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Income inequality in the U.S. from 1950 to 2010 – the neglect of the political

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Abstract
Based on the empirical observation of a global trend towards increasing income inequality across developing and developed economies, this article analyses the *causes* of increasing income inequality. Surprisingly, the role of institutions and policies with regards to rising income inequality have been under-researched. A case study of the U.S. from 1950 to 2010 reveals the substantial role of political institutions in increasing and perpetuating income inequality. Policies have a major impact on the distribution of income and thus influence income inequality. The case study reveals empirical evidence of two trends which are politically induced and reinforce income inequality. First, stagnating real wages for the majority of the population despite increasing productivity due to anti-labour policies which undermine collective bargaining. Second, increasing accumulation of wealth at the top of the income distribution through decreasing taxes for high incomes and corporations.

Introduction[1]

This article analyses *causes* of high and persistent income inequality in the U.S.[2] The analysis provides an explanation of the interconnected factors behind rising income inequality and the upward redistribution of national income from labour to capital. Followed by a series of reports about rising inequalities from various International Organisations (IO) (ILO 2011; UNCTAD 2012; OECD 2011b), the interest peaked after the publication of the English translation of Piketty's (2014) *Capital in the Twenty-First Century*. The publication triggered a heated debate and brought widespread attention to the issue also from non-academic circles ever since. Not surprisingly, there is as much empirical evidence supporting as broad a variety of arguments as scholars working on the subject.

The interaction between *exogenous* and *endogenous* drivers of inequality is of particular interest. At first sight the global trend towards increasing inequality across developed and developing economies suggests that exogenous forces are the main driver of inequality. However, the impact of exogenous drivers can be counteracted or reinforced by national policies and are thus highly country-specific. For example the experience of most countries in Latin America which successfully reduced inequality while being subject to the same exogenous drivers as other countries, suggests that countries do have the means to reduce inequality. One major influence on inequality are the policies adopted (or not adopted) by the respective governments. Those vary considerably across regions and countries and alter the distribution of income significantly. It is argued that the *political dimension* as an endogenous driver of inequality has been neglected to the benefit of economic-based explanations. Some political scientists and sociologists have explored possible political explanations of increasing inequality (DiNardo, Fortin, and Lemieux 1995; Bartels 2010; DiPrete 2007; Rosenthal 2004), while economists have mostly neglected the role of the political.

[1] I would like to thank Howard Nicholas and Rolph van der Hoeven for their support and critical remarks.
[2] If not further specified inequality refers to income inequality and growth to economic growth as measured by the Gross Domestic Product (GDP) throughout the remainder of this article.

How and to what extent the *political dimension* has contributed to increasing inequality has been under-researched. In order to analyse the political causes of increasing inequality the U.S. has been chosen as a case study. The research question reads as follows: Which factors are the main drivers of income inequality in the U.S.? The U.S. is of particular interest because the country has experienced a sharp increase of inequality relative to other countries. In addition to that the U.S. is one of the few countries where continuous and reliable data is available. This enables the analysis and comparison of the changing patterns of income inequality from the early 1950s onwards.

Partly, as it is argued, inequality has been caused by politically induced decisions. Certain policies, such as the decreased support for unions and tax cuts favouring the relatively well-off and corporations, have benefitted a small minority of the population at the expense of the majority and have thus contributed to widening income inequality. It is argued that this particular type of *income* inequality leads to *representational* inequality. High and persisting inequality in the U.S. has contributed to the strengthening of an economic elite who have a vested interest and the means to influence policies accordingly which increases and perpetuates inequality. This in turn reduces the purchasing power of the majority of the U.S. population (and hence aggregate demand). Thus, growth stalls also due to decreasing means of purchasing goods and services for the majority, or, contributes to economic and financial instability because the stagnating real wages are compensated by increasing accumulation of debts (Onaran and Galanis 2013, 88).

The overall argument is that an influential driver of increasing inequality is the capability of the relatively well-off to capture large parts of the national income at the expense of the majority of the population through political influence. While the real wages of the economic elite increase, the majority of the population experiences stagnating real wages. In this regard, the changing shares of national income as measured by the functional income distribution (FID), which distinguishes between the factors labour and capital, have been neglected so far. The former measures the return to labour which is a major source of income for the majority of the population, whereas the latter measures the return to ownership which accrues mostly to a wealthy minority of the population. There is a gap in the empirical analysis which connects increasing inequality with changing factor shares of national income. The FID provides a different angle on how economic gains and losses are distributed in an economy.

Main drivers of U.S. income inequality

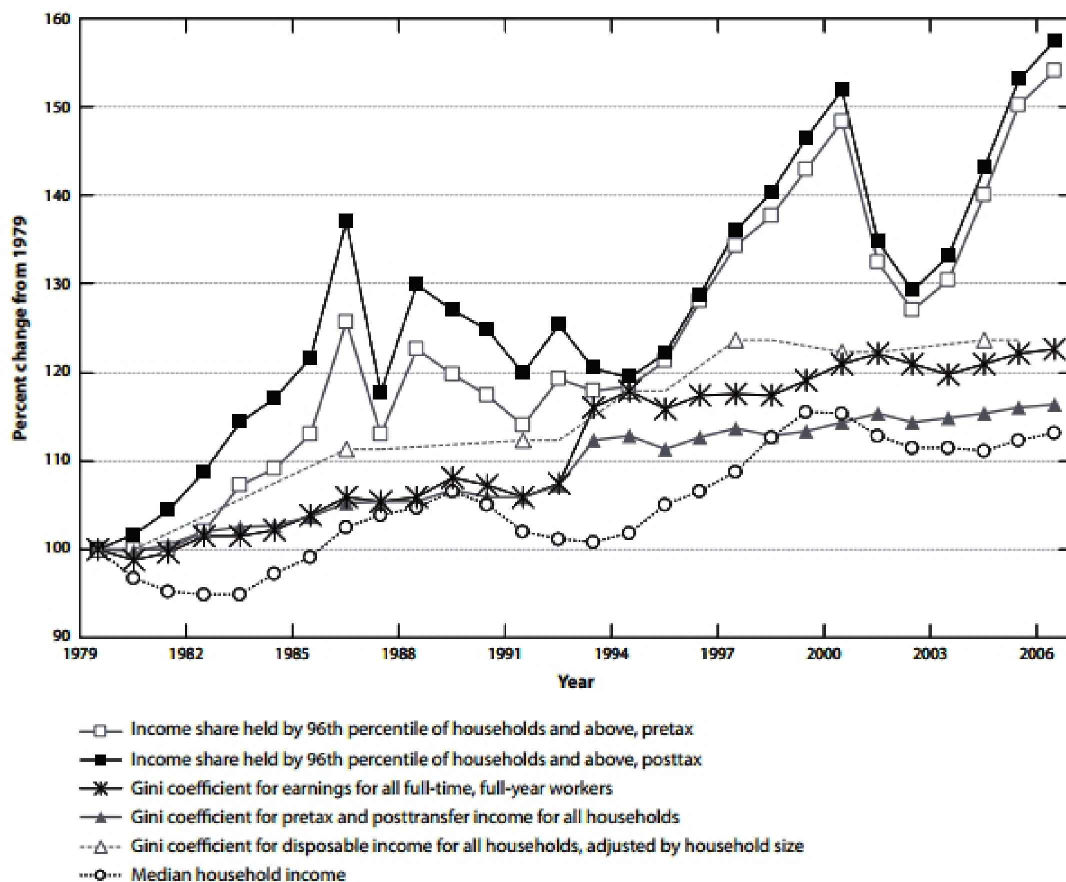
There is agreement among scholars about the trend towards higher income inequality in the U.S. The increase, "although present in many other wealthy democracies, has not been as substantial elsewhere" (Jacobs and Myers 2014, 752). While there is agreement regarding the trend, the causes or drivers of increasing income inequality are widely debated. Palma (2011) pointed out the importance to focus on the tails of the distribution when analysing inequality. This paper first analyses the consequences of inequality on growth in the U.S. and then how political measures, for example the introduction of decreasing corporate and high income tax, have contributed to an upward redistribution.

The trend commonly agreed by scholars is that "[i]nequality in wages, earnings, and total family incomes […] has increased markedly since 1980" and that the "level of inequality today, for both market income and disposable income, is greater than at any point in the past

40 years or longer" (McCall and Percheski 2010, 332). Taking 1979 as the baseline the upward trend is reflected by a variety of inequality indicators (Figure 1). While in the intermediate post-World War period inequality decreased the trend was reversed. Trend reversals began in 1960s, gathered pace throughout the 1980s, to contemporarily remain at an all-time high. "[T]rends for all units of analysis, measures of inequality, and types of income show that inequality in the United States increased from 1970 through the present" (332).

One major driver of increasing inequality was the shift of the focus of macroeconomic policies in the late 1970s and early 1980s intended to combat high inflation and low output induced by the oil shocks in 1973 and 1979. "This period saw the launch of structural reforms to make OECD economies more efficient, flexible and competitive – although modestly at first and with the United States […] leading the way"(OECD, 2011b, 314). Whereas in the 1960s and 1970s macroeconomic policies were aiming at full employment, external balances and low inflation, the early 1980s witnessed a shift towards a focus on the medium-term. The focus shifted towards structural reforms to liberalise markets in order to make the economy more efficient (OECD 2011a, 310–311).

Figure 1: U.S. Trends in Economic Inequality, 1979-2006

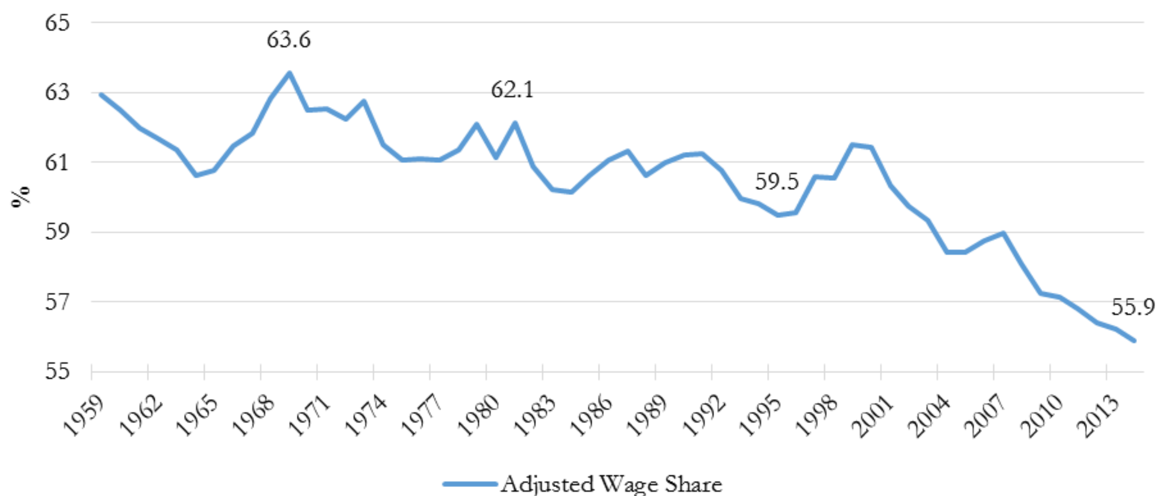


(Source: McCall and Percheski 2010, 334.)

However, the shift of macroeconomic policies in the late 1970s and early 1980s in most developed economies had a deeper structural impact which entailed a "more general redefinition of the role of the State in the economy, which favoured significantly reducing the extent of State intervention and public sector involvement in the economy" (UNCTAD, 2012b,

12). This change of macroeconomic focus also had redistributive consequences which resulted in an upward redistribution benefitting the already relatively rich parts of the U.S. population mostly. “[R]ising inequality is the direct result of a range of policy choices that predictably boosted bargaining power for those at the top of the income and wage distributions” (Bivens 2013, 21). The upward redistribution is visible in the changing FID (Figure 2) where the income of labour decreases which implies an increase of the capital share of national income. The analysis of the FID is indispensable because the type of income inequality witnessed ever since the early 1980s lends itself a clear class feature where the relatively rich extensively gain at the expense of the broad parts of the population who experience decreasing shares of national income. The decline of the wage share in the FID does not seem be to “limited to any particular set of countries and appears to be a general phenomenon” (Rodriguez and Jayadev 2010, 3).

Figure 2: U.S. adjusted wage share, 1960-2013

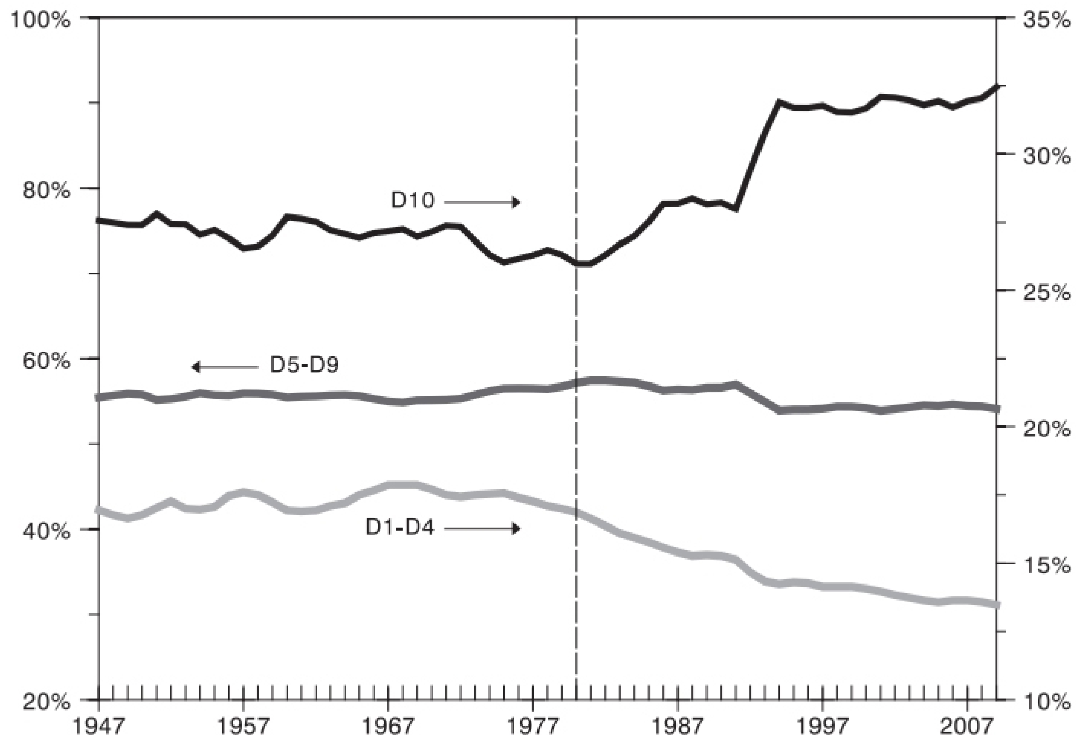


(Source: author’s compilation, data retrieved from AMECO (2014).[3])

As Stockhammer (2013, 44) argues only recently the determinants of FID have attracted researchers’ attention. Theoretical models, such as the Heckscher-Ohlin model and the Cobb-Douglas production function, assume the share of labour and capital to remain constant. However, the adjusted wage share of the total economy of the U.S. peaked in 1969 and then declined by 7.7 percentage points. The decline of the wage share has not been as pronounced as in other advanced economies but the increase of top incomes has been even higher. “In the Anglo-Saxon countries a sharp polarization of personal income distribution has occurred, combined with a modest decline in the wage share” (41). This is partly explained by the fact that high incomes partly offset the negative trend of the FID. They nevertheless, only occur to a small minority of the work force. What are the drivers of the skewed FID? Until the early 1970s productivity gains were passed onto labour in terms of real wage increases (Fleck, Glaser, and Sprague 2011, 59). From 1947 until the late 1960s real hourly compensation and productivity increased and followed a very similar trend. However, as of 1973 real hourly compensation and productivity started to diverge. A trend which has continued until today (ILO 2013, 46).

[3] Refer to Appendix A for a more detailed description of the data.

Figure 3: U.S. decile shares of national income, 1947-2007



Note: Income shares of D10 and D1–4 are shown on right-hand side scale; that of D5–9 on left-hand scale. Three-year moving averages.

(Source: Wade 2011, 66.)

Another reason identified by scholars as possible driver of inequality in the U.S. is the marked increase of salaries of top-income earners (Reardon and Bischoff 2011, 1095; Piketty and Saez 2003) which is also referred to as "upper-tail inequality". "Growing concentration at the top of the distribution is a striking departure from earlier patterns of inequality" (Neckerman and Torche 2007, 337). Another OECD report finds evidence for a stark increase of top incomes especially for the U.S. (OECD 2011b, 39). The top decile of income earners could expand their share of national income drastically reaching similar levels as before the Great Depression in the late 1920s (Atkinson, Piketty, and Saez 2011, 6). Wade (2011) presents a detailed analysis of the size of the distribution of national income which tracks the whole income distribution over time (Figure 3). The author divides the population into ten deciles. The first decile (D1) represents the first ten percent of U.S. population who are at the bottom of the income distribution. D2 represents the second most unequal ten percent of the population and so forth. His observation begins in 1947 and ends in 2007. Wade's (2011) findings show that until the late 1970s the distribution of national income among the deciles remained relatively constant although there were some minor fluctuations. From 1980 onwards D4 to D9 (which represent half of the population) continue to have a relatively constant share of slightly more than 50 percent of national income. However, at the same time the shares of the upper decile D10 diverges from D1 to D4. This means that those who were already at the top end of the income distribution could further gain at the expense of 40 percent of the people at the lower end of the distribution and of the middle class which saw their share of the national income stagnate (Palma 2011). Consequently, a small minority at the top of the income distribution captures most parts of national income, forcing the wages of the majority to stagnate or even decline.

Another trend that contributes to rising inequality is decreasing unionisation. Declining power of labour vis-à-vis capital can be one reason for the declining labour share of total national income. In contrast to asymmetric income gains of top earners this pushes the lower-end of the income distribution downwards. In the case of the U.S. stagnating real and minimum wages contributed to growing inequality and amplified the trend towards diverging incomes.

> "[T]he weakening of U.S. labor market institutions is a source of income inequality. […] Weakening unions may also contribute to the stagnant minimum wage" (Park 2013, 18).

National policies in the U.S. have supported this trend. OECD (2014, 7) found a high correlation between top tax rates and pre-tax income inequality: The higher the top tax rate the lower the share of top percentile of national income. This goes hand in hand with another long-term trend of decreasing top income tax rate in OECD countries. The OECD average of top income tax rate fell from 66 percent in 1981 to 43 percent in 2013. A similar development happened in the U.S. where the top marginal income tax rate steadily decreased from slightly above 80 percent in 1950 to 35 percent in 2011 (Piketty 2014, 499). "[T]he evolution of top tax rates is a good predictor of changes in pre-tax income concentration" (Saez and Piketty 2013). The reduction of top tax rates either for business or for top income individuals is based on arguments that less taxes induce higher investments and thus translate into higher growth. However, expected higher investments through a reduction of top marginal income tax rates which translate into growth have not materialised (Piketty, Saez, and Stantcheva 2013, i).

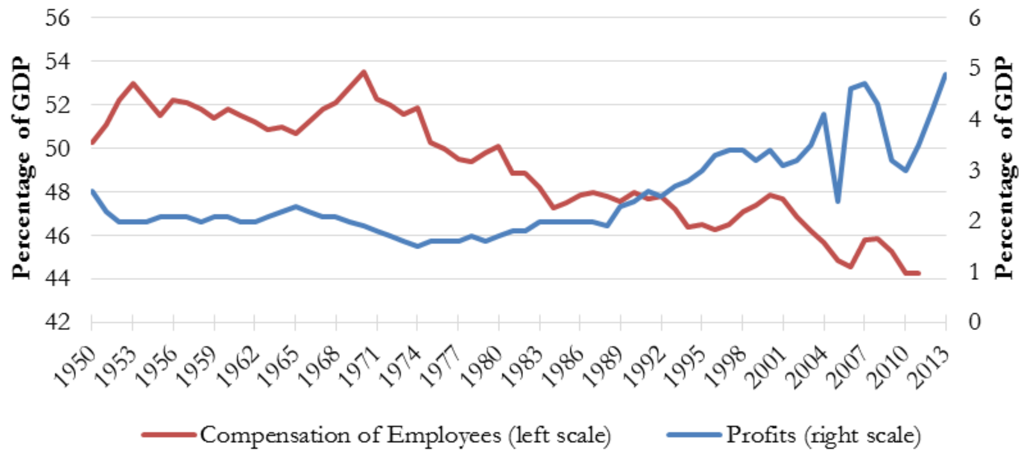
Another example of such policies next to the decrease of top income tax rates is the decrease in corporation income tax which has diminished constantly as a share of GDP. However, corporate profits as a share of GDP have been growing which benefited the upper-tail of the income distribution disproportionally and supported accumulation. Piketty & Saez (2006, 21) find that the "progressivity of the U.S. federal tax system at the top of the income distribution has declined dramatically since the 1960s" while the average tax rate for the middle class remained constant. "This dramatic drop in progressivity at the upper end of the income distribution is due primarily to a drop in corporate taxes" (Piketty and Saez 2006, 21). This leads to a situation where the "[c]orporate profits are at their highest level in at least 85 years. Employee compensation is at the lowest level in 65 years" (Norris 2014). As it is the case with the below analysed top income tax rate and the increasingly hostile behaviour towards unions the beginning of those favourable policies can be found during the Reagan administration.

> "These large reductions in tax progressivity since the 1960s took place primarily during two periods: the Reagan presidency in the 1980s and the Bush administration in the early 2000s" (Piketty and Saez 2006, 22).

These union-hostile and business-friendly policies had a major impact on the income distribution between factor shares and on which part of the population receives how much of national income. For example, these policies have contributed to a decreasing compensation of employees as a share of national income (Figure 4). Corporate profits as a share of national income remained fairly stable at around 2% with some minor fluctuations between 1950 and 1988. However, after 1988 the share of corporate profits experienced a steady increase to 4.9% of national income, only interrupted by two sharp drops in 2004 and in 2007. Profits bounced back to "pre-crisis levels" within one year and less than three years respectively. Besides, the long-term trends of sources of tax receipts as a percentage of GDP which distinguish between individual income taxes and taxes paid by corporations is also

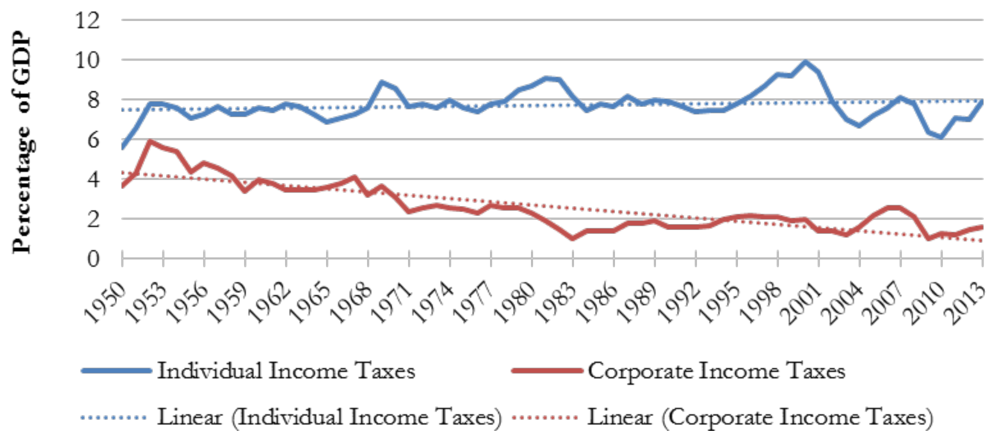
interesting (Figure 5). Taxes received from individual income tax payers increased slightly from 7.8% (1952) to 7.9% (2013). However, the taxes received from corporations experienced a steady decrease. They dropped from 5.9% (1952) to 1.6% (2013). Despite increasing profits the share of tax receipts as percentage of national income decreased constantly. Thus, the corporation's tax burden has decreased relative to the burden of the individuals.

Figure 4: U.S. Compensation of Employees and Profits, 1950-2012



(Source: author's compilation, date retrieved from FRED (2014).[4])

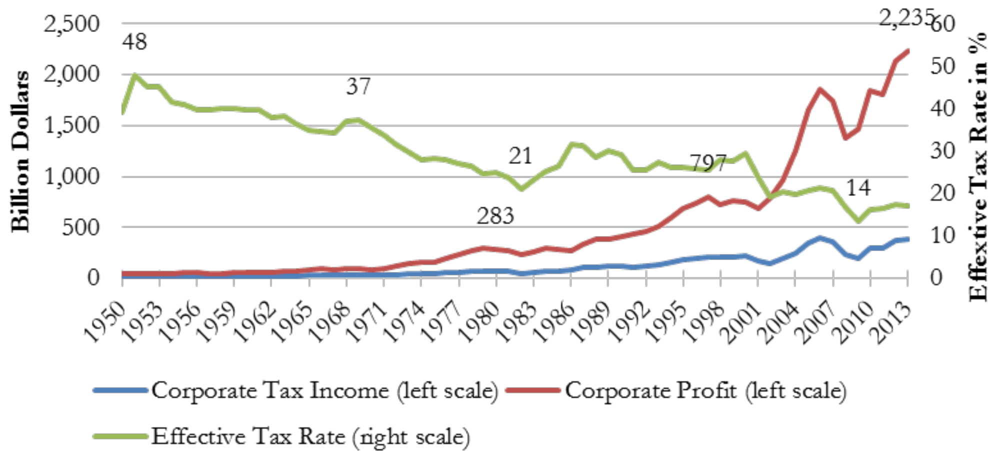
Figure 5: U.S. Tax Receipts by Source as Percentage of GDP, 1950-2013



(Source: author's compilation, data retrieved from Historical Tables (2014).)

[4] Refer to Appendix B for a more detailed description of the data.

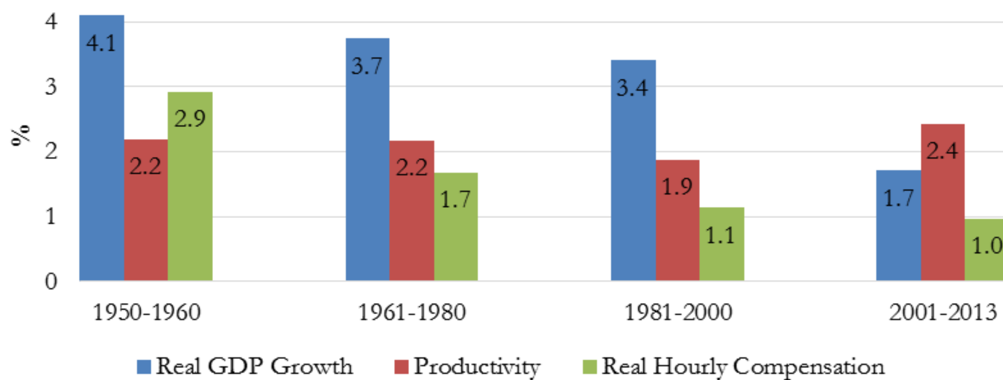
Figure 6: U.S. Effective Corporate Tax Rate, 1950-2013



(Source: author's own compilation, based on FRED (2014).[5])

Another consequence is the continuous reduction of the effective tax rate paid by corporations during the same time period (Figure 6). It peaked at 48% (1950) to drop to its lowest point at 14% (2009) and slightly increased to 17% (2013). The corporate profits steadily increased from 1950 to late 1960s, however, in the early 1970s they increased at a faster pace. The trend experienced another sharp increase from 1986 onwards. The shift of focus of macroeconomic policies in the early 1980s in general and the increase in top salaries, the decrease in union power, the decrease in top income tax rate and the decrease in corporation income tax in particular have contributed to the divergent factor shares of income. The explicit pro-capital and labour hostile nature of policies governing the unions put downward pressure on real wages. Productivity gains are not passed on to labour in terms of real wage increases anymore (Figure 7). It furthermore shows that stagnating real wages are not related to falling productivity of labour. On the contrary, gains from increasing productivity have not been passed on to labour.

Figure 7: U.S. Growth, Productivity Growth and Real-Hourly Compensation



[5] Refer to Appendix B for a more detailed description of the data.

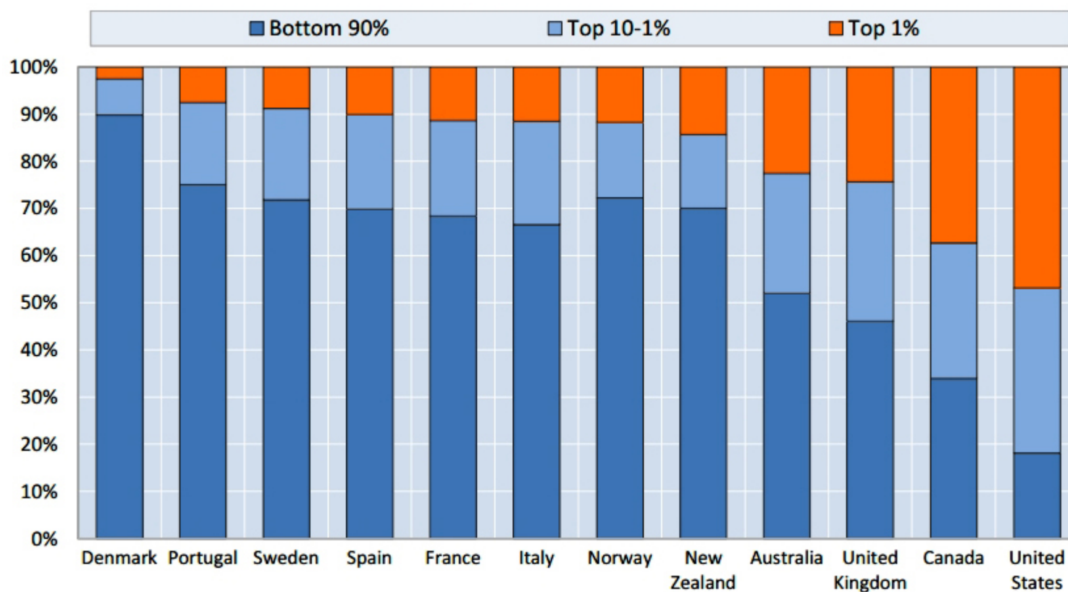
(Source: author's own compilation, date retrieved from Fleck et al. (2011) and FRED (2014).[6])

In order to justify the upward redistribution often the argument of increased investments and the consequent trickle-down effect are advanced. However, neither the decrease in high income taxes nor the decrease in corporation tax have increased the savings ratio. In the post-World War period the:

> "top marginal tax rate and the top capital gains tax rate do not appear correlated with economic growth […] saving, investment, and productivity growth" (Hungerford 2012, 17).

At the same time, these policies have enabled the upper end of the income distribution to gain large and disproportional shares of national income (capturing most of the productivity increases). The share of national income increases the closer one moves to the upper end of the distribution. Atkinson et al. (2011, 9) calculate annual real income growth for the top 1% of the income distribution in the period from 1976 to 2007 at 4.4%, whereas the real income for the remaining 99% increased by 0.6% only. OECD (2014) provides data showing the growth capture of national income according to income groups (Figure 8). The bottom 90% of the income distribution received less than 20 percent of national income growth from 1975 to 2007, whereas the top 1 percent of the income distribution received the lion share of nearly half of national income growth. Another 30 percent of national income growth is received by the top 10 percent to 1 percent. The "top tax rate reductions appear to be correlated with the increasing concentration of income at the top of the income distribution" (Hungerford 2012, 17). Thus, both, the marked increase in the share of top income earners of national income (upward trend in upper-end income distribution) and the stagnation of real wages (downward pressure on the lower-end income distribution) reinforce the trend towards inequality and result in changing factor shares of the FID.

Figure 8: Growth Capture of Total Income, OECD Countries, 1975-2007



Note: Incomes refer to pre-tax incomes, excluding capital gains
Source: OECD calculations based on the World Top Income Database.

(Source: OECD 2014, 3)

[6] Refer to Appendix B for a more detailed description of the data.

Analysing the FID in the U.S. reveals an increasing share of capital to the detriment of labour. This section has shown *how* drivers of income inequality impact the distribution of income within the U.S. The top income earners successfully captured most parts of the income generated by the economy while the income of labour stagnated. Productivity gains were not passed on to labour as it was the case in the intermediate post-World War period. The upward redistribution is actively supported by U.S. policies which decreased the top income taxes constantly; discouraged unionisation which decreased the means of unions to successfully bargain for increasing real wages. Thus, it is important to look at the FID for the general trend. More detailed causes of changes in the income distribution can be derived by analysing to which income group accrues how much of national income.

As it is not possible to argue, based on the empirical evidence provided above, for a direct causal relationship between the policies favouring the already rich disproportionally at the expense of decreasing the aggregate demand of the majority, the pattern is nevertheless remarkable. However, upward redistribution from large parts of the population to the benefit of a few at the top of the income distribution must have (had) an impact on aggregate demand. During the same period in which globalisation supposedly increases the competition among companies corporate profits in absolute numbers and in relation to GDP as well as high incomes soar. However, if those income gains had not been made at the expense of the majority "aggregate demand would have grown faster and the recovery would be stronger" (Bivens, 2013, 20). This contradicts the austerity policies. Growth policies which increase the demand of the majority through increases in real wages would be more fruitful (Onaran and Galanis 2013, 89). The low purchasing power of the majority and the lack of demand for goods and services has attracted the attention of other traditionally more conservative actors (Reuters 2014a; Reuters 2014b; S&P 2014).

To conclude, the politically induced decrease in unionisation, the decrease in high income and corporation tax have been the main drivers of increasing inequality. These trends lead to a decrease of the labour share of national income and reduced the aggregate demand for the majority of the population. One of the (arguably many) *necessary* preconditions for constant and sustainable growth is a certain degree of an equal distribution of national income. Which degree of equality is *sufficient* as a precondition for sustained growth is difficult to determine. However, if the labour share of national income in the U.S. does not increase it is unlikely that aggregate demand will be able to sustain a modest growth of the economy. The most efficient way to stimulate aggregate demand is to increase the real wages of the majority. For economic and normative reasons alike more equality, instead of higher inequality, is the foundation of sustained growth.

Conclusion

Several trends which contributed to this phenomenon of increasing income inequality started around 1980 and were politically induced. Some trends have contributed to a greater, others to a lesser extent and there might be others which have not been considered in this analysis. However, if income inequality is seen through the FID and income groups, a clear picture emerges. Politically induced decreasing unionisation and the fact that the gains in productivity are not passed on to workers translate into stagnating real wages for large parts at the lower end of the income distribution. At the upper-end, however, income increases in real terms through the politically induced decrease in top income tax rates and the marked increase of

top-income salaries. Both trends reinforce the divergence between labour and capital. The share of the middle-class stagnates.

Despite the fact that exogenous drivers play an important role in the determination of inequality, countries do have the necessary policy tools in order to prevent, or at least, curb the trend of increasing inequality posed by the exogenous drivers. However, the tools that were employed by the U.S. governments turn out to be catalysers of the upward trend instead of absorbing the starkest increase. One such example is the shift of macroeconomic policies away from the "traditional" focus of overall macroeconomic stability and full employment towards price stability which has a direct bearing on the distribution of income and increases the divergence of income between upper- and lower end of the distribution. But why are the exogenous drivers of increasing inequality reinforced by endogenous drivers (meaning political decisions) which instead could have been employed to diminish the effects of exogenous drivers?

Partly, this question can be answered with the growing influence of economic elites on the decision-making legislative process in the U.S. High and persistent income inequality has led to representational inequality. In the case of the U.S. economic elites influence policies to their advantage and do so successfully even in those cases where the majority of citizens disagree on particular matters. This finding hints at a more fundamental issue in the analysis of income inequality: the neglect of the political dimension as a major contributor to increasing income inequality. The political dimension is not the only driver of income inequality in a country but again it plays an important role to which academic attention has failed to do justice to.

The analytical neglect of the political dimension has severe consequences. Being an under-researched but definitely important dimension it is not well-understood by scholars to what extent and how the political dimension affects income inequality. The argument put forward in this analysis is that institutions actively contribute to the sharp divergence of the income distribution. Since the impact of the political dimension on inequality has been neglected by researchers it is not possible to include it in growth models or regression analysis in a meaningful way. However, if a variable for which empirical evidence finds a major role in the determination of income inequality is not included in such models or regression analyses the outcome is less reliable. Thus, further research needs to focus on how to include the political dimension in growth models and regression analyses in a meaningful way.

It has to be acknowledged that structural changes create more competition and lead to tectonic shifts in the process of economic organisation. Globalisation allows to shift labour intensive production from developed economies to other economies more easily. These arguments are often advanced to explain the decreasing share of labour income and to legitimise policies which favour corporations and high-income individuals disproportionally. However, why is accumulation at the top soaring? Why do corporations have increasing revenues in absolute terms as well as a share of GDP while at the same time the real wages of large parts of the population are stagnating? There is an undeniable influence of the economic elite on legislative processes. Redistribution always takes place what changes are the groups which benefit.

Most importantly, decreasing inequality is not an automatic outcome of growth. Redistribution always takes place and institutions (the political dimension) determine whether national income is redistributed upwards or is more equally shared among the population. In the case

of the U.S. various policies since 1980 have favoured an upward redistribution which benefited a few at the expense of the majority. If compared to the intermediate post-World War period, where economic growth came along with *decreasing* inequality, a clear faultline can be established. After 1980 a trend towards growth and *increasing* inequality began to emerge. The concentration of income at the top of the income distribution turned into means which increased the political influence of the economic elite and perpetuated inequality even further.

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Appendix A: Description of Data based on AMECO (2014)

Variable	Acronym	Description
Adjusted Wage Share	ALCD0	Adjusted wage share: total economy: as percentage of GDP at current market prices (Compensation per employee as percentage of GDP at market prices per person employed.)

(Source: AMECO (2014).)

Appendix B: Description of Data based on FRED (2014)

Variable	Acronym / Formula	Description
Corporate Income Tax	FCTAX	Federal Government: Tax Receipts on Corporate Income
Corporate Profit	A053RC1A027NBEA	Corporate profits: Profits before taxes, NIPAs
Effective Tax Rate	FCTAX/A053RC1A027NBEA*100	See above
Compensation of employees	W269RE1A156NBEA	Shares of gross domestic income: Compensation of employees, paid: Wage and salary accruals: Disbursements
Profits	A449RE1A156NBEA	Shares of gross domestic income: Corporate profits with inventory valuation and capital consumption adjustments, domestic industries: Profits after tax with inventory valuation and capital consumption adjustments: Net dividends

(Source: FRED (2014).)

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