Figure 5, using data from Piketty and Saez, suggests large declines in the effective tax rates for the richest 0.01 percent and 0.1 percent in the late 1970s. However, that graph shows no decline in the rate for the richest 1 percent prior to the early 1980s. This means the effective rate on those in the top 1 percent but below

the top 0.1 percent must have increased. So the tax changes in the late 1970s seem to have resulted in redistribution within the top 1 percent.

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