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Partisan Politics, Financial Deregulation, and the New Gilded Age

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Abstract

This paper examines how financial deregulation and the partisan underpinnings of deregulation shaped the path of income inequality in the United States. Using time-series data from 1914 to 2010, we assess the effect of partisan politics on financial deregulation and, in turn, the effect of deregulation on income inequality. We find that financial deregulation has generally declined when Democrats attain more power in Washington and that deregulation has contributed to rising inequality. We also learn that the partisan effect on deregulation has diminished since the early 1980s, suggesting that one way partisan politics has contributed to the recent rise in inequality is related to convergence on matters of financial deregulation. We explore several potential explanations for this post–1980 partisan convergence, finding evidence supporting the idea that globalization, the increasing availability of credit, and shifts in campaign finance were contributing factors.

Keywords

economic inequality, regulatory policy, U.S. politics, political parties, financial sector

The gap between the rich and the poor in America has been far from constant over time. At the low water mark in the mid-1970s, the top 1 percent of U.S. tax units had nearly 9 percent of total national income. The picture today is different. Now, the top 1 percent have around 20 percent of aggregate income (Piketty and Saez 2006).[1] The situation has become sufficiently stark to attract the attention of politicians ranging the ideological spectrum. Democrats from Barack Obama to Elizabeth Warren and Bernie Sanders seem to be talking about economic inequality and its potential negative ramifications for America's economy more than ever. On the other side of the political spectrum, several Republican presidential candidates have conceded that economic inequality is a serious problem and have begun to lay out their preferred policies for combating it. But identifying the proposals most likely to reduce inequality requires a clear understanding of the factors that push inequality up and down, and such an understanding should be based in the best possible evidence and analysis.

In the growing literature on income concentration in the United States, one of the emerging themes is the role of politics and the myriad ways that government intervenes in the economy (Bartels 2008; Enns et al. 2014; Hacker and Pierson 2010; Volscho and Kelly 2012). In this paper, we build on and connect several strands of literature related to the effects of partisan politics and policy decisions on economic inequality. Although there is substantial agreement that political factors have important distributional consequences, there is less agreement about the precise policy mechanisms that link politics to inequality. Those focusing on government's role in shaping income inequality have emphasized redistribution (Danziger and Gottschalk 1995; Kelly 2004). More recently, scholars have brought attention to "market conditioning," or how government structures the economic rules of the game (Kelly 2009). Examples of such policies include corporate regulation, public education programs, minimum wage laws, and environmental regulation (Page and Simmons 2000). This line of research has provided empirical support for the idea that political dynamics shape income inequality via market conditioning by showing that shifts in the partisan and ideological composition of policymaking institutions are associated with shifts in market inequality measured prior to the effects of taxes and transfers (Hacker and Pierson 2010; Kelly and Witko 2012; Morgan and Kelly 2013).

However, existing research has rarely specified tests that identify which, *if any*, of the proposed market conditioning policies actually link left–right political dynamics to pretax and transfer income inequality. Here, we build on recent studies placing a spotlight on the role of the finance sector in rising inequality (Philippon and Reshef

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2012; Tomaskovic-Devey and Lin 2011; Witko 2015) and examine regulatory policy in the financial sector as a market conditioning mechanism linking partisan politics to distributional outcomes.

Our second contribution examines whether the partisan effects on financial deregulation identified in the first portion of the analysis have been maintained over time. One important characteristic of American politics over the past several decades has been polarization. But within this context of general polarization, some have suggested the possibility of partisan convergence in certain domains (Hacker and Pierson 2010; Roy and Denzau 2004). Most relevant to our analysis, Hacker and Pierson (2010) argue that Democrats have converged with Republicans on policies related to distributional outcomes generally and market conditioning more specifically. Democrats and Republicans, then, may have converged in the domain of financial regulation even while general partisan polarization has increased. Here, we provide evidence for partisan convergence and then explore four potential explanations—the increased reliance of families on consumer debt, changes in the sources of campaign contributions, globalization, and the decline of unions. In sum, we find that while policy divergence between Republicans and Democrats coupled with Democratic strength in national politics likely contributed to the post–World War II decline in income inequality, policy convergence in the domain of regulatory policy during the early 1980s explains a portion of the increase in inequality over the last three decades.

Our analytical framework has two major components. The first traces the effects of partisan politics on financial deregulation and, in turn, the effects of deregulation on income concentration. We begin by discussing the divergent motivations of Democrats and Republicans in the realm of financial deregulation. The general pattern is that Democrats have both electoral and ideological incentives to defend regulation while Republicans have countervailing incentives to deregulate. Deregulation, we argue, is likely to have distributional consequences, with inequality increasing in response to deregulatory policy changes in the financial sector. The second component addresses whether and why Democrats and Republicans have more recently converged in the domain of financial regulation. We synthesize previous discussions suggesting the possibility of partisan convergence in the realm of regulatory policy and then develop and empirically explore several potential explanations for any such convergence.

The Path from Politics to Deregulation to Income Concentration

It would be somewhat surprising if politics did not play a role in the ebb and flow of regulation, but the aspects of politics that might shape regulation and deregulation are not as obvious. Power resources theory (PRT; Bradley et al. 2003; Hicks 1999; Korpi 1978; Stephens 1979), which discusses how the relative power of economic groups in society affects distributional outcomes, has potential purchase for understanding connections between political dynamics and financial regulation. From the perspective of PRT, the poor and middle class organize through left parties in the political realm.[2] These left parties, to the extent that they gain control over the governing apparatus of the state, produce policies that generate a more equitable income distribution. Regulatory policy in the financial sector is a possible policy mechanism linking party control to market income inequality (Witko 2015). The Glass–Steagall Act, which separated commercial and investment banking activities, was passed in a context of unified Democratic control in the aftermath of the Great Depression. This regulatory framework became a target for repeal by conservative Republicans beginning as early as the 1960s, and a series of legislative victories culminated with passage of the Gramm–Leach–Bliley Act in 1999, which formally repealed the main limitations previously placed on banks. So recent research and a basic understanding of the history of financial regulation suggests that the partisan balance of power in Washington has implications for regulatory policy in the financial sector:

> **Hypothesis 1 (H1):** Democratic control of policymaking institutions is associated with reductions in deregulation, while Republican control is associated with increases in deregulation.

The connection between partisan politics and financial deregulation is an important aspect of our argument, but this connection is important for understanding distributional outcomes only to the extent that deregulation, in turn, increases income concentration. According to rent-seeking perspectives on regulation, there is good reason to doubt this is the case (Stigler 1971; Tullock 1989). Regulation often serves to benefit the regulated industry, in particular by creating barriers to entry that shield firms from market competition. For instance, professionals in sectors that require licensing, from salon stylists to physicians, are insulated to some extent from competition due to regulation-induced barriers to entry.

More pertinent to the argument here, financial services firms are subject to complex chartering and reporting requirements, which create high barriers to entry that likely serve to protect existing finance firms from competition and enhance their profitability. Given that those in the highest echelons of the income distribution often come from the finance sector, the purest form of the rent-seeking theory of regulation predicts a positive association

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between regulation and economic inequality. As the finance sector is more heavily regulated, and thus more protected from market competition, profits and salaries in this sector should rise, thereby driving income inequality higher. Another way that the rent-seeking theory of regulation could explain any positive association between deregulation and income inequality is by raising the possibility of reverse causation, with finance firms seeking new regulation when their profits (and income inequality) are low and seeking deregulation when their profits (and income inequality) are high. In this circumstance, any positive association between deregulation and rising income inequality would be due to inequality's influence on deregulation rather than the reverse.

However, such a simplistic view of regulation is likely misleading. Regulatory policy toward almost any sector is some combination of industry protection and public goods provision. The passage and ongoing implementation of the Affordable Care Act (ACA) provides a useful example. Aspects of the ACA are designed to enhance the quality and affordability of health insurance, thus making these products more accessible and useful to consumers. But other aspects of the ACA clearly provide benefits to the health insurance industry. And in this particular instance, many health industry actors—from professional associations of physicians to health insurance firms—supported the policy changes. In the context of the financial sector, however, stances toward regulation among affected firms have typically been much more negative. For instance, efforts to implement the Dodd–Frank Act aimed at regulating the financial sector have faced vociferous opposition from finance, suggesting that the reforms are not perceived as primarily protecting existing firms. Moreover, recent scholarship provides good reason to believe that income inequality is, in fact, exacerbated by financial deregulation (Hacker and Pierson 2010; Krippner 2011; Lin and Tomaskovic-Devey 2013; Tomaskovic-Devey and Lin 2011). Philippon and Reshef (2012) document, in the context of financial deregulation, the steady rise of finance sector compensation as well as the growth of the finance sector more generally. These changes were happening at the same time that income concentration was beginning to increase (Hacker and Pierson 2010; Tomaskovic-Devey and Lin 2011). However, the idea that financial deregulation contributed to rising inequality is highly contested (Beck, Levine and Levkov 2010; Delis et al. 2014). We seek to contribute additional evidence to this ongoing debate by testing the following hypothesis:

Hypothesis 2 (H2): Increasing deregulation in the financial sector produces increasing income inequality.

Partisan Convergence and Financial Deregulation

Traditionally, Democrats have been the primary proponents of financial regulation. The major regulatory efforts in response to the Great Depression (such as Glass–Steagall) were driven by Democratic policymakers. And Democratic leaders stood squarely in the way of legislative efforts to move toward deregulation from the end of the Great Depression until the late 1970s. While one of the key characteristics of the contemporary U.S. party system is party polarization (Fleisher and Bond 2004; Stoker and Jennings 2008; Theriault 2008), an examination of the largest changes in financial regulation suggests that partisan convergence occurred in the last two decades of the twentieth century (Fligstein 2010; Hacker and Pierson 2010). The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 marked an important deregulatory policy shift. This bill was introduced by a Democrat and had broad bipartisan support, passing with more than 90 percent of both parties in both chambers. When signing the bill, President Clinton stated that his support was rooted in a larger desire for deregulatory policy change: "It represents another example of our intent to reinvent government by making it less regulatory and less overreaching . . ." (Clinton 1994: 1656). When the remnants of Glass–Steagall were fully repealed, more than 70 percent of Democrats and 90 percent of Republicans supported the bill in Congress. Clearly, by the 1990s, a large bipartisan majority was in favor of rolling back financial regulations. Existing qualitative analyses of financial deregulation, then, suggest the following hypothesis related to partisan convergence on the issue of financial deregulation:

Hypothesis 3 (H3): The association between Democratic control of policymaking institutions and decreased deregulation declined around 1980.

H3, then, is essentially stating that the relationship hypothesized in H1 is time-contingent, with any observed partisan effect on deregulation diminishing around 1980.

But what might explain partisan convergence? We examine four potential explanations. The first relates to increasing demand for credit. Stagnating wages in the middle and bottom of the income distribution coupled with rising wages for the highly skilled since 1970 created a situation in which the middle class was left behind economically. One potential, if unsustainable, solution to this problem was credit. If credit could more easily be extended to middle- and lower-income families, they could maintain increasing standards of living in the face of declining or stagnating wages. The regulatory environment of the

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late 1970s, however, made substantial growth in credit to low- and middle-income individuals difficult. This basic trajectory of stagnating middle incomes increased demand for credit, and the deregulatory response has been documented elsewhere (Gorton 2012; Heathcote, Perri, and Violante, 2010; Krippner 2011; Kumhof, Ranciere, and Winant 2015; Treeck 2014). This increased demand for credit among low- and middle-income individuals could explain greater support for deregulation among Democrats. While financial deregulation might have previously been seen as a benefit only to the wealthy, the economic context of the 1980s made it possible for Democrats to reinterpret financial deregulation as essential to the short-term well-being of their core constituents. Some Democratic policymakers made this argument fairly explicit. During the House debate of Gramm–Leach–Bliley, which opened the door to the creation of megabanks conducting both savings and investment, Cynthia McKinney (D-Georgia) touted its potential benefits to middle- and lower-income Americans: "When banks offer securities, insurance, and other financial services directly and through affiliates, they will bring a new level of convenience and choice to customers from every economic bracket from Decatur, Georgia to Watts, Los Angeles" (U.S. House Committee on Banking and Financial Services 1997: 430). President Clinton (1999, 2081) echoed this sentiment in his signing statement for the bill: "[The bill] will guarantee that our financial system will continue to meet the needs of underserved communities." If credit expansion is part of the explanation for partisan convergence, then we should observe smaller partisan effects on deregulation as credit increases:

> **Hypothesis 4 (H4):** The association between Democratic control of policymaking institutions and decreased deregulation is attenuated as credit utilization increases.

The second potential explanation of partisan convergence is campaign finance. It is not controversial to assume that donors from the financial sector are more supportive of financial deregulation than average citizens (Page, Bartels, and Seawright 2013). There is also evidence that politicians are more attentive to their donors than regular constituents (Kalla and Broockman 2015).[3] Therefore, if an increasing share of campaign funds has come from the financial sector, it is possible that politicians would become more open to deregulation. If, in particular, Democratic campaign funding sources shifted toward the financial sector, this could provide a compelling explanation for partisan convergence. If this explanation is correct, we should observe smaller partisan effects on deregulation as more campaign funds come from the finance sector:

> **Hypothesis 5 (H5):** The association between Democratic control of policymaking institutions and decreased deregulation is attenuated as Democratic campaign support from the financial sector increases.

A third potential explanation of partisan convergence on financial deregulation is a shift in the interest system. Labor unions, which were once a strong voice for workers, have declined in membership and become increasingly representative of public sector professionals rather than the traditional working class. As labor unions have declined, corporate interest groups have proliferated, weakening the voice for middle-class interests at the same time that upper-class interests grew stronger. Because labor unions were historically a key source of campaign funding and votes for Democratic politicians, their decline could have especially important implications for the electoral calculus of Democrats. One likely implication of declining support from labor for Democrats is a reduced incentive for Democratic policymakers to support regulatory policies that protect the working class. If this explanation for partisan convergence is correct, we should observe fewer partisan effects on deregulation as the strength of unions decreases:

> **Hypothesis 6 (H6):** The association between Democratic control of policymaking institutions and decreased deregulation is mitigated as labor union strength decreases.

Finally, a fourth potential explanation for partisan convergence is globalization. In a globalized economy, domestic policymakers could face pressures to deregulate due to increasing international competition. As exposure to international competition increases, a corporate sector that faces regulation can credibly argue that they are placed at a competitive disadvantage relative to competitors based in countries with less regulation. Globalization, in a sense, can reduce the ideological dimensions of the debate over deregulation and shift the discussion in a more technocratic direction. If this mechanism is at work, we would expect legislators in contexts that are more highly exposed to the global economy to be more supportive of deregulation. As Republicans in the United States have long been ideologically predisposed toward limiting regulation, globalization is most likely to have effects on the policy preferences of Democrats, pushing them to converge with Republicans on financial deregulation, thereby generating the following hypothesis:

> **Hypothesis 7 (H7):** The association between Democratic control of policymaking institutions and decreased deregulation is attenuated as exposure to the international economy increased.

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Data and Method

Our analysis has two major components. The first is designed to test H1 and H2—the effect of partisan politics on financial deregulation and the effect of deregulation on income concentration. For this portion of the analysis, we rely on annual time-series data from 1914 to 2010. The second component of the analysis assesses H3 through H6, all of which relate to whether and why the connection between party control and financial deregulation diminished around 1980. This portion of the analysis employs annual time series of various lengths contingent upon the data available to assess each hypothesis. The variables used are described in the sections below. Descriptive statistics for all variables and charts depicting the two key dependent variables are available in the SI file (at http://prq.sagepub.com/supplemental/).

Dependent Variables

Financial deregulation. The heart of our analysis considers two dependent variables. The first is *Federal Deregulation*. Our measure is based on Philippon and Reshef (2012). Their measure includes (1) branching, which is the percentage of U.S. population living in states that removed branching restrictions; (2) separation of commercial and investment banks (Glass–Steagall indicator), which shows the decrease in regulatory separation of these two types of banks; (3) interest rate ceilings, which captures the ceilings in effect from 1933 to 1983; and (4) separation of banks and insurance companies. For our analysis, we remove the state branching measure as our focus is deregulatory activity at the federal level.

Top income shares. The second dependent variable we analyze is income concentration. To capture economic inequality, we focus on the income shares of the top 0.01 percent.[4] We focus on top income shares because it has become clear that income concentration at the very top is the primary driver of income inequality (Hacker and Pierson 2010; Piketty and Saez 2006). As our interest is in how the *market* has responded to changes in politics and policy, we use measures of top income shares that are based on pretax, pretransfer income (wages and salaries, small business and farm income, partnership and fiduciary income, interest, rents, dividends, royalties, capital gains, and miscellaneous sources) and that include realized capital gains because investments are an important income source for the very rich. These data come from the World Top Incomes Database (http://topincomes.gmond.parisschoolofeconomics.eu/).

Explanatory Variables

Partisan control of policymaking institutions. We include measures of Democratic control of the presidency, Senate, and House. *Democratic President* is coded 1 when a Democrat is in the White House and 0 otherwise. *Democratic Senate* is coded 1 when Democrats are in the majority and 0 otherwise.[5] *Democratic House* is coded 1 when Democrats hold a House majority and 0 otherwise. We expect Democratic control of these institutions to be associated with less financial deregulation. However, we anticipate that this effect may diminish around 1980. We explore this possibility and explain our strategy for doing so in greater detail after our initial analysis using the full-time period.

Unified partisan control. We also include a measure capturing partisan control of the policymaking institutions while accounting for the role of divided government. This measure, which we label *Unified Democrat*, ranges from −1 to 1 with −1 indicating unified Republican control of the House, Senate, and Presidency; 0 indicating divided government; and 1 indicating unified Democratic control. As this variable moves toward unified Democratic control, we expect financial deregulation to decrease, with the effect possibly diminishing around 1980.

Financial deregulation. Federal deregulation, the dependent variable in the first phase of our analysis, is the key explanatory variable in the second phase of the analysis. We expect financial deregulation to be associated with increased economic inequality, though we expect that any effects of regulatory changes may take several years to be fully realized as implementation takes time. The independent variable is identical to that described above.

Top marginal income tax. This variable captures the highest possible top marginal income tax rate, which we expect to be inversely associated with economic inequality. These data come from the Urban Institute and the Brookings Institution's Tax Policy Center.

Dow Jones Industrial Average (DJIA). This variable comes from the Federal Reserve Bank of St. Louis Federal Research office, which supplies the historical values of the DJIA. We converted the historical series to constant 2005 values using the Consumer Price Index to create a deflator with 2005 as the base. This variable is included because better stock market performance likely increases income concentration at the very top of the distribution (Baker 2009; Shiller 2005; Volscho and Kelly 2012).

Trade openness. This variable is defined as imports and exports as a percentage of gross domestic product (GDP; Roine, Vlachos, and Woldenstrom 2009), and the data come from the Bureau of Economic Analysis (2012, Table 1.1.5). Trade openness may weaken the bargaining power of workers because of increasing labor competition (Tonelson 2000; Wood 1994), thereby increasing income concentration.

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Union membership. This variable captures the percent of the nonfarm workforce in unions or labor associations with data coming from U.S. Census Bureau and Bureau of Labor Statistics. Union strength is a key indicator of lower class power resources in PRT. In addition, previous inequality literature for the United States has identified the decline of union membership in the United States as a major factor in explaining income inequality (Kristal 2013; Volscho and Kelly 2012; Western and Rosenfeld 2011).

Partisan Convergence Variables

Our approach for this portion of the analysis is designed to assess whether the effect of Democratic partisanship on financial deregulation changes as other variables change. We use a series of multiplicative interaction terms between Democratic control and a variety of potential moderating variables to estimate how the effect of Democratic partisanship changes as values of the moderating variable change. If Democratic partisanship reduces financial deregulation at some values of the interacting variable and does not reduce financial deregulation at other values of the interacting variable, this is evidence that the variable does indeed have a moderating influence on the effect of Democratic control. Our first task is to assess whether the partisanship effect shifted sometime around 1980. We then move on to examining the four possible explanations for partisan convergence discussed above by identifying moderating variables connected to each of the potential explanations. These moderating variables are as follows.

Regime-change variables. To examine several potential time points for a regime change in the relationship between party power and financial deregulation, we create a series of dummy variables coded 0 prior to the possible regime change and 1 from the possible regime change onward. We consider regime changes from 1975 to 1986. When interacted with party variables, these regime change measures provide an initial test of whether the effect of partisanship on deregulation diminished after some point around 1980. In the analysis below, the post–1982 dummy variable becomes central, which is coded 0 prior to 1982 and 1 since 1982. Results are similar as long as a year in the late 1970s or early 1980s is selected as the break point. The SI file contains a more detailed explanation of our focus on 1982 in the remainder of the analysis.

Private debt. Loans per Capita is a measure of credit based on total household and nonprofit loans per capita, calculated from Board of Governors of the Federal Reserve data. This variable is only available since 1945 so this model includes a reduced number of time points. The expectation is that partisan effects on deregulation move toward zero as credit utilization increases.

Finance sector campaign funding. Finance Sector Contributions is a variable tapping the proportion of campaign funds coming from the finance sector among Democratic Members of Congress relative to Republican Members of Congress. This variable was calculated by the authors based on data from the Database on Ideology, Money in Politics, and Elections (Bonica 2013). During the period in which data are available (since 1980), Democrats have always received less support from the finance sector than Republicans. However, the ratio of Democratic to Republican support ranges from 0.61 (meaning Democrats received just 60% as much support from the finance sector as Republicans) to 0.99 (meaning the two parties were nearly at parity). The expectation is that partisan effects decreased as campaign funding from the finance sector for Democrats became more important.

Union membership. This variable is identical to the union variable described above. The negative effect of Democratic control on deregulation should be enhanced as union membership increases if union decline contributed to partisan convergence.

Trade openness. Again, this variable is as described above. If exposure to international competition contributed to partisan convergence, partisan effects on deregulation should diminish as trade openness increases.

Modeling and Estimation Strategy

Given the nature of our data, it is important to assess the time-series properties of the variables analyzed. All of the variables contain a unit root or are near-integrated (see SI). Thus, we must take care to avoid problems of spurious regression. In the analyses below, we use one of two methods as appropriate. For some portions of the analysis, we estimate single-equation error correction models (ECMs). ECMs are useful because they allow estimation of both short- and long-term effects, which is particularly important as we explicitly expect that deregulation has long-term effects on inequality that are not confined to a particular point in time. In addition, because ECMs use a differenced version of the dependent variable, concerns about spurious regression are eliminated for the portion of the model estimating short-term effects and are also mitigated in the long-term portion of the model so long as cointegration is present (Banerjee et al. 1993; De Boef and Keele 2008; Engle and Granger 1987). We therefore conduct tests to confirm (near-)cointegration.[6]

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Table 1. Models of Financial Deregulation and Income Concentration, 1914–2010.

	Δ Federal deregulation$_t$		Δ Top 0.01% share$_t$
	(1)	(2)	(3)
Δ Democratic President$_t$	−0.12*		
	(0.07)		
Δ Democratic Senate$_t$	−0.20**		
	(0.08)		
Δ Democratic House$_t$	0.06		
	(0.10)		
Δ Unified Democrat$_t$		−0.11**	
		(0.05)	
Top 0.01% Share$_{t-1}$			−0.49***
			(0.09)
Δ Federal Deregulation$_t$			0.36*
			(0.21)
Federal Deregulation$_{t-1}$			0.22**
			(0.09)
Δ Top Marginal Tax Rate$_t$			−0.012**
			(0.006)
Top Marginal Tax Rate$_{t-1}$			−0.011**
			(0.004)
Δ Union Membership$_t$			−0.00
			(0.04)
Union Membership$_{t-1}$			−0.00
			(0.02)
Δ DJIA, Deflated to 2005$_t$			0.0004***
			(0.0001)
DJIA, Deflated to 2005$_{t-1}$			0.0001**
			(0.0000)
Δ Trade Openness$_t$			0.08**
			(0.03)
Trade Openness$_{t-1}$			0.01
			(0.02)
Year			−0.00
			(0.01)
Constant	−0.01	−0.01	6.08
	(0.02)	(0.02)	(12.47)
Observations	97	97	96
R^2	.13	.06	.54

OLS regression coefficients with standard errors in parentheses. Ericsson and MacKinnon (2002) critical values for error correction rate. OLS = ordinary least squares; DJIA = Dow Jones Industrial Average.
*p < .10. **p < .05. ***p < .01.

Where cointegration is not present, long-run effects are not present, and we therefore revert to a more straightforward auto-regressive integrated moving average (ARIMA) model. In these portions of the analysis, we difference integrated and near-integrated variables until they are stationary and use the stationary, prewhitened versions of the variables in our analysis. This prewhitening process ensures that spurious regression is avoided.[7]

Results

We begin the analysis in Table 1 with three models designed to test H1 and H2. The first two models present evidence that Democratic control of policymaking institutions is associated with less financial deregulation (H1). In Model 1, we observe a statistically significant negative association between both Democratic control of the

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Senate and presidency and financial deregulation, but no effect of House partisanship. For the sake of attaining efficiently estimated, parsimonious models, we therefore drop the House from all following models in which separate institutional effects are estimated. But this result is interesting, possibly suggesting that there were never policy differences between the two parties in the House. We think this is unlikely. Rather, the null result for the House likely should be interpreted to mean that, within the legislature, the Senate played a more central role than the House in the policymaking process related to financial regulation and deregulation. Future research could explore this possibility explicitly. In Model 2, a measure of unified Democratic versus unified Republican control evidences a negative relationship between Democratic control and financial deregulation. In both of these models, we found ECMs to be inappropriate, so ARIMA models using first-differenced (stationary) versions of the variables are estimated. Model 3 estimates an ECM that provides evidence regarding the effect of financial deregulation on income concentration (H2). This model shows a positive association between financial deregulation and top income shares.[8] Here, the effect occurs partially in the short term (see the coefficient for the change in federal deregulation) and partially in the long term as evidenced by the coefficient for the lagged level of deregulation (along with the evidence of cointegration provided by the significant error correction rate). The fact that some of the effect of deregulation on top income shares is distributed over a period of time makes sense given that national policy changes are typically not immediately implemented and that those targeted by the regulation might take some time to fully adapt.

We also hypothesized that the effect of partisanship diminished over time (H3). We test this hypothesis in the next portion of our analysis presented in Table 2. Model 1 largely mirrors the first model of financial deregulation from the previous table, but in these models, we include a post–1982 dummy variable (coded 1 from 1982 onward) as well as multiplicative interactions between the post–1982 dummy variable and variables capturing Democratic control of the presidency and Senate (as those were the institutions in which Democratic control had the expected effect of diminishing financial deregulation). The interaction terms test whether there was a statistically significant difference in the effect of partisanship before and after 1982.

To accurately assess how the effects of partisan power change before and after 1982, it is helpful to chart the effects at the two possible values of the post–1982 dummy variable. We present these charts in Figure 1. In each chart, we see two dots along with confidence intervals. The left dot in each chart presents the effect of Democratic control before 1982, while the right dot shows the post-1982 effect. We see some evidence that the parties converged on matters of financial deregulation post-1982. Prior to 1982, the effect of Democratic control of the Senate on financial deregulation was negative and strongly statistically significant. But after 1982, this effect diminishes to zero. For the president, however, the effect of Democratic control before and after 1982 is clearly not different. It may be that the limited number of years with Democratic presidents after 1982 helps explain why we see no difference here. These results suggest that to the extent partisan convergence occurred on financial deregulation, the key convergence happened in the Senate.

To this point, we have seen evidence that party control, particularly in the Senate, influences regulatory policy in the financial sector and that, in turn, financial regulation shapes distributional outcomes. We can use information from the analysis above to examine the substantive size of the estimated effects of partisanship on economic inequality via financial deregulation. Based on the results in Table 1, we estimate that a shift from Republican to Democratic control in the Senate produces a 0.20 decrease in deregulation. The results in that table also allow us to calculate the effect of a 0.20 point decline in deregulation on top income shares. The long-run coefficient for the effect of deregulation on top income share is 0.22, so the long-run multiplier effect of a 0.20 point decline in deregulation is a 0.09 reduction in top income shares ($-0.20 \times [-0.22 / 0.49] = 0.09$). With this information in hand, we generate counterfactuals to illustrate the substantive importance of partisan divergence on deregulation prior to 1982 and the partisan convergence that occurred in the Senate from the early 1980s onward.

In the left panel of Figure 2, we ask, based on the regression results above, how policy differences in the domain of financial regulation would have influenced the path of top income shares had Republicans controlled the Senate from World War II until 1982. During this period, Democrats controlled the Senate for twenty-nine years. This means that our counterfactual situation of complete Republican dominance would produce twenty-nine "shocks" to observed partisan control of the Senate. The analysis above indicates that each of these Republican shocks would increase deregulation enough to increase inequality by 0.09 points. In the chart, we account for the fact that shifts in deregulation rooted in changes in party control do not have their full effect on income inequality until about four years after the initial shock. What we see in the chart, then, is a solid line depicting the actual path of top income share from 1913 to the early 1980s and a dashed line showing the path of income inequality predicted by our models had Republicans controlled the Senate for the entire post–World War II period. By 1982, top income shares are estimated to be approximately 2.5 points higher under the counterfactual situation. This represents a substantial increase over the observed level of top 0.01 percent income share in 1982, which was 1.73.

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Table 2. Models of Partisan Convergence on Financial Deregulation.

	Δ Federal deregulation$_t$				
	(1)	(2)	(3)	(4)	(5)
Δ Democratic President$_t$	−0.07				
	(0.09)				
Δ Democratic Senate$_t$	−0.31***	−0.25***	−0.05	−0.20***	−0.23***
	(0.09)	(0.09)	(0.13)	(0.06)	(0.07)
Δ Democratic President$_t$ × Post-1982$_t$	−0.06				
	(0.15)				
Δ Democratic Senate$_t$ × Post-1982$_t$	0.28**				
	(0.13)				
Post-1982	0.12**				
	(0.05)				
Δ Democratic Senate$_t$ × Δ Loans$_t$		0.0001*			
		(0.00006)			
Δ Total Loans per Capita$_t$		0.00			
		(0.00)			
Δ Democratic Senate$_t$ × Δ Finance Contributions$_t$			0.62		
			(1.17)		
Δ Finance Contributions$_t$			0.12		
			(0.59)		
Δ Democratic Senate$_t$ × Δ Union Membership$_t$				0.20**	
				(0.08)	
Δ Union Membership$_t$				−0.00	
				(0.02)	
Δ Democratic Senate$_t$ × Δ Trade Openness$_t$					0.06
					(0.06)
Δ Trade Openness$_t$					−0.00
					(0.02)
Constant	−0.05*	−0.02	0.06	−0.00	−0.01
	(0.03)	(0.04)	(0.05)	(0.02)	(0.02)
Observations	97	61	31	97	96
R^2	.22	.14	.03	.16	.11

Ordinary least squares (OLS) regression coefficients with standard errors in parentheses.
*p < .10. **p < .05. ***p < .01.

Our results suggest that uninterrupted Republican control in the post–World War II era would have hastened the rise of economic inequality.

The partisan effects shown in the left panel of the figure were only present prior to the 1980s. It is tempting, therefore, to conclude that partisan politics has had no effect via financial deregulation on the dramatic rise of economic inequality since the early 1980s. The chart in the right panel of Figure 2 shows, to the contrary, that partisan convergence on financial deregulation has contributed to the increase in income inequality. In the right panel, we compare observed reality to a counterfactual in which partisan effects on deregulation were maintained in the post-1982 period. Essentially, we are comparing the observed reality in which the effect of a Democratic versus Republican Senate is nonexistent to a hypothetical circumstance in which the effect of a shift from Republican to Democratic control reduces deregulation (thereby reducing income inequality) by the amounts previously estimated. Had partisan divergence on deregulation been maintained after 1982, our estimates indicate that top income shares would currently be approximately 1.15 points lower. This effect is clearly much smaller than the effect charted in the left panel of the figure, but this effect is still considerable given that it represents more than a 20 percent reduction in top income shares relative to the observed level in 2012. In addition, even a 1 point reduction in top income share represents billions of dollars. Although it is clear that top income shares would have moved substantially higher with or without partisan convergence on financial deregulation, partisan convergence has likely contributed to rising inequality over the past three decades.

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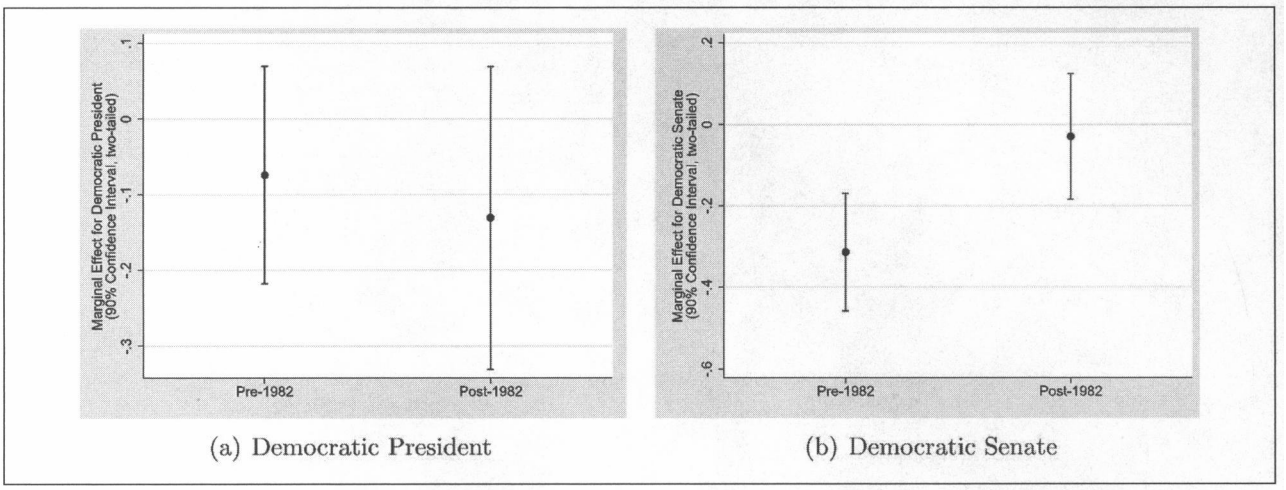

Figure 1. Effect of party control on financial deregulation pre- and post-1982.

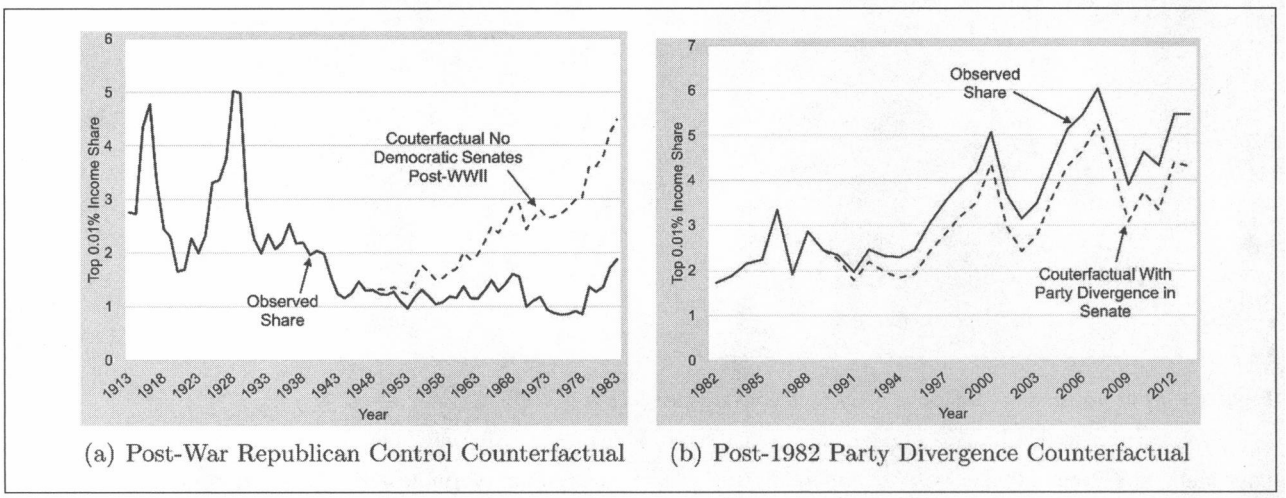

Figure 2. Substantive distributional effects of partisan divergence and convergence via financial deregulation.

Why Did the Parties Converge?

We have seen that partisan disagreement on financial deregulation contributed to declining inequality prior to the early 1980s and partisan convergence on this issue in the Senate contributed to rising inequality since. Ideally, we might also gain some insight into *why* the convergence happened. In our discussion above, we identified four potential explanations for partisan convergence. We examine some preliminary macro evidence for each of these explanations in Table 2.

Our strategy in each of the models is to identify variables connected to the four potential explanations identified above and include the relevant variables in a multiplicative interaction term with Senate party control (as the convergence was evident in the Senate). In Model 2, we test whether the expansion of consumer credit helped to drive partisan convergence. The expectation is that partisan effects on deregulation moved toward zero as credit utilization increased. In Model 3, we examine the potential for campaign finance to produce partisan convergence. The expectation is that partisan effects are more limited when campaign funding from the finance sector for Democrats is more important. Model 4 tests whether the decline of unions contributed to partisan convergence. If this is the case, the negative effect of Democratic Party control on deregulation should be enhanced as union membership increases. Finally, Model 5 uses a measure of trade openness to examine whether globalization contributed to partisan convergence. The expectation is that partisan effects on deregulation diminish as trade openness increases.

Although we report the results from the full regression models in Table 2, it is once again most helpful to chart the effects of Democratic Senate control over the observed range of the interacting variables (see Figure 3, which includes

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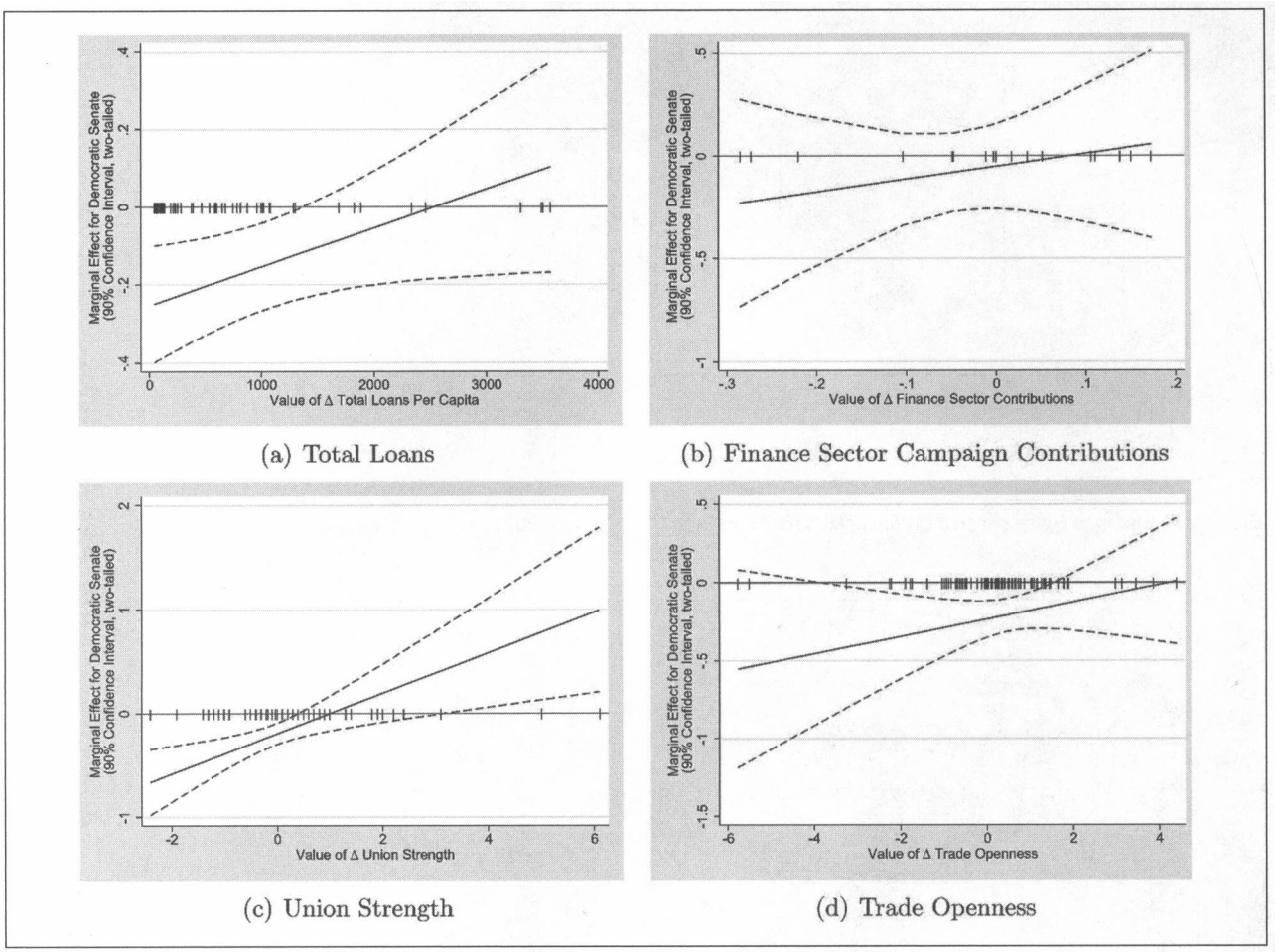

Figure 3. Four potential explanations of partisan convergence on deregulation.

hash marks for observed values of the moderating variable on the x-axis).[9] Based on the evidence in these charts, we see suggestive support for three of the four potential explanations of partisan convergence in the Senate. The strongest evidence relates to the expansion of credit. When total loans per capita increase, the effect of a shift from Republican to Democratic control of the Senate on financial deregulation diminishes. This supports the idea that as the potential credit benefits afforded by deregulation broadened, Democratic opposition to deregulation diminished.

The moderating effect of trade openness is also in line with expectations (Panel d of Figure 3). Here, we see that when trade openness decreases, Democratic strength reduces deregulation. However, when trade openness increases, the effect of Democratic partisanship moves to zero. While at first glance the evidence provided in this chart appears somewhat weak given that the effect of partisanship is not statistically significant from zero at the lowest values of the moderating variable, if we look at the portion of the chart including all but the lowest two values of trade openness, the result is stronger. This suggests that the wide confidence interval at the lowest values of the moderating variable is due primarily to a limited number of observations. This result is consistent with the idea that the parties converged as the United States was more exposed to the global economy.

In Panel b of the figure, we see only suggestive evidence that campaign finance played a role in partisan convergence. Although there is not a large shift in partisan effects as finance sector funding for Democrats increased and the observed effects are not significant across the entire range of the campaign finance variable, the direction of the shift is consistent with the idea that campaign finance contributed to partisan convergence. Although the results for campaign finance are certainly not strong, they are suggestive. In the SI file, we include a micro-level analysis of roll-call voting on repeal of Glass–Steagall. We find that members of Congress (MCs) who receive more donations from the finance sector were much more likely to support repeal. We also find that as finance contributions increase, Democrats actually become more likely than Republicans to support repeal. This provides additional evidence in support of campaign finance as a source of convergence.

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The evidence related to the role of unions in partisan convergence is contrary to expectations. Rather than seeing a stronger negative association between Democratic Party strength and deregulation as union strength increases, the effect of party is actually stronger when union strength is declining. The decline of unions, then, did not drive partisan convergence on deregulation in the Senate.

Conclusion

The analysis above leads to several important conclusions and implications. First, we add to the mounting evidence that decisions made in the political system influence distributional outcomes. We assessed the effect of policy decisions in the realm of financial regulation and found that the ebb and flow of deregulatory decisions is connected to the movement of income concentration over time. As the movement toward deregulation of the financial sector gained speed in the late 1970s through the 1990s, the income shares of those in the upper echelons of the U.S. economy increased dramatically, and this association is present while controlling for several other potential explanations of rising inequality. Contrary to the predictions of a pure rent-seeking theory of regulation, we find that the finance industry has been more able to enrich itself relative to the rest of society when exposed to less regulation.

Our analysis also suggests that financial regulation and deregulation have at least the potential to serve as an important mechanism linking partisan politics to distributional outcomes. Recent scholarship on U.S. income inequality has placed an emphasis on the partisan underpinnings of economic inequality and has discussed several possible ways that party strength in government might shape distributional outcomes by conditioning the market. Here, financial deregulation was explicitly considered as a market conditioning mechanism. We discovered that for most of the twentieth century, the two major parties in American politics did, in fact, achieve divergent outcomes on financial regulatory policy. When Democrats had more strength in policymaking institutions, financial regulation was more likely and deregulation was less likely. These partisan differences in policy outputs produced less market inequality as Democratic strength increased and more market inequality as Republican strength increased.

But this general picture does not hold from 1982 onward. During this period, Democrats and Republicans, in the Senate at least, appear to have converged in the domain of financial regulatory policy outcomes. After 1982, there is no discernible difference between the two parties with regard to their effect on financial deregulation. Simply stated, after 1982, it did not matter whether Democrats or Republicans were ascendant in Washington in the realm of financial deregulation. And this convergence in the area of financial deregulation is interesting for at least two reasons. First, the convergence could be viewed as highly improbable given the general context of increased ideological polarization across the parties. While the parties were diverging on a wide variety of issues, they appear to be converging in the domain of regulatory policy. Second, this result sheds some light on why income inequality increased so much over the past four decades. The Democratic Party was, in part, not upholding its traditional support of middle- and lower-income Americans. Rather than providing policy alternatives designed to reduce income concentration, when it comes to financial deregulation, Democrats became essentially indistinguishable from Republicans. Without clear opposition from Democrats, financial deregulation became more politically feasible and was broadly enacted, likely contributing to the rise of the uber-rich. This is not to say that Republicans and Democrats have fully converged in all policy domains relevant to the income distribution (Bartels 2008), but convergence on this issue connects both Democrats and Republicans to rising inequality. Future research might examine whether partisan convergence in other areas of policymaking has also contributed to the substantial rise in economic inequality over the past thirty-five years.

Our analysis provides some insight into possible explanations for partisan convergence on financial regulation. We explored four potential factors that could have contributed to the shift of Democrats toward Republicans in this policy domain. We found some evidence suggesting a role for increasing reliance on credit, campaign finance, and globalization. Understanding the underpinnings of partisan convergence in this policy domain is important because voters are less able to shape distributional outcomes if the U.S. political parties fail to provide substantive alternatives in policy areas that affect distributional outcomes. Our results suggest that building an economic model that is less reliant on credit might reduce the incentives that pushed Democrats toward Republicans on financial deregulation. To the extent that changes in campaign finance have contributed to partisan convergence, modifications in how campaigns are regulated and funded could hold promise. But there is no simple policy solution to overcoming the effects of globalization. While it should be noted that globalization has likely produced many good outcomes, one side effect may have been partisan convergence on financial deregulation, which then contributed to rising inequality. These results explaining partisan convergence, however, are quite preliminary as the moderating effect of only one of the explanations (credit availability) is both statistically significant and in the expected direction. We should also note that globalization's role in partisan convergence may have as much to do with the general dominance of the neoliberal economic model as explicit exposure to international competition. Therefore, more

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evidence using a broader array of research designs is needed to fully understand the underpinnings of partisan convergence in this policy domain.

It is a noteworthy development that politicians from both parties have begun to acknowledge economic inequality as an important societal problem. Our work both helps to place the current debate in historical context and suggests paths that policymakers who are serious about fighting inequality could take to achieve their objective. With regard to historical context, we would draw attention to the fact that both parties played a role in a portion of the policy changes that have contributed to rising inequality over the past thirty-five years. Democrats converged with Republicans on the financial deregulation, which contributed to the recent rise in inequality and implicated both parties in the creation of America's New Gilded Age. With regard to policy options moving forward, our work makes it fairly clear that maintaining the regulatory environment that has reigned supreme since the late 1990s (notwithstanding the passage of Dodd–Frank in 2010) is not a path toward reducing income concentration in the United States. Any serious proposal to reduce economic inequality should at least consider the role of financial regulation.

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Authors' Note

Data and code to replicate the analyses presented in the paper are available at https://dataverse.harvard.edu/dataverse/nkelly-data. Supplemental Information (SI) file is available at http://web.utk.edu/~nkelly.

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Notes

1. Updates to 2010 are from the World Top Incomes Database (http://topincomes.g-mond.parisschoolofeconomics.eu/). All income data are pretax and pretransfer, inclusive of capital gains.
2. The Democratic Party in the United States would be classified as a center–left party rather than a left party in the cross-national comparisons. The important point for our translation of power resources theory (PRT) to the U.S. context is that Democrats are the left party relative to the Republicans.
3. However, scholars of interest groups have rarely found explicit connections between money in politics and policy outcomes (Ansolabehere and Snyder 2003).
4. We conducted the analysis with top shares ranging from the top 5 percent to the top 0.01 percent. Results were substantively identical regardless of the precise measure of inequality.
5. When neither party has the majority, we code majority party based on the party having a larger party caucus, including any independents who caucus with one of the major parties.
6. Specifically, when all variables in a model are (near-)integrated, the coefficient for the error correction rate provides evidence of cointegration. If the coefficient is between 0 and −1 and is statistically significant using adjusted critical values (Ericsson and MacKinnon 2002), this is evidence of cointegration. Therefore, in the tables below, we report significance levels for the error correction rate based on these adjusted critical values so that the results provide a test of cointegration when coupled with the unit root tests reported in the Supplemental Information (SI).
7. All integrated variables are rendered stationary by first-differencing and no other patterns of autocorrelation are present, meaning that they are integrated of order 1 (I(1)). All ARIMA models are of order (0,1,0).
8. This result undermines a pure rent-seeking perspective on regulation, in which increasing regulation should either have no effect on income inequality or produce higher levels of inequality. One other possibility is that the positive association we observe between deregulation and income inequality is spuriously driven by reverse causation flowing from inequality to deregulation. Under this view, firms would seek regulation precisely when their profits are low and they are under economic threat. For the finance industry, this would likely be during times of low inequality. This would produce exactly the type of association we observe, but for contradictory theoretical reasons. Therefore, it is important to sort out whether deregulation drives income inequality as we have posited, or whether the reverse is true. We conducted a vector autoregression (VAR) analysis along with Granger causality tests to shed light on this issue. The VAR analysis shows that although there are long-run effects of deregulation on income inequality (as shown in the error correction models [ECMs] reported here), there are no such effects of income inequality on deregulation. Granger causality tests suggest the same conclusion. Details of these analyses are reported in the SI file.
9. Focusing just on the relevant interaction terms reveals that just one of the four potential explanations is both statistically significant and in the expected direction. Showing a chart of partisan effects across levels of the potential explanations shows some level of support, however, for two additional explanations.

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