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KEY FINDINGS

FINANCIAL DEREGULATION, U.S. PARTY POLITICS, AND RISING INCOME INEQUALITY

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With recent estimates of the income share held by the top 1% rivaling the concentration of U.S. economic privilege last seen before the Great Depression and World War II, it is no surprise that rising economic inequality is receiving more attention from politicians, pundits, and scholars. But what can be done by government to reverse the trend of widening income gaps? In order to craft legislation that reduces inequality, we first need to understand what drives it. Recent research reveals that government and party politics play an important role, but the specific mechanisms and policies that drive inequality are still not completely clear.

Our research focuses in particular on the contribution of financial regulations to economic inequality. For most of the 20th century, partisan balances in Congress shaped these regulations. The U.S. financial sector was more tightly regulated when Democrats gained power, while deregulation occurred more frequently when Republicans were in charge. But these partisan differences diminished toward the end of the twentieth century, because many Democrats converged with Republicans to promote deregulation. This policy shift mattered, as financial deregulation has become a driver of greater income inequality over the past three decades.

Connecting Income Inequality to the Politics of Financial Regulation

For a long time, Democrats and Republicans in the United States held distinctive views on whether banks, investment firms, and other parts of the financial sector should be more tightly regulated or face loosened public oversight. Broadly speaking, Democrats favored more regulation and Republicans pushed for less of it. Examining data from 1914 to 2010, we found significant increases and declines in financial regulation depending on which party controlled the White House and Congress. Deregulatory shifts in policy were more likely to happen when Republicans held power in Washington, but were less likely when Democrats were in charge.

Our research also reveals that regulation of the financial sector has demonstrable implications for economic inequality. Controlling for a variety of other important economic factors and general historical trends, we find that in the years following a deregulatory policy shifts the country experiences increases the share of U.S. income going to the top 0.01 percent, a tiny sliver of mega-privileged Americans. This is important, because accumulating evidence suggests that rising income inequality can have broadly detrimental effects not just on social wellbeing but also for economic growth and opportunities.

Partisan Convergence on Financial Deregulation

We wondered, however, whether partisan disagreements over financial regulation have been consistent over time – that is to say, whether partisan effects have changed over the full 95 years we analyzed. Anecdotal evidence suggests that, in recent times, Democrats may have moved toward longstanding Republican support for financial deregulation. Congressional Democrats did vote with Republicans in favor of key deregulatory bills in the 1990s, including the definitive repeal of the Glass-Steagall Act that had previously restricted affiliations between banks and investment securities firms. Many analysts believe that this rule was a source of market stability that helped keep income gaps in check.

To move beyond particular changes like this, we assessed more systematically whether partisan convergence on financial deregulation may have spurred rising inequality. Our findings suggest that this may, indeed, have happened. In years prior to 1980, a robust relationship between partisan power in Washington and financial deregulation is evident -- with Democrats in power producing more regulation and Republicans less. But this relationship disappears after that, as Democrats and Republicans agreed on financial deregulation to a much greater extent during the deregulatory era of the 1980s and 1990s.

Why did the post-1980 partisan convergence happen? Additional analyses suggest some reasons Democrats may have moved toward deregulation:

- Democrats who raise a greater proportion of their campaign funding from sources connected to Wall Street and other financial interests are likely to support deregulation – and as time went on, more Democrats became much more reliant on contributions from the finance industry as opposed to labor unions.

- Globalization has spurred utilization of consumer financial services, supplied by companies that manage personal loans like credit cards and mortgages. Recognizing that many in the American middle class were turning to credit to maintain living standards in the face of stagnating wages, many Democrats may have become convinced that financial deregulation could serve the interests of some of their core constituents.

Larger Trends and Implications

From the 1930s to the 1970s, sustained financial regulation contributed to declining economic inequality in the United States. But deregulatory trends since the 1970s have fueled rising income gaps and disproportionate income flows to the very top. Support for this finding is drawn from many kinds of annual data from 1914 to 2010, including measures of top income shares, party control of policymaking institutions, financial regulations, union membership, tax rates, trade flows, and stock market valuations. Overall, we estimate that post-1980 partisan convergence in support of financial deregulation and subsequent policy changes furthered an approximately 20% increase in U.S. income inequality by 2012. More fundamentally, trends in partisan convergence have themselves been partially shaped by changes in campaign finance rules, globalization, and the increasing utilization of consumer debt.

In short, in recent times both major U.S. parties have played a significant role in deregulatory shifts that have fueled sharply rising income inequality. Clearly, Democrats will not reverse course without new incentives and pressures in the larger political process. Recent shifts among Democratic voters and some donors may be starting to deliver the message to party leaders and officeholders that serious progress to reduce economic inequality requires tighter regulation of the financial sector.

Read more in Eric Keller and Nathan J. Kelly, "Partisan Politics, Financial Deregulation, and the New Gilded Age." *Political Research Quarterly* 68, no. 3 (2015): 428-442.