
Winner-Take-All Politics

How Washington Made the Rich Richer—
And Turned Its Back on the Middle Class

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The Winner-Take-All Economy

Americans like crime dramas, and for good reasons. There is an exciting discovery that immediately creates mystery. The scene has clues to pore over (increasingly, with the latest in forensic technology). Suspects are found and interrogated, their motives questioned, their alibis probed. And if the crime drama is worth its salt, there are surprises along the way—unexpected twists and turns that hopefully lead to a satisfying explanation of the once-mysterious felony.

This book starts with a mystery every bit as puzzling as that of the typical crime drama, and far more important for the lives of Americans: Why, after a generation following World War II in which prosperity was broadly distributed up and down the income ladder, did the gains of economic growth start going mostly to those at the top? Why has the economy become more risky and unreliable for most Americans even as it has created vast riches for the well-positioned and well-off? The mystery is dramatic. The scene is strewn with clues. And yet this mystery has continued to bedevil some of the nation's finest economic detectives.

It's not as if the post-1970s transformation of our economy has gone unnoticed, of course: Even before the economic crisis that shook the nation in 2008, scores of economists and experts in allied fields, like sociology and political science, were creatively crunching the numbers and fiercely debating their meaning. Yet again and again, they have found themselves at dead ends or have missed crucial evidence. After countless arrests and

interrogations, the demise of broad-based prosperity remains a frustratingly open case, unresolved even as the list of victims grows longer.

All this, we are convinced, is because a crucial suspect has largely escaped careful scrutiny: American politics. Understandably, investigators seeking to explain a set of economic events have sought out economic suspects. But the economic suspects, for the most part, have strong alibis. They were not around at the right time. Or they were in a lot of countries, doing just the same thing that they did in the United States, but without creating an American-style winner-take-all economy.

This chapter is not the place to pin the case on American politics—or spell out exactly *how* American politics did it. These are tasks for the rest of this book. But we will show what a convincing solution has to look like and introduce the clues that lead us to zero in on American politics as our prime suspect. In the next chapter, we will start laying out what we mean when we say, “American politics did it.” For, as will become clear, resolving our first mystery only raises a deeper one: How, in a political system built on the ideal of political equality and in which middle-class voters are thought to have tremendous sway, has democratic politics contributed so mightily to the shift toward winner-take-all?

Investigating the Scene

As in any investigation, we cannot find the suspects unless we know more or less what happened. A body dead for twenty-four hours yields a very different set of hunches than one dead for twenty-four years. Likewise, we need to be able to characterize the winner-take-all economy in clear, simple, and empirically verifiable terms to rule certain explanations out and others in. Unfortunately, much of the discussion of our current economic state of affairs has lacked such clarity.

Indeed, most of the economic investigators have actually been looking in the wrong place. Fixated on the widening gap between skilled and unskilled workers, they have divided the economic world into two large groups: the “haves” with college or advanced degrees; the “have-nots”

without them. The clues suggest, however, that the real mystery is the runaway incomes and assets of the “have-it-alls”—those on the very highest rungs of the economic ladder. These fortunate few are, in general, no better educated or obviously more skilled than those on the rungs just below, who have experienced little or none of these meteoric gains.

The mystery, further, is not just why the have-it-alls have more and more. It is also how they have managed to restructure the economy to shift the risks of their new economic playground downward, saddling Americans with greater debt, tearing new holes in the safety net, and imposing broad financial risks on Americans as workers, investors, and taxpayers. The rising rewards at the top, as startling and important as they are, are only a symptom of a broader transformation of the American economy. The deeper mystery is how our economy stopped working to provide security and prosperity for the broad middle class. The deeper mystery, the mystery that has yet to be systematically outlined or unraveled, is the rise of the *winner-take-all economy*.

A big reason for the continuing confusion is that the largest body of evidence on which economic investigators have traditionally relied fails to capture the crucial facts. Most of those who have asked how the poor, middle class, and rich have fared have examined national surveys of income, such as the Census Bureau’s widely used Current Population Survey—the basis for those annual summaries of income and poverty trends that appear in the news late each summer. These surveys, however, have a serious problem: They do not reach many rich people and, even when they do, do not usually show their exact incomes. (Instead, they cap the maximum amount disclosed, a practice known as top coding.) As a result, most investigators are examining the winner-take-all economy without looking at the winners at all. It is as if *Lifestyles of the Rich and Famous* took you on an exciting tour of the financial life of a couple making \$125,000 a year (“Look: their own washer and dryer!”).

Enter two young economists who have turned the investigation upside down: Thomas Piketty and Emmanuel Saez. They are a transcontinental team—Piketty is now based at the Paris School of Economics, while Saez is at the University of California, Berkeley (both are natives of France).

In 2009, at age thirty-six, Saez was awarded the John Bates Clark Medal for the economist younger than forty making the greatest contribution to the discipline. The medal was, in large part, for pathbreaking work that he and Piketty have done using income tax statistics to paint a new and revealing portrait of the distribution of economic rewards in the United States and other rich nations.¹

Piketty and Saez's approach is simple but revolutionary. Rather than talking to witnesses, the most important of whom (the rich) cannot be easily found, they scour the scene itself. More precisely, Piketty and Saez tap into a source of data that is particularly good at revealing what the have-it-alls actually have: namely, income reported when paying taxes. Information that taxpayers provide about their wages, salaries, capital gains, and other income may contain errors—and sometimes deliberate errors. But tax forms require careful documentation that income surveys don't, and taxpayers have strong legal inducements to get the numbers right. More important, the one group that the tax code generally singles out for special scrutiny is the rich, the very people whom income surveys tend to miss. To be sure, the tax data are not without flaws, and Piketty and Saez assiduously try to correct them (for example, they adjust the results to account for the fact that some people don't file tax returns).^{*} But they are enormously better than survey results in capturing the full distribution of economic rewards.

And what the Piketty and Saez evidence uniquely shows is just how sharply our economy has tilted toward winner-take-all. Most of the gains of economic growth since the 1970s have gone precisely to those that the commonly used surveys miss—not just the top 10 percent, but especially the top 1 percent, and especially the highest reaches of the top 1 percent.

* We should emphasize that the Piketty and Saez data only allow us to say how well different income *groups* are doing, not how well individual households fare over time—an issue with traditional surveys of income as well. We can say the rich of today are richer than in the past, not how much change there is from year to year in who is rich and who is not. But, as we shall see, taking into account the upward or downward income mobility of households does not change this basic picture. It may even strengthen it, since long-term income mobility is much more limited than Americans believe, and may have declined since the 1960s. In any case, income groups are not statistical fictions. If the rich grow much richer, while the poor and middle class do not, the structure of society will look very different.

Three Big Clues

Compared with the standard surveys that portray the rich as earning upper-middle-class salaries, Piketty and Saez's data are like DNA evidence in a case previously investigated using only eyewitness accounts. As it turns out, the DNA evidence reveals three essential clues that were previously neglected.

Clue #1: Hyperconcentration of Income

The first clue is that the gains of the winner-take-all economy, befitting its name, have been extraordinarily *concentrated*. Though economic gaps have grown across the board, the big action is at the top, especially the very top.

To grasp this point, consider an alternate reality in which income grows at the same pace for all groups in society. In this scenario, the rich get richer at the same rate as everyone else, so the share of national income earned by the rich stays constant. We might call this imaginary country Broadland—a counterfactual parallel to the real world of runaway gains at the top that the writer Robert Frank has evocatively termed “Richistan.”²

Broadland would not be some kind of egalitarian fantasy. It would simply be a country where economic growth was making the income distribution neither more equal nor less. It would, in fact, be pretty close to the situation that existed from the end of World War II until the early 1970s, a period in which incomes actually grew at a slightly faster rate at the bottom and middle of the economic distribution than at the top.

But Broadland is not the world of the past generation. Instead, the share of income earned by the top 1 percent has increased from around 8 percent in 1974 to more than 18 percent in 2007 (the last year covered by the data)—a more than twofold increase. If you include capital gains like investment and dividend income, the share of the top 1 percent has gone from just over 9 percent to 23.5 percent. The only time since 1913 (the first year of the data) that this share has been higher was 1928, on the

eve of the stock market crash that ushered in the Great Depression, when it tickled 24 percent.

But the top 1 percent, while seemingly an exclusive group, is much too broad a category to pinpoint the most fortunate beneficiaries of the post-1970s income explosion at the top. The Piketty and Saez evidence allows us to climb higher up the economic ladder and peer into the pocket-books of the richest tenth of a percent and even the richest hundredth of a percent—yes, 0.1 percent and 0.01 percent—of Americans. The latter comprise the highest-earning 15,000 or so families in the United States, a group in which we would expect *Lifestyles of the Rich and Famous* to have little trouble finding private jets and opulent mansions.

Plenty of jets and mansions, it turns out: The top 0.1 percent (the richest one in a thousand households) collectively rake in more than \$1 trillion a year including capital gains—which works out to an average annual income of more than \$7.1 million. In 1974, by comparison, the top 0.1 percent's average income was just over \$1 million. (All these incomes are adjusted for inflation by expressing them in 2007 dollars.) In terms of the share of national income earned, the top 0.1 percent have seen their slice of the pie grow from 2.7 percent to 12.3 percent of income—a more than *fourfold* increase.

We shall say more about *who* is in this rarefied group in the chapters to come, but for now, let us simply note that its denizens are not, for the most part, superstars and celebrities in the arts, entertainment, and sports. Nor are they rentiers, living off their accumulated wealth, as was true in the early part of the last century. A substantial majority are company executives and managers, and a growing share of these are financial company executives and managers. High earners in law, medicine, real estate, and other potentially lucrative fields also make an appearance, but they pale in prominence to the “working rich” of the executive world.³

By now it will come as no surprise that the gains within this superrich group are themselves highly concentrated. While things have been good for the top 0.1 percent, the top 0.01 percent (the richest one in ten thousand households) has seen an even more spectacular rise. From less than \$4 million in average annual income in 1974, the average member of this

select group now earns more than \$35 million. From earning less than 1 of every 100 dollars, these supremely fortunate souls now earn more than 1 of every 17—or more than 6 percent of national income accruing to 0.01 percent of families. This is the highest share of income going to this group since the data began to be collected in 1913.

The more closely we look at changes in the distribution of economic rewards, the more it becomes clear that the big gains have been concentrated at the very, very top.⁴ According to Piketty and Saez's revealing evidence regarding pre-tax incomes, we have gone from Broadland to Richistan—from a world in which most of the nation's income gains accrue to the bottom 90 percent of households (the pattern of the economic expansion of the 1960s) to one in which more than half go to the richest 1 percent (the pattern of the last economic expansion from 2002 to 2007). For those in the tightly circumscribed winner's circle of the winner-take-all economy, the last generation has truly been a golden age.

Clue #2: Sustained Hyperconcentration

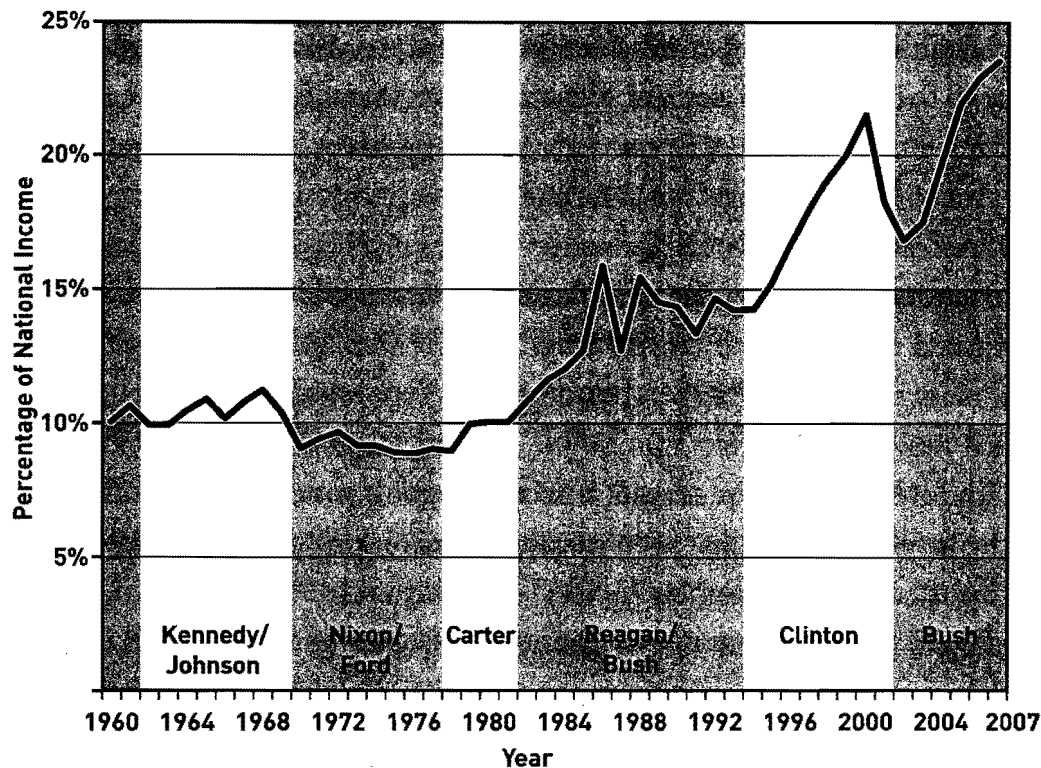
The DNA evidence reveals a second important clue: The shift of income toward the top has been *sustained*, increasing steadily (and, by historical standards, extremely rapidly) since around 1980.

Figure 1 tells the story. The poor may not be getting poorer, but the rich have been steadily pulling away: in good times (the strong economy of the mid- to late 1990s) and in bad times (the very weak economy of the early 1980s); under Republican presidents (Reagan, George H. W. Bush, and George W. Bush, whose presidencies are shaded in gray on the figure) and under Democratic President Clinton. The only brief reversals occur during the dives in the stock market that occurred in the late 1980s and around 2000. But the occasional setback associated with a decline in the stock market has only been a springboard to new heights. For thirty years, the good times have just kept rolling.

The solution to our mystery, in short, needs to account for a simple fact: The rising share of national income captured by the richest Americans is a long-term trend beginning around 1980. It is a trend, moreover, that is not

obviously related to either the business cycle or the shifting partisan occupancy of the White House.⁵ The partisan to-and-fro and economic ebb and flow surely had some part to play. But something else was at work in creating the winner-take-all economy—something that fostered a sharp divide between broadly shared prosperity and winner-take-all.

**Figure 1: The Richest 1 Percent's Share of National Income
(Including Capital Gains), 1960–2007**



Source: Thomas Piketty and Emmanuel Saez, "Income Inequality in the United States, 1913–1998," *Quarterly Journal of Economics*, vol. 118, no. 1 [2003]: 1–39. Data updated through 2007 available at <http://elsa.berkeley.edu/~saez/TabFig2007.xls>.

Clue #3: Limited Benefits for the Nonrich

We come, finally, to the third clue—and perhaps the most puzzling of all. It is so puzzling, and potentially controversial, that we spend much of the rest of this chapter documenting and delving into it.

The third clue is this: In an era in which those at the top reaped massive gains, the economy stopped working for middle- and working-class Americans. We know that the rich grew fabulously richer over this period. We know that relative to the rich, the rest of Americans lost ground. But what we have not yet investigated is whether they lost ground overall. How well did they fare in an era in which so large a share of economic gains accrued to those above them? Did they become richer and more economically secure? Did they see their chance of rising to the top increase? How much, in other words, did they really benefit from the winner-take-all economy?

The evidence can be summarized in a two-word answer: Not much. When we look at the DNA evidence on U.S. incomes, we find that most Americans experienced extremely modest gains over the era in which the rewards at the top multiplied. This is true, surprisingly and revealingly, even for the mostly highly skilled individuals just below the very top rungs of the income ladder. But the evidence on income gains actually understates the case—by a lot. When we expand our view beyond income to take in the broader canvas of the winner-take-all economy, the argument for thinking that the gains of America's top-heavy economic growth "trickled down" becomes even weaker. This is not just a story of relative income erosion. The fallout of the winner-take-all economy has reached broadly and deeply into the security of the middle class—and, as recent events reveal, the entire American economy.

Trickle-Up Economics

Ronald Reagan famously asked, "Are you better off than you were four years ago?" Our own version of the question is, "Are you better off than

you were a generation ago?”—or, more specifically, “How much better off are middle- and lower-income Americans than they were a generation ago?” The answer has substantial implications for how we judge the economic trends of the last thirty years. After all, if everyone experienced very large gains and the rich just happened to experience even larger gains, this might not cause great concern. Indeed, this is the “trickle-down” scenario that advocates of helping the have-it-alls with tax cuts and other goodies constantly trot out: If a rising tide lifts dinghies as well as yachts, who cares if it does a bit more for yachts?

But trickle-down is not the only possibility. Another scenario might be called “trickle-up”: The rich are getting fabulously richer while the rest of Americans are basically holding steady or worse. What if the modern economy looks less like an open sea, where rising water lifts all boats, and more like a system of locks, where those who don’t get through the gates are left behind? Yachts are rising, but dinghies are largely staying put, locked out (so to speak) from higher waters. Indeed, in this alternative scenario, there is reason to suspect that the dinghies are staying put in part *because* the yachts are rising—that the rich are closing the locks behind them to capture resources that would otherwise have enhanced the living standards of everyone else.

So which of these scenarios is correct—trickle-down or trickle-up? The evidence is not completely consistent, and there is room for debate at the margins. But it’s increasingly clear that trickle-down economics is not working as its proponents promise. Trickle-up economics, by contrast, seems to be working all too well.

Bringing In Government Taxes and Benefits

To see trickle-up in action, we need a source of evidence slightly different from that provided by Piketty and Saez. As mentioned, Piketty and Saez look at tax records, so the family incomes they report basically add up the private sources of income that people list on their tax forms: wages, salaries, investment income, gifts, and so on. These income sources do not include government benefits, such as Social Security payments. Nor

do they take into account the effect of taxes themselves: They are the incomes on which people pay taxes, not incomes *after* people pay taxes.

These omissions matter for studying inequality, because in all rich nations, including the United States, government taxes and benefits make the distribution of income more equal, taking more from those at the top and providing more to those at the bottom. These omissions also matter because some of the compensation that people receive in the workplace takes the form of noncash benefits like health insurance and retirement pensions. Thus, if we want the most accurate measure of the resources that middle- and lower-income Americans have at their disposal, we need to take into account government's effect on incomes as well as tally up private noncash compensation. The basic tax data include neither.

Fortunately, the Congressional Budget Office—Congress's nonpartisan budget agency, known as CBO—has developed these broader indicators. CBO does this by combining the basic tax data with the results of income surveys that ask people about government and private benefits. In addition, CBO calculates what people with different incomes are required to pay in federal taxes. The result is considered the gold standard for studying family income trends. Although available only back to 1979—unlike the Piketty and Saez data, which go back to 1913—this augmented DNA evidence is as close as we can get to an accurate picture of what happened to the income of American households at the bottom, middle, and top of the distribution over the last generation.⁶

This picture turns out to be stark: The bottom went nowhere, the middle saw a modest gain, and the top ran away with the grand prize.

How Much Did Family Incomes Grow for the Poor, Middle Class, and Rich?

Let us start with the simplest measure of economic gains: the percentage increase in the inflation-adjusted incomes of households on different rungs of the economic ladder. The first point to make is that the overall economy expanded substantially over the twenty-seven years covered by CBO. Between 1979 and 2006—the last year currently available—real

average household income, according to the augmented DNA evidence, rose by almost 50 percent, a compounded gain of 1.5 percent per year. A household earning exactly the average income had \$47,900 in 1979 and \$71,900 in 2006, or half again as much.

This is the happy story. The less happy story, at least for the nonrich, is where the gains of that growth went. Start with those at the bottom: As figure 2 shows, the average income of the poorest 20 percent, or quintile, of American households rose from \$14,900 to \$16,500, a meager 10 percent gain over twenty-seven years, even after taking into account government taxes and benefits and private employment-based benefits.

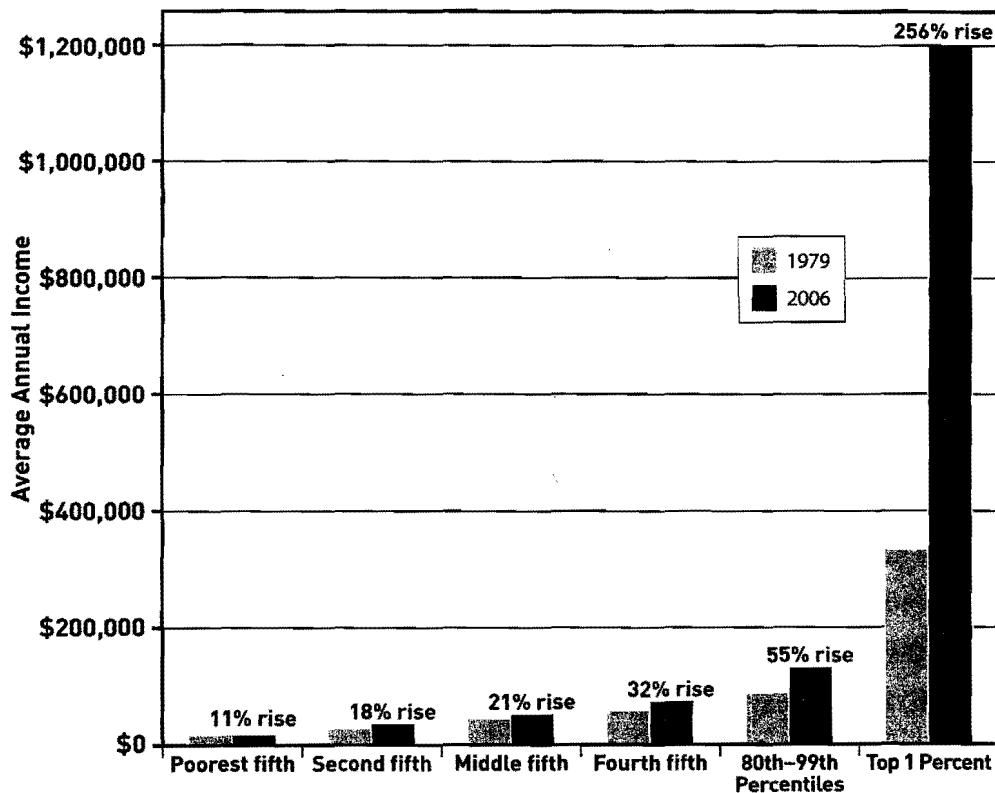
What about those in the middle? They did better, but not that much better: The middle quintile of households (that is, the 20 percent of households above the bottom 40 percent and below the top 40 percent) saw their average inflation-adjusted income rise from \$42,900 to \$52,100—a gain of 21 percent. This may sound good (and because families became smaller over this period, the gains per family member within households are a bit larger). But it works out to a real gain of just 0.7 percent a year, a rate of increase less than half the growth of average income over this period. Not much of a yearly raise.

These numbers look all the more striking when we consider a simple fact: American households are working many more hours today than they were in the late 1970s. This is because women are much more likely to work outside the home than they were a generation ago, augmenting both family income and the amount of time that household members spend in the workforce. Among working-age married couples with children, these extra hours totaled more than ten additional full-time weeks in the workforce (406 hours) in 2000, as compared with 1979. Without those additional hours and income, households in the middle of the distribution would have barely budged upward at all. The incomes of households at the bottom would actually have fallen.⁷

So who received the gains? The simple answer is those at the top, especially the very top. The average after-tax income of the richest 1 percent of households rose from \$337,100 a year in 1979 to more than \$1.2 *million* in 2006—an increase of nearly 260 percent. Put another way,

the average income of the top 1 percent more than tripled in just over a quarter-century. Figure 2 graphically portrays the scale of the disparity. Just getting the 2006 average income of the top 1 percent on the same axis as the average incomes of other groups is a challenge, so stark is the difference.

**Figure 2: Average Household After-Tax Income
Including Public and Private Benefits, 1979 and 2006**



Source: Calculated from Congressional Budget Office (CBO), *Historical Effective Tax Rates, 1979-2006* (Washington, D.C.: CBO, April 2009), www.cbo.gov/publications/collections/tax/2009/average_after-tax_income.xls. Income includes wages, salaries, self-employment income, rents, taxable and nontaxable interest, dividends, realized capital gains, cash-transfer payments, and cash retirement benefits, as well as all in-kind benefits, such as Medicare, Medicaid, employer-paid health insurance premiums, food stamps, school lunches and breakfasts, housing assistance, and energy assistance. Federal taxes are subtracted from income and account for not just income and payroll taxes paid directly by individuals and households, but also taxes paid by businesses (corporate income taxes and the employer's share of Social Security, Medicare, and federal unemployment insurance payroll taxes).

And, again, the gains enjoyed by the top 1 percent pale in comparison to those received by the top hundredth of 1 percent—a group CBO separated out in its analysis up through 2005. Between 1979 and 2005, the CBO numbers show, the average after-tax income of households in the top 0.01 percent increased from just over \$4 million to nearly \$24.3 million—more than quintupling in a little more than a quarter-century.

How Much Richer Are the Rich Because of Unequal Growth?

The statistics are stark: Most growth since the late 1970s has gone to the very richest Americans. But what does this mean in terms of the actual incomes of different income groups? Let us return to Broadland. How much more would the poor or middle class take home each year if incomes had grown at the same rate across all income groups between 1979 and 2006, as they more or less did for a generation after World War II? How much better off would Americans at different income levels be if they had stayed in Broadland over these twenty-seven years, rather than moving to Richistan?

The answer is summed up in table 1: Few of the benefits of economic growth at the top between 1979 and 2007 trickled down. If the economy had grown at the same rate as it actually did yet inequality had not increased, the average income of the middle fifth of households would be over \$12,000 higher today. The average income of the bottom fifth of households would be more than \$5,800 higher. Note, again, that we are assuming no change in the overall growth of the economy, just a broader distribution of the economy's rewards. Note, too, that we are accounting here for all government taxes and benefits as well as private workplace benefits. And remember: Broadland is not some hyperegalitarian world in which the rich get "soaked"; rather it's a world in which the rich simply experience the same income growth rate as everyone else, just as they basically had before the late 1970s.

Table 1: Richistan vs. Broadland

	Richistan (average actual income in 2006)	Broadland (all groups experience the average rate of household income growth between 1979 and 2006)	How Much Richer or Poorer in Broadland in 2006?
Bottom Fifth	\$16,500	\$22,366	\$5,866 Richer
Second Fifth	\$35,400	\$45,181	\$9,781 Richer
Middle Fifth	\$52,100	\$64,395	\$12,295 Richer
Third Fifth	\$73,800	\$84,209	\$10,409 Richer
80th–90th Percentile	\$100,915	\$106,696	\$5,781 Richer
90th–95th Percentile	\$132,258	\$128,714	\$3,544 Poorer
95th–99th Percentile	\$211,768	\$181,992	\$29,776 Poorer
Top 1 Percent	\$1,200,300	\$506,002	\$694,298 Poorer

So what would have happened to those at the top if they had experienced the same average growth of their income as everyone else? The answer is that they would be pulling down around \$500,000 a year on average, rather than the more than \$1.2 million the top 1 percent actually earned, on average, in 2006—a nearly \$700,000 difference. Unequal growth has been very, very good for the have-it-alls.

When Richistan and Broadland are compared, another arresting conclusion comes into view. Other than the richest 10 percent of Americans, *every income group would have done better if they had experienced the average growth of household income*, that is, if they had lived in Broadland rather than Richistan. (The tipping point where Richistan delivers higher incomes than Broadland is somewhere between the 90th and 95th percentiles, though the gap between Richistan and Broadland is small until the very top of the distribution.) Put another way, the entire bottom 90 percent saw their incomes rise more slowly than average household income between 1979 and 2006. If trickle-up economics has a textbook case, this is it.

A Victimless Crime?

The DNA evidence shows that real household incomes for all groups but the very well-off have risen only modestly, and almost entirely because of increased family work hours. Meanwhile, the overall economy has expanded substantially. The explanation for this disconnect, mathematically speaking, is that most of the gains of growth have gone to Americans at the top of the economic ladder.

But this simple mathematical explanation leaves open an obvious objection: The economy is not zero-sum. Perhaps the gains of the rich, as impressive as they are, did not come at the expense of the rest of Americans. Maybe “Broadland” is not just an imaginary but an unimaginable country. After all, didn’t the United States grow much more quickly than other rich nations during this period, allowing the rich to get richer even as the rest of Americans moved ahead as well? In particular, didn’t the United States grow a lot faster than Europe, where incomes are generally much more equal and where the massive rise in income inequality seen in the United States did not occur?

The answer is no. The American economic engine ran hotter in some years than the European economic engine. But on average, between 1979 and 2006, economic growth per capita was essentially the same in the fifteen core nations of Europe as it was in the United States.⁸ The United States is richer than these nations, but the gap has been surprisingly stable since the late 1970s.

The historical evidence certainly doesn’t suggest an American economic miracle alongside European sclerosis. This lends strength to the supposition that the outsized gains of the rich came at the expense of those lower on the economic ladder, who found themselves enjoying less and less of the economic pie. On average, the economic pie grew at essentially the same rate in the United States as it did in nations where the poor and middle class have continued to enjoy a much larger piece.

Indeed, in one important respect, the pie actually grew more quickly in Europe than it did in the United States. Recall that American households are working more hours than they did in the past. The same is true

in Europe, but not nearly to the same extent. Women have entered the workforce to roughly the same degree—in fact, the share of the population in the workforce grew more quickly in Europe than in the United States between 1979 and 2006.⁹ Yet in Europe average work hours for those in the workforce have declined, so the net effect is only a small increase in overall work hours, compared with a much more substantial rise in the United States.¹⁰ As a result, GDP per hour worked—perhaps the best single measure of a country's economic health—actually rose faster in Europe than in the United States between 1979 and 2006.

To be sure, the story of divergent work hours is complicated: Some of the decline in work hours in Europe is involuntary, due to higher levels of unemployment. But the basic story is that the United States did not grow markedly faster than Europe even as American inequality skyrocketed. Adjusted for the growing work hours of American families—with all the attendant stress and strains that those increased hours have caused—the American economic pie actually grew slightly more slowly.

The Big Zero

If there is a nail in the coffin of the dismissive view about middle-class economic problems, it is the decade that shall not be named: the 2000s. Some call these years the “aughts,” others “the aughties,” still others “the big zero.”¹¹ The last moniker may be the most appropriate. The decade closed with the nation mired in the worst economic downturn in more than seventy years, with the unemployment rate around 10 percent and with the share of Americans unemployed for more than six months at the highest level ever recorded.¹² Economically speaking, the 2000s was truly a lost decade. At its end, the stock market was partying like it was 1999. Housing prices had crashed. Home ownership was at 2000 levels.¹³ Even the most optimistic estimates suggested it would take years to recover from the hemorrhaging of jobs and incomes triggered by the collapse.

Here's the kicker: The aughties were awful even *before* the economy began to crumble in late 2007. They featured six years of consecutive

economic growth (from the end of 2001 until the end of 2007) in which the median income of non-elderly households actually fell while the share of Americans living in poverty actually rose. This was the first economic expansion on record in which the typical non-elderly household lost economic ground.¹⁴ Yet it wasn't all bad news. Between 2002 and 2007, the real pretax incomes of those in the top 1 percent rose by 10 percent. Per year.¹⁵

Beyond Income

Those who are inclined to be dismissive of the evidence just reviewed frequently respond by insisting that the focus on income is short-sighted: We should also look at the chance people will rise up the economic ladder, at their workplace benefits, at their spending and wealth, and so on. True enough. Unfortunately, when we take a broader perspective, the conclusion that our economy has become increasingly winner-take-all only becomes stronger.

Stagnant Social Mobility

Americans have always believed in upward social mobility—both as an ideal and a description of reality. And if social mobility had been rising along with inequality over the last generation, then the growing concentration of income at the top might be less of a concern. One year's poor household might be next year's middle-class or even rich household. Social mobility would soften the sharp edges of a growing class divide.

Alas, the evidence is overwhelming that upward social mobility has *not* increased at the same time that inequality has skyrocketed. Indeed, according to a number of innovative new studies, American mobility may well have declined over the last generation, even as inequality has risen. This is true of both individual mobility ("Am I richer than I was a decade or two ago?") and of intergenerational mobility ("Am I richer than my parents were?").¹⁶ Over a typical decade, for example, just under four in five

people stay in the same income quintile or move a single quintile up or down.

We know less about the long-term mobility of the top 1 percent, but all indications are that people in this rarefied group usually don't drop very far down the ladder for any length of time. Looking just at wage and salary income, for example, more than 70 percent of the highest-earning 1 percent of American households in 2004 were among the highest-earning 5 percent of households in 1994. Only around one in ten had risen from the bottom 80 percent—down from around one in seven in the 1970s.¹⁷ And of course, as the gains of economic growth become ever more concentrated, almost by definition fewer individuals will be able to move into the shrinking ranks of the economic winners.

Compared with other rich nations, moreover, U.S. intergenerational mobility is surprisingly low, in part because the gap between income groups is so much bigger. The American Dream portrays the United States as a classless society where anyone can rise to the top, regardless of family background. Yet there is more intergenerational mobility in Australia, Sweden, Norway, Finland, Germany, Spain, France, and Canada. In fact, of affluent countries studied, only Britain and Italy have lower intergenerational mobility than the United States does (and they are basically even with the U.S.).¹⁸

The differences are often stark. In the United States, more than half of the earnings advantage (or disadvantage) of fathers is passed on to sons. In Canada, only about a fifth or less is. And almost all of the difference is accounted for by the fact that Americans are much more likely to be stuck at the bottom or secure at the top than are Canadians. In short, when mobility is accounted for, the picture of the winner-take-all economy looks no better. If anything, it looks worse.

Broken Benefits

It is often argued that workplace benefits, like health insurance and retirement pensions, alter the story of the winner-take-all economy—and that, in particular, the middle class does better when you take into ac-

count the growing share of compensation that comes in the form of such benefits, rather than cold, hard cash. Actually, the CBO numbers we have been looking at already take into account health and pension benefits, so the anemic gains of working- and middle-class Americans cannot be explained away by suggesting that they are getting better and better benefits at their place of work.

But let's take the argument a little further. Are Americans getting better benefits tied to their jobs? Not when it comes to retirement benefits. Employers contribute less to such benefits than they did in the 1970s, and workers are less likely to have an employer-sponsored pension than they were in the late 1970s.¹⁹ And many fewer have a guaranteed defined-benefit pension that pays them a fixed income in retirement. Instead, most Americans who have pensions rely on defined-contribution plans that place all the risk of retirement savings on them. This risk has been driven home by the recent stock market drop, which reduced the median balance in 401(k)s by a third between 2007 and 2008.²⁰ As notable as the decline is the end point: the typical amount in a 401(k) in 2008 was a paltry \$12,655. Given this, it's no shock that the share of Americans who are at risk of retiring without adequate income has risen substantially since the early 1980s.²¹

On the other side of the benefits equation, employers and workers are certainly spending more on health insurance—much, much more. The question is what this spending has bought. Are Americans better insulated against medical costs than they were a generation ago? No. Are they more secure against the medical crises and costs that, studies suggest, are associated with more than half of the rising number of personal bankruptcies?²² No. Health costs that outstrip the growth of earnings year after year after year—pushing more people out of coverage and more people into hardship—can hardly be seen as an unqualified benefit for the middle class.

That's especially so because these higher costs are not inevitable. The United States spends vastly more than any other rich nation on health care—both as a share of the overall economy and on a per-person basis—even though we are the only affluent democracy that doesn't guarantee

insurance to all its citizens. In 2007, the price tag for our exorbitant system came to \$7,290 per person. The next most profligate nation, Norway, featured spending of \$4,763 per person. Canada's spending per capita is essentially half the U.S. level.²³

Yet the United States has fewer doctors, hospital beds, and nurses per person than the norm among rich nations, and Americans (while less healthy overall) visit doctors and hospitals less often and have shorter hospital stays. Indeed, by some measures our care looks surprisingly substandard. For example, recent analyses of "amenable mortality"—deaths that could have been prevented with timely care—find that the United States has the highest rate of preventable death before age seventy-five among rich nations, and that it is falling farther and farther behind.²⁴

And, of course, the United States has had a higher share of citizens without coverage than any other rich nation, and that share has been growing. In 2006, more than 46 million Americans younger than sixty-five were uninsured—nearly 18 percent of the non-elderly population. Back in 1979, the number of uninsured was 27.5 million, or less than 15 percent of the nonelderly population.²⁵ Add in workplace benefits and the situation of most Americans looks even more dire than when we focus on income alone.

Consumption to the Rescue?

Can another definition of economic well-being come to the rescue? It has long been known that inequality of spending (or "consumption") is less than inequality of income. The reasons are obvious: The rich save more of their money than the poor; at the same time, two major groups in society—retirees and young adults—often spend more than they earn, thanks to savings and loans. So we should expect less consumption inequality than income inequality. The issue is whether we see the same basic trends in inequality of consumption that we do in inequality of income, namely, a big increase.

Tackling this issue turns out to be extremely difficult, in part because the main source of evidence, the Consumer Expenditure Survey, largely

misses the high-income folks who've benefited from the winner-take-all economy. Still, it is increasingly clear there is no "consumption paradox." Consumption inequality is not as great as income inequality, as we'd expect (especially since the evidence fails to capture the big winners at the top). But the two have grown at more or less the same rate over time.²⁶

Here again we find smart analysts ignoring the most notable feature of the winner-take-all economy—that it's, well, winner-take-all. Have lower-income Americans been borrowing more to sustain their spending? Definitely. Are the less affluent experiencing lower price inflation than richer Americans thanks to cheap Chinese goods?²⁷ Perhaps. But none of this is going to alter fundamentally our view of American inequality. The access of the poor to easy credit or Wal-Mart prices has little bearing on the growing gap between the superrich and the merely well-to-do.

Drowning in Debt

Furthermore, the flip side of consumption is savings and investment—and the wealth that comes with savings and investment. After all, it's not as if the rich are giving all the money they don't spend to charities for the poor. In fact, money that high earners do not spend gets turned into wealth, and the share of wealth held by the rich is both high and growing. In 2004, the wealthiest 1 percent of households had an average net worth of nearly \$15 million.²⁸ (At the very top of the ladder, the wealthiest 400 Americans—according to the famous *Forbes* 400 list—had an average net worth of \$3.9 billion in 2008, more than six times the 1985 average for the *Forbes* 400.)²⁹

The average net worth of the bottom 80 percent of households, in contrast, was around \$82,000, and that includes the wealth that households had in their homes. Average net worth for the bottom 40 percent of households was a paltry \$2,200 in 2004, less than half the \$5,400 that this group enjoyed in 1983. Strikingly, over the entire period between 1983 and 2004, only 10 percent of all wealth gains went to the bottom 80 percent of Americans, an even more skewed pattern of growth than seen in income.³⁰

Perhaps more striking, 17 percent of households in 2004 had zero or negative net worth—they owed more than they had. (And this was before the collapse of real estate prices put more homes “underwater”—with home loans exceeding home values—than at any time in U.S. history.) Here we find a major clue to why consumption is not always a good measure of income: For a time, at least, people can spend beyond their income by borrowing, and before the 2007 downturn, Americans were borrowing at record rates. But, as the late economist Herbert Stein is reported to have said, “If something can’t go on forever, it won’t.” The inexorable increase in household debt was not sustainable without comparable income gains—and those gains did not occur. Once again, scouring the scene turns up plenty of additional proof that the winner-take-all economy has produced limited gains for those outside the winner’s circle.

The clues are undeniable: Not only did those below the top reaches of the economic ladder find themselves falling ever farther behind the have-it-alls; they reaped surprisingly few of the gains of the massive expansion at the top.

This is an economic puzzle. It is also a political puzzle. Democracy may not be good at a lot of things. But one thing it is supposed to be good at is responding to problems that affect broad majorities. How could events and trends like these evolve with so little response from democratically elected leaders? Indeed, as we shall see, the puzzle is even deeper. For government was no mere bystander in many of these developments. It actually pushed them along. Why?

Before we turn to these questions, however, we have one last piece of unfinished business: We need to explain why the prime suspect that America’s economic detectives have fingered is, at most, a modest accomplice to the crime.

The Usual (but Wrong) Suspect

Tune into the cable money stations or read the business press and you are likely to hear an account of rising inequality that goes something like this:

“Education is the key to understanding broad inequality trends.”³¹

“To explain increasing inequality we must explain why the economic return to education and to the development of skills more generally has continued to rise.”³²

“We have an economy that increasingly rewards education and skills because of that education.”³³

These quotes were not chosen at random. They are the pronouncements, respectively, of the former head of President George W. Bush’s Council of Economic Advisers, Gregory Mankiw, a Harvard economist; Fed chairman Ben Bernanke (another economist, formerly of Princeton); and, finally, former President George W. Bush himself.

It might seem that the common element connecting these quotes is that those responsible for them have ties to the Republican Party. After all, rising inequality was an inconvenient reality for a GOP president (and, before 2006, a GOP Congress) intent on cutting taxes for the wealthy. The fact is, however, that these three quotes express what was, until recently at least, the overwhelming consensus view on inequality among economists, a view summarized in the ungainly acronym SBTC.

The SBTC Seduction

SBTC is not a regional telephone company. It stands for “skill-biased technological change,” and it is still by far the dominant explanation for American inequality trends.³⁴ According to the SBTC argument, the last thirty or so years have witnessed a massive shift toward more knowledge-based employment. In the popular version of the argument, this shift has been greatly accelerated by the globalization of the American economy. This transformation has made formal education and advanced skills much

more valuable, fueling a growing divide between the highly educated and the rest of American workers.

In some versions of the argument, skill-biased technological change is driven by computers and the Internet. In others, the main culprit is the failure of the educational advancement of most workers to keep pace with the growing skill demands of a global knowledge economy.³⁵ The account of the crime, however, is the same: SBTC did it.

There are just two problems: SBTC isn't even charged with the right crime. And the suspect has an alibi.

Why Educational Gaps Can't Explain American Top-Heavy Inequality

If there is an Exhibit A in the case that SBTC did it, it is the rising "college wage premium"—the extra amount that college graduates earn relative to their less educated peers. Each year, the College Board publishes a report entitled, "Education Pays," in which it announces that the gap between those who have finished college and those who have not is large and growing. More sophisticated economic analyses usually emphasize the effects of education across the full spectrum of educational achievement, before college and beyond. But they reach the same conclusion: a growing "return to schooling." From here, it's a short leap to the view that the rising bang for one's educational buck is the main cause of growing inequality.

Only it's not. The return to schooling—and especially to a college degree—has risen. But, as we've seen, rising American inequality is not mainly about the gap between the college-educated and the rest, or indeed about educational gaps in general. It is about the pulling away of the very top. Those at the top are often highly educated, yes, but so, too, are those just below them who have been left increasingly behind.

There's more: The college educated did well relative to those below them, but not because they experienced massive economic gains. Rather, they merely managed to avoid the devastatingly slow growth at the bottom.

Assume that the story about a new educational elite is true. The top 20 percent of the income distribution should therefore be composed almost entirely of college graduates. (The share of Americans with a college degree was 29 percent in 2007.) What, then, happened to the household income of someone at the 80th percentile, the starting point for entry into this supposedly favored class? The answer is that it has grown extremely slowly compared with the income of folks at the very top—roughly one-fourth as quickly per year as the average income of the top 1 percent.

That middle-class income growth, moreover, is mostly because of increased household work hours, not increased individual earnings. Hard as it may be to believe, a typical entry-level worker (ages 25–34) with a bachelor's degree or higher earned only \$1,000 more for full-time, full-year work in 2006 than did such a worker in 1980 (\$45,000 versus \$44,000, adjusted for inflation).³⁶ And college-educated workers are substantially less likely to receive health insurance in their first job than they once were—almost four in ten now start out in the labor market without health benefits.³⁷ So much for the enormous general rewards of a college degree.

To be sure, some workers with advanced education make enormous sums. But that's exactly the point: A huge amount of inequality occurs among workers who have heeded the advice of "Education Pays" and sought a college degree. Economists call this "within-group inequality" (that is, inequality among people with the same education or skills), and it is one of the strongest pieces of exculpatory evidence on SBTC's side. That is because within-group inequality, by definition, cannot be explained with reference to education, since it occurs among people with the same basic characteristics. And within-group inequality accounts for a major part of the rise in inequality since the 1970s, especially at the very top—where almost everyone has a good education.³⁸

Maybe SBTC was at work among these workers in more subtle ways—some argue that college-educated workers with the skills to do routine tasks have lost out to those who do higher-level "abstract tasks"—but the

case against SBTC, considered so strong at the outset, becomes harder to make.

But forget about the weak case, because the suspect has a strong alibi.

Why Didn't Other Rich Nations Experience SBTC's Wrath?

SBTC is attractive to economic detectives because it is an all-purpose criminal—one that, its prosecutors argue, can explain both the decline in American inequality in the first half of the twentieth century and its rise in the last thirty years. It is a suspect whose influence should be seen over long spans of time and, more important for the present discussion, across national borders. After all, other rich nations have computers and the Internet too—indeed, quite a few are more networked than we are—and most rich nations are *more* exposed to the global economy than we are. If SBTC did it here, it should have done it elsewhere, where the same technological and global shifts were taking place.

Embarrassingly for the SBTC-did-it consensus, however, SBTC seems to be picky about where to strike. When it comes to rising inequality, the world isn't flat after all. American income inequality is the highest in the advanced industrial world. As one labor economist wryly puts it, "If there were a gold medal for inequality, the United States would win hands down . . . [S]tandard measures show that the United States more closely resembles a developing country than an advanced country on this measure of economic performance."³⁹

Yet gaps in skills, as measured by years of schooling, are not larger in the United States than they are in other affluent nations. They are actually smaller. Inequality is dramatically higher in the United States not because of greater skill gaps or greater returns to education, but because within-group inequality is greater than it is in other rich nations. Indeed, there is more inequality among workers with the *same* level of skills (measured by age, education, and literacy) in the United States than there is among *all* workers in some of the more equal rich nations.⁴⁰

The Uniqueness of America's Winner-Take-All Economy

SBTC's alibi appears even stronger when it comes to the meteoric rise of earnings at the very top, because that rise has been substantially more meteoric in the United States than in other rich nations.

Figure 3 shows the share of income, excluding capital gains, going to the top 1 percent of households in twelve nations: Australia, Canada, France, Germany, Ireland, Japan, the Netherlands, New Zealand, Sweden, Switzerland, the United Kingdom, and, of course, the United States.⁴¹ The first bar shows the average share in the mid-1970s (1973–1975); the second shows the average share around the millennium (1998–2000).

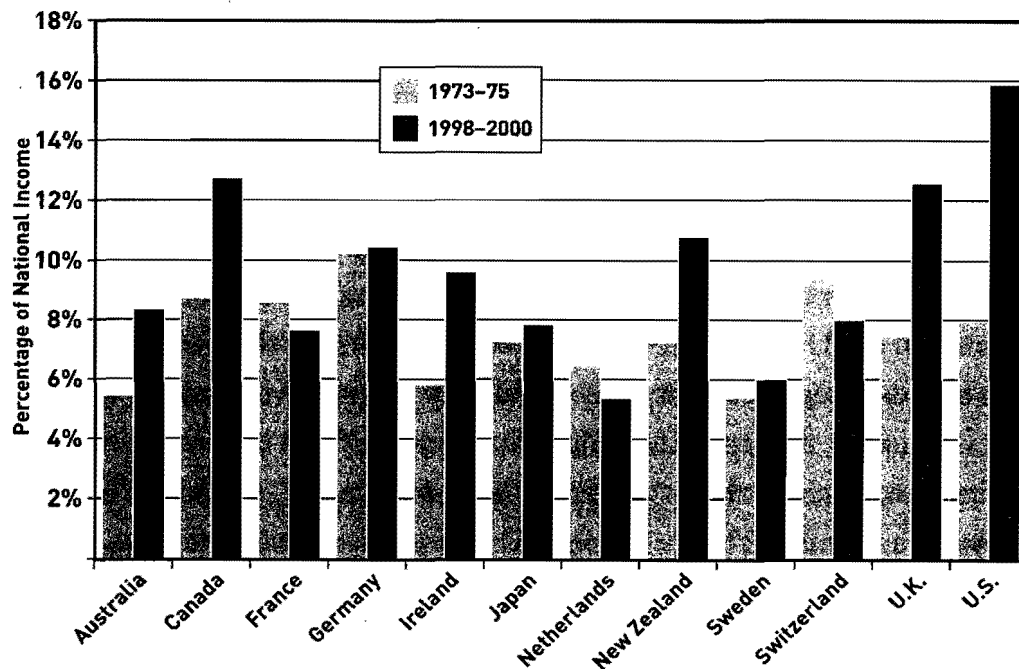
One feature of figure 3 that jumps out is that the United States did not look all that exceptional in the early 1970s. Germany, Switzerland, Canada, even France—all had a higher share of national income going to the top 1 percent a generation ago.

Yet that has changed dramatically. The United States is now at the top of the advanced industrial pack, with regard to both the level (16 percent) and the increase (virtually a doubling) of the top 1 percent's share of income. Half of the nations in figure 3—a diverse group that includes France, Germany, Japan, the Netherlands, Sweden, and Switzerland—experienced little or no increase in the share of income going to the top 1 percent. Apparently in these countries SBTC was AWOL.

It's true that the other English-speaking nations in this group—Australia, Canada, Ireland, and the United Kingdom—have followed a path more like the United States'. Still, the United States is well in the lead in the competition for the gold medal for inequality. Whereas the United States experienced a doubling of the income share of the top 1 percent, the other English-speaking nations saw only an average rise of around half that in percentage terms.

The English-speaking world has certainly emulated the American pattern more closely than other nations have. But this is hardly proof that government policy doesn't matter, since these nations have also generally emulated U.S. *public policy* more than other nations have. What's more, the trajectory of the two countries that are most often compared

**Figure 3: The Top 1 Percent's Share of National Income
(Excluding Capital Gains), Mid-'70s vs. Circa 2000**



Notes: The first bar for each nation is the top 1 percent's average share of national income (excluding capital gains) in 1973-75 (except for Ireland, for which data are unavailable until 1976; the first bar for Ireland averages the years 1976-79). The second bar for each nation is the top 1 percent's average share in 1998-2000 (except, for reasons of data availability, France and Germany [1996-98], the Netherlands [1997-99], and Switzerland [1994-96]).

Source: Andrew Leigh, "How Closely Do Top Income Shares Track Other Measures of Inequality?" *The Economic Journal* 117 (November 2007): F589-F603. Data available at <http://people.anu.edu.au/andrew.leigh/pdf/TopIncomesPanel.xls>. [The figure uses Leigh's data on the top 1 percent excluding capital gains, adjusted for consistency across nations.]

to the United States, the United Kingdom and Canada, cannot be viewed as wholly independent of the rise of America's winner-take-all-economy. As we saw when we started to parse the composition of the top 0.1 percent, the rise in the compensation of the highest earners, especially corporate executives and financial managers, drives much of the outsized gains at the top in the United States. Companies in English-speaking na-

tions compete for these workers, and thus have faced the most pressure to match the massive salaries on offer in the States.⁴² This appears to hold particularly true for Canada.* While this contagion effect is hard to pin down, there is little doubt that some of the increase in top incomes in other English-speaking nations reflects competitive pressure to match the more dramatic rise in the United States—a rise that we shall see has a great deal to do with U.S. public policy.

The cross-national window just opened puts the rise of the winner-take-all economy in surprising perspective. The hyperconcentration of income in the United States—the proximate cause of the death of America's broad-based prosperity—is a relatively recent development. It is also a development that sets the United States apart from other rich nations, calling into serious doubt the usual explanation for America's winner-take-all economy, SBTC.

But if SBTC didn't do it, who did? Enter the unusual suspect: American politics.

* Perhaps most telling, there is little sign of the same meteoric rise at the top among *French*-speaking portions of Canada. Executives in Quebec do not appear to be competing in the same common labor market that has allowed American pay levels at the top to diffuse to the rest of Canada.

How the Winner-Take-All Economy Was Made

The winner-take-all economy—the hyperconcentration of rewards at the top that is the defining feature of the post-1970s American economy—poses three big mysteries: Who did it? How? And why? We have seen that the main suspect fingered by most investigators, Skill-Biased Technological Change, is at most a modest accomplice. Now, it is time to turn to the unusual suspect, American government and politics.

No less important, it is time to ask, if American government and politics did it, how? Only after understanding the basic, powerful ways in which government fueled the winner-take-all economy will we be in a position to delve into the “Why” questions: What were the motives behind the public policies that fostered winner-take-all? How, in a representative democracy, could public officials favor such a small slice of Americans for so long? That part of our investigation begins in chapter 3 with a whirlwind tour of American political history that seeks to uncover the reasons why, and the means by which, politicians in our capitalist constitutional democracy do—or do not—seek to redress imbalances of economic resources and power.

We face a high hurdle in our investigation. If there is one thing on which most economic experts seem to agree, it is that government and politics can’t be much of an explanation for the hyperconcentration of American incomes at the top. President Bush’s treasury secretary, Henry Paulson, may have tipped his Republican hat when he asserted in 2006

that inequality “is simply an economic reality, and it is neither fair nor useful to blame any political party.”¹ (No one could doubt which party he thought was being unfairly and uselessly blamed.) Yet Paulson is hardly alone in his exculpatory judgment: Most economists on both sides of the political spectrum argue that government policy is at best a sideshow in the inequality circus. There are exceptions, of course. Nobel Laureate in Economics Paul Krugman has forcefully argued that policy is a crucial reason for rising inequality, and other experts have usefully examined the role of policy in specific areas.² But the dominant perspective remains highly skeptical of attributing much influence to government—in part because there has yet to be a systematic accounting of the full range of things that American public officials have done (or, in some cases, deliberately failed to do) to propel the winner-take-all economy.

Think of this chapter as the opening argument of our case. Like any opening argument, it won’t address all the questions. In particular, it will leave almost entirely unaddressed the core mystery that motivates the rest of the book: Why have American politicians done so much to build up the winner-take-all economy? But as in any investigation, finding the right suspect—and showing just how powerful the case against that suspect is—represents the first step toward unraveling the larger mysteries that started the search.

Why Politics and Policy Are [Wrongly] Let Off

Much of the widespread doubt about the role of American politics and public policy in fostering rising inequality centers on a simple fact: The great bulk of the growth in inequality has been driven by rising inequalities in what people earn before government taxes and benefits. Simply put, those at the top are raking in a lot more from their jobs than they used to. The winner-take-all economy reflects a winner-take-all labor market.

Enter the doubters: It would be one thing, they argue, if government was taking much less from the rich in taxes or giving much less to the middle class in benefits than it used to. That would be a transparent case of government abetting inequality. But how, the skeptics ask, can government influence what people earn *before they pay taxes or receive government benefits*? On the conservative side, for example, Harvard's Gregory Mankiw insists that while "some pundits are tempted to look inside the Beltway for a cause" of rising inequality, "policymakers do not have the tools to exert such a strong influence over pretax earnings, even if they wanted to do so."³ On the liberal side, economist and former Clinton Treasury official Brad DeLong of the University of California at Berkeley says, "I can't see the mechanism by which changes in government policies bring about such huge swings in pre-tax income distribution."⁴

This skeptical response, however, makes three elemental mistakes.

The first is to miss the strong evidence that government *is* doing much less to reduce inequality through taxes and benefits at the *very top* of the income ladder. Here again, a fixation on inequality between big chunks of the income distribution misses the extent to which, at the very pinnacle, government policy has grown much more generous toward the fortunate. As we will show, this increasing solicitousness accounts for a surprisingly large part of the economic gains of America's superrich.

Second, the skeptical response feeds off a mistaken presumption that if government and politics really matter, then the only way they can matter is through the passage of a host of new laws actively pursuing the redistribution of income to the top. We'll show that a large number of new laws that greatly exacerbate inequality *have* been created, but we will also show that big legislative initiatives are not the only way to reshape how an economy works and whom it works for. Equally, if not more, important is what we will call "drift"—systematic, prolonged failures of government to respond to the shifting realities of a dynamic economy. We will have a lot to say about drift in this book, because the story of America's winner-take-all economy isn't just about political leaders actively passing laws to

abet the rich, but also about political leaders studiously turning the other way (with a lot of encouragement from the rich) when fast-moving economic changes make existing rules and regulations designed to rein in excess at the top obsolete.

The third problem with the skeptical response goes even deeper: The skeptics suggest that the only way government can change the distribution of income is through taxation and government benefits. This is a common view, yet also an extraordinarily blinkered one. Government actually has enormous power to affect the distribution of “market income,” that is, earnings before government taxes and benefits take effect. Think about laws governing unions; the minimum wage; regulations of corporate governance; rules for financial markets, including the management of risk for high-stakes economic ventures; and so on. Government rules make the market, and they powerfully shape how, and in whose interests, it operates. This is a fact, not a statement of ideology. And it is a fact that carries very big implications.

Perhaps the biggest implication is that public policy really matters. The rules of the market make a huge difference for people’s lives. And what matters is not the broad label applied to what government does (“tax reform,” “health care reform”) but the underlying details that most commentators blithely ignore. As our investigation proceeds, we will see again and again that the devil truly is in the details of public policy. Policy is not a sideshow; in the modern age of activist government, it is often the main show.

To be sure, it is sometimes difficult to know exactly what the effects of these rules are. But there’s no question that these rules, taken together, have a massive cumulative impact. Just stop for a moment to contemplate how different economic affairs would be in our nation without basic property rights or government-regulated financial markets and you begin to appreciate how pervasive the role of government really is. And governments at different times and in different nations can and do make markets in very different ways, and with very different distributional results.

When these mistaken assumptions are corrected—when, that is, we look at what’s happened at the very top, take political efforts to block the adaptation of government policy seriously, and look at how markets have been politically reconstructed to aid the privileged—a conclusion that can’t be mistaken comes into view: Government has had a huge hand in nurturing America’s winner-take-all economy.

To be clear, we are not saying that technological shifts haven’t played a role too. Changes in information technology have fostered more concentrated rewards in fields of endeavor, such as sports and entertainment, where the ability to reach large audiences is the main determinant of economic return.⁵ Computers, increased global capital flows, and the development of new financial instruments have made it possible for savvy investors to reap (or lose) huge fortunes almost instantly—a point first made by Sherwin Rosen and elaborated by Robert Frank and Philip Cook in their 1995 book, *The Winner-Take-All Society*.⁶ But such technologically driven explanations have little to say about why the hyperconcentration of income at the top has been so much more pronounced in the United States than elsewhere. Nor do they come close to explaining just how concentrated economic gains have become.

For example, the “superstar” story of celebrities, artists, and athletes who now reach, and thus make, millions has a good deal of merit. As noted in chapter 1, however, these sorts of professions only account for a tiny share of the richest income group.

Table 1, based on a recent study of tax return data, shows that roughly four in ten taxpayers in the top 0.1 percent in 2004 were executives, managers, or supervisors of firms outside the financial industry (nearly three in ten were executives). By contrast, high-earners in the arts, media, and sports represented just 3 percent of this top-income group.

**Table 1: Percentage of Taxpayers in
Top 0.1 Percent (Including Capital Gains), 2004**

Executives, managers, supervisors (non-finance)	40.8%
Financial professions, including management	18.4
Not working or deceased	6.3
Lawyers	6.2
Real estate	4.7
Medical	4.4
Entrepreneur not elsewhere classified	3.6
Arts, media, sports	3.1
Computer, math, engineering, technical (nonfinance)	3.0
Business operations (nonfinance)	2.2
Skilled sales (except finance or real estate)	1.9
Professors and scientists	1.1
Farmers & ranchers	1.0
Other	2.6
Unknown	0.7

Source: Jon Bakija and Bradley T. Heim, "Jobs and Income Growth of Top Earners and the Causes of Changing Income Inequality: Evidence from U.S. Tax Return Data," working paper, Williams College, Office of Tax Analysis (March 17, 2009), Table 1.

As for financial professionals, who make up a much larger proportion of the top 0.1 percent (nearly two in ten taxpayers), it strains credulity to say they are merely the talented tamers of technological change. After all, plenty of the so-called financial innovations that their complex computer models helped spawn proved to be just fancier (and riskier) ways of gambling with other people's money, making quick gains off unsophisticated consumers, or benefiting from short-term market swings. Moreover, most of these "innovations" could occur only because of the failure to update financial rules to protect against the resulting risks—much to the chagrin of the rest of Americans who ended up bailing the innovators out. Former Fed chairman Paul Volcker was no doubt channeling a widespread sentiment when he said in 2009 that the last truly helpful financial innovation was the ATM.⁷

What is more, government policy not only failed to push back against the rising tide at the top in finance, corporate pay, and other winner-take-

all domains, but also repeatedly promoted it. Government put its thumb on the scale, hard. What's so striking is that it did so on the side of those who already had more weight. We can see this most clearly in the most transparent case of government abetting inequality: the gutting, over the course of three decades, of progressive taxation at the top of the economic ladder.

A Cut Above

The major rollback of taxation for those at the very top has received surprisingly little notice among today's economic detectives. Most commentators appear to accept—with pleasure or displeasure, depending on their ideological persuasion—that the tax burden of the rich is not an important part of the rise of winner-take-all inequality.

But this is not true. Yes, as the *Wall Street Journal* editorial board never tires of reminding readers, the well-off are paying a larger share of the nation's total income taxes than in the past. But that does not mean that the well-off are paying higher income tax *rates*. The amount of taxes we pay is a function not just of how steep tax rates are but also of how much we earn. And over the last generation, the well-off have earned more and more—so much more that they can pay a larger share of the nation's income taxes and still pay a much lower overall *rate* on their massively larger incomes.

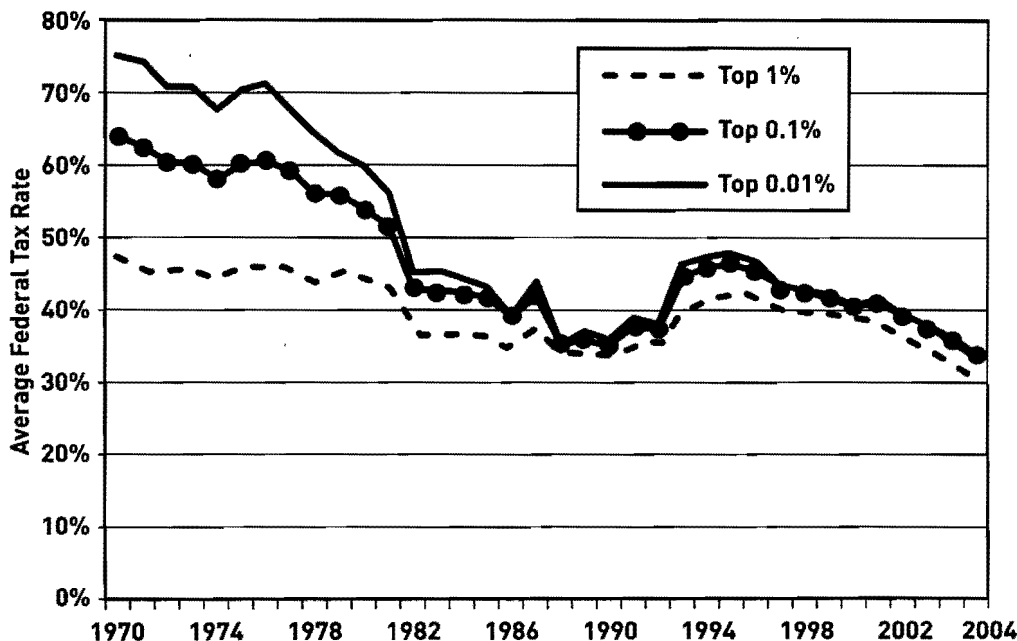
Moreover, income taxes are among the taxes that hit the rich hardest. When you take into account all federal taxes—including payroll taxes, which only hit the rich lightly, and corporate and estate taxes, which once hit the rich much harder than they do today—tax rates on the rich have fallen dramatically.

Perhaps most important, talking about the rich as a monolithic group makes no sense. As we have learned, there are the rich, and there are the *rich*. And what is most striking is that the latter group—the very, very, very rich—have enjoyed by far the greatest drop in their tax rates.

Figure 1, drawn from the research of the economists Thomas Piketty

and Emmanuel Saez discussed in the last chapter, shows just how spectacular the decline has been for the tiny slivers of the top 1 percent we talked about earlier.⁸ This figure tracks the effective average federal rate—what people *actually* pay as a share of their reported income, not the official rate that enterprising lawyers and accountants make mincemeat of for the rich every day. As can be seen, those in the top 1 percent pay rates that are a full third lower than they used to be despite the fact that they are much richer than those in the top 1 percent were back in 1970. But as the top 1 percent is sliced into smaller and richer groups, the even more startling story becomes clear: The truly advantaged are paying a much smaller share of their reported income than they used to—at the very top (the richest 0.01 percent) less than half as large a share of income. They are not simply richer because their paychecks have grown; they're richer because government taxes them much less heavily than it once did.

Figure 4: Average Federal Tax Rates for Top Income Groups, 1970–2004



Source: Thomas Piketty and Emmanuel Saez, "How Progressive is the U.S. Federal Tax System? A Historical and International Perspective," *Journal of Economic Perspectives* 21, no. 1 (Winter 2007); data available at <http://elsa.berkeley.edu/~saez/jep=results=standalone.xls>.

Tax policy experts have a name for a tax code that taxes higher-income people at a higher rate: “progressive.” The federal tax code is still progressive overall. But what used to be a key feature of the code—its steep progressivity at the very top income levels—has simply disappeared. The richest of the rich now pay about the same overall rate as those who are merely rich. Indeed, though figure 1 doesn’t show this, the upper middle class—families, say, in the top 10 or 20 percent of the income distribution—are paying an average federal tax rate not much lower than that paid by the superrich. This is a pattern we will see again and again: dramatic benefits for the rich that are so precisely targeted that they are only visible when we put that tiny slice of Americans under our economic microscope. It is as if the government had developed the economic policy equivalent of smart bombs, except these bombs carry payloads of cash for their carefully selected recipients.

How much of the rise in winner-take-all outcomes does this three-decades-long tax-cutting spree account for? Unlike the effect of government on how much people earn, this is relatively easy to calculate (at least to a first approximation), and the numbers are staggering. The top 0.1 percent had about 7.3 percent of total national after-tax income in 2000, up from 1.2 percent in 1970. If the effect of taxes on their income had remained what it was in 1970, they would have had about 4.5 percent of after-tax income.⁹ Put more simply, if the effects of taxation on income at the top had been frozen in place in 1970, a very big chunk of the growing distance between the superrich and everyone else would disappear.

This dramatic change in tax policy didn’t happen magically. Starting in the 1970s, the people in charge of designing and implementing the tax code increasingly favored those at the very top. The change began before Reagan’s election, and continued well after the intellectual case had crumbled for the supply-side theories that had justified his big tax cuts. It resulted from a bidding war in which Democrats as well as Republicans took part, and involved cuts in estate and corporate taxes as well as in income taxes. The one big regularity was an impressive focus on directing benefits not just to the well-to-do but to the superrich. On provisions as diverse as the estate tax and the Alternative Minimum Tax, elected offi-

cials repeatedly chose courses of action that advantaged the very wealthy at the expense of the much larger group of the merely affluent.

All this occurred, moreover, even as Americans as a whole remained strongly supportive of making the richest pay more in taxes. In 1939, as the nation still grappled with the Great Depression, 35 percent of Americans agreed with the (very strongly worded) statement that “government should redistribute wealth by heavy taxes on the rich.” In 1998, 45 percent agreed; and in 2007, 56 percent did. Public concern about taxes has ebbed and flowed, but large majorities of Americans consistently say higher-income Americans pay too little in taxes and that corporate income taxes—which have fallen to less than 15 percent of all taxes—should be a key source of government revenue.¹⁰ And yet, taxes on the richest of Americans have, for more than thirty years, just kept coming down.

Not all of the tax-cutting has been as prominent as the estate tax cuts of 2001. Given public concerns about tax breaks for the wealthy, politicians have, not surprisingly, opted for more subtle means of achieving similar ends. One is slashing back enforcement of tax law. Call it “do-it-yourself tax cuts.” Roughly one out of every six dollars in owed taxes goes unpaid—literally, hundreds of billions a year.¹¹ Not all of these dollars are owed by the rich, of course. But just as Willie Sutton robbed banks because “that’s where the money is,” tax evasion by the rich is where the money is. Most Americans, after all, have most of their taxes automatically taken out of their wages. Rich people and corporations, by contrast, are largely responsible for reporting their complex earnings and capital gains, and they have the will and the way to use intricate partnerships, offshore tax havens, and other devices that skirt or cross legal lines. Yet, as the investigative reporter David Cay Johnston has painstakingly documented, audits of high-income taxpayers and businesses have plummeted. About the only area where audits have gone up is among poorer taxpayers who claim the Earned Income Tax Credit.¹²

Another way public officials have cut the taxes of upper-income filers without passing new laws is by leaving in place loopholes through which rich Americans and their accountants shovel lightly taxed cash. Take one

of the more egregious examples: the ability of private equity and hedge fund managers to treat much of their extraordinary incomes as capital gains, subject only to a 15 percent tax rate. (In 2006, the top twenty-five hedge fund managers earned nearly \$600 million on average, with the richest, James Simons, taking in \$1.7 *billion*.)¹³ The “carried interest” provision that allows this sweetheart deal is a bug in the tax code that predates the rise of hedge funds. But while this loophole is almost universally viewed as indefensible (and may finally be closed a bit in 2010), it has been protected for years by the fierce lobbying of its deep-pocketed beneficiaries and the strong backing of Wall Street supporters like Senator Chuck Schumer, Democrat of New York.

Given all the energy spent trying to pin rising inequality on relatively dubious suspects, it’s striking how little attention is paid to the very easily fingered culprit of declining tax rates on the rich. We’ve hardly begun laying out the full case for government’s role, but there’s no doubt that U.S. tax policy has exacerbated American hyperinequality by the demise of progressive taxation at the top of the economic ladder.

Reducing Redistribution

The fixation on inequality between large sections of the income distribution has obscured the extent to which government policy has grown more generous toward those at the very top. The second common oversight mentioned earlier—failing to take seriously how government policy can be undermined by deliberate efforts to block its being updated—has led observers to ignore the extent to which policy has become *less* generous toward the vast majority of Americans who have been on the losing side of rising inequality.

Indeed, a big clue in the cross-national statistics that points toward government policy as the suspect is that the United States stands out in its response to increases in inequality in market earnings since the 1970s. Elsewhere in the advanced industrial world, creeping tendencies toward greater economic disparities—whether due to globalization, technolog-

ical change, or other broad economic or social forces—have been met with concerted, active resistance. In the United States, this pressure has proceeded with little government interference, aside from policies that have actively pushed it along.

We know this thanks to a major international research effort, the Luxembourg Income Study (LIS). For more than a decade, LIS researchers have been combing through national income data to examine how actively governments redistribute the income that people earn in the market, taking money from people higher on the economic ladder and distributing it to people lower. The LIS data suffer from the now-familiar problem that they are not very good at accounting for the incomes of the very richest. But they nonetheless offer a revealing picture of how countries have responded to rising inequality.

That picture may come as a surprise: We think of the welfare state as embattled, but in the majority of rich nations for which we have evidence, income redistribution over the past few decades has either held steady or actually risen. In many of these countries—and that includes our northern neighbor, Canada—inequality created by the market has been significantly softened by a greater government role.¹⁴

On American soil, the opposite has been true. Government is doing substantially less to reduce inequality and poverty below the highest rungs of the income ladder than it did a generation ago. We sometimes hear about expanding programs for the poor such as the Earned Income Tax Credit. But against the rising tide of inequality, these programs have represented fragile levees, crumbling under the weight of quickly moving water. Between 1980 and 2003, for example, the percentage by which government taxes and benefits reduced inequality (as measured by the Gini index, a common inequality standard) fell by more than a quarter.¹⁵

Can the absence of a government response to rising inequality really be treated as a form of policy? Absolutely—when it takes the form of “drift,” the deliberate failure to adapt public policies to the shifting realities of a dynamic economy.¹⁶

The idea of drift is simple, but central to understanding what has transpired in the United States. Major shifts in the economy and society

change how public policies work. Think of how rising inflation erodes the value of the federal minimum wage. Workers at the very bottom of the economic ladder have seen their economic standing decline in part because the minimum wage has not been updated to reflect the rising price of consumer goods.¹⁷

And why has it not been updated? Because intense opponents of the minimum wage have worked tirelessly and effectively to prevent it from being increased to prior levels or pegged to inflation (a proposal that came close to passing in the 1970s). This has been every bit as much a political fight as, say, the Bush tax cuts of 2001 and 2003. But it is a far less visible fight, resulting not in big signing ceremonies, but in *nothing happening*. Our point is that nothing happening to key policies while the economy shifts rapidly can add up to something very big happening to Americans who rely on these policies.

Drift, in other words, is the opposite of our textbook view of how the nation's laws are made. It is the passive-aggressive form of politics, the No Deal rather than the New Deal. Yet it is not the same as simple inaction. Rather, drift has two stages. First, large economic and social transformations outflank or erode existing policies, diminishing their role in American life. Then, political leaders fail to update policies, even when there are viable options, because they face pressure from powerful interests exploiting opportunities for political obstruction.

Drift is not the story of government taught in a civics classroom, but it is a huge and growing part of how policy is actually made in the civics brawl room that is contemporary American politics. Our nation's fragmented political institutions have always made major policy reforms difficult. But, as we will see in the chapters to come, the slog has only grown more strenuous. Perhaps the biggest barrier in the last few decades has been the dramatically expanded use of the Senate filibuster. The insistence on sixty votes to cut off debate has allowed relatively small partisan minorities to block action on issues of concern to large majorities of Americans. Add to these institutional hurdles the increasing polarization of the two major political parties, and you have the perfect recipe for policy drift—and an increasingly threadbare safety net.

Still, a big part of the rise in American inequality has indeed occurred in the market, that is, in what people earn through their work and their assets even before America's (dwindling) government benefits and (less and less progressive) taxes have a chance to do anything. Could government have any role in *this* part of rising inequality? Yes, because government has rewritten the rules of the market in ways that favor those at the top.

Rewriting the Rules

During the 2008 presidential campaign, the Republican candidate John McCain pilloried his opponent, Barack Obama, as the "Redistributor-in-Chief" because Obama called for letting the Bush tax cuts expire for families making more than \$250,000 a year. The charge was revealing, not because Obama's tax program was particularly redistributive, but because it reflected a view that is widespread not just among conservative politicians but also among experts and academics who study public policy. If this view has a title, it might be something like "The Rugged Individualist Meets Big Government."

In this familiar story, there are two neatly defined worlds: the market, where the rugged individualist makes his home, and the government, which takes money from the rugged individualist and provides him and others with benefits. The popular version is summed up in tales of independent frontiersmen conquering the West, without the evident help of the U.S. Army or postal service or Lewis and Clark's government-sponsored expedition. In a more contemporary vein, it is captured in the celebration of the can-do spirit of states like Alaska, from which John McCain's running mate, Sarah Palin, prominently hailed. Despite Alaska's status as the state most dependent on federal largesse on a per-person basis, politicians there persist in extolling the state's self-made rise and criticizing the meddling hands of the federal government.¹⁸

Academics and policy experts are not immune to this view either—though their version generally lacks the ideological tinge. Indeed, in the preceding discussion of the changing role of government, we have largely

been following the standard expert convention of parsing inequality into two parts: "market" inequality and "postgovernment" inequality. In this perspective, people earn money in the market thanks to their labor and assets. Governments then take that money through taxes and redistribute it through government transfers. It is a tidy view of the relationship between markets and governments. It is also utterly misleading.

Governments *do* redistribute what people earn. But government policies also shape what people earn in the first place, as well as many other fundamental economic decisions that consumers, businesses, and workers make. Practically every aspect of labor and financial markets is shaped by government policy, for good or ill. As the great political economist Karl Polanyi famously argued in the 1940s, even the ostensibly freest markets require the extensive exercise of the coercive power of the state—to enforce contracts, to govern the formation of unions, to spell out the rights and obligations of corporations, to shape who has standing to bring legal actions, to define what constitutes an unacceptable conflict of interest, and on and on.¹⁹ The libertarian vision of a night-watchman state gently policing an unfettered free market is a philosophical conceit, not a description of reality.

The intertwining of government and markets is nothing new. The frontier was settled because government granted land to the pioneers, killed, drove off, or rounded up Native Americans, created private monopolies to forge a nationwide transportation and industrial network, and linked the land settled with the world's largest postal system. Similarly, the laissez-faire capitalism of the early twentieth century was underpinned by a government that kept unions at bay, created a stable money supply, erected trade barriers that sheltered the new manufacturing giants, protected entrepreneurs from debtors' prison and corporations from liability, and generally made business the business of government.

When the political economy of the Gilded Age collapsed, it was government that reinvented American capitalism. With the arrival of the New Deal, the federal government took on a much more active role in redistributing income through the tax code and public programs. But the activist state that emerged did not just involve a new layer of redistribu-

tion. It fundamentally recast the national economy through the construction of a new industrial relations system, detailed and extensive regulation of corporations and financial markets, and a vast network of subsidies to companies producing everything from oil to soybeans. It also made huge direct investments in education and research—the GI Bill, the National Science Foundation, the National Institutes of Health—promoting the development of technological innovations and a skilled workforce that continue to drive American economic productivity.

And so it is with today's winner-take-all economy. Redistribution through taxes and transfers—or rather its absence—is only part of the story, and not even the biggest part. Even the word “redistribution” is symptomatic of the pervasive distortions in contemporary discussion. It suggests the refashioning of a natural order by meddling politicians, a departure from market rewards. But the treatment of the market as some pre-political state of nature is a fiction. Politicians are there at the creation, shaping that “natural” order and what the market rewards. Beginning in the late 1970s, they helped shape it so more and more of the rewards would go to the top.

Beyond the stunning shifts in taxation already described, there were three main areas where government authority gave a huge impetus to the winner-take-all economy: government's treatment of unions, the regulation of executive pay, and the policing of financial markets. These changes are so crucial to understanding how government rewrote the rules that we take them up now as a prelude to our larger story.

The Collapse of American Unions

No one who looks at the American economy of the last generation can fail to be struck by the precipitous decline of organized labor. From a peak of more than one in three workers just after World War II, union membership has declined to around one in nine. All the fall has occurred in the private sector, where unionization plummeted from nearly a quarter of workers in the early 1970s to just over 7 percent today.²⁰ (By contrast,

public-sector unionization increased, partially masking the private-sector collapse.)

This decline has abetted rising inequality in very obvious ways. Wages and benefits are more equal (and higher) where unions operate, and less educationally advantaged workers, in particular, have lost ground as the reach of unions has ebbed.²¹ But the near-extinction of private-sector unions has had a much broader and less appreciated effect on the distribution of American economic rewards. It has created a political and economic vacuum that has proven deadly to those seeking to redress winner-take-all inequality and friendly to those seeking to promote and consolidate it.

This is because organized labor's role is not limited to union participation in the determination of wages. Much more fundamental is the potential for unions to offer an organizational counterweight to the power of those at the top. Indeed, while there are many "progressive" groups in the American universe of organized interests, labor is the only major one focused on the broad economic concerns of those with modest incomes. In the United States, and elsewhere, unions are the main political players pushing leaders to address middle-class economic concerns and resisting policy changes that promote inequality. Unions also have the resources and incentives to check corporate practices, such as bloated executive pay packages, that directly produce winner-take-all outcomes. Indeed, even with their current weakness, American unions (through operations like the AFL-CIO Office of Investment) represent one of only two organized groups providing a potential check on the unfettered autonomy of top executives and investors—the other being "investor collectives" like public pension systems and mutual funds. It is surely no coincidence that almost all the advanced industrial democracies that have seen little or no shift toward the top 1 percent have much stronger unions than does the United States.²²

The conventional view is that American labor's collapse was inevitable and natural, driven by global economic changes that have swept unions aside everywhere. But a quick glance abroad indicates that extreme union decline was not foreordained. While unions have indeed lost members

in many Western nations (from a much stronger starting position), their presence has fallen little or not at all in others. In the European Union, union density fell by less than a third between 1970 and 2003. In the United States, despite starting from much lower levels, it fell by nearly half.²³ Yet we do not need to gaze across the Atlantic to see a very different picture of union fortunes. In Canada, where the rate of unionization was nearly identical to the United States' a few decades ago, unions have seen little decline despite similar worker attitudes toward unions in the two nations.

If economic forces did not dictate the implosion of American unions, perhaps American workers have simply lost interest in joining unions. Wrong again. In fact, nonunionized workers have expressed an *increasing* desire to be unionized since the early 1980s. In 2005, more than half of nonunionized private-sector workers said they wanted a union in their workplace, up from around 30 percent in 1984.²⁴ Compared with other rich democracies, the United States stands out as the country with the greatest unfulfilled demand for union representation.²⁵

Looking at surveys like these, it's tempting to pin the blame on labor leaders for having their heads in the sand—and indeed, their initial response was overly complacent.²⁶ By the late 1970s, however, unions were seeking reforms in labor laws that would have helped them maintain their reach. The most prominent was a major labor law reform bill in 1978. Unions made the bill their top political priority.²⁷ Employers, energized and organized as they had not been for decades, mobilized in return, targeting Republicans and conservative Southern Democrats. Reform passed the House and commanded majority support in the Senate. But in a sign of the gridlock that would soon seem normal, the bill's opponents were able to sustain a Senate filibuster—despite the presence of large Democratic majorities in the Senate.

The message of the failed reform drive was clear: Business had the upper hand in Washington and the workplace. In the words of economists Frank Levy and Peter Temin, the defeat sent "signals that the third man—government—was leaving the ring."²⁸ Even before Reagan took office, business adopted a much more aggressive posture in the workplace, newly confident that government would not intervene. When Reagan came to

power, he reinforced the message by breaking a high-profile strike by air-traffic controllers, as well as stacking the National Labor Relations Board (NLRB) in favor of management. Within a few years, it was evident to all involved that the established legal framework for recognizing unions—the National Labor Relations Act, or NLRA—placed few real limits on increasingly vigorous antiunion activities. Writing in the *Wall Street Journal* in 1984, a prominent “union avoidance” consultant observed that the “current government and business climate presents a unique opportunity for companies . . . to develop and implement long-term plans for conducting business in a union-free environment.” The “critical test,” he continued, was whether corporations had the “intellectual discipline and foresight to capitalize on this rare moment in our history.”²⁹

They did. Reported violations of the NLRA skyrocketed in the late 1970s and early 1980s.³⁰ Meanwhile, strike rates plummeted, and many of the strikes that did occur were acts of desperation rather than indicators of union muscle.³¹ Nor did the assault abate in subsequent years. Between the mid-1980s and late 1990s, the share of NLRA elections featuring five or more union-avoidance tactics more than doubled, to over 80 percent.³² By 2007, less than a fifth of the declining number of workers organized in the private sector gained recognition through the traditional NLRA process, once the near-exclusive route to unionization.³³

As the effective sidelining of the NLRA suggests, drift was the most powerful weapon of union opponents. Simply blocking federal actions that countered the economic and state-level shifts that were devastating unions, or that might weaken employers’ hand in union struggles, usually proved enough. In part, this reflected a harsh mathematical reality—the smaller the number of unions, the greater the cost per member needed to organize the vast nonunion sector. Once labor decline began to gain momentum, American unions confronted a harsh choice: devoting more of their evaporating resources to organizing, or gambling it on national and state political action to promote new rules.

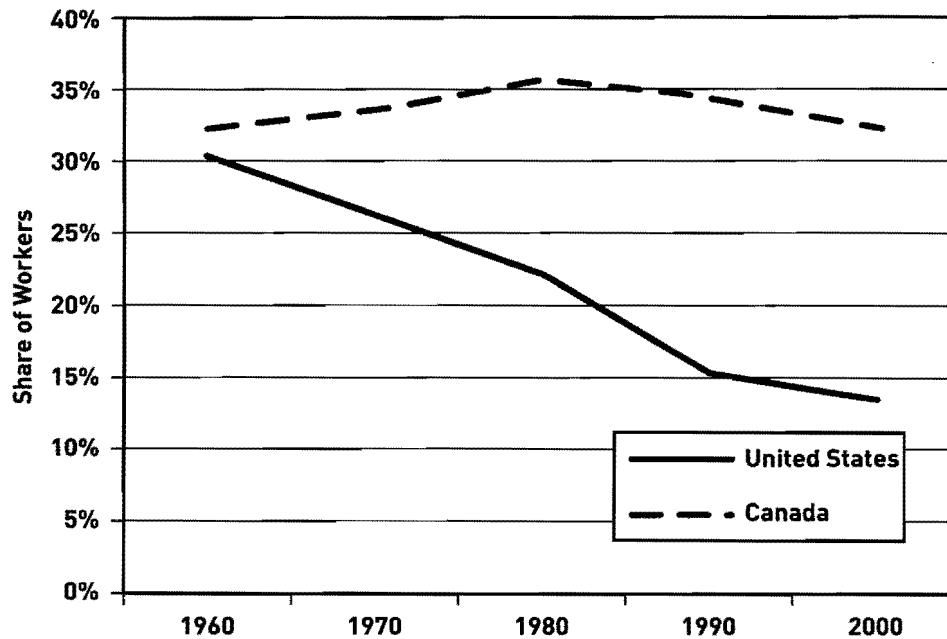
Drift was especially dangerous to American unions for two other reasons. The first was their very uneven geographic and industrial reach. Well established in certain manufacturing industries in particular states, they

were acutely vulnerable to the movement of manufacturing jobs to states where labor rights were more limited, as well as shifts in employment to sectors that had not previously been organized. These features made it easier for employers to pit one group of workers against another, and to move their activities—or threaten to move their activities—to areas where unions were weak or absent, inside or outside the United States.

The second reason is less well understood: American workers are unique in the extent to which they rely on individual firms to protect their health and retirement security.³⁴ Government's failure to update health-care and retirement policies left unionized companies in sectors from autos to airlines to steel highly vulnerable to the "legacy costs" associated with benefits for aging union workers (that is, the costs of benefits promised in the past, especially those granted to retirees). These costs—which in other rich democracies are either borne by all taxpayers or mandatory across firms—have contributed to slower employment growth in the unionized sector while stiffening corporations' resistance to labor inroads.

A quick glance at Canada's very different postwar experience drives these points home. As figure 5 shows, the gap in unionization between Canada and the United States has dramatically opened over the past four decades. The Canadian economist W. Craig Riddell has found that little of the divergence can be explained by structural features of the two nations' economies, or even by varying worker propensities to join a union.³⁵ Rather, the difference is due to the much lower (and declining) likelihood in the United States that workers who have an interest in joining a union will actually belong to one. Canadian law, for example, allows for card certification and first-contract arbitration (both features of the Employee Free Choice Act currently promoted by labor unions in the United States). It also bans permanent striker replacements, and imposes strong limits on employer propaganda.³⁶ Moreover, because Canada has national health insurance and substantially lower medical costs, unionized sectors in Canada also bear far lower legacy costs. All this contrasts starkly with the United States, where national political leaders have done little to ease the burdens of private benefits and where aggressive antiunion activities by employers have met little resistance from public authorities.

**Figure 5: Union Share of Wage and Salary Workers
in the U.S. and Canada, 1960–2000**



Sources: David Card, Thomas Lemieux, and W. Craig Riddell, "Unions and Wage Inequality," *Journal of Labor Research* 25, no. 4 (2004): 519–59; Sylvia Allegretto, Lawrence Mishel, and Jared Bernstein, *The State of Working America* (Ithaca, NY: Cornell University Press, 2008).

In short, American unions did not just happen to be in the way of a fast-moving economic train. They were pushed onto the tracks by American political leaders—in an era in which an organized voice would increasingly be needed to provide an effective counterweight to the rising influence of those at the top.

Blank Checks in the Boardroom

When the mercurial Home Depot CEO Bob Nardelli reaped a \$210 million severance package upon his firing in 2007, even as the company's stock fell, he became a poster child for the pay-without-performance world of executive compensation.³⁷ Yet Nardelli was hardly the only corporate ex-

ecutive benefiting handsomely from the winner-take-all economy. As we saw earlier, the highest-paid executives in firms outside the financial sector account for around 40 percent of those in the top 0.1 percent.³⁸

In historical perspective, the rise of executive pay has been nothing short of staggering.³⁹ For roughly forty years between the New Deal and the mid-1970s, the pay of top officers in large firms rose at a modest rate.⁴⁰ Around 1980, however, executive compensation started shooting up, and the pace of the acceleration increased in the 1990s. Despite dipping with the stock market in the early 2000s, executive pay has continued skyward. In 1965, the average chief executive officer (CEO) of a large U.S. corporation made around twenty-four times the earnings of the typical worker. By 2007, average CEO pay was accelerating toward *three hundred* times typical earnings. In that year, the average CEO of the 350 largest publicly traded companies made more than \$12 million per year.⁴¹

Once again, the standard story is that top executives earn what they earn because they are so much more valuable to companies than they once were. Government has been a bystander as market forces have benignly played out.

Once again, however, the standard story is wrong. Executive pay is set in a distorted market deeply shaped by public policy. CEOs have been able to take advantage of a corporate governance system that allows them to drive up their own pay, creates ripe conditions for imbalanced bidding wars in which executives hold the cards, and prevents all but the most privileged insiders from understanding what is actually going on.

These arrangements are no accident. Over the last generation—through both changes in public policy and the failure to update government regulations to reflect changing realities—political leaders have promoted a system of executive compensation that grants enormous autonomy to managers, including significant indirect control over their own pay. Bob Nardelli's outsized check could very well have had "Made possible by Washington" written on it.

As with the decline of unions, the experience of other rich nations shows that nothing about modern globalized capitalism makes extraordinary executive salaries inevitable or even likely. American CEOs are paid

more than twice the average for other rich nations. In the country with the second-highest CEO pay levels—Switzerland—CEOs are paid on average around three-fifths of what American executives earn.⁴² Pay is not only lower in other rich nations; it also takes different forms. American CEOs, for example, receive much of their pay in short-term stock options, which not only lack transparency for stockholders but are also highly lucrative for CEOs who can create quick stock market gains through job cuts, restructuring, or creative accounting. Stock options are used in other nations, too, but they are much more often linked to long-term rather than short-term performance, as well as to firm performance relative to industry norms.⁴³ Thus, for instance, options can be designed so that when the rising price of oil drives up the share price of energy companies, CEOs receive extra compensation only if their firm's performance exceeds industry averages.

Defenders of American arrangements argue that they are in the best interests of shareholders.⁴⁴ By negotiating with executives on behalf of the diffuse interests of those owning stock, this argument goes, boards of directors act as faithful defenders of shareholder value. Many of those who study how this process actually works are more doubtful. Looking at corporate governance in a number of rich democracies, the political economists Peter Gourevitch and James Shinn argue that a better description is "managerism," a system in which managerial elites are in a strong position to extract resources.⁴⁵ The financier John Bogle has contended that instead of an "ownership society" in which managers serve owners, the United States is moving toward an "agency society" in which managers serve themselves.⁴⁶ Two of the nation's leading experts on corporate compensation, Lucian Bebchuk and Jesse Fried, provide many findings more consistent with a "board capture" view than a "shareholder value" perspective. In their telling, boards are typically so beholden to CEOs—who influence the nomination of board members and have substantial influence over those members' pay and perks—they offer little countervailing authority.⁴⁷

The most revealing findings concern the design of executive compensation. Executive pay frequently departs from what would be expected to

encourage good performance. Instead, corporate pay arrangements are shot through with what Bebchuk and Fried call “camouflage”: features designed to mitigate public outrage rather than limit excessive pay or link it more closely to value. To cite a few examples: Stock options are designed so that CEOs gain the upside of bull markets but are protected from bear markets. A huge chunk of executive pay is hidden in so-called deferred compensation—pay that’s put off to postpone taxes on interest and earnings—and in guaranteed-benefit pensions.

That’s right. In an era in which most workers receive no defined benefit in retirement, CEOs still do. IBM’s CEO, for example, was entitled to over \$1 million a year in retirement benefits after about nine years of service to the company—an amount estimated to be worth about as much as he made while at the company.⁴⁸ The economic rationale for this guaranteed payout was nonexistent. Indeed, unlike ordinary workers’ pensions, these massive executive benefits are not tax-free to the company (though they do shield *executives* from taxes on the interest that their pensions earn), and they can create staggering long-term liabilities for firms. But the camouflage they provided was substantial: IBM never had to report a cent of the payout as compensation.

The list goes on. Retired executives enjoy perks without parallel in the rest of the workplace. Guaranteed hours on corporate jets, chauffeurs, personal assistants, apartments, even lucrative consulting contracts—none has to be reported as executive pay. In 2001, executives at GE and Enron were guaranteed a rate of return on their deferred compensation of 12 percent, when long-run Treasury bills were paying out one-third of that. Coca-Cola’s CEO was able to defer taxes on \$1 billion in compensation and investment earnings—gains that did not have to be reported in the company’s pay statements.⁴⁹ In 2008, while Wal-Mart workers lost an average of 18 percent of their 401(k) holdings, Wal-Mart’s CEO, H. Lee Scott Jr., saw gains of \$2.3 million in his \$47 million retirement plan.⁵⁰

Where were America’s political leaders while all this was happening? For the most part, they were either freeing up executives to extract more or, like police officers on the take, looking the other way. This is in sharp

contrast to the experience abroad, where there have been substantial efforts to monitor executive pay and facilitate organized pushback against managerial power.⁵¹ In many nations, organized labor has served this countervailing role. But while American unions have tried to take on corporate pay, the broader challenges they have faced have severely hampered them. Another possible check on managerial autonomy, private litigation, was radically scaled back by mid-1990s legislation engineered by congressional Republicans. The bill had strong enough support from Democrats to pass over President Clinton's veto.

Washington also opened the floodgates for the rise of stock options, the main conduit for the tide of money streaming from corporate coffers to top executives. During the 1990s, stock options became the central vehicle for enhancing executive compensation, comprising roughly half of executive pay by 2001. These options were typically structured in ways that lowered the visibility of high payouts and failed to create strong connections between compensation and managerial effectiveness, even though instruments for establishing such links were well known and widely used abroad.⁵² The value of options simply rose along with stock prices, even if stock price gains were fleeting, or a firm's performance badly trailed that of other companies in the same sector. In the extreme but widespread practice of "backdating," option values were reset retroactively to provide big gains for executives—a practice akin to repositioning the target after the fact to make sure the archer's shot hit the bull's-eye. But when the Financial Accounting Standards Board, which oversees accounting practices, tried to make firms report the costs of stock options like other compensation in the early 1990s, it was beaten back by a bipartisan coalition in the Senate galvanized by industry opposition.⁵³ This is a textbook example of drift.

Recent efforts to increase board independence and capacity tell a similar story. In the early 2000s, after a series of massive scandals in which CEO self-dealing wiped out the assets of shareholders and employees, elected officials faced strong pressure to reform corporate governance. Still, the bill that eventually passed, called Sarbanes-Oxley after its two congressional sponsors, would most likely have died but for the collapse

of WorldCom as the 2002 elections approached. Even then, corporations were able to beat back the sorts of reforms that would have put the most effective checks on managerial autonomy.⁵⁴ Indeed, the nature of the compromise embodied in Sarbanes-Oxley is revealing. Managers accepted efforts designed to modestly increase transparency and regulate some of the most blatant conflicts of interest. At the same time, they quite effectively resisted efforts to increase the ability of shareholders to influence the governance of firms, including compensation practices.

Former chair of the SEC Arthur Levitt perfectly captures the political world that fostered ever-increasing executive payouts in his firsthand recollections of the unsuccessful battles over corporate reform in the 1990s:

During my seven and a half years in Washington . . . nothing astonished me more than witnessing the powerful special interest groups in full swing when they thought a proposed rule or a piece of legislation might hurt them, giving nary a thought to how the proposal might help the investing public. With laserlike precision, groups representing Wall Street firms, mutual fund companies, accounting firms, or corporate managers would quickly set about to defeat even minor threats. Individual investors, with no organized labor or trade association to represent their views in Washington, never knew what hit them.⁵⁵

Finance Rules: Heads I Win, Tails You Lose

With the pillars of Wall Street now battered, it is easy to forget how dramatic the rise of the financial sector has been. Between 1975 and 2007, wages and salaries in the industry roughly doubled as a share of national earnings.⁵⁶ The proportion of the economy comprising its activities exploded. Between 1980 and 2007, financial service companies expanded their share of company profits from around 13 percent to more than 27 percent. Even staid corporate giants got into the act. In 1980, GE

earned 92 percent of its profit from manufacturing. In 2007, more than half of GE's profits came from financial businesses.⁵⁷

In part, this is simply a chapter of the broader rise of executive pay just chronicled. But the other part is the runaway rewards that have flowed into the pockets of the rich from America's widening range of exotic new financial institutions. These rewards have involved the development of complex new financial products that, for most Americans, offered limited benefits and sometimes real economic risks. For the financial sector, however, the new instruments and expanding freedom to use them created astonishing opportunities: to increase the number of transactions (with intermediaries taking a cut on each one), to ratchet up leverage (and thus potential profits), and to increase the complexity and opacity in ways that advantaged insiders. Not coincidentally, all of these developments increased the risk to the system as a whole. However, that would be someone else's problem—or, as economists gently put it, an "externality." As Martin Wolf of the *Financial Times* observed acerbically in 2008, "No industry has a comparable talent for privatizing gains and socializing losses."⁵⁸

At the very top, those privatized gains were mind-boggling. Wages in the financial sector took off in the 1980s. The pace of the rise accelerated in the 1990s, and again after the millennium. In 2002, one had to earn \$30 million to make it to the top twenty-five hedge fund incomes; in 2004, \$100 million; in 2005, \$130 million (when the twenty-fifth spot was occupied by William Browder, grandson of Earl Browder, onetime head of the Communist Party of the United States). A year later, the average for the top twenty-five had nearly doubled to \$240 million; in 2007, it hit \$360 million. That year, five hedge fund managers made \$1 billion or more, with the top three weighing in around \$3 billion.⁵⁹ In the two years before they began reporting losses that dwarfed the profits of prior years and brought many of their stockholders to ruin, the venerable firms of Goldman Sachs, Merrill Lynch, Morgan Stanley, Lehman Brothers, and Bear Stearns paid their employees bonuses of \$65.6 billion.⁶⁰ The home address of the winner-take-all economy has been neither Hollywood nor Silicon Valley, but Wall Street.

Until a few years ago, high finance was depicted as the purest of markets. When politicians and analysts referenced the preferences of “Wall Street,” the phrase was taken (without irony) as a synonym for economic rationality itself, rather than as a set of specific interests. Yet financial markets, like others, are not pre-political. As Robert Kuttner detailed in his prescient 2007 book *The Squandering of America*, our financial system has always rested on an extensive set of government interventions.⁶¹ The legal environment for financial transactions governs such crucial issues as what constitutes insider dealing or conflicts of interest, how much monitoring and transparency there must be in major financial transactions, and what levels of leverage and risk are acceptable. In response to market failures on all these dimensions, the New Deal ushered in extensive new federal regulations designed to ensure investor confidence and align private ambitions more closely with broad economic goals such as financial stability.⁶²

Over the last three decades, these relatively quiet and stable financial markets have given way to much more dynamic and unstable ones with far more pervasive effects on the rest of the economy. Some of the shift was clearly driven by changes in the nature of economic activity and the possibilities for financial intermediation. Technological innovation made possible the development of new financial instruments and facilitated spectacular experiments with securitization. Computers helped Wall Street transform from million-share trading days in the 1980s to billion-share trading days in the late 1990s, magnifying the possibilities for gains—and losses.⁶³

The shredding of the post-New Deal rule book for financial markets did not, however, simply result from the impersonal forces of “financial innovation.” In Canada, for instance, government effectively resisted many of the efforts of financial interests to rewrite the rules—and Canada was largely spared the financial debacle of the past few years. The transformation of Wall Street reflected the repeated, aggressive application of political power. Some of that power was directed at removing existing regulations designed to protect against speculative excess and conflicts of interest. Some focused on thwarting would-be regulators who sought

to update rules to address rapidly evolving financial realities. The net effect was not an idealized free market, but a playing field tilted in favor of those with power, connections, lack of scruples, and the ability to play the profitable but systematically risky new game.

Assessing the contribution of specific policy initiatives to the restructuring of financial markets is a matter of considerable controversy. That public action played a vital role, however, is less in doubt. A recent careful study by two enterprising economists, Thomas Philippon of New York University and Ariell Reshef of the University of Virginia, shows that regulatory restrictions on banking had been reduced below their pre-New Deal levels by the late 1990s.⁶⁴ The changes included deregulation of bank branching (facilitating mergers and acquisitions), relaxation of the traditional separation of commercial and investment banking (which was finally repealed by the Gramm-Leach-Bliley Act of 1999), removing ceilings on interest rates, and repealing the decades-old separation between banks and insurance companies.

Other policy efforts were geared at keeping regulators away from emerging areas of financial activity—a classic form of policy drift. Consider the case of Wendy Gramm, George H. W. Bush's chair of the Commodity Futures Trading Commission (CFTC). Only a few days before leaving office in early 1993, Gramm granted a "midnight order" that Enron had sought to allow it to trade in self-designed derivatives free of CFTC supervision.⁶⁵ A few weeks later, she received a seat on Enron's board. Her husband, Phil Gramm, was an even more prominent performer in the deregulation drama. As chair of the Senate Banking Committee, he was instrumental in laying down a little-noticed deregulatory milestone, the Commodity Futures Modernization Act. The 262-page bill—slipped into a far larger appropriations bill during the lame-duck fall 2000 session of Congress and signed into law by President Clinton—essentially exempted derivatives and other exotic instruments from oversight by the agencies that regulated more conventional financial assets.

Few now doubt that high finance profited at the expense of sensible regulations. But Philippon and Reshef's research indicates just how intertwined private rewards and public rules have been. For decades after the

stock market crash of 1929, they find, finance jobs were neither all that glamorous nor all that lucrative, but pretty much run-of-the-mill white-collar positions whose compensation tracked the rewards available elsewhere in the economy to those with similar skills. As deregulatory fever took hold, however, all this changed. Suddenly, and increasingly, financial professionals were earning much more than similarly educated workers. Perhaps as much as half of their expanding pay premium, Philippon and Reshef calculate, can be linked to the deregulation wave.⁶⁶

Economists have a name for such government-created rewards: “rents”—money that accrues to favored groups not because of their competitive edge, but because public policy gives them specific advantages relative to their competitors. The rents in zip code 10005 have risen through the roof.

We now know that the price tag for two decades of deregulatory excess will be unconscionably high. Yet in one respect the success of the deregulatory agenda remains undeniable and largely intact: the massive enrichment of an extremely thin slice of American society. In the eight years leading up to the collapse of Bear Stearns and Lehman Brothers in 2008, the top five executives at each firm cashed out a total of roughly \$2.4 billion in bonuses and equity sales that were not lost or clawed back when the firms went under.⁶⁷ As one postcrash exposé explained the game, “Here’s how it goes. You bet big with someone else’s money. If you win, you get a huge bonus, based on the profits. If you lose, you lose someone else’s money rather than your own, and you move on to the next job. If you’re especially smart—like Lehman chief executive Dick Fuld—you take a lot of money off the table. During his tenure as CEO, Fuld made \$490 million (before taxes) cashing in stock options and stock he received as compensation.”⁶⁸

Friends in High Places

The myth of America’s winner-take-all economy is that government does not have much to do with it. Skyrocketing gains at the top are simply the

impersonal beneficence of Adam Smith's "invisible hand," the natural outcome of free-market forces. Listen to Sanford Weill, the former chairman of Citigroup: "People can look at the last twenty-five years and say this is an incredibly unique period of time. We didn't rely on somebody else to build what we built."⁶⁹ Weill may not have relied on "somebody else" during this "unique period." He did, however, rely a great deal on government. When Citigroup formed in 1998, one of the top bankers involved joked at the celebratory press conference that any antitrust concerns could be dealt with easily: "Sandy will call up his friend, the President."⁷⁰ Within a few months, the financial industry had mounted a successful campaign to repeal the Glass-Steagall Act, which since the 1930s had prohibited powerful financial conglomerates of the sort Weill now headed on the grounds that they created conflicts of interest and impaired financial transparency and accountability. Leading the charge against Glass-Steagall was, yes, Sanford Weill.

The truth is that most people have missed the *visible* hand of government because they've been looking in the wrong place. They have talked about the minimum wage, the Earned Income Tax Credit, Medicaid for vulnerable children and families—in short, programs that help those at the bottom. The real story, however, is what our national political elites have done for those at the top, both through their actions and through their deliberate failures to act.

We have our suspect. The winner-take-all economy was made, in substantial part, in Washington. Yet identifying the main suspect only makes the core mystery more perplexing: How could this happen? No one expects the invisible hand of the market to press for equality. Yet there are good reasons for thinking that the visible hand of government will. Indeed, as we shall see in the next chapter, a long line of thinkers has argued that popular representation through democratic government creates powerful pressures for greater equality, as less-advantaged majorities use their political power to offset the economic power of those at the top.

That is clearly not what has happened in the United States over the last generation. Where governments in other democracies worked energetically to offset increasing inequality, public policies in the United States

actively nurtured it. Why? How, in a country governed by majority rule, a country born of revolt against persistent differences in power and opportunity, could policy and government so favor such a narrow group, for so long, with so little real response? With the suspect identified, we now turn to the fundamental puzzle: What happened to American politics that precipitated these momentous changes?

This is not, it turns out, simply a question about contemporary American politics. In our search for clues regarding the transformation of American government since the 1970s, we kept coming upon striking parallels between our nation's present struggles and moments of political decay and renewal in the past. The winner-take-all economy described in the last two chapters is distinctively of our time. But the process by which it arose—and the prospects for its reform—can only be seen with clear eyes if we take a longer historical perspective.

American government has a rap sheet, if you will. Repeatedly in our nation's political history, Americans have found themselves buffeted by dislocating market forces while their government has seemed mired in gridlock and beholden to concentrated economic power. In the story of these past periods, we find the foundation of the answer to our central mystery.