Thoughts on Inequality and the Financial Crisis

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Different Hypotheses

- The Rajan hypothesis:

  Technology $\longrightarrow$ Inequality $\longrightarrow$ Political responses $\longrightarrow$ Financial crisis.

- Alternative hypothesis:

$$\text{Politics} \longrightarrow \text{The state of finance} \quad \Big\} \begin{array}{cc} \longrightarrow & \text{Top inequality} \\ \longrightarrow & \text{Financial crisis} \end{array}$$

Outline of Comments

- Three points:
  1. Why what is known about the US political system favors the alternative hypothesis.
  2. Why the timing and nature of inequality favors the alternative hypothesis.
  3. Why what we know about the financial crisis favors the alternative hypothesis.

Who Does the US Political System Respond to?

- Dahl in *Who Governs* studying Connecticut politics in the 1950s asked:

  In a political system where nearly every adult may vote but where knowledge, wealth, social position, access to officials, and other resources are unequally distributed, who actually governs?

and concluded that

power is widely dispersed.

- But this seems to be the past, not the present.

Who Governs Today

- Larry Bartels *Unequal Democracy: the Political Economy of the New Gilded Age*, Martin Gilens (various articles) and other political scientists:

  The rich elite—like in the Gilded Age.

- Bartels, for example, uses data from the Senate Election Study, which has detailed questions about the attitudes of almost 10,000 US citizens of voting age, on various issues legislations and their general attitudes. He compares this to voting patterns of the representatives from the 101st, 102nd and 103rd Congresses (elected in 1988, 1990 and 1992).
- Gilens (2005) uses an alternative data set, iPOLL, with similar information, to reach the same conclusion.

Who Governs Today (continued)

- From Bartels:

Ordinary least squares regression coefficients (with standard errors in parentheses) for Poole-Rosenthal W-NOMINATE scores.

	101st Congress	*102nd Congress*	*103rd Congress*	*1989–1994 (Pooled)*
Low-income constituency opinion	−.11 (.61)	−.50 (.59)	−.39 (.55)	−.33 (.44)
Middle-income constituency opinion	2.47 (.72)	2.91 (.71)	2.58 (.65)	2.66 (.60)
High-income constituency opinion	4.73 (1.03)	4.43 (.99)	3.22 (.92)	4.15 (.85)
Republican senator	.91 (.04)	.95 (.04)	.99 (.04)	.95 (.04)
Intercept	−.87 (.06)	−.96 (.06)	−.92 (.05)	Congress-specific intercepts; observations clustered by senator
Standard error of regression	.216	.213	.195	.207
adjusted R^2	.83	.84	.88	.85
N	100	102	101	303
High- vs. Low-income responsiveness gap	4.84 (1.30)	4.92 (1.25)	3.61 (1.17)	4.48 (1.04)

Source: Calculations based on data from Voteview.com and NES Senate Election Study.

Who Governs Today (continued)

- **Bartels's Conclusion:** both on their general Poole-Rosenthal ideological scores and on their voting on specific issues—ranging from minimum wage, civil rights, budget waiver, budget cloture, and various abortion roll calls—Senators highly "responsive" to (i.e., highly correlated with) their high income voters, somewhat responsive to their middle-income voters and not responsive at all to their low income voters (in fact negatively associated if anything, though not significant).
- There is no evidence that this is because low income voters have less strongly determined preferences (in fact, they tend to have fairly "left-wing" preferences).

Who Governs Today (continued)

- Why?
- We don't know, and this may not be a "causal fact", but one possibility is lobbying and campaign finance.
- Bartels also provides during this time period, politicians are highly responsive to campaign contributions.
- Possible that Mark Hanna's dictum

  "There are two things that matter in politics. The first is money. I can't remember the second."

has become more important today than when Hanna stated as McKinley's campaign manager.

- Since the 1980s expenditures by House and Senate candidates more than tripled and the number of PACs has exploded.
- Hacker and Pierson, "Winner Take All Politics," provide anecdotal evidence that fund-raising concerns have forced both parties, particularly Democrats, to adopt positions favorable to big donors.

Who Governs Today (continued)

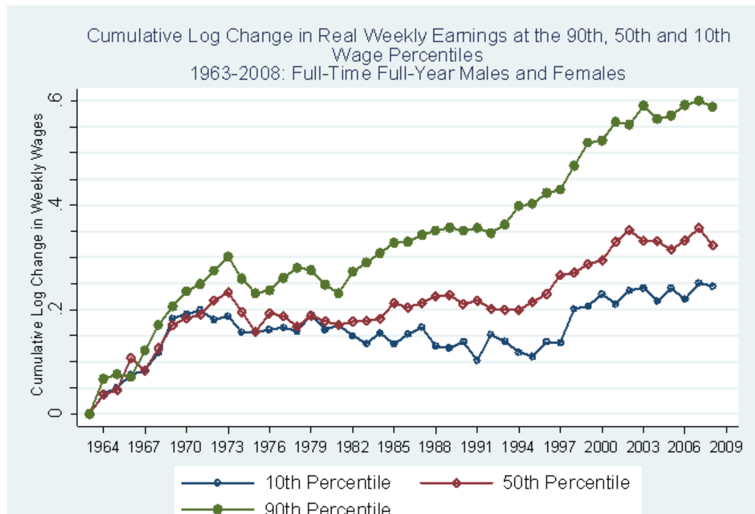
- An example of responsiveness?

Who Governs Today (continued)

- More careful work by Igan, Mishra and Tressel, "A Fistful of Dollars: Lobbying and the Financial Crisis," finds that lobbying matters greatly in the context of the financial crisis.
- They show that mortgage lenders lobbying more on precisely these issues had higher loan-to-income ratios, securitized more intensively, and had faster growing portfolios. And in fact, after the crisis, they had higher delinquency rates and abnormal negative stock returns.
- Mian, Sufi and Trebbi, "The Political Economy of the U.S. Mortgage Default Crisis," find that higher campaign contributions from the financial services industry for congressmen appear to increase the likelihood that they will vote supporting bills in favor of the financial services industry (though they also find that politicians are highly responsive to mortgage defaults).

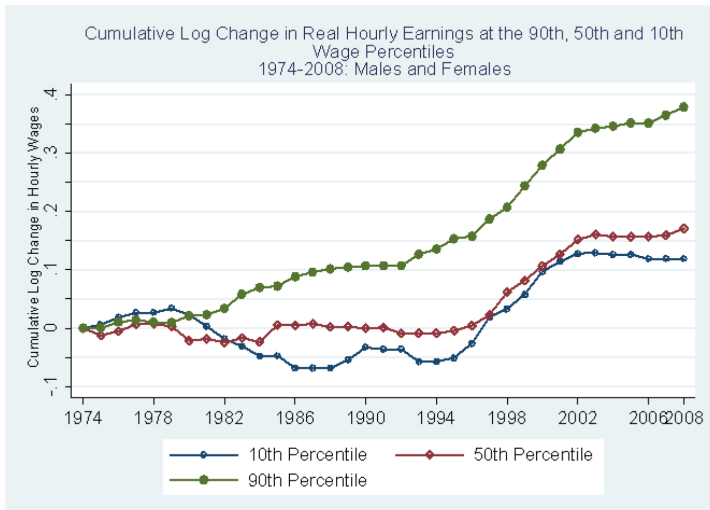
What Happened to Low Earning Americans?

- Weekly earnings from March CPS (Acemoglu and Autor, 2010)



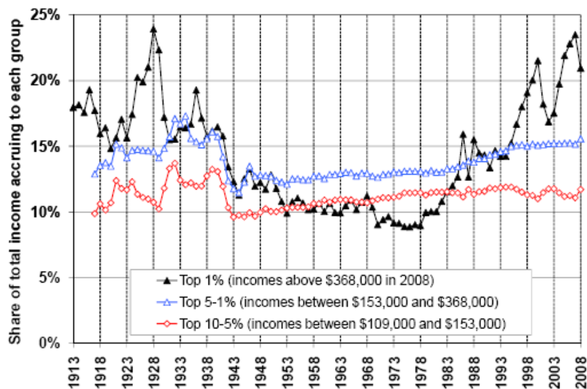
What Happened to Low Earning Americans? (continued)

- Hourly earnings (prices) from May CPS (Acemoglu and Autor, 2010)



Top Inequality

- From Piketty and Saez:

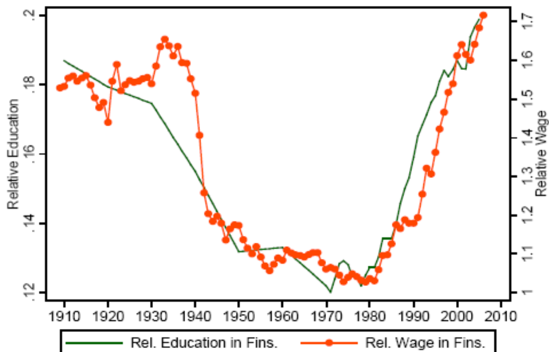


Inequality and Top Inequality

- As we have seen, inequality has increased, but this has a fairly complex and nuanced structure.
  - Movements of college premium, postcollege premium, 90-50 and 50-10 inequality, and occupational structure generally well explained by supply, technology and trade.
- What seems to have less of a nuanced structure is what's gone on at the top of the income distribution.
- It is entirely possible that wage inequality below the 99th percentile is being driven by supply, technology and trade, while the top percentile is being driven by something entirely different and this something entirely different is also very related to the causes of the financial crisis and to the peculiar political processes that have been underway in the United States over the last 25 years.

Could Inequality at the Top Be Deleted to Finance?

- Philippon and Resheff, finance earnings take off in the 1980s/90s.



- Piketty and Saez: top inequality is much more driven by high salaries than high returns to capital in the 1990s compared to the 1970s.

Preliminary Conclusions

- If there was a time for appeasing the bottom of the distribution that was falling behind it was the 1980s, not the 2000s.
- Forces driving wage inequality at the 90th and 10th percentiles in the 1980s and late 1990s/2000s potentially different (potentially related to how the nature of technology may have changed and also to trade/offshoring).
- Forces driving top inequality (top one percentile) likely yet further different.

Nature of the Crisis

- No general consensus, but...
- Lack of regulation of financial practices, something won by the financial industry by lobbying and cultivating close political contacts, potentially much more important than government policies distorting the housing market, including the induced behavior of Fannie and Freddie (Johnson and Kwak, "13 Bankers").
- In fact, the constant during this era, particularly when the bottom was falling out of US income distribution, has been efforts by the financial industry to push for deregulation, not increase or even rely on the role of Fannie and Freddie.

Nature of the Crisis (continued)

- On the contrary, efforts to marginalize GSEs.
  - Reagan's Commission on Housing recommends in 1982 that Fannie and Freddie stripped of their government status.
  - In 1984, with the support and leadership of the financial industry, the administration passes the Second Mortgage Market Enhancement Act, which put financial products without GSE involvement on an equal footing (in additional to freeing Wall Street from state blue sky laws).
  - In the late 1980s, other attempts to remove Fannie and Freddie's involvement in mortgage-backed securities and their government subsidies.
  - Fannie and Freddie in fact not big players in designing and pushing subprime early on, and go in the game really late.

Nature of the Crisis (continued)

- Housing certainly wasn't a sideshow, but government subsidies to housing may have been.
  - Similar financial problems in countries where regulation did not prevent investments in risky derivatives, such as France, Germany, Italy, Switzerland, which did not themselves have a housing bubble.
- Repeated resistance by many powerful senators, Alan Greenspan, Rubin, Summers and others against financial regulation.
- E.g., Phil Gramm's reaction that the problem in the mortgage market wasn't "predator lenders" but "predator borrowers," and to Arthur Levitt:

"Unless the waters are crimson with the blood of investors, I don't want you engaging in any regulatory flights of fancy".

Nature of the Crisis (continued)

- In the aftermath, consistent with the alternative hypothesis, many of the key financial players were bailed out, but low income house owners were not and there has been powerful political resistance to extension of unemployment benefits.
- All in all, preliminary (and admittedly subjective) reading of facts suggests that politics was key as the Rajan hypothesis also maintains, but in a different way. Not as a mere response to inequality, but a potential driver of the changes in parts of the income distribution and financial crisis.