Financial Deregulation, Income Inequality, and Partisan Politics from the Great War to the Great Recession

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Abstract

This study examines how financial deregulation and partisan politics shaped American market-based income distribution from 1914 to 2012 through a process called *market conditioning.* By using time-series data analysis, I access the effect of legislative and bureaucratic financial deregulation on market-based income concentration for the very wealthy. Then, I use process-tracing to determine why both political parties converged in the 1980s to support financial deregulation. I find financial deregulation does increase market-based income for top income earners, especially the top .01 percent. In addition, I determine that both parties were captured by neoliberal economic ideology and through the bureaucracy, shaped the financial free market in favor of the top income earners.

Preface

The United States' economic inequality has risen to alarming levels over the last few decades. Whereas the Democrats began talking about inequality in a negative way after 2010, the Republicans began in 2014 framing economic inequality as problematic (naturally, both parties also blamed the other for enacting policies that caused it in the first place). However, both parties contributed to the deregulatory policy making that characterized financial legislation from 1990 to 2010 and it is this financial deregulation that contributed to the steep increase of income inequality. Understanding this political dynamic is an important part of planning the economic path forward. Since politicians enact legislation which then is executed by the government bureaucracy, it is just as important to know how and why financial deregulation shaped the financial markets that created this steep increase in market-based income inequality.

Financial deregulation really began in the mid-1980s when neoliberalism as an ideology replaced Keynesian economics with government policymakers. However, this study begins in 1914 when the financial sector, especially banking and the securities industry had little government regulation to interfere with their activity in the market. The analysis continues through the Great Depression when the financial market failed and the government strongly regulated banking and to a lesser degree, securities. Thus, when politicians from both parties began to encourage deregulation in the mid-1980s (and some in the mid-1970s), this is a political phenomenon worth a closer look. Why did the Democratic Party, the author of the major regulatory banking legislation of the 1930s, move to deregulate those very laws in the 1990s? What was the Democrats justification to do so?

This study concludes that financial deregulation, over time, increases market-based income inequality. It also concludes that both political parties used neoliberal economic ideation to justify the passage of deregulatory financial legislation which dismantled the strong regulatory boundaries created by the Democrats during the Great Depression.

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Chapter 1

Introduction

"Amongst the novel objects that attracted my attention…in the United States, nothing struck me more forcibly than the general equality of condition. … The more I advance in the study of American society, the more I perceived that this equality of condition is the fundamental fact from which all others seem to be derived…."

Aexis De Tocqueville, Democracy in America, 1835

"The banker stands in all our shoes….There is scarcely a person anywhere whose interests do not run parallel with those of the banker."

1946 Annual Report of the Comptroller of the Currency

"It is rather for us to be here dedicated to the great task remaining before us—that from these honored dead we take increased devotion to that cause for which they gave the last full measure of devotion—that we here highly resolve that these dead shall not have died in vain—that this nation, under God, shall have a new birth of freedom—and that government of the people, .by the people, .for the people, shall not perish from the earth."

Abraham Lincoln, Gettysburg Address, 1863

Recently, economists, political scientists, sociologists, politicians, pundits, and the American public have begun discussing the strong economic inequality in the United States. By no means a new phenomenon in American history, this inequality has steadily grown from the late 1970s to 2014 with income, wealth, and even consumption being concentrated at the very top while the majority of Americans experience stagnant, if not declining, economic well-being. This study's premise is that economic inequality has many sources, many enablers, interacting in a complex dance to produce this severe condition. However, the focus is on one particular enabler embedded in a powerful economic mechanism: financial deregulation. While not ignoring that legislation can create financial *regulation* that also increase economic inequality, my argument is that

legislative and bureaucratic *deregulation* serves to concentrate wealth in the upper-socioeconomic strata. In particular, I create bureaucratic variables from almost one hundred years of annual reports from two influential government agencies to determine their influence in the financial free market. From this data, the connection between governmental financial deregulation and market-based income inequality is clearly shown. Furthermore, this study reveals the strong influence neoliberalism has on both U.S. political parties after 1980 which gives the ideological rationale for financial deregulation.

Section 1: This Study's Contribution

This project is designed to expand the study of economic inequality in two fundamental ways. First, by using dynamic time-series statistical analysis, this study explores the link between financial deregulation and increased economic inequality. Finance is American society's lifeblood; no other sector is so intertwined in American lives. Knowing its effect on the economic well-being of everyone is critical. By using time-series, error-correction regression analysis, I will determine the immediate and long-term effects of any displacement that substantially altered the United States' market-based income flow from 1914 to 2012. *Displacement* is defined here as "…an outside event or shock that changes horizons, expectations, anticipated profit opportunities, behavior…" (Kindleberger & Aliber, 2005, p.47). The authors give one category of a recent displacement to the financial market, which is the deregulation of bank and financial institutions. Second, the historical/political process-tracing analysis will explore how partisan politics shaped financial deregulation and thus shaped the economic well-

being of the people the politicians are elected to serve. Process-tracing is a qualitative research technique which, in this study, follows the decision-making progression of political elites as they debate financial regulatory policy. The focus is on the critical decade of the 1990s, which saw the most significant deregulatory actions since the Great Depression. Process-tracing, as implied by its title, will enable me to determine the ideological thinking that created deregulatory decisions, thus helping answer the question regarding the influence of free market fundamentalist ideology (or neoliberalism) on both parties' decision-makers. The process-tracing will determine how this ideology enabled the political elite to then enact deregulatory policy outcomes. Political outcomes are important since they drive bureaucratic behavior as well as establish financial market parameters.

Admittedly, financialization, neoliberalism, economic inequality, legislative and bureaucratic failure are so intertwined and complex that no one research project can fully explain them all. Hence, this study is a narrower focus on how financial regulation/deregulation affects market-based income inequality and how partisan politics affects, if at all, financial regulation/deregulation creation. It focuses on government market conditioning, a dynamic which ties the financial markets with governmental actions. *Market conditioning* are those actions taken by governmental forces that shape the market (Kelly, 2009). To research this phenomenon, the dependent variable must be one that will allow for the best possible results, hence the choice of market-based income

as the dependent variable.[1] Financial deregulation are policies that impact pre-tax/pre-redistribution income rather than post-tax and/or redistributed income. That is not to say taxation or government redistribution of income play no role in economic inequality, but to study the effects of legislative and bureaucratic financial deregulation, only market-based income reflects their influence. Even when post-tax/post-redistribution policies were changing simultaneously with the deregulatory movement, these changes would not offset the deregulation's effect of raising income inequality.

Also, as many researchers have noted, financialization has increased its influence in the United States' economy (Krippner, 2011; Tomaskovic-Devey & Lin, 2011; Palley, 2007). *Financialization* is simply defined as the increased activity and importance of the finance sector in the overall American economy. Beginning in the late 1970s, the financialization process grew until it is impossible to imagine one of the mega-banks failing without creating another Great Depression. As will become evident latter in this study, finance, especially banking, is central to economic inequality. Thus, the legislation of finance, along with the agencies tasked to regulate finance, are critically important in gaining a better understanding who gets what in American society. My study examines in detail financial deregulation's relationship with economic inequality from 1914 to 2012 using time-series econometrics. It is anticipated that financial deregulation is closely correlated with economic inequality with inequality increasing as the financial sector deregulates.

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[11] After much consideration, other household indicators of economic concentration, such as wealth, consumption, well-being, and post-tax/redistribution income were rejected due to the ability of market-based income's ability to capture legislative and bureaucratic financial deregulatory effects.

During two eras in the recent past, the financial sector was not firmly regulated. The first is *laissez-faire* capitalism, which existed before 1934; the second is neoliberal capitalism, which emerged in America in the late 1970s. *Neoliberalism* is simply defined as a strong belief in the free market providing optimal economic outcomes while government actions mainly degrade those actions. Financial deregulation, especially in the banking industry, is puzzling. Whereas many political scientists and economists would claim the deregulatory movement proved to increase economic inequality (Admati & Hellwig, 2013; Bartels, 2008; Blinder, 2013; Blair, 2012; Calabria, 2009; Groton, 2009; Hacker & Pierson, 2010; Johnson & Kwak, 2010; McCarty, Poole, & Rosenthal, 2013; Murdock, 2012), other researchers claim the opposite (Calomiris, 2000; Beck, Levine, & Levkov, 2010; Strahan, 2003; Hendrickson, 2011; Wilson, 2012). These researchers claim that financial regulations that restrict the capital market actually hurt consumers and, thus, contribute to inequality. This study explores this puzzle and provides an empirically based analysis of deregulation. I theorize that financial deregulation increases economic inequality by enabling the transfer of market income from the lower percentile of income earners to the top income earners due to two failures: government (regulatory) failure and market failure. In other words, an unknown number of the very wealthy rent seek using both failures to divert income from the less wealthy to themselves. An *economic rent* is defined as "…an income above which would be realized in a perfectly competitive market" (Tomaskovic-Devey & Lin, 2011, p. 541). Thus, rent seeking by the very top income earners created these failures by using political resources to condition the free market in their favor. By using empirical analysis, my

theory is tested to determine if financial deregulation truly does contribute to market-based income inequality and if so, to what extent. This project closely examines the first failure mentioned, government failure in its bureaucratic capacity, to determine its influence on market-based income inequality.

Why Study Bureaucratic Financial Deregulation?

Whereas political scientists have provided multiple insights into the legislative process that produces economic inequality, research is lacking in terms of bureaucratic effects, either contributing to or decreasing economic inequality. However, government bureaucracy is important. For example, a study of the Enron emails clearly showed industry attempts to create favorable policy outcomes through a concentrated assault on bureaucratic decision making (Drutman & Hopkins, 2012). The financial industry is well aware of this dynamic and thus expended tremendous resources influencing bureaucratic outcomes (Johnson & Kwak 2010). Therefore, this study scrutinizes the effects of bureaucracy on income inequality.

Related to the financial deregulatory puzzle is a political question. Political scientists have clearly shown that after 1994, the United States' political parties became very polarized (Bonica, McCarty, Poole, & Rosenthal, 2013) with a strong bias towards maintaining status quo (Enns, Kelly, Morgan, Volscho, & Witko, 2012). Whereas status quo bias is seen to perpetuate inequality due to the difficulty in passing legislation, a reasonable assumption is that pro-deregulatory legislation struggles as well in such a polarized political environment. Yet, from the 1980s to 2010, virtually all of the legislation increased financial deregulation (with some exceptions related to the Savings

& Loans debacle) with substantial deregulation occurring after 1992 (Bartels, 2004; Hendrickson, 2011; Sherman, 2009; Takiff, 2010; Suskind, 2011). Thus, using process analysis, this project determines the political progressions that enabled this failure to happen in both government sectors. I believe that the ideological capture of bureaucrats and politicians by neoliberal economics meant they sincerely believed they were acting in the public interest as they dismantled financial regulations, even if many of them reaped personal economic rewards from this dismantlement.

This project will make two political assumptions in looking at this ideological capture. The first assumption is that Republicans will, by virtue of their ideology, push for a deregulatory agenda. Thus, any detailed analysis of neoliberal capture will focus more on the Democrat Party. The second assumption is that Democrats (starting from the Great Depression) were, for the most part, pro-labor and Keynesian before the New Democrat movement of the mid-1980s. This study will focus in some detail on the Democrat Party after the mid-1980s to gain a better understanding of how this ideological capture occurred. Again, the Enron email records revealed how corporate actors used economic arguments to further their cause, specifically energy deregulation; therefore expecting the same behavior of financial actors regarding financial deregulation is reasonable (Drutman & Hopkins, 2012). Despite the perceived reasonableness of neoliberal assertions, *failure* ,to be very clear, is the proper word to use in this case since inordinate economic inequality is a failure of American leadership with frightening consequences to the very people they are claiming to care for.

Section 2: Economic Inequality

The United States is once again struggling with formidable inequality (see Figure 2-A in chapter 2), which shows the income concentration of the top 1% from 1914 to 2010. As clearly shown, income inequality peaked in two eras, the late 1920s and the mid-2000s. Laissez-faire capitalism, or liberal capitalism, was the foundation for the first inequality peak. Despite Theodore Roosevelt's progressive policies and the strong populist movement, income inequality only decreased with World War I and then rapidly returned to a high level after the war (Piketty & Saez, 2004; Pizzigati, 2012). A permanent federal income tax began in 1913 followed by the establishment of the Federal Reserve Board in 1914 with both designed to influence the United States' free market. However, the early income tax mainly funded federal government operations and except for veterans' pensions and the like did not redistribute income to a large degree. The early Federal Reserve Bank system, while tasked to regulate the national banking system, believed its main function was to serve as the lender of last resort to prevent bank runs and manage federal bonds. Due to the decentralized decision-making structure of the early Federal Reserve System, even those tasks were difficult to find enough consensus to execute as the Great Depression soon revealed (Ahamed, 2009; Meltzer, 2003). The regulatory initiative was primarily designed to support those two missions with the twelve Federal Reserve Banks' regional districts insuring regulations were few and far between (Meltzer, 2003). Thus, for the purposes of this study, the first movement of inequality is from 1914 to 1932.

After FDR's first election in 1932, the inequality curve began to decline and move into a period with lower economic inequality, which lasted from 1932 to approximately the late 1970s. This "Great Compression" occurred not only during the dramatic decades of the Great Depression and World War II but also during a very strong and stable era of American economic growth in the 1950s and 1960s (Goldin & Margo, 1991). This Keynesian era of the Federal Reserve Board of Governors managed the economy with monetary measures while the Federal government used fiscal measures to do the same. The Securities and Exchange Commission, a product of the New Deal, also grew during this time, even if its economic philosophy dictated a light regulatory stance on securities exchange.

The Great Compression ended with the advent of President Reagan's presidency, which was characterized by economic inequality again beginning to rise, until it peaked in the mid-2000s. The "Great Recession" created a sharp decline in inequality with a severe loss of wealth throughout the United States; however; this economic inequality began to grow again during a recovery which seemed to favor the very wealthy more than other Americans (Saez, 2013). This era of increased economic inequality was characterized by the Federal Reserve System and the SEC letting go of tight regulatory reins while the Federal Government began a deregulation period, which for this study is defined as between 1980 and 2012. This project will examine potential reasons and consequences for this pattern of economic inequality. However, it is worth a digression into this pattern's social and economic consequences, which directly affects the American people.

In 2014, another Frenchman wrote about the United States within the context of analyzing wealth and income for several centuries. Thomas Piketty, a French economist from the Paris School of Economics, conducted an exhaustive study of capital (wealth) and income using a host of historical economic data. His research examined multiple countries, including the United States, compared over time as well as space. For income inequality, he used the income distribution tables from tax returns for the United States beginning in 1913. Along with several other noted economists (Emanuel Saez from University of California, Berkeley being one of them), Piketty created the World's Top Income Dataset, tracking historical trends (or comparative studies). Among the many findings, one of the most interesting is his confirmation of the "Great Compression," a period of lower economic inequality that began after World War I and with the exception of the very high peak of inequality of the 1920s, stayed low until the early 1980s. The resulting 700-page analysis found, among other things, that reducing high capital/income inequality required the shock of two world wars and the Great Depression, along with the fiscal policies that were enacted around those events (Piketty, 2014). Piketty then noted that beginning in the 1980s and up to 2012, this inequality once again increased to its previous level. The "Great Compression" was over and replaced with increasing levels of both income and wealth inequality. He found that inherited wealth means steep income inequality due to wealth's ability to generate non-labor income. Despite the American myth of equal opportunity, inherited wealth privileges the higher income/wealth holders at the expense of the rest, reflected in the loss of social mobility in the United States (Piketty, 2014). Unless economic inequality, its origins and its

consequences are better understood, conceivably only a great shock as painful as the Great Depression and both World Wars would be capable of reducing this savage economic inequality.

Is There Economic Inequality?

There are scholars who would argue that economic inequality is not problematic in American society. This perception of economic inequality is a topic of debate coming from two strands of thought. The first strand is the idea that economic inequality is overstated or even non-existent. Using the same economic and statistical tools, some scholars claim the current focus on economic inequality is not supported by research and thus has a purely political motive. This strand, for example, would use various measures of consumption to determine that economic inequality is less severe than income inequality. For example, the "Wal-Mart effect" of poorer households having the ability to consume at a lower cost than the wealthy. The "Wal-Mart" effect is the reality that lower quality products will cost less and thus lower income earners can consume more than what the Consumer Price Index measures. Despite the perceived quality disparity, some scholars would then conclude economic inequality is being overstated (Mathur, 2013). Another argument is that economic inequality is inadequately measured since it does not account for a lifetime of earnings, which fluctuate, nor for the "underground" economy, which enables lower-income households to supplement income below the government's radar (Bertrand, M. & Morse A., 2013).

The second strand agrees with those who see a severe economic inequality, but who claim that this inequality is an inevitable consequence of a free market and that "a

rising tide lifts all boats" (Wilson, 2012; Murray, 2012). For instance, Demirguc-Kunt and Levine (2009) provide cross-country analysis, which indicates efficient and competitive financial systems reduce income inequality by enabling poorer clients to gain access to financial products. This access means these clients could conceivably borrow for better educational or business opportunities than if the financial system were inefficient with crony capitalism (Demirguc-Kunt & Levin, 2009). Thus, economic inequality is compressed with the rise of a better educated and/or stronger middle-class due to a competitive financial sector, as neoliberal theory would predict. However, Demirguc-Kunt & Levin mitigate this argument by noting the lack of research on macro-financial processes (national financial deregulation):

> First, there is also startling little research on how formal financial policies—such as bank regulations or securities market laws—affect inequality. Given the accumulated body of theoretical and empirical research on the central—though frequently underappreciated—role of finance in explaining economic inequality, this is a serious gap. (p. 48)

Both strands have a legitimacy that will be discussed more fully later to better understand economic inequality's nuances. Interestingly enough, both strands tend to focus on consumption as a measure of economic inequality rather than of income. Despite the above objections, virtually all researchers would agree that some economic inequality is normal in advanced industrial democracies (Gordon & Dew-Becker, 2008). Many of those same researchers would probably also agree this economic inequality became savagely severe over the last three decades.

Three Pieces of Economic Inequality: Ideology, Institutions, and Interests

While always part of a capitalistic democracy, inequality—whether of race, gender, national origin, politics or economy—becomes a threat when it is too severe for those affected This research project is about one such threat, severe economic inequality, which is dominant in the United States. In his 2012 State of the Union speech, President Obama directly addressed this issue:

> No challenge is more urgent. No debate is more important. We can either settle for a country where a shrinking number of people do really well while growing numbers of Americans barely get by, or we can restore an economy where everyone gets a fair shot…."

This economic inequality is not new in American history; the Gilded Age of the late 1800s and the Roaring Twenties are prime examples of an earlier age of inequality. Again, it is worth emphasizing that some inequality is expected, even necessary, in a capitalistic democracy. Innovations, overall wealth creation, and higher standards of living for all people are by-products of this competitive system, which creates unequal outcomes depending on many factors. However, extreme inequality is a distortion of this competitiveness and thus stands as a danger to the United States' health.

McCarty, Poole, and Rosenthal (2013) wrote about three factors of American society that create this inequality: ideology, institutions, and interests. Ideology is identified by several labels: market fundamentalism, neoliberalism, free market conservatism, and unfettered free market (Alesina & Rosenthal, 1995; Chomsky, 1999; Fox, 2009; Jones, 2012; McCarty, Poole, & Rosenthal, 2013; Palley, 2012). Simply put,

neoliberal ideology is a belief that the open market is totally efficient in allocating resources for all people; thus, any government inteference with the market is detrimental. Markets are self-regulating and the invisible hand of Adam Smith rules, which states human self-interest works together to produce the most efficient allocation of economic resources. Institutions are those financial and political bodies that create policies, practices, and procedures related to the United States' monetary/fiscal environment. Thus, banking, investment vehicles, and the government branches are intimately involved in creating economic reality for its citizens. Finally, interests are organized (or even informal) groups attempting to influence political actors into favoring one policy over another (McCarty, Poole, & Rosenthal, 2013). Examples include various associations that represent commercial banking by lobbying representatives. This dissertation examines economic inequality by exploring all three of these entities.

The Consequences of Economic Inequality

There is a picture of a Brazilian city portraying a stark line drawn between the wealthy and the *favelas,* which are shanty towns emerging beside a large wall that separates them. In looking at that picture, one can quickly see two, very different worlds the people there live in. As economic inequality continues to grow in America, the U.S. population divergence is not far behind this dramatic division. The decline of the middle class creates two separate worlds within the United States with the very wealthy increasingly excluding themselves from the majority of Americans (Noah, 2012; Stiglitz, 2012; Else, 2012). This frightening vision was this dissertation's genesis. Examples of this stark divide are found in multiple areas in the United States, and a quick subway ride

in New York City or Washington D.C. will take a person from the world of affluence to the world of poverty very quickly. As will be seen, consumption, wealth, and income inequality in the United States have critical consequences, which researchers, policy-makers, and the American public are slowly understanding.

When thinking of economic inequality, specifically income inequality, I like to use an image of a river. The water represents money in all its various forms. The riverbed signifies how that money is channeled, like water moves through environment. This riverbed is then altered by human activity to control the flow whether it is the marketplace or the government. Always present, the river moves downstream in time with many streams that feed into it, which increases the river's size and momentum, but needs to be controlled. The streams embody income sources, both labor and capital. Sometimes, the streams are strong and the river grows rapidly, leaving victims in its wake, like a financial bubble that grows rapidly and overflows the regulatory shores. Other times, the streams are controlled, so the river moves more slowly and does what it is supposed to do, creating incentives to work hard and learn more. It brings Person "A" who wishes to sell an item to Person "B" who wishes to buy that item; thus, both benefit. Controlled, it leaves fewer victims stranded on the shore and ensures all have the ability to thrive despite personal circumstances.

However, periodically, the river dramatically dries up, just as the economy did in the Great Depression or in the financial crisis of 2008/2009, and dazed victims are left perishing due to lack of water. This project will use econometric analysis as well as qualitative narrative to determine the various factors that might create a financial drought

for most Americans while creating a large surplus for a small number of Americans. To continue the analogy, I am trying to determine who is damming the river or diverting it from the rest of the populace. As Cooley and Walter said, "Like water channeling its way to the sea, financial flows seek the least costly and least regulated bypasses…" (2011, p. 38). Understanding this flow might be difficult due to its inherent complexity; however, it is possible to gain knowledge of how this process (the river bed and the human activity which alters it) moves along with the money (the water) it is moving. This is vital research since economic inequality's consequences tend to be controversial with some political elites claiming that economic inequality is transitory and thus inconsequential, while others point to this type of inequality's devastating economic consequences.

To provide one quick snapshot, the United States' total financial wealth was 49,614 billion or about 50 trillion dollars in 2012 according to the U.S. Federal Reserve Board.[2] Of this total, the net wealth of the top 1% of the U.S. population was 35.4% or 17563.356 billion (17.5 trillion). That same year, the top 1% average household net worth was $16,439,400 (Wolff. , 2012) while the average household net worth of the total U.S. population was $66,740. The total number of taxable households that were 1% of the total U.S. population in 2010 was 780,835 families whose average income was $418,378.[3] The real median household income for 2010 was $51,144.[4] These numbers highlight the extreme gap between the higher income deciles and the rest of Americans.

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[2] Source: FRED, http://www.irs.gov/uac/SOI-Tax-Stats-Individual-Statistical-Tables-by-Tax-Rate-and-Income-Percentile and http://www.federalreserve.gov/releases/z1/Current/

[3] Source: Piketty & Saez, The World's Top Income Dataset, http://topincomes.g-mond.parisschoolofeconomics.eu/

[4] Source: U.S. Census, http://www.census.gov/prod/2012pubs/acsbr11-02.pdf

As Saez noted, the wealthy dramatically captured income growth from 2009 to 2012, with the top 1% gaining 31.4% and the rest of the total population (the 99%) growing by .04% (2013). These numbers empirically illustrate economic inequality's harsh reality, which have drastic consequences for those households who make up the bottom 99% of Americans. Looking at growth, Piketty (2014) observed that from 1980 to 2010, only .5% of total income growth went to the bottom 90% of the U.S. population while the top decile captured three quarters of the total growth. Severe income/wealth inequality leads to all sorts of unfavorable outcomes for most Americans and, thus, as President Obama highlighted, are a threat to the Great American Experiment[5].

Economic Inequality and the Great Recession of 2009

Looking at recent history, one argument is that economic inequality caused the financial crisis of 2008/2009. According to this argument, the stagnated wages of the lower- and middle-wage earners in the United States after the late 1970s created a need for those segments of the population to maintain their relative consumption. At the same time, either as a cause or an effect, financial deregulation meant consumers were exposed to credit mechanisms enabling them to borrow from equity to maintain their desired lifestyle. Thus, household debt increased while household income remained flat. As the very wealthy reached the culmination of their personal consumption, they looked for ways to invest their wealth, primarily in the financial sector. These investments created securitization of personal debt, be it household credit cards, automobile loans, or mortgages. As the financial sector grew, so did economic inequality. Household

[5] Note- To be fair, Tocqueville considered the threat to the American Experiment to be twofold: when politicians discover money's power and when voters discover politicians can create laws to exclude them from laws which restrict capital acquisition.

leverage increased since financial actors' incentives were tied to providing credit to consumers so that credit could then be securitized into additional wealth, all by using an unregulated banking system known as *shadow banking*, which continued to create "wealth" with the belief that risk could be managed with this securitized credit system, all the while increasing the average American consumer's debt. Finally, this system came crashing down, and the median household earners found much of their equity was lost in the financial crisis of 2008/2009. Foreclosures increased with unemployment, and the United States went into the Great Recession (Kotz, 2009; Palley, 2012; Groton, 2009; Johnson & Kwak, 2010; Lewis, 2010; Kaboub, Todorova, & Fernandez, 2010; Kumhof & Ranciere, 2010).

Although others have different versions of the Great Recession's creation, this project is not designed to enter into that debate. It is sufficient to note that many scholars would agree with the above narrative. Therefore, severe economic inequality not only brings about a reduction of social capital, or a decline in the lower economic classes' perceived well-being, but also can potentially damage the United States' macroeconomic health. An unlikely source, Standard & Poor's Global Credit Portal's research arm conducted a meta-analysis of severe economic inequality's effects on United States' economic growth; that analysis concluded, "At extreme levels, income inequality can harm sustained economic growth over long periods. The U.S. is approaching that threshold. Standard & Poor's sees extreme income inequality as a drag on long-run economic growth" (Maguire, 2014, p.1). They defined *income* as market income including capital gains since inequality in the market influences government

redistribution. As of this project's writing (2015), economic inequality has not waned dramatically despite the 2012 increase of the marginal tax rate for top-income earners. Hence, this phenomenon needs to be better understood.

Section 3: Research Methods

This project will analyze economic inequality using two major approaches, which are paradoxically both interconnected and separate. The first is economic inequality, specifically market-based income inequality and its relationship with financial regulation/deregulation, mainly in the banking system in the United States. The second is partisan politics. Political parties in the United States differ in their economic outcomes; thus, partisan politics plays a key role in this research. This dissertation examines whether financial deregulation from 1914 to 2012 affected pre-tax/pre-redistribution (market-based) income inequality and if so, whether partisan politics created policies deregulating the financial sector. As will be seen, financial deregulation has a strong effect on increasing income inequality, apparent in the time-series statistical analysis. The United States' financial sector grew rapidly under a relatively benign environment in the latter part of the 20th century and the first part of the 21st century (Krippner, 2011; Philippon, 2008). However, the political maneuvering that created this deregulatory environment is less clear and, as will be shown below, somewhat murky with both parties contributing to financial deregulation and thus to income inequality. For example, Clinton's second administration was notable with the passage of two strongly deregulatory banking bills, which contributed to economic inequality. This fact brings into focus the concept of neoliberal ideology, which justifies such political acts as well as

partisan politics' normal give-and-take. However, did Clinton support these bills supported for ideological reasons or simply political expediency? Therefore, financial deregulation seems to contribute to income concentration with wealthier Americans; conversely, stronger financial regulation decreases income concentration and thus provides more income to the lower deciles. Finally, partisan politics appears to contribute to financial regulatory movements.

This project is a mixed-methods one which uses quantitative methods, mainly time-series statistical analysis along with qualitative methods, primarily process-tracing. My aim is to test first, whether financial deregulation increases market-based income inequality and, second, whether both political parties converged to the neoliberal ideology of financial deregulation with the consequence of a wider market-based income gap between the wealthy and everyone else.

Time-Series Regression Analysis

Unique to this project is a detailed analysis of the three approaches to economic inequality over a 98-year period using time-series regression analysis for the first two approaches and process-tracing analysis for the third. By looking at the financial sector's regulatory bodies, primarily the banking industry but including securities, metrics can be created to measure two aspects of governmental influences on financial regulation. Philippon and Reshef (2012) have created one such metric, which social scientists commonly use to examine financial deregulation's effects; their metric quantifies financial laws' legislative outcomes. While this metric captures laws' effects on financial regulations, the bureaucratic effect is not significantly reflected. This study uses two

deregulatory variables to quantify the elusive influence bureaucracies can have on enforcing and interpreting the laws. The first variable involves various measures of the Federal Reserve Board's and the Securities Exchange Commission's bureaucratic strength. The number of personnel, actual yearly expenses, and number of investigations initiated are used to determine the annual the above agencies' activity. The second variable is a combined bureaucratic one that uses both the Federal Reserve Board and the Securities Exchange Commission variables to determine their overall collective effect on inequality. Thus, Philippon and Reshef's deregulation variable, the separate regulatory agencies' variables and the combined bureaucracy variable could then determine financial deregulation's effect on market-based income inequality. I expect that neoliberal capture of both the Federal Reserve System and the Securities Exchange System will strongly contribute to increased market-based income inequality with the very top income earners growing rapidly at the lower income earner's expense. I also anticipate that combining Philippon and Reshef's legislative financial-deregulation variable with my newly created bureaucratic variables will significantly strengthen the contribution to inequality.

Process Tracing

The examination of the political process that created, weakened, or strengthened financial regulations is conducted by using a qualitative technique called process tracing, which is "the systematic examination of diagnostic evidence selected and analyzed in light of research questions and hypotheses posed by the investigator" (Collier, 2011, p. 123). Process tracing looks carefully at the sequencing of events, especially the decision-

making process, to create causal-process observations (CPOs), which are then used to test the proposed hypotheses (Collier, 2011). Thus, the decision-making process analysis looks at such factors as who made what decision, when, and with what information. This analysis leads to the consequences, both intended and unintended, that arise from those decisions, creating the need for new ones to be made.

In this project, process tracing is being used to examine several questions that arose from the quantitative analysis. In a landmark study, McCarty, Poole, and Rosenthal (2013) used meticulous research to demonstrate the strong polarization that has existed in the United States in a strong form since the mid-1970s. However, Keller and Kelly (2014) found partisanship was drastically reduced regarding financial deregulation after 1980, despite strong polarization between the two parties in other areas. Hence, Republicans and Democrats alike supported financial deregulation, especially during the Clinton administrations. Thus, the first question is why this deregulation was supported. Keller and Kelly explored several possible reasons, including interest groups, increased consumer debt (requiring more access to financial products), and the decline of union support for the Democratic Party. While s all of those factors play a role, I believe a fundamental shift in economic thinking occurred in which most political actors, regardless of party, began to believe in neoliberalism as the right choice for the American economy. This belief, combined with the United States' financialization, created a political environment conducive to financial deregulation. This neoliberal ascendency permeated both elected and nominative offices, thus influencing both the bureaucracies and the legislation. Process tracing the legislative process as recorded by journalists and

in the Congressional Records will help illuminate this curious dilemma of bipartisanship embedded in bitter polarization.

The results are expected to reveal that financial neoliberal ideology captured both parties' economic decision-makers beginning in 1988. Also expected is the creation of the Democratic Leadership Council's "New Democrats" and its support of financial neoliberalism enabled Democrats to embrace new sources of campaign contributions from the financial sector. It did so by providing a seemingly strong rationale that deregulation was for the public good. The detailed quantitative time-series work shown here will help illuminate bureaucratic failure's bipartisan nature when captured by neoliberal ideology pertaining to economic inequality. In one very important sense, both bureaucratic and political, both sides of the aisle failed many Americans who experienced little to no economic growth (other than debt) from the early 1980s to 2012.

Section 4: Organization of This Study

To restate this study's main theory, it is believed that over time financial deregulation contributed to increased income inequality in the United States and that both political parties participated in this deregulatory movement after 1980. This deregulatory movement's main impetus came from an ideological change from Keynesian economics to neoliberalism ideals. The *laissez-faire* economic paradigm that drove American economics from the beginning of U.S. history evolved into a different type of *laissez-faire* thinking after the Keynesian dominance during the Great Compression of 1934 to 1980. Neoliberalism provided the academic "cover" for policymakers to create deregulatory policies, which increased market-based income inequality, even if

unintentionally. This theory requires two general hypotheses to begin the testing process. The first is very simple: over time, both bureaucratic and legislative financial deregulation increased income concentration for the top 5%, 1%, and .01%. Second, despite strong Democratic support for financial regulations after the Great Depression through the mid-1970s, the neoliberal ideal of small government intervention in the market never completely withered and, thus, captured the Democratic Party after the 1980/84/88 presidential losses to the Republicans.

This project is organized as follows. The second chapter consists of four sections. Each one presents the current thinking on the major theoretical pieces of this project. As mentioned earlier, economic inequality is extremely complex with multiple explanations as to cause and effect of this phenomenon. Multiple theories are explained in the first section to provide the background for the rest of the study. The next two sections then provide the theoretical underpinnings of two critical parts of this project, the financial sector with its accompanied bureaucracy and the partisanship politics that provide the legislation of finance. Finally, chapter two will conclude with a detailed look at neoliberalism which is the economic theory that accounts for the financial deregulatory movement which began after the stagflation of the 1970s. Knowing how neoliberalism was deliberately magnified as the only alternative by conservative economic thinkers helps explain its dominance today.

Chapter three on the research methodology is divided into three sections. In the first section, the general hypotheses given in the introduction are narrowed to very specific sub-hypotheses for quantitative or qualitative testing. The dynamic nature of

macroeconomic data creates the need to use a methodology which accounts for the unique problems brought to statistical analysis by looking at data over time. The Error-Correction Method (ECM) is designed to solve those issues and the first section explains how it will do that. The second section presents detailed information about the time-series analysis, such as the variables used and the exact modeling process used in the study. There are a horde of potential models that make theoretical sense that can be tested, yet only a few will provide a reasonable analysis of the dynamics of financial deregulation. In addition, this section provides the modeling evolution so the reader can understand the theoretical rationale behind the final modeling decisions.

The fourth chapter provide the results of the time-series statistical analysis. To best explore this complex phenomenon of financial deregulation and market-based income inequality, the models are presented in a logical flow. The quantitative results, based on market-based income concentration for the top .01% and top 5% as the dependent variables, show how the Federal Reserve System and the Securities and Exchange Commission effect market income. These results are then compared with regressions conducted on the bottom 90% of all income earners to determine if market-based income is shifted from the lower deciles to the top 5% or top .01%. Finally, time-series regression results from separate time eras are given to demonstrate how legislative and bureaucratic deregulatory effects are influenced by the historical context that surrounded them. Thus, the Great Compression relied on strong legislative financial controls with minimal bureaucratic interference while the neoliberal era relied on both

legislative, but mainly bureaucratic deregulatory actions to increase market income inequality.

The fifth chapter discusses the process-trace methodology. Then, using process-tracing techniques, it begins with President Clinton's first administration and concludes in 2000 with the advent of President George W Bush's administration. Chapter five also closely examines the legislative process to test several hypotheses claiming the New Democrats, whom President Clinton supported, were captured by neoliberal economic theory and thus deregulated finance (especially banking). Since Democrats traditionally opposed reducing regulatory strength, understanding why so many Democrats, including President Clinton, supported deregulation is important. Of the many possible motives, or hypotheses, such as political expediency, greed, carelessness, or interest group capture, I contend that President Clinton, as the leader of the Democrat Party in the 1990s, supported the neoliberal tenet that financial deregulation would benefit Americans. Chapter five will test this assertion. Chapter six concludes this very complex analysis by providing specific policy recommendations to reduce the severe market-based income inequality in the United States.

As this chapter has noted, economic inequality is dangerous when brought to extremely high levels. As also noted, controversy surrounds whether such high inequality exists and if it does, what creates and sustains it. By examining market-based income's flow to individuals and how financial regulation/deregulation affects this flow, it will be determined how a major economic sector in the United States influences economic inequality. In addition, by empirically studying this influence, the mechanisms

of bureaucracy and legislation can be seen at work moving our economic outcomes. The next chapter will provide the theoretical background needed to complete this picture, a map of the financial, political, and ideological contexts that surround this study's theory as described above.

Chapter 2

The Literature

"The importance of money flows from it being a link between the present and the future."
"The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually slaves of some defunct economist."

John Maynard Keynes

"Money, it's a crime. Share it fairly but don't take a slice of my pie. Money, so they say, is the root of all evil today. But if you ask for a raise, it's no surprise they're giving none away."

Pink Floyd, lyrics by Roger Waters

As the above quotes imply, this chapter is primarily one about money and ideas, with both embedded in the larger context of politics. Thus, this chapter first examines the flow of money, income, to people and presents the many potential causes for the unequal money flow to the United States' population. When presenting these causal theories, it is important to note that some are relatively undisputed, such as high unemployment or low union density, while others are more controversial, such as financialization and financial deregulation. At the conclusion of this chapter, those causes are summarized which I would argue are primary causes of market-based income inequality according to others' research and those which still needed to be empirically tested. As previously noted, this study tests one potential mechanism of market-based income inequality: financial deregulation by both legislation and bureaucracy. It would be disingenuous to claim financial deregulation is the only cause of market-based income inequality or even the

primary one, though it might be. It is one of many societal factors and, as will be shown, an important one.

This chapter contains five sections, which are explained below. This study begins by examining income flow in 1914, when the U.S. Federal Banking system was created, and ends by examining 2012, when President Obama began publicly focusing on income inequality. As will be shown, this flow was strongly concentrated among the very top income earners in the early 20th century, moderated after the Great Depression, and remained moderate until the late 1970s. Then the flow began concentrating again among the very top income earners until it peaked in the mid-2000s, thus replicating the earlier inequality of the Gilded Age. This chapter's first section provides the characteristics of market-based income. Section two of this chapter examines theories explaining how income distribution became strongly concentrated at the very top decile. The third section of this chapter examines economic neoliberalism. Neoliberal theory is a general broad concept applicable to governance, international relations, and public/private policies. However, it is primarily concerned with economics and, as such, serves as a counter-argument to the Keynesian/neo-Keynesian thinking that also influenced American policy. The fourth section of this chapter explores finance. This section discusses financialization and its role in American society, mainly from 1980 to 2012. The fifth and final section ties the above dynamics to politics. The United States'. political system makes and maintains policies, which come from several sources, including ideology, interest groups, electorate preferences, and pragmatic political maneuvering.

Section 1: Characteristics of Market-based Income

When Piketty and Seaz published their first major analysis of income inequality in the United States using Internal Revenue Service tax data, one of their most startling findings was income concentration's U-shape curve (Figure 1), indicating strong income concentration in the upper decile during the neo-classical economic era (1913- 1933) followed by inequality's relatively steep decline during the Great Depression (Piketty & Saez, 2001). This income compression remained reasonably steady until the late 1970s, when income began to rise again to eventually reach the heights previously seen at the beginning of the 20th century. As clearly shown, income inequality peaked in two eras: the late 1920s and the mid-2000s. Laissez-faire capitalism, or liberal capitalism, was the foundation for inequality' first peak. Despite the progressive policies of Theodore Roosevelt and the strong populist movement, income inequality decreased with World War I and then rapidly returned to a high level after the war ended (Piketty & Saez, 2004; Pizzigati, 2012). Permanent federal income tax began in 1913 while the Federal Reserve Board began in 1914 with both designed to influence the U.S. free market.

However, the early income tax mainly funded federal government operations and, with the exception of Veteran's pensions and the like, redistributed income to a large degree. The early Federal Reserve Bank system, while tasked to regulate the national banking system, believed its main function was to serve as the lender of last resort to prevent bank runs and to manage federal bonds (Meltzer, 2003). This phenomenon, identified by many other researchers using the same or similar datasets, requires explanation (Attanasio, Hurst, & Pistaferri, 2012; Grubb & Wilson, 1992; Enns, Kelly,

Morgan, Volscho, & Witko, 2012; Hassett & Mathur, 2012; Heathcote, Perri, & Violante, 2009' Piketty, 2014; Saez, 2013; Smeeding & Thompson, 2010).

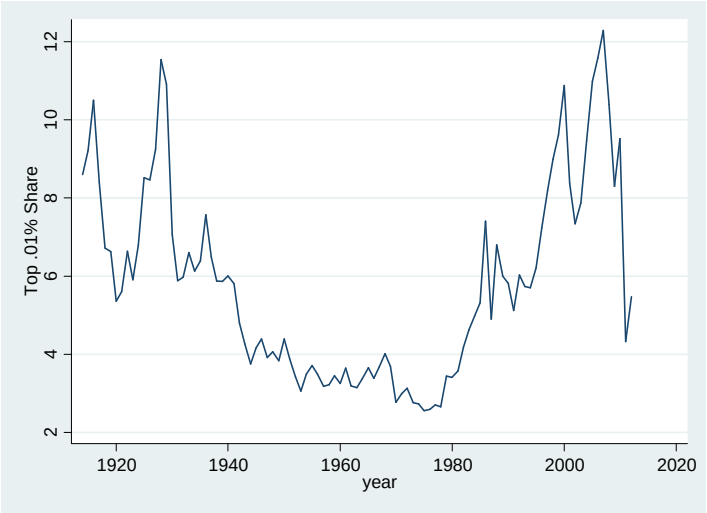

Figure 2-A: Top .01% Market Income Share

Market-based Income Inequality

Based on the Internal Revenue Service's detailed records, along with other reasons that will soon be evident, market-based income inequality is used to examine this phenomenon from 1914 to 2012. Income has three basic sources: labor, capital, and the interaction between the two (Piketty, 2014). Income is flow while capital is stock; but capital can produce income in the form of capital gains, interest, and dividends, which are important income sources for the very wealthy. Total income is the combination of labor income and capital income. In addition, these two types of income create an interaction effect. For example, a person with vast capital ownership can use capital income to acquire skills, contacts, and assets to increase labor income (Piketty, 2014). To again use

the river analogy, the three income streams combine for any given household into the main income flow, enabling people in the household to consume or save depending on their needs.

The income studied here is both pre-tax and pre-government redistribution, which is income the free market produces (whether in wages or capital income). I believe ideology drives both elected and appointed policy makers' economic decision-making to a very large degree. Thus, ideology is reflected in both fiscal post-tax/*redistribution* income and the market itself. This observation is not to minimize taxation's importance because tax policies influence market-based income as well as re-distributed income. Nevertheless, how the United States' government decides to structure and regulate the market will always influence economic outcomes and, to a certain degree, fiscal policies. Therefore, market-based income is the most direct and most reliable metric to measure this effect. Dollars are concrete; and while measurement errors (such as tax evasion masking some incomes) with tax distribution tables do exist, these errors are not insurmountable. Later in this study, *pre-tax/pre-redistribution income* is defined along with other variables used in this analysis. Suffice to say now, the definition used includes both capital and labor income, measured by income-tax return data found in the World's Top Income's Database.

Section 2: Current Theories on Causes of Market-based Income Inequality

Nothing in researching income inequality is easy. For example, as noted earlier, cofounding variables must be accounted for in the statistical analysis. Financial deregulation is just one of many potential causes and, in fact, might not have the

strongest effect in creating income inequality. This section discusses several other known causes of income inequality, which will then later be used as control variables in the time-series analysis. This section examines multiple theories explaining this extreme income concentration at the very top. These theories range from the labor unions' decline, which depressed wages and increased corporate profits, to an increased wage premium for workers with technological skills. Globalization, however defined, has also been blamed as the culprit due to such phenomenon as capital flight, labor "blackmail" with threats of relocation, and increased international competition demanding United States companies to lower wages. Furthermore, Corporate Executive Officers (CEOs) as well as other senior management positions saw a dramatic increase in the late 1980s to early 2010s in their compensation, thus concentrating labor income at the very top of the income brackets. Moreover, increased income from return on capital as well as reduced taxation on those returns also creates a cycle of income concentration for the top 1% of all income earners. Financialization of the United States' economy is another possible agent providing the environment for financial actors to increase their profits and compensation at the other market players' expense. In turn, financialization leads to yet another potential cause, distortions in the business cycle created by income inequality, when a downturn increases unemployment during a recession and previous inequality leaves few, if any resources, for the newly unemployed. Persistent unemployment then follows with a larger segment of the American population dependent on the government for minimal income or with skilled workers taking unskilled jobs at a far lower wage. Finally, the idea of an unfettered and free market, that is neoliberalism's ideology,

seemingly contributes to income concentration at the top by providing the rationale for political and corporate actors from both parties to pass deregulatory actions. Market-based income inequality is a highly complex phenomenon encompassing many potential explanations. Understanding these various theories is important because, more than likely, not any one cause is primarily responsible for this income inequality pattern. This study focuses on one such force undergirding the policies, both public and private, that recreated the early 20th century's *laissez-faire* economics.

Union Density

According to many researchers, noted below, one of the strongest predictors of income inequality is union density. The graph for union density (Figure 2) from 1914 to 2012 contains an interesting curve, which is the opposite of the one found in the income inequality) graph (Figure 2-A). Unlike inequality's U-shaped curve, this curve shows union membership grew rapidly immediately after the Great Depression in the late 1930s and peaked in the late 1950s. Then, a slow decline began, accelerating after 1980 until finally leveling out in the mid-2000s A comparison of these two curves suggests a potential relationship between union density and market-based income inequality with the lower the union membership, the higher the income inequality. In a 2007 study, Levy and Temin discussed the reality of the Washington Consensus' replacing the Treaty of Detroit, meaning the Treaty of Detroit represents the post-World War II labor-management agreements, allowing labor to receive increased wages and benefits. This period from the late 1940s to the early 1980s ushered in the Washington Consensus, which these researchers defined as policymakers' shift to privatization, deregulation, and

anti-union government policies. Testing the effect of the Washington Consensus ideation above, Levy and Temin (2007) investigated market-based income inequality and analyzed several other variables to determine their effect on this inequality. They concluded that the labor-market institutions' decline, rather than education, technology, and globalization, created the lion's share of the market-based income inequality as wages failed to grow with productivity

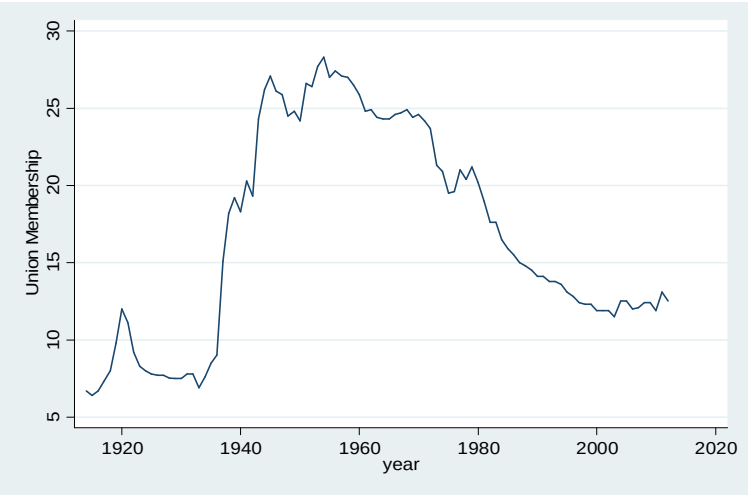

Figure 2-B: Union Membership Percentage from All U.S. Workers

. Later, Volscho and Kelly (2013) used time-series analysis to determine the dynamics of the rise of the super-rich, the top .01%, and confirmed union membership's importance in relationship to income inequality. In an updated study of the United States' income inequality, Piketty and Seaz (2004) stated, "We think that this pattern of evolution of inequality is additional indirect evidence that non-market mechanisms such as labor market institutions…may play a role in the setting of the compensation at the top" (pp. 22-23). Later, Saez (2013) reinforced the impact of the labor union's decline on

income inequality's rise with his analysis of how income concentration at the top decile evolved over time. During a 2012 speech, Alan Krueger, Chairman of the President's Council of Economic Advisors, explicitly noted that the labor union's decline directly decreased the lower-middle-class worker's ability to rise to the middle class. With the financial sector's increased role in corporate profits, manufacturers reduced the demand for industrial labor. This reduced demand, along with its associated reduction in labor-union membership, created falling wages, which then reduced consumer demand (even with rising consumer debt), thus further increasing industrial labor demand (Krippner, 2011; Smith D. , 2011). Based on this strong evidence that union density is an important factor in explaining market-based income inequality as well as labor's central role in Power Resource Theory, union density is used as a control variable in virtually all of this study's time-series modeling. However, union density is far from the only strong source of market-based income inequality. In 2008, Gordon and Dew-Becker conducted a survey, which concluded that labor unions played only a minimal role in decreasing income inequality, mainly with male high-school graduates, and thus is not a primary cause (Gordon & Dew-Becker, 2008). They believed, as do several other researchers that skill-biased technical change (SBTC) is the primary agent of market-based income concentration at the top.

Technology and Worker-skill Deficit

Many researchers speak of skilled wage inequality (Piketty & Saez, 2004; Plotnick, Smolensky, & Evenhouse, 1998; Attanasio, Hurst, & Pistaferri, 2012; Domhoff, 2012; Fligstein, 2010; Grubb & Wilson, 1992; Heathcote, Perri, & Violante, 2009;

Johnson, Smeeding, & Torrey, 2005; Krugman, 2012; Wolff, Masterson, & Sharpe, 2012; Stiglitz, 2012; Smeeding & Thompson, 2010; Gordon & Dew-Becker, 2008). Later, wages/compensation's dramatic rise at the top will be examined; but for now, the focus is on median-wage earners and those potential causes that created a stagnation of their wages. As most researchers acknowledge this inequality, the issue is the causes of such divergence in labor income. While skeptical of the unions' effect on income inequality, Gordon and Dew-Becker (2008) identified skill-biased technological change (SBTC) as the primary culprit. They defined SBTC as "…the demand for skilled workers growing faster than the supply" (p. 18). . In classic economy theory, when a demand for something or someone increases more than its supply, the price/wages increase due to competitive bidding. In an earlier study, Plotnick, Smolensky, and Evenhouse (1998) described the process in which high school graduates dependent on manufacturing jobs experienced a drop in wages as the demand for unskilled labor dropped while skilled laborers, those with vocational or higher learning experience, could earn lightly more market-based income.. In a comprehensive study of capital and income, Piketty (2014) noted, "Over the long run, education and technology are the decisive determinants of wage levels" (p. 307). He justified this observation by examining a training system (universities, public schools, vocational colleges, etc.) interacts with technological change (information, computation, robotic, etc.) to determine if a dynamic exists between the two. He concluded that technological innovations create the need for newly skilled workers, who can demand more wages, while those unable to adapt to these innovations are destined to reduced wages or unemployment. Regarding the United States, he quoted

a Goldin and Lawrence's study that tracked the wage gaps between college and high school graduates and contrasted those market-based income gaps with the gross number of college degrees produced in a given year between 1890 and 2005. Noting wage gaps grew rapidly while the number of college graduates stopped growing, they concluded wage inequality was due to the United States' lack of investment in higher education (Piketty, 2014; Goldin & Katz, 2009). As with unions, a graph (Figure 2-C) is included showing the number of people with a bachelor's degree contrasted with the income share of the top .01%.

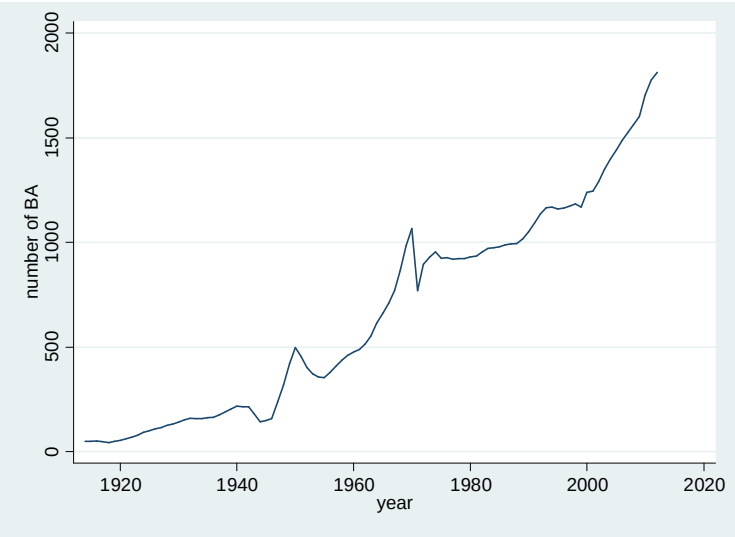

Figure 2-C: Number of bachelor degrees earned 1914-2012

Unlike with unions, the relationship is less clear between the gross number of people with a bachelor's degree and the concentration of income in the top .01%. Exploring this relationship more fully is beyond this project's scope; however, Philippon and Reshef provided a possible explanation when they examined rising wages in the

financial sector versus those with similar educational skills (engineers, for example) and found a large divergence in wages between the two groups as finance grew in importance after deregulation (Philippon & Reshef, 2012). Given the evidence, educational attainment is useful to include as a control variable when modeling bureaucratic deregulation's effects using labor-related controls.

Super-Mangers/Super-Earners

To continue this exploration of potential caused of market-based inequality, examining the rise of the "Super-Managers" Piketty (2014) described is useful. One theory of income inequality's U-shaped curve is that of executive compensation. Before the Great Depression, laissez-faire capitalism created a wealthy class, who remained wealth through a combination of capital and labor earnings. Whereas capital earnings represented the majority of the income in Europe during the early 20th century, the United States exhibited much less of this phenomenon due to resources available to Americans. Thus, Westinghouse, Sears, Ford, and other innovators created sizable incomes through their compensation as well as their capital investments. However, \ important to note is that realized capital gains in the 1920s accounted for much of the large spike in income inequality; thus, lasses-faire capitalism produced much of its wealth with capital in the left "stem" of the U.. The right side of the U is a very different story. Piketty (2014) described a phenomenon called "meritocratic extremism" (p. 334), whereby United States' society seems to designate certain individuals, including CEOs, as winners and thus is tolerant of their extremely high compensation. This "super-manager" phenomenon is then reflected in income share's sharp increase among the top percentages: the 1, .1,

and .01% of all income earners. As Piketty noted, the 1 % share of national income went from 9% in the 1970s to 20% in the 2000s with most of this increase coming from labor.

Other scholars have examined this phenomenon as well with slightly different conclusions. For example, Frydman and Molloy (2011) conducted two pivotal studies by first examining top-income inequality's compression in the 1940s in terms of manufacturing executives' compensation in the 1940s. They discovered government policies, such as salary restrictions and high taxation, did not account for this compression as much as did war-driven declines on firms' returns and labor unions' increased power. Frydman and Saks (2012) expanded this study to examine manufacturing executives' compensation from 1936 to 2005 to gain a long-term perspective. They tested four theories explaining the rise of executives' pay after the mid-1970s. First, they determined that executives' ability to increase personal compensation through rent-seeking behavior did not explain the steep pay increase since they found executive pay and firm performance rose in tandem from 1980 through 2005. The other three commonly accepted concepts— incentives for risk-taking, firm size and complexity, and a demand for general managerial skills over firm-specific skills—were also discounted. Frydman and Saks' explanation for the sharp increase in executive compensation clearly coincides with the idea of pay-to-performance, whereby managerial compensation is directly tied to firm performance. . However, these studies indicate CEO compensation increases regardless of reasons, which seemingly is a major factor in the increased market-based income inequality after 1980.

Bivens and Mishel (2013) analyzed CEO compensation to determine if rent-seeking behavior, that is, receiving more income than an efficient market would allow, explains income concentration's rapid increase. They would disagree with Frydman et al. with evidence showing executive compensation, especially in the financial sector, comes from shifting income from the lower income deciles to the very top (rent-shifting); thus, financial executive compensation is critical in explaining income inequality's steep rise after 1980. This analysis agrees with Philippon and Reshef (2012), who noted the larger increase of compensation for financial workers since the 1980s' deregulation movement.

Gordon and Dew-Becker (2008) extensively explored the research on executive compensation and discussed several important dynamics of CEO pay. First, hidden compensations are not recorded, such as lifetime healthcare or company vehicles. Second, as they noted , "It is clear from the literature that increasing relative executive pay is dominated by the role of stock options, the growth in role of stock options, and wealth changes from CEO existing stock options" (p. 27). . Given all the evidence, having a control variable that reflects this concept of "super-managers" is useful. Using the top .01% income's disaggregation, a variable has been constructed combining entrepreneurial, rent, interest, and dividend income from 1916 to 2010, but not using wages, realized capital gains, or other compensation. This variable reflects capital income. As Figure 2-D shows, this decreased income is offset by the top earners' increased wage income, thus confirming the importance of executives' compensation to market-based income inequality. This "super-manager" concept arose when corporate competition became very sharp due to the pressures of international competitors, who

penetrated American markets during the globalization process that began in the latter 20th century. Hence, market-based income would come from high-priced labor rather from capital accumulation which sharp divisions between the top earners and everyone else. Super-managers are a fairly recent phenomenon in one sense, however; the Gilded Age certainly had their Carnegies and Rockefellers. However, the next variable, globalization, is commonly blamed for increased inequality.

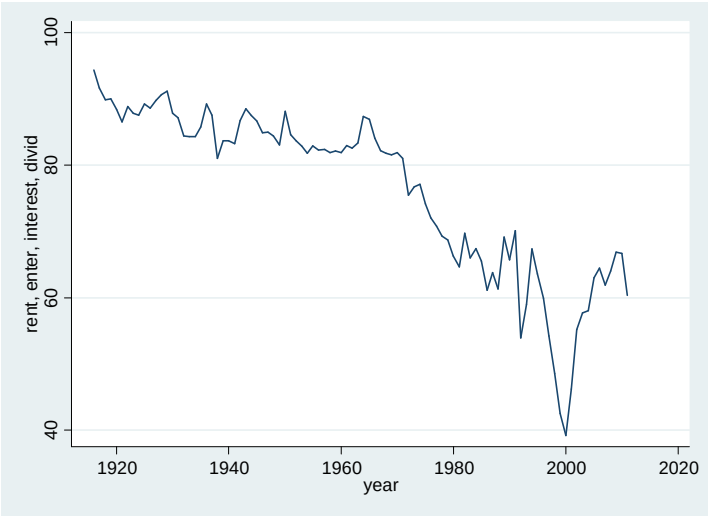

Figure 2-D: Income from Entrepreneurs, Rent, Interest, and Dividends

Globalization

Related to the above theories is globalization, the reality that increased communication, shipping, trade, and capital movement created an environment which would increase income for the very wealthy (Chomsky, 1999; Fligstein, 2010; Guillen & Suarez, 2010; Galbraith, 2012; Rogawski, 1987; Volscho & Kelly, 2013; Chang, 2008). *Globalization* can be defined as "…an accelerating rate and/or higher level of economic interaction between people of different countries, leading to a qualitative shift in the

relationship between nation-states and national economies" (Pollin, 2000, p. 8). One theory is that trade liberalization through such treaties as the North American Free Trade Agreement (NAFTA) enabled United States' manufacturers to take advantage of cheaper labor overseas in what is called the "race to the bottom" (Konisky, 2007). This theory would postulate that corporations gravitate to nations with weak or non-existent labor unions, low taxation, and favorable environmental regulations, thus reducing the need for labor in the United States. South Carolina' textile industry is an example of this migration whereby textile companies left in search for cheaper international labor after the North America Free Trade Agreement became law. Furthermore, the textile plants left in South Carolina modernized due to global competition, thus requiring fewer highly skilled workers to run the computerized machinery and robotic equipment (Eades, Barkley, & Mark, 2007). Thus, the United States' political elite who wanted this trade liberalization produced trade deficits, a strong dollar, a corresponding loss of labor intensive manufacturing jobs, and higher wage inequality. Higher wage inequality results because higher unemployment generally means lower wages due to the labor glut (Palley, 2012).

In contrast, others believe globalization has produced a different effect of raising most Americans' standard of living and thus is far from being at fault for market-based income inequality. Their claim is that increased productivity due to global competition has decreased prices, electronics being a prime example, and that United States' firms are therefore more efficient and capable as a result of such advancements as containerized super ships (Friedman, 2005). A detailed analysis of this phenomenon is beyond the

scope of this project; however; globalization obviously needs to be accounted for in this research. Thus, trade openness, the total GDP's import/export share for a given year from 1914 to 2012, is used as a control variable (see Figure 5). As seen in Figure 2-E, trade openness increased dramatically after the 1980s, matching the rise seen in the market-based income inequality graph 2-A. Additionally, a small upward curve before the Great Depression also reflects, to a lesser extent, inequality's U-shape curve. This curve seemingly gives credence to the argument that globalization is a factor in increasing income concentration with the very wealthy.

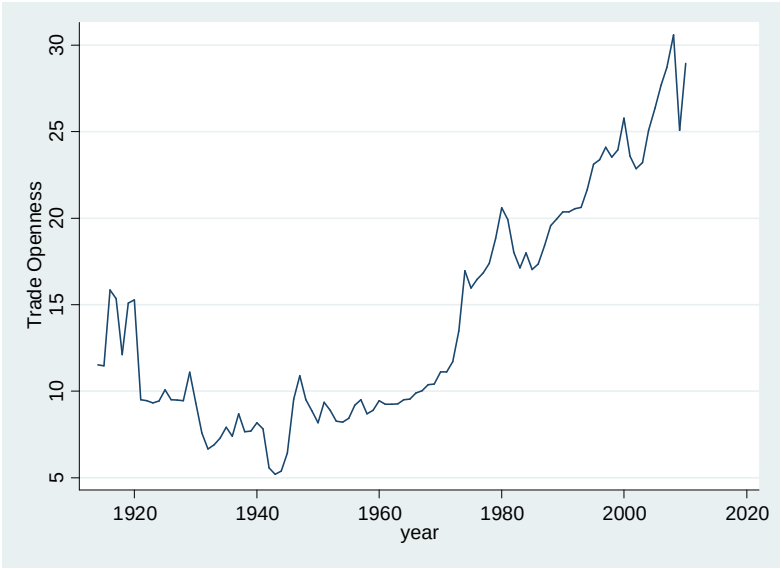

Figure 2-E: Trade Openness, Import/Export Percentage of Total GDP

Return on Capital > GDP Growth

Worthwhile is a brief discussion the work of Thomas Piketty, who meticulously documented wealth and income inequality in the global setting with a strong focus on

France, Great Britain, and the United States. His underlying theory is that when looking at the wealthy's income over time, both capital and labor income need to be considered. If the return on the wealthy's capital (estimated at 4-5% for much of the 20th/21st century) is higher than the nation's GDP and population growth combined, then the income gap will continue to diverge. Thus, inequality's U-shaped curve has multiple explanations, including the formula r > g, reflecting the dynamics explained above. If the United States has a GDP growth of 1%, a stable population with little growth (due to declining birthrate and limited immigration), and a return on capital of 5%, then income from capital will ensure that the top .01% will continue widening the gap from the rest of the income earners (Piketty, 2014). Piketty's research shows that while wealth (or capital) inequality was historically less in the United States than in France/Great Britain, nonetheless; since the late 1980s, wealth inequality became larger in the United States than in France/Great Britain. In fact, Piketty stated, "Indeed, inequality of wealth there [U.S.] is greater today than it was at the beginning of the nineteenth century" (p. 350). Since this dynamic is clearly seen in Piketty's research, having a control variable to reflect this dynamic is useful. Thus, two variables are used: the United States' total private wealth in a given year from 1914 to 2012 and either the log or natural log of GDP growth using 2005 constant dollars. (See Figures 2-F and 2-G for comparison.) Figure 2-H is a graph of both the United States GDP's natural log over time and the total private wealth over time standardized for comparison. As Figure 2-G shows, the amount of private wealth overcame GDP growth in two eras: from 1914 to 1940 and from the late 1990s to 2012. These two instances would imply that the super wealthy received higher returns on their

wealth during those times than the GDP growth was giving in wages to the remaining income earners. Thus, market-based income inequality would increase during times of greater wealth holdings for the top .01%.

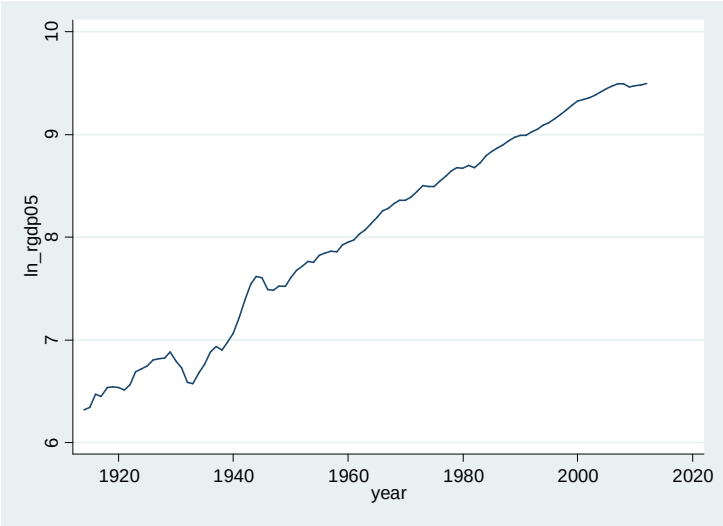

Figure 2-F: Natural Log GDP in 2005 Dollars

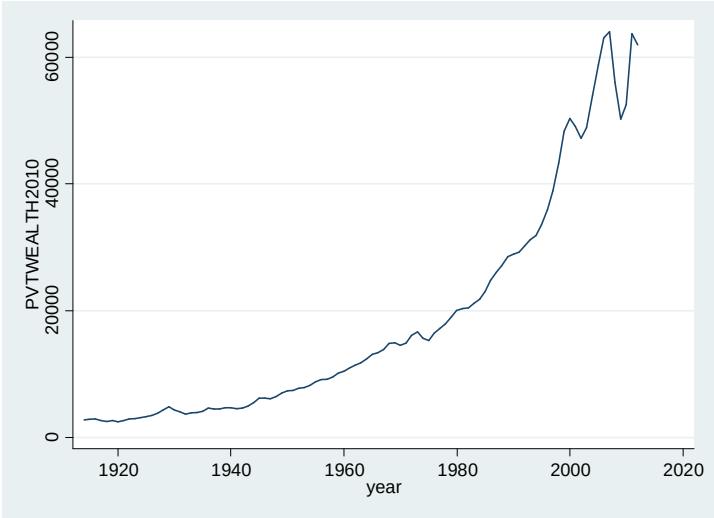

Figure 2-G: U.S. Total Private Wealth in 2010 dollars

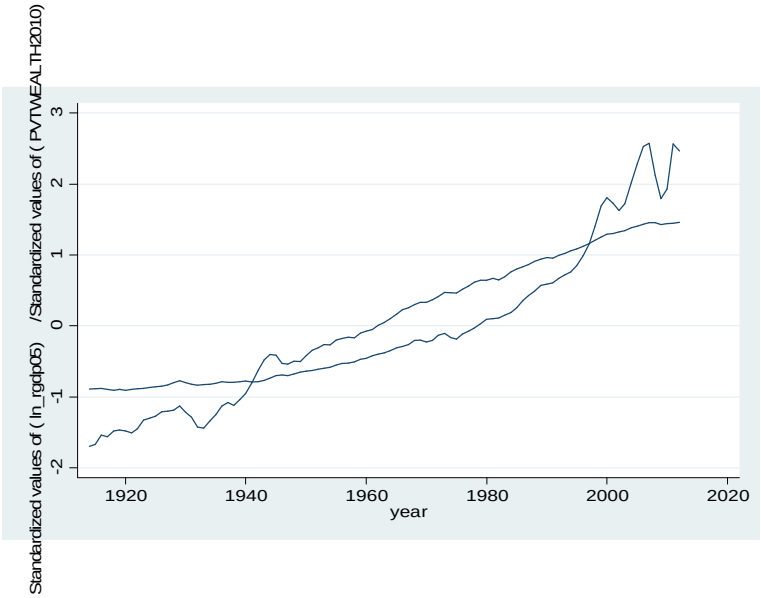

Figure 2-H: Standardized Comparison of Natural Log GDP and Total Private Wealth

Section 3: The World of Finance

The third section of this chapter explores finance. Section three's detailed examination of the financial sector, focusing on banking and securities, provides the needed backdrop to discuss the surrounding regulatory environment. The various agencies charged with regulating finance are a bewildering mix, answering to their political masters as well as their financial charges. The fourth section will then examine the regulation theory as well as how regulation interacts with financial actors. In addition, each agency is defined, especially those interacting with banking and securities, in terms of their regulatory responsibilities. However, they are incomplete by themselves since they are created and ruled by policies stemming from partisan politics. Hence, the need to first explain finance's structures and dynamics before moving to the political environment which influences the industry so strongly.

Financial Industry

Defining the *financial industry* for this study is critical to understanding its influence on income inequality. According to the National Income and Product Accounts (NIPA), the financial industry consists of four major parts: 1) credit intermediation; 2) investment banking, venture capital, brokerage and portfolio management; 3) insurance and reinsurance; and 4) pension funds, mutual funds, and trusts (Philippon, 2008). Another way of looking at the financial industry is through its core functions. Financial actors engage in 1) moving funds from consumers to producers (payments), 2) moving funds backward in time with credit/borrowing, 3) moving funds forward in time with savings and investments, 4) risk management through insurance, and 5) providing expertise on these functions to non-financial actors (Ryan, Trumball, & Tufano, 2010). A third way to view the financial industry is through its sectors and functions since both focus on moving funds (money or money substitutes) from one entity to another for productive use and mitigating risk of losing those funds through natural or human-made disasters. Extending the earlier metaphor, the financial industry can be viewed the human constructs that shape the river flowing through a land and bring water (money) to those who need it. Sometimes, it is dammed and pooled so only a few enjoy it; while at other times, it is re-channeled into places that have a scarcity. The financial industry, like the river, exists to bring money to those who need it from those who have a surplus that needs moved. Regardless of the way the financial industry shapes the river, it must flow

to all people for a nation to prosper. Too little flow (deflation) creates a funds drought and hardship; and too much (inflation) creates a glut, devaluing money's worth.

For this study's purposes, the focus is on finance and, more specifically, on banking and securities. This focus aligns with the U.S. Bureau of Economic Analysis, which divides finance into two subsectors: securities and credit intermediation (Greenwood & Scharfstien, 2013). The financial services sector grew at a phenomenal rate (see graph 2-I) from 1980 to 2012 (Greenwood & Scharfstien, 2013), while manufacturers began to see increased profits from their finance divisions and thus depended more on this profit stream (Krippner, 2011). This financial growth process is critical to understand since many scholars theorized that regulatory controls failed to keep up with these financial innovations, creating the unwanted side effects of robust market-based income inequality and the financial crisis of 2008/2009. (Blair, 2012; Blinder, 2013; Groton, 2009; Guillen & Suarez, 2010; Johnson & Kwak, 2010; Kaboub, Todorova, & Fernandez, 2010; Lewis, 2010; McCarty, Poole, & Rosenthal, 2013). The

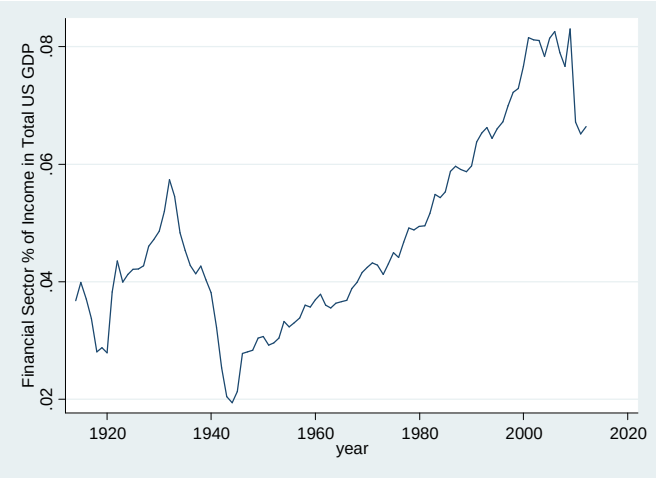

Figure 2-I: % Financial Sector Income in U.S.

incentives for finance to become dominant soon became apparent through a process called financialization, a phenomenon which began in the late 1970s and shows no sign of declining despite the 2009 recession or the Frank-Dodd Act.

Financialization

Financialization is defined as "…the growing importance of financial activities as a source of profits in the economy" (Krippner, 2011, p. 27). However, that definition needs additional elaboration. Palley (2007) expanded the definition whereby financial markets, institutions, and elites gain greater influence over both economic policy making and policy outcomes. Finally, Tomaskovic-Devey and Lin (2011) divided financialization into two parts: financial services' increased importance to American society and nonfinancial firms' increased tendency to become more involved in financial activity. This latter definition which includes both financial and non-financial firms is the definition used in this study. However, all agree that *financial activities* is a broad concept, including the categories mentioned in the discussion of the financial industry as well as corporate finance, which can include non-finance firms having robust financial departments.

To illustrate this growth, Philippon (2008) provided an analysis the financial industry's share of the total GDP from 1860 to 2007. The financial industry rose markedly (see graph 2-H) from 1940 to 1980 with a steep increase from 1980 to 2006. His study concluded with the financial industry's share being 8% of the GDP in 2006. This share remained fairly steady after 2006 with the GDP's finance/insurance share

being 8.5% in 2010.[6] In comparison, real estate was normally much higher with 2010's GDP share at 12.9%.[7] However, the financial industry and real estate combined represent almost a quarter of the total United States' GDP, a significant increase from the post-Great Depression/World War II low. Related to this internal financial growth is capital's international flow, which strongly increased during the 1980s with United States' lenders procuring funds from overseas due to low U.S. interest rates. This procurement enabled the financial sector, especially banks and securities, to increase its proportion of the United States' corporate profits from 20% in the beginning of the 2000s to 41% on the eve of the 2007 financial crisis (Guillen & Suarez, 2010). However, considering non-financial firms' important role in the financialization process, understanding their influence on this process is important.

Krippner (2011) used two measures to display financialization's effects in non-financial firms. Portfolio income, which measures total earnings accrued from interest, dividends, and accrued capital gains, steadily rose from the late 1970s to 2001, while the corporate cash flow (profits from production) remained steady. Using data from the Bureau of Economic Analysis, Krippner examined corporate profits' industry shares comparing FIRE (finance, insurance, and real estate) profits to those profits from manufacturing, and services. This comparison revealed manufacturing's fairly slow decline from 1950 to 2001 with services having a small, steady share until the early 1970s. Services slowly grew until the dotcom bust of 1999/2000, which sharply decreased them while manufacturing continued its decline. However, FIRE slowly rose

[6] U.S. Census: http://www.census.gov/compendia/statab/2012/tables/12s1162.pdf
[7] U.S. Census: http://www.census.gov/compendia/statab/2012/tables/12s1162.pdf

from 1950 to the mid-1980s, when they then steeply rose until 2001 even in the face of the dotcom crash. The combination of portfolio income increasing with corporate cash flow decreasing and the overall decline of manufacturing in general meant corporate found their financial divisions to be more profitable than production. Thus, both the financial and the non-financial industries contributed to the financialization process in the United States.

In a study examining the rise of financial wages and human capital from 1909 to 2006, Philippon & Reshef (2012) identified another possible cause of financial sector's rise. They documented financial compensation's steady rise compared with that of other skilled sectors (engineers, etc.) and concluded, "In the long run, it appears the most important factors driving the relative skill demand and relative wages in the financial sector are regulation and corporate finance activity followed by financial innovation" (p. 22). Much of the literature examining the financial crisis of 2007-2009 focuses on financialization, especially financial innovations enhancing credit and creating over-leveraging by both business and consumers. Financial firms could provide easier credit to their respective consumers due to deregulation enabling the construction of new financial products. These products created a "shadow" banking system, which fulfilled regulated banking's functions, but existed outside the regulatory umbrella.[8]

Thus, as income inequality grew during the late 20th and the early 21st centuries, financial firms delivered virtually unlimited credit to households and businesses.(Gorton,

[8] An example is the creation of MBS (mortgage backed securities) that were instrumental in the securitization process. According to Groton (2009), "Securitization is banking in the sense that SPVs (special purpose vehicles or a legal entity without personnel) holds loans and finance these loans with high-grade debt which is largely informationally-insensitive" (p. 24).

2012; Kumhof & Ranciere, 2010; Treeck, 2012). Both increased compensation for financial firms and increased banking activity through “shadow” banking relate to the earlier discussion of income inequality. The very wealthy capitalized on financialization and thus strongly contributed to increasing the inordinate income inequality that has been evident ever since the 1980. This rent seeking activity is clearly described by Tomaskovic-Devey and Lin (2011), who claim financial actors are unfairly compensated by a non-neutral market, which political, institutional, and ideological systems influence.

Based on the discussion so far in this chapter, pre-tax and pre-distribution income flow has been determined to be the best metric in measuring changes in market-based income’s distribution. Given multiple causes for these changes, a central one is the shift in ideology from Keynesian government activism to economic neoliberalism. Neoliberal thinking became more than an academic economic theory due to the deliberate actions of certain academic, business, and political elites. A very broad theory, neoliberalism includes the concept that deregulation is desired to free market forces to achieve an efficient Patero equilibrium. While applicable to multiple sectors in society, due to financialization in the United States, the financial sector was especially receptive to neoliberal ideology, meaning this deregulatory ideology captured both legislators and regulators, resulting in the top-income earners’ redistributing market-based income from the bottom to the top. This rent-seeking behavior was seen in both legislation and regulatory enforcement, thus highlighting the reality of regulatory failure by both.

The issue, then becomes policy-making, leading to the economic-inequality puzzle’s final piece, political inequality. While seemingly divorced from

income/consumption/wealth, politics is intimately intertwined with economic inequality. To clarify that relationship, this chapter's final section examines two policy-making institutions in the United States, the legislative and the bureaucratic, which are responsible to produce and enforce financial regulations. Political outcomes produce the regulatory guidance that bureaucrats are then tasked to follow. Regulatory agencies are constructed from partisan politics while simultaneously influencing the political elite who construct them. Therefore, understanding the regulation theory and how regulatory failure occurs is critical to setting the stage for empirically analyzing the interaction between the two.

Financial Regulation

The following quote from Komai and Richardson (2011), who provided a history of financial regulation from 1789 to 2011, is an overview of financial regulations' dynamics: "In the United States today, the system of financial regulation is complex and fragmented. Responsibility to regulate the financial services industry is split between about a dozen federal agencies, hundreds of state agencies, and numerous industry-sponsored self-governing associations" (p.1). The system they described evolved in the typical American political fashion of compromise and deal-making, so to understand exactly how that evolution took place is important to grasp why this regulatory morass exists today. The following will be a brief history of the regulatory evolution of the banking and security industries from 1916 to 2012.

Banking Regulatory History: 1916 to 1933

The Federal Reserve System (Fed) was created in 1914 to serve as the lender of last resort in case of bank runs with some regulatory authority over its member banks. Previously the Office of the Comptroller of the Currency, created in 1864, existed to support the National Banking system and provided little regulatory constraints on the banking industry. In trying to find a balance between central control (feared by rural Americans) and decentralized banking (feared by industry due to its proneness to failures), the Fed created twelve Federal Reserve Banks that covered as many districts, divided by banking activity. Each district had a director and were, in theory, equal in decision-making. However, the New York Federal Reserve Bank became first among equals while the other governing body, the appointed Board of Governors, charged with overseeing the banks, had very little authority. The Fed followed the dictates of a strong banker like Benjamin Strong, who the New York Federal Reserve Bank's president during the early years with impotent appointees on the board acquiescing to him (Ahamed, 2009). This divided system of governing became totally dysfunctional after Strong's death before the Great Depression and directly contributed to the depression's severity due to its incapacity to make decisions (Meltzer, 2003; Ahamed, 2009).

The Federal Reserve Banking System and the Office of the Comptroller of the Currency were not the only two government agencies tasked to regulate banks. State legislators provided the primary regulatory controls along with state banking associations, state clearing houses, and the even the American Banking Association. Although commodity futures contracts are beyond this study's scope, important to note is

that Congress passed the 1922 Grain Futures Acts to regulate the commodities market. The 1916 Federal Farm Loan Act created the Federal Farm Loan Board, supervising credit banks, which gave short-term, seasonal loans to those who worked the land. This legislative constellation of light financial regulation continued until the Great Depression when, beginning in 1932, the United States' government reacted to this financial crisis with a series of regulatory acts.

The famous laws passed in the first 100 days of FDR's administration contained measures to strengthen central control of banking and created new agencies to control the financial sector. The Federal Home Loan Act, for example, was created in 1932 to oversee government-backed banks, whose primary role was to purchase mortgages from other bank originators. Another critical act was the creation of the Reconstruction Financial Corporation (RFC), which existed to extend loans to all United States' financial institutions, including state banks. While the RFC provided Federal funding to a suffering financial sector, Congress passed the first Banking Act of 1932 as well as the Emergency Banking Relief Act in 1933; both acts were designed to get funds to banks quickly to reopen them during the federally mandated emergency bank holiday. The Federal Reserve Board of Governors was given additional authority to make national financial decisions while the twelve banking districts' presidents were placed more firmly under central control. Finally, the Glass-Steagall Banking Act of 1933 transformed the pre-depression-era banking system dramatically (Calomiris, 2000; Hendrickson, 2011; Komai & Richardson, 2011; Sherman, 2009).

The Banking Act of 1933 (Glass-Steagall)

Due to its importance in the banking environment discussed later, the Banking Act of 1933 (Glass-Steagall) is described in some detail. It consisted of five parts, created to enhance a stabilizing financial community and to prevent such financial crises as the Great Depression in the future. The first part gave the President extraordinary powers during a finance crisis to declare an emergency and take control of national finances. The second part authorized the Office of the Comptroller of the Currency (OCC) to nationalize any United States' bank deemed "unfit" and to assign conservators to either reopen, merge, or reorganize the bank (Komai & Richardson, 2011). The third part permitted national banks to issue preferred stock up to 6% per year. The fourth and fifth parts dramatically expanded the Federal Reserve's powers and lending authority. These additional provisions changed banking in the United States. The banking legislation also included the creation of the Federal Deposit Insurance Corporation (FDIC), which insured members' bank deposits against bank runs so consumers could be confident the United States' government would insure their deposits (up to certain dollar limits). Commercial banking and investment banking were separated with the Federal Reserve given authority to prevent member banks from extending investment loans into securities. Regulatory measures included minimum capital requirements, prohibition of private banking, stricter guidelines for officers/directors, and tighter lending guidelines.

In 1935, Congress passed another banking act that modified FDIC such that it insured only the first $5000 for all consumers and required all state-insured chartered banks with deposits over one million dollars to join the Federal Reserve System.

Additionally, this act sharply increased the Federal Reserve Board's control of money supply and credit by granting the Board of Governors far more authority to set discount rates; establish lending policies; appoint the district banks' governors/vice-governors; and discount member banks' commercial, agricultural, or industrial bonds (Hendrickson, 2011; Komai & Richardson, 2011). This act also created the Federal Reserve Open Market Committee, which dominated the United States' economy through market regulations and policies pertaining to purchasing and selling securities. Finally, the 1934 National Housing Act created the Federal Savings and Loan Insurance Corporation (FSLIC), which regulated the Savings and Loan Banks, while the Federal Credit Union Act insured and regulated member-owned credit unions (Komai & Richardson, 2011).

All these banking acts increased the United States government's central authority from capping interest rates on home loans to assuring the American populace their money was safe in a bank. This decade of banking acts made the American banking system relatively stable from the late 1930s until the mid-1970s, when stagflation began eroding

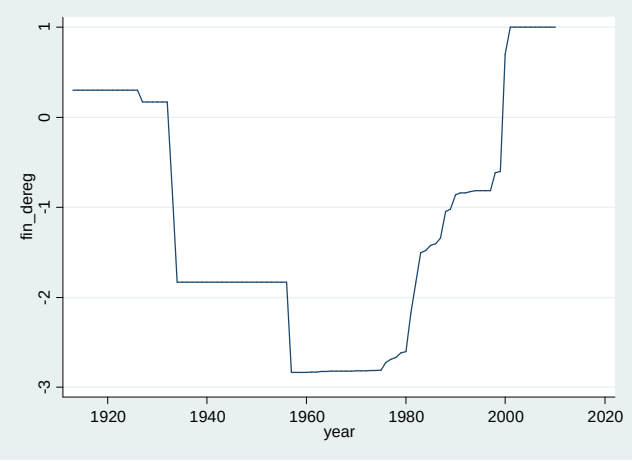

Figure 2-J: U.S. Legislative Financial Deregulation 1914- 2012

the government's ability to maintain the standards set in the 1930s. In this arc of strong banking regulation, market-based income inequality was at its lowest. Since correlation does not mean causation, this project is designed to test the theory that strong commercial and investment banking regulations assist with lower market-based income inequality. A similar pattern is seen in Philippon and Reshef's (2012) graph of legislative financial deregulation that uses metrics from commercial banking.

Securities Act of 1933/Securities Exchange Act of 1934

Congress passed the 1933 Securities Act of 1933, permitting the federal government to regulate securities markets while the Securities Exchange Act of 1934 established the Securities Exchange Commission (SEC) to "regulate the issuance, purchase, and sale of securities, particularly equities and debt instruments" (Komai & Richardson, 2011, p. 17). The SEC came with fewer new regulatory bodies than with banking. All public companies were required to submit financial statements annually; and all new securities issued had to be registered, along with the brokers who traded them. However, the SEC relied far more on self-regulation than banking did with such entities as the Financial Accounting Standards Board (FASB), who created agreed-upon accounting standards for securities and publically traded companies (Komai & Richardson, 2011; Sherman, 2009; Ryan, Trumbull, & Tufano, 2010).

Beginning of Financial Deregulation

As Krippner (2011) noted, the Depression-era banking system worked with low or no inflation along with reasonably obtainable credit for corporations and household consumers, prompting the banking industry's desire to deregulate the laws created in the

1930s. During the late 1960s and early 1970s, as inflation began to rise coupled with corporations and consumers struggling to obtain sufficient credit, a strong groundswell arose from the finance industry as well as from consumers to lift interest caps and free up credit. For example, in 1973, the Federal Reserve allowed commercial banks to introduce "wild card" certificates, "…offered in denominations as small as $1000 and *carried no interest rate ceilings* (original italics)" (Krippner, 2011, p. 74). With regulators withdrawing within a few months, their withdrawal began to erode the strong regulatory environment of the 1930s. Furthermore, over the two decades of the 1960s/1970s, banks eroded the 1930s banking legislation by creating financial innovations, such as money-market mutual funds, household consumers' certificates of deposit (previously only business could purchase certificates of deposit), and more innovative adjustable mortgages (Krippner, 2011). As noted earlier, this deregulatory trend continued in the 1980s with Reagan's administration using the bureaucracy and legislation to deregulate finance. For example, the Depository Institutions Deregulation and Monetary Control Act of 1980 exempted the savings and loan industry from interest caps to keep it afloat when inflation outran the caps and eliminated interest caps for household consumers' deposits.

With American consumers then able to leverage more income due to the above changes, the stage was set for the critical deregulatory decade of the 1990s. Beginning with the passage of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 and culminating with the passage of both the Gramm-Leach-Bliley Act of 1999 and the Commodity Futures Modernization Act of 2000 (which exempted the shadow

banking system from regulation), the financial sector continued down this deregulatory stream until the banking system built in the 1930s was virtually eliminated (Admati & Hellwig, 2013; Hendrickson, 2011). Neoliberalism arose and the financial sector maneuvered in a virtually free and open market. During the late 1980s and up to 2009, regulatory arbitrage became common in the banking and securities system. Regulatory arbitrage involves regulated use some part of an existing regulation to "game" the market and create a financial advantage only existing due to that gaming process. A very complicated, but excellent example of this process is found in investment banking and hedge funds, which began a form of regulatory arbitrage in the late 1990s. This arbitrage involved creating money-like entities, securitized bonds, designed to be considered as safe as United States treasury bonds or currency (Admati & Hellwig, 2013; Kwak, 2009; Johnson & Kwak, 2010).

Investment and even commercial banks would engage in regulatory capital arbitrage, "…the amount of capital a financial institution must hold because of regulatory requirements" (Kwak, 2009, p. 1). The arbitrage comes when the bank in question begins to use securitized assets to meet its capital requirements (banking capital is the bank's equity with the capital requirement being the amount of capital the bank must maintain at all times). Securitization uses consumer debt (such as credit cards, mortgages, car loans, student loans, and a host of other types of loans) and bundles them into a bond that is then sold or kept as collateral or capital. The theory is that the loans' default risk is spread across a wide range of the population so the securitized bond is essentially risk-free. Using a risk estimator (value-at-risk or VaR), banks could meet the capital

requirement using securitized bonds rather than United States treasury bonds, which are risk-free. Since banks want to hold less capital (the lower the capital held, the higher the bank's profits) and since securitized bonds can have different risk levels within any one bond, the bank could use these bonds to lower the risk weights and thus hold less capital. However, the securitized bonds, being the bank's capital, are only as good as the market is willing to pay; therefore, for example, when the subprime-mortgage market crashed, capital requirements for banks to maintain their loans would increase. The securitized bonds would lose value, the banks would not be able to roll over their loans since their capital would be worth far less, and the United States would be in financial crisis (Admati & Hellwig, 2013; Calomiris, 2000; Gorton, 2012; Groton, 2009; Hendrickson, 2011; Krippner, 2011; Johnson & Kwak, 2010; Ryan, Trumbull, & Tufano, 2010; Sherman, 2009).

In Support of Financial Deregulation

Not all scholars agree that financial deregulation resulted in market and government failure. For example, the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 permitted nationwide bank branching starting in 1997. Several scholars studied this act's results to determine how expanded bank branching enhanced the lower middle class's financial welfare due to increased competition among commercial banks. In theory, household consumers, would have better access to saving vehicles and to credit, which would then increase their standard of living (Calomiris, 2000; Hendrickson, 2011; Calabria, 2009). Strahan (2003) conducted a study of bank branching deregulation and concluded that regulatory constraints enable less efficient

banks to survive and that this branching eliminates these banks in favor of well-run banks that, de facto, would benefit the consumer. Using various metrics to examine each state's macroeconomic and entrepreneurial growth from 1976 to 1996, he concluded, "These changes allowed banks to offer better services to their customers at lower prices. As a result, the real economy- Main Street- as it were- seems to have benefitted" (Strahan P. E., 2003, p. 24).

In a study examining market income, Beck, Levine, and Levkov (2010) used cross-time, cross-state econometrics to conclude that branching deregulation increased income for those in the lower deciles while it had little impact on the top incomes due to the more efficient delivery of banking services for the poor. However, these researchers used a less exact market-based income-dependent variable, the Current Population Survey (CPS), which is top-coded and does not reflect a detailed analysis of the top decile. They also used two global measures as dependent variables: the Gini coefficient and the Theil Index. Finally, they used the 75/25 income percentage ratio's logarithm to capture income distribution. These metrics call into question these researchers' conclusion since CPS and 75/25 are less exact measures of market-based income distribution than the Pikkety and Seaz dataset, which uses tax data to provide a far more detailed examination of this income distribution. The Gini and Theil Index, while useful as global measures of income inequality, is even less exact than the CPS and 75/25 income ratio.

Another challenge to the deregulatory failure narrative comes from adherents to the neoliberal discourse and thus provide a different understanding of how financial

deregulation affected the United States up to and including the financial crisis of 2009. These scholars are opposed to the Frank-Dodd Act of 2010, which created a strong financial regulatory environment and thus provides an alternative economic narrative to deregulation. In an exhaustive study of commercial banking's history in the United States, Hendrickson (2010) noted that banking regulations tend to focus on two areas: controlling banks' risk taking and changing the nature of banking competition. The former would have regulatory controls, for instance, with commercial banks' capital requirements or insuring depositor's accounts, while the latter might restrict branching or interest rates. Hendrickson's contention was that both of these regulatory controls, regardless of their form, increased the banks' risk taking and enabled inefficient banking practices to be used. The problem of moral hazard, such as the FDIC insurance taking care of depositors, might encourage reckless lending by commercial banks as they pursue profit. Hendrickson concluded, "…the statistical and theoretical evidence overwhelmingly indicates that competition enhances stability, not instability. Competition forces banks to reduce costs, improve efficiency, hold adequate capital, diversify portfolios, take prudent risks, and perform profitably (Hendrickson, 2011, p. 235). While the financial crisis of 2009 might contradict her conclusions, even if fewer regulations lead to more stable banking, the question remains at what cost? The 1990s/early 2000s era of deregulated finance did not produce optimum outcomes for most Americans, both in the financial crash of 2009 and with the crippling market-based income inequality that co-existed with the deregulatory era.

Another scholar, Calomiris (2000), used U.S. and international banking history to examine banking regulations' effect on banking efficiency and profitability. He noted the issue of moral hazard mentioned above as well as the need for more competition to increase efficiency. His central argument was that "…regulatory limitations on the scale and scope of banking in America hampered financial coordination and substantially increased the cost of capital for industrialization…" (p. 212). Furthermore, believing that market forces would keep risk in check, he advocated a move to consolidated, uninsured banks with unlimited branching ability. His contention was that agricultural populism created a fragmented banking system, allowing local monopolies to grow and causing bank failures when externalities (such as crop failures or steep drops in crop prices) stressed local economies. Universal banking would eliminate these monopolies, and international banking competition would ensure stability in the banking industry (Calomiris, 2000). His conclusions beg the question, at what cost? However, the phenomenon of the "too big to fail" banking system makes his conclusions doubtful. Local inefficient monopolies seemingly yielded to large national monopolies during the early 2000s with the many bank mergers. In the name of financial stability, the United States' government underwrote these large banking monopolies' risk taking; and the banking elite's risk taking was not minimized as Calomiris had hoped (Admati & Hellwig, 2013; Palley, 2012). Hence, the counter-arguments supporting financial deregulation are problematic. Again, even assuming part of this argument is correct (i.e., larger, unregulated banking leads to more stable and efficient commercial/investment banks), the savage market-based income inequality that it supports might be a price many

Americans would not wish to pay. This connection between deregulation and inequality leads to the final part of this chapter's financial section: a brief look at financial regulatory theory and how it might fail.

Financial Regulatory Theory

In looking at regulatory theory for the financial sector, experts generally agree on what regulations should do. By definition, a regulation restricts an entity, person, or firm, from performing a particular action; or a regulation requires that an entity must perform a particular action (Moss & Cisternino, 2009). In finance, regulations affect those handling financial matters, such as commercial banking, investment banking, asset management firms, insurance firms, and the financial market itself. Stiglitz (2010) described three types of regulations: information requirements, proscriptions, and mandates. All of these are used in the financial sector due to two phenomenon, both of which policy-makers, scholars, and even segments of the American populace dispute.

These phenomenon are market failure and/or government failure. Over the almost 100-year history being analyzed in this study, the number, intensity, effectiveness, and efficiency of government agencies designed to implement these regulations waxed and waned depending on economic and political factors. As noted previously, the financial sector has a bewildering number of agencies regulating it. Rather than providing these agencies' evolution, including the creation of a consumer finance protection agency found in the Dodd-Frank Act (The Bureau of Consumer Financial Protection), exploring the theory creating these agencies might be more useful.] Historically, a continuous tug-of-war has been waged between those who believe government failure as understood

by Public Choice Theory should be mitigated through less regulation and others who believe market failure should be mitigated through more--if not in number, in effectiveness--regulation. Understanding the dynamics of government and market failure will assist in understanding how financial regulations swung back and forth between 1914 and 2012.

Adherents who advocate government failure, in essence, claims government regulatory actors have their own agenda, which might conflict with the public good. These actors are captured by the industry they are supposed to regulate and thus distort a free market's outcome by favoring one firm or financial segment over another. Stigler's (1971) Public Choice Theory postulates that voters are rationally ignorant of policy-making, permitting financial interest groups, which might compete among themselves for dominance, to overly influence policy making. This influence is directed toward either legislators or bureaucrats or both (Leight, 2010). In addition to Public Choice Theory the neoliberal movement, which Hayek and Friedman promoted, reinforced the idea of government regulations' theoretical market distortion. In an essay reviewing scholarly books on the causes of the 2007 financial crisis, Levitin (2014), a Georgetown law professor, provided a detailed overview of regulatory capture's unique characteristics when applied to the banking industry. He identified four characteristics: the legality whereby banks could "shop" for their regulatory agency, the regulators' primary mission being preservation of sound financial institutions, the "soft law" administration of finance rather than a formal structure of adjudication, and the influence legislators have over regulators (Levitin, 2014, pp. 2042-2044). Lucca, Seru, and Trebbi's (2014) study of

employee movement between the banking industry and regulatory agencies concluded that regulatory agencies have retention issues, mainly from "regulatory schooling," which states employees want more arcane regulations so they may then take their expertise from the bureaucracy to industry for a higher wage. Interestingly, the "revolving door" hypothesis received less empirical support despite high ranking bureaucrats' very public movement from banking to government. This study's contention is that both dynamics are at work with the financial elite moving back and forth with somewhat different incentives than those of the "rank and file." All of these factors have led many scholars, politicians, and members of popular culture to believe that financial regulation was undesirable in any circumstance (Baxter, 2012; Novak, 2013; Moss & Cisternino, 2009).

Market failure is a well-documented phenomenon, which was further investigated after the 2009 financial crisis (Min, 2014). Market failure, that is, the inability of the free market to efficiency and safely allocate financial resources, strongly contributed to the 2009 financial debacle (Stiglitz, 2010; Blair, 2012; Gorton, 2012; Groton, 2009; Johnson & Kwak, 2010). However, neoliberal adherents would disagree (Calabria, 2009) and thus it is useful to state again what neoliberalism says about the market. As mentioned earlier, using theories such as Coase's (stating private actors can reach Pareto efficiency without needing the state), market fundamentalists believed an unfettered and free market would arrive at a society's best resources allocation due to its ability to determine a particular item's value (price). This scenario did not prove to be the case (Stiglitz, 2010). Efficient market theory requires strict adherence to several assumptions that are unrealistic in any society, let alone an advanced industrial democracy like the United States. For instance,

the assumption that market actors, the buyer and seller, have all available information to set a fair price is a heroic assumption at best. This assumption would claim all known and unknown information is used to arrive at stock prices to include future expectations (Fox, 2009). Refuting this assumption are the realities of transaction costs, information asymmetry, under-production of public goods, and market irrationality (Stiglitz, 2010; Sniderman, Brody, & Tetlock, 1991; Palley, 2012; Groton, 2009).

Even Hayek (1947) recognized the following issues: the elites' exploitation of the majority with better market information; the industrial markets' tendency to recessions with long episodic periods of unemployment and under-utilization of industrial capacity; the environmental damage in reducing private costs; and, interestingly enough, income inequality due to monopolies with rent-seeking actors (Solow, 2012). Efficient market adherents commonly counter they do not necessarily believe that the free market is perfect, but that it is more efficient in resource allocation than government intervention. Stiglitz (2010) responded to this claim by simply stating, "But there is no general theorem asserting the inevitability of 'government failures' outweighing market failures, and no persuasive 'counterfactual' analysis contrasting what a world without regulation might look like compared to the current regime" (p. 17).

Section 4: Partisan Politics and Inequality

As shown later in this study, one consequence of this inequality of wealth is the inequality of political representation. According to a 2013 *Washington Post* column, "When it comes to helping Wall Street lobbyists gut reforms passed in the wake of the financial crisis, there is often very little difference between the Republicans and the

Democrats" (Goldstein, 2013, pp. A-15). Based on the political environment over the last 95 years, common sense would suggest that Democrats generally favor greater income redistribution and thus lower economic inequality, while Republicans generally favor market outcomes dictating economic status. The political process is a two-way street where political actors and the electorate communicate policy preferences with each other. Two questions lie behind income inequality: (1) Do legislators listen to the entire electorate? (2) Are legislators producing policies that either enhance or degrade market-based income inequality? Related to these questions is one of partisanship: Are both parties contributing to economic inequality by passing financially friendly legislation? Since the first question of whether the electorate matters in policy making determines the second question, looking at it next is useful. ?

There is an assumption that democracies will tend to produce more economically equal conditions since the median voter will support redistribution policies over legislation increasing market-based income concentration at the top (Downs, 1957). Simon Kuznets' classic work in the 1950s made this assumption with his famous inequality curve showing the more advanced a democracy became, the less unequal it became (Piketty, 2014). However, this assumption turned out not to be the case for several reasons, one of which is the harsh reality of electorates' unequal political voice which favors the wealthy over the median income earner (Schlozman, Verba, & Brady, 2012; Gilens, 2012). In a comprehensive study designed to determine how responsive the United States' government is to the electorate's wishes, Gilens (2012) compared policy adoption versus policy preferences, which were broken into income deciles. He

determined the policy influence of the affluent (the top 10% of income earners) normally determined policy adoption over the policy preferences of the middle (50% of income earners) and poor (bottom 10% of income earners). This finding demonstrated that affluent Americans have a strong ability (for many reasons) to turn their policy wishes into reality.

This political voice inequality has other sources as well. Butler (2014) explored political bias, i.e., politicians favoring policies stemming from their socio-economic sector. Since most politicians in the modern era come from upper socio-economic divisions, this would imply their policy outcomes would be shaped to favor the elite. This bias is against the poor in three ways: who the policy makers listen to, how they form agendas to act on, and which inputs inform those agendas. Brady, Verba, and Schlozman's (1995) very detailed, longitudinal study examined the relationship between socio-economic status, political voice, and politicians' policy responsiveness. Using social survey data, they found the lower socio-economic scale (SES) brackets had little voice with and little responsiveness from policy-makers while the affluent were able to speak with a louder voice and thus influence policies for decades. These researchers concluded that economic inequality is directly related to this dynamic and is exacerbated by the inability of the low SES population to be heard politically. There is a partisan pattern with this inequality of voice. In a breakdown of political party's membership over the last 95 years, the majority of the top 10% of income earners have voted Republican rather than Democrat (Gelman, 2008; Sides & Vavreck, 2013).

To further expand on this notion of unequal political voice, Page, Bartels, and Seawright (2013) conducted a study to determine the policy preferences of the very wealthy, whom they defined as the top .01% of United States' wealth-holders. Using a survey they created for a pilot program in Chicago, they interviewed people who earned approximately one million dollars or more a year. They discovered a population extremely active in politics, able to communicate with first-tier politicians regularly, and capable of prioritizing policies that would benefit them. The interviewees showed a regulatory cleavage "…respondents with $5 million or less in net worth tended to lean slightly toward more regulation, but those with $40 million leaned distinctly toward *less* regulation" (p. 64). Despite the study's limitation, it revealed a hint of what the very wealthy prefer in terms of financial regulation, which is applicable to this study. Since this study is examining financial regulations from 1914 to 2006, a link should exist between deregulation and the policy preferences of the political party favored by the majority of the very wealthy that tends to be the Republican Party. As Gelman (2008) noted, "The geographic bases of the two parties have changed over the years, but at the individual level, income continues to be an important predictor of the Republican vote" (p.126). The 2012 election maintained that same pattern of higher-income households, in the aggregate, supporting Republicans.[9] Thus, as indicated above, if the political elite favor the wealthy and if the wealthy favor financial policies, such as deregulation, that will increase their wealth, then it stands to reason the party catering to the wealthy will support market-based income inequality. . This conclusion points to a political hypothesis

[9] 2012 Presidential Election Results came from Roper Center, http://www.ropercenter.uconn.edu/elections/how_groups_voted/voted_12.html

where the Republican Party would favor policies deregulating the financial sector to increase the very wealthy's accumulation of wealth. Research, however, is somewhat mixed when testing this hypothesis.

Partisan Politics

Bartel's (2004) seminal work on political parties' influence on United States' income distribution clearly shows "…partisan politics has a profound impact on the economic fortunes of poor and middle-class" (p.20). Patterns of pre-tax income growth were examined, and Republican and Democrat presidents from the post-World War II to 2004 were compared. This work revealed more income growth under Democratic presidents for the lower income deciles while Republican presidents greatly increased the wealthier deciles income (Bartels L. , 2004, Bartels L. M., 2008). Thus, this work points to a Republican Party that might contribute to income inequality through multiple mechanisms, such as vetoing proposals that increase redistribution, enabling pro-business proposals to become law, and heading the deregulation movement both politically and bureaucratically. A major finding clearly shows this difference in parties by noting how poorer families earned six times more under Democratic administrations than under Republican administrations, supporting the theory that partisan politics affects income inequality. Hibbs and Dennis' (1988) earlier work explained the parties' basic differences with the pro-employment/pro-transfer spending Democratic Party lowering inequality while the anti-inflation/anti-spending Republican Party tending to increase inequality. Thus, putting the two together would show that the Republican Party, more

concerned about inflation and spending, would push for a smaller government with minimal market interference.

Despite the logical conclusion above that the Republican Party is spearheading the financial deregulatory movement, the evidence is somewhat mixed. Hacker and Pierson (2010) found, in their landmark study of the United States government's policy responsiveness, that deregulation occurred under the Democratic administrations of Carter and especially Clinton while Republican administrations under Reagan and both Bushes continued the deregulatory movement. In addition, their research showed the government's ability to increase inequality post-tax with new taxation and/or government redistribution policies as well as the important concept of policy drift, whereby inequality can increase when policy-makers take no action to account for inflation or societal changes (for instance, the degrading minimum wage). Based on that research, both political parties clearly contribute to these processes.

Fligstein (2010) also noted that political parties were captured more by the neoliberal philosophy of the free market than any other economic theory, creating a pro-business Congressional environment as well as the "New Democrats" of Clinton in the 1990s. In addition, work on status-quo bias and distributional outcomes shows that the multiple veto points in the U.S. government as well as the separation of powers also influence inequities due to the strong difficulty in reversing inequality-producing policies (for example, the Depository Institutions Deregulation and Monetary Control Act of 1980) to which both parties might contribute (Enns, Kelly, Morgan, Volscho, & Witko, 2012). Therefore, evidence shows that partisan politics is not influential with financial

deregulation, not because politics does not influence regulatory actions, but because both parties participate in the neoliberal deregulation movement. As stated above, this study is designed to clarify that quandary.

Politics and finance are mutually dependence (Calomiris & Haber, 2014). Due to banking functions (i.e., acting as an intermediator between those who need money for production and those who need to use their money productively), politicians understand banking's centrality in any civilized society (Calomiris & Haber, 2014; Admati & Hellwig, 2013; Groton, 2009; Hendrickson, 2011; Morrison & Wilhelm, 2007; Kindleberger & Aliber, 2005). As discussed above, political inequality in representation exists with those at the bottom of the socio-economic scale having very little political voice while those on the top rungs can speak with and thus influence policy-makers. Bankers certainly fit into the latter category; and given the United States' financialization, it is logical to expect the banking industry's strong political influence. Calomiris and Haber speak of the "Game of Bank Bargains," in which coalitions of bank insiders, minority shareholders, depositors, debtors, and taxpayers compete to create favorable political outcomes to best "allocate the rent created by the rules that govern an economic system…" (Calomiris & Haber, 2014, p. 39). In the early 20th century, with the creation of the Federal Reserve Banking System, the Republican Party was normally understood to favor bank insiders and shareholders while the Democrat Party favored taxpayers and debtors (Pizzigati, 2012; Calomiris & Haber, 2014). This political dynamic persisted through World War I, The Great Depression, World War II, and the Great Compression. The decline of unions, the need for increased debt services by

consumers, and the electoral defeats created a new set of challenges for the Democrats that was met by Wall Street.. From Clinton to Obama, both parties seemingly formed strong alliances with the banking industry; thus, the taxpayers and the median debtors are excluded. They used neoliberal ideology to justify this alliance.

Section 5: The Power of Ideology

Examining the sociology of knowledge in the mid-1960s, Berger and Luckman (1966) postulated that ideas are socially constructed and are thus powerful influences in any society's policy making. As they observed, "Frequently an ideology is taken on by a group because of specific theoretical elements that are conducive to its interests" (p.124).Furthermore, they explained how ideology is both shaped by and shapes self-justification of the group for various actions taken within its framework. They also noted that ideas evolve, are powerful, and justify decisions (Berger & Luckman, 1966). This observation on *idea's* characteristics is directly related to financial deregulation. Policy makers used neoliberalism ideology that claimed to promote economic growth and employment to approve financial deregulatory actions. For instance, the Commodities Futures Modernization Act of 2000 exempted new debt/derivative products from regulation based on an insistence that free market ideology will enhance growth and employment (Hockett & Dillon, 2013). In a book by Hillary Clinton about her time with the Obama administration as Secretary of State, she discussed the transitions into Obama's presidency in 2008. In one very telling sentence, she wrote, "The President-elect picked his [President Bill Clinton's] brain about possible members of the economic team he was assembling to tackle the financial crisis facing the country" (p.317). This

new economic team consisted of members of Clinton's second administration from 1996 to 2000, including Larry Summers and Paul Rubin. In Clinton's first administration, the economic team, headed by Treasury Secretary Lloyd Bentson, believed firmly in unfettered free markets, open trade, and economic-sector deregulation over and above labor interests (Harris, 2006). Finally, the two administrations of President George W. Bush, being Republican, continued focusing on markets, trade, deregulation, and supply-side economics. Thus, from the New Democrats of 1992 to President Obama's choice of an economic team in 2008, an economic ideology's continuity proved to be a very powerful influence in American economic life.

Assuming all of the above explanations result from both economic and political actors' policy decisions, what ideology existed during times of market-based income inequality? This section briefly explores how neoliberal ideology originated and how it maintained its sway even after the 2009 financial crisis. However, ideology is not the only explanation; instead, interest groups, political expediency, and other explanations are woven into the decision-making process. However, policy makers commonly use ideological justifications (making banking more efficient and thus helping the poor, for example) as they publically unveil their decisions. As Stiglitz states, "Markets can sometimes create their own reality. If there is widespread belief that markets are efficient and that government regulations only interfere with efficiency, then it is more likely that government will strip away regulations, and thus will affect how markets actually behave" (p.151).

***Lassiez-faire* Economics**

Since this study examines income inequality, financial deregulation, and partisan politics from 1914 to 2012, it is useful to begin with the economic ideology that dominated United States' thinking during the decades before the Great Depression and that provided the foundations for the neoliberalism that followed it. When speaking of *lassiez-faire* economics in the United States after the turn of the 20th century, Adam Smith is commonly quoted. As he wrote in the *Wealth of the Nations*, first published in 1776, the free market brings wealth and prosperity to the nation. He noted, "It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest" (p. 6). With his disdain for government actions that potentially restrain the free market's movement and competition, he strongly justified minimal government interference in commerce. Several of the United States' founders knew of Adam Smith well and argued strongly for minimal government involvement in private trade. The Anti-Federalists claimed that government must be restrained from distorting markets by granting monopolies and subsidies and allow private business to remain unfettered (Pirie, 2014). This classical understanding of economics dominated the United States, culminating in the *lassiez-faire* system, which the Progressive Movement fought in the late 1800s.

Despite some successes of the "trust-busters", the following clearly showed the power of Adam Smith's ideas: the lack of income tax, favorable financial law passed by the "millionaires' club" of the Senate and the complacent House of Representatives, and the unregulated securities market of the late 1800s/early 1900s (Pizzigati, 2012). In

1906, an economist presented a paper for the American Association for the Advancement of Science claiming that one-thousandth (.001%) of the United States' population is extremely wealthy; one-twentieth (.05%) is comfortable; and that the other 95% live day to day in poverty, even if employed (Pizzigati, 2012). Increasing backlash from the American population began to move against such concentration of wealth with Theodore Roosevelt's advocating a federal progressive income tax in 1906, which President Wilson eventually adopted in 1913,, even though limited and somewhat ineffective in redistributing market income (no more than 7% on income over $500,000).

Thus, *lassiez-faire* economics still ruled, especially in the open securities market where stock speculation occurred with virtually no regulation (other than states' "clear blue sky" laws). Additionally, banking had primarily state regulators as well as bank friendly regulators, such as the Officer of the Comptroller of the Currency and the Federal Reserve System of 1914 (Pizzigati, 2012; Komai & Richardson, 2011). *Lassiez-faire* banking and securities continued until it all crashed from 1929 through1933 with the Great Depression. Waiting in the wings was a dramatic departure from this economic theory and the invention of macroeconomic.

Keynesian Economic Policies

This study is not designed to explore the Keynesian economic ideology that became dominant after the failure of *lassiez-faire* economics. However, understanding some of its economic principles leading to political policies from 1933/4 to the mid-1970s is important. The most important idea of Keynesian economics is directly opposed to *lassiez-faire* capitalism: the importance of government actions to ensure the market is

fair and competitive. The business cycle of expansion and recession, which commonly came with *lassiez-faire* policies, could be managed by government economic experts who were able to "tweak" the U.S. economy using various mechanisms discussed below. Noteworthy is that this ideology was the dominant economic driver from the mid-1930s to the late 1970s, replicating the bottom of the inequality's U-shaped curve.

As Jones (2012) wrote in his detailed history of neoliberal politics' rise, Keynesian ideas influenced three bases of the United States' political decision-making. One has already been identified: the belief that a government had the ability to increase consumer demand with public works as well as other governmental stimulus projects to ward off high unemployment, thus modulating the business cycle.

The second base was the creation of macroeconomics, which claimed that "…the economy can be managed according to large-scale relationships that were in operation, which in turn influences the many economic decisions of individual actors in the marketplace" (Jones, 2012 p. 186). Thus, taxes, money, credit, debt, and expenditures were all involved in a complex macro-relationship that governmental economic experts could use to control the United States' economy. For example, Keynesians believed in the "stickiness" of wages due to labor unions; thus, a *laissez-faire* economy would not see wages decrease when labor supply increased. Businesses would have no choice then, but to reduce the number of laborers and thus unemployment would rise. The government would then need to increase demand, even with public works, to increase the need for more laborers despite the "sticky" wages. This increased demand would also increase the money supply and potentially, increase inflation. Labor would then expect

inflation to rise and demand higher wages which stimulates the cycle again. However, Keynesians postulated the United States government could control economic expectations and thus, the economy can be managed. Regulations, agencies, government programs, and strict government controls of financial actors were thus required for the Keynesian theory to be applied.

The creation of macroeconomics leads to the third base that Jones (2012) mentioned: the way Keynesians applied his theory and took it beyond the original thesis. Due to advancements in information collecting and statistical analysis, Keynesian economists believed they could use more extensive economic information to accurately forecast future economic trends. Hence, policymakers could "fine tune" the economy between unemployment and inflation without losing control of either. As the 1970s moved to the 1980s, stagflation (high unemployment coupled with high inflation) began to cast serious doubts on Keynesian policies. Even as President Nixon made his famous claim, "we are all Keynesians now" (Harvey, 2005, p. 13), the stagflation phenomenon was beginning to discredit the Keynesian ideology for managing the U.S. economy. Once again, a new economic theory was needed.

Neoliberalism

When Keynesian economic theory began to falter, another theory was waiting in the wings to take its place as the primary policymaking driver in the United States. *Neoliberalism* is a very broad term, which can describe a host of ideas. Defining, *neoliberal economics* is quite complex, even if the basics are not. The key neoliberal tent is the efficient market concept, which states that prices always reflect an asset's true

value since rationale actors' expectations about that value are built into the price (Blyth, 2013; Chomsky, 1999; Fox, 2009; Harvey, 2005; Jones, 2012; Krugman, 2012; Stiglitz, 2012; Quiggins, 2010). Hence, anything interfering with this pricing mechanism produces inefficient outcomes and economic havoc.

Alan Greenspan, the chairman of the Federal Reserve Board from 1987 to 2006, believed in efficient market theory and thus supported this belief's logical outcome: financial structures' deregulation (Palley, 2012). Free trade, public agencies' privatization, capital's free flow, freely flowing currency exchange rates, and corporate merging are all found underneath the large tent of neoliberalism primarily due to rational expectations of economic actors and efficient markets. Efficient markets result in Patreo outcomes where equilibrium is reached so the gain of one is not at the expense of another (Blyth, 2013; Fox, 2009; Chang, 2008; Kindleberger & Aliber, 2005). An excellent definition of *neoliberalism* comes from Kotz (2009), who provided nine features found in neoliberal capitalism. Several have already been mentioned: corporate and finance deregulation, privatization of public services, and small governments with reduced social spending. Kotz also included tax reduction for business and the top income earners (supply-side theory), shift from full-time labor to part-time/temporary laborers, "unrestrained, cutthroat competition" in the market, and a government fiscal policy that ceased having any concern about unemployment and reducing swings in the business cycle (p.307).

Frequently used to describe neoliberal capitalism, the term *market fundamentalism* refers to the belief (or faith) in the market's capability to always get it

right. Thus, privatization is justified by claiming the private sector will use the above market principles to provide better services to its clients than the public sector's bureaucracy will. Whether public housing in Great Britain or the welfare system in Florida, neoliberal adherents were sure that an unfettered free-market system would keep taxation low as well as improve outcomes (Schram, Soss, Houser, & Fording, 2010; Jones, 2012). In addition, neoliberalism created a commodification effect, which logically follows its main precept of market pricing. Since the market efficiently finds an asset's best value (price), all assets, people, places, or things must have a price. The price is always right; therefore wages are always correct and any institution, other than the market, that interferes with this process creates inefficient distortions. Labor unions fall into the category of interfering institutions as well as government regulatory agencies that restrict the market's freedom of movement. Therefore, neoliberalism would be hostile to any mechanism—other than the market itself— that influenced market income. Thus, the strong market-based income inequality noted earlier is a manifestation of labor's worth, and the CEO/median wage earner ratio is an accurate measure of their relative value in the market. These concepts became dominant in the United States by deliberate and methodical actions planned by its adherents and facilitated by think-tanks, corporate interest groups, and academia (Harvey, 2005; Jones, 2012).

Mount Perelin Society

In 1947, the famous Austrian economist, Friedrich Hayek, created an intellectual society dedicated to the study of free market principles and the furtherance of an economic ideology called neoliberalism. This society, the Mount Pelerin Society,

eventually joined forces with Milton Friedman, another eminent economist from the University of Chicago/. During the 1950s and 1960s, these two economists, while insisting their academic research was separate from their political beliefs, began advocating politically for their ideas to be applied in the United States. Along with two other theoretical centers of gravity, the theory of public choice and William Riker's idea of rational choice theory, neoliberalism ideology grew among policy-makers and corporate interests due to its academic credentials and "business-friendly" ideas (Jones, 2012). In describing the period from Hayek's creation of the Mount Pelerin Society to stagflation's beginnings in the 1970s, Jones noted that "Neoliberal thought had been expertly promoted by the intellectuals and entrepreneurs who made up the web of transatlantic institutions and organizations that were beginning to influence policymakers in London and Washington, D.C" (p. 179). He was describing such efforts as William F. Buckley, Jr. and *The National Review*, Friedman's weekly column in *Newsweek*, and Charles Murray's critique of the New Deal in *Losing Ground*. Think tanks of that period included the Heritage Foundation, which published its ideas in *Guide to Public Policy Experts*; the Cato's Institute with its magazine, *The Inquiry*; and the Adam Smith Institute, which published *The Monthly Bulletin*.

These neoliberal idea streams were reinforced by economists subsidized by such donors as Joseph Coors, Richard Mellon Scaife, and Charles Koch. These industrialists created policy making foundations to fund research that would advocate neoliberal ideals (Harvey, 2005; Jones, 2012). As these ideas began to grow in the public's awareness, both Great Britain and the United States started to move towards a more anti-Keynesian

stance, especially when Richard Nixon's wage/price controls failed to improve the American economy as promised. Taxes, as opposed to anti-poverty, moved to the forefront of American political actors' attention; and with the California tax revolt in 1979, Ronald Reagan's strong neoliberal stance became more attractive to American voters. Inflation proved stubborn to stop; therefore, President Carter was faced with 10% inflation in 1977/1978. The Federal Reserve Board's chairman, G. William Miller, still used Keynesian expansion to try stemming the tide while allowing banking "work-around" to continue (Jones, 2012).

President Carter began a deregulatory emphasis with other economic sectors, such as transportation and the airlines, partly influenced by the neoliberal concept of public choice theory that Stigler expounded (Jones, 2012; Harvey, 2005). Finally, when appointed by President Carter to chair the Federal Reserve System in 1979, Paul Volker immediately introduced "Volker Shock." In 1980, inflation rose to 15%, but Volker decided to control the flow of money supply by controlling bank reserves. This control dampened supply, and interest rates naturally rose to account for the lower monetary supply. As interest rates rose, inflation began to fall; by 1983, interest rates had fallen to 3% (Jones, 2012). By then, however, the American public lost faith in Keynesian policies and began to demand a better economic solution to the resulting high employment that accompanied Volker's battle against inflation. As the neoliberal history given above shows, free market fundamentalism slowly became the dominant social narrative, especially under Ronald Reagan (Jones, 2012).

Neoliberalism and Finance

One example of neoliberalism's slow rise in the American social narrative is in finance. In the name of increasing American finance's competitiveness, bankers increasingly advocated to degrade bank branching regulatory limitations as well as regulatory limits on interest rates before the significant deregulatory legislation in the 1980s. Financial regulators, professional bureaucrats in government agencies designed to regulate banking, became sympathetic to this neoliberal concept of increasing competitiveness through deregulation. Thus, money market mutual funds were created and approved in 1971 by-passing Regulation Q's interest-setting function. In 1973, the Federal Reserve Board suspended interest-rate ceilings on certificates of deposits over $100,000, ($548, 350 in 2014 dollars). In addition, the Euromarkets banking system provided a pre-1980 American banking method of having access to higher interest, which meant depositing American dollars in Euromarkets banks. In a related action designed to increase competitiveness, bank mergers increased during the 1960s with bureaucratic approval (Campbell & Bakir, 2012; Hendrickson, 2011; Krippner, 2011).

During the 1975 energy crisis, President Ford struggled with finding the correct method to battle the accompanying inflation. Ronald Reagan, the ex-governor of California, opposed President Ford on virtually everything, including economic ideas. A quote from Reagan in a 1975 *Newsweek* article best illustrates the growing neoliberal influence. The article writer noted, "So much more easy to be Ronald Reagan. 'Just get rid of all the regulations,' he had told *Newsweek* in March. 'Then you have competition and the marketplace takes care of itself'" (Perlstein, 2014, p. 150). Neoliberalism, while

certainly beginning to convert President Ford and Carter in small ways, found its true voice with President Reagan's election in 1980.

Neoliberalism, Ronald Reagan and Finance

When Ronald Reagan was elected, he used neoliberalism and its economic companion, supply-side economics, for improving the American economy. As mentioned above, Paul Volker used monetary aggregation controls to begin fighting inflation; thus, the market mechanism became crucial in this battle. For most of his administration, President Reagan kept Volker as chair; and the idea that markets would solve the United States' economic ills became firmly entrenched, especially in the financial sector. The deregulatory emphasis continued, and the American labor unions' long descent took a steep downward curve as anti-union policies became the norm for President Reagan's tenure (Harvey, 2005; Kotz, 2009; Jones, 2012; Pollin, 2000). In a counter response from the Republican Study Committee's response to a pro-Keynesian bill that Congress passed in 1978, the Humphrey-Hawkins Act, the basic tenants of Reaganomics was outlined. The critique begins with a call for permanent, large tax cuts for all taxpayers; significant reduction in government bureaucracy/regulation on all levels; a fiscal and monetary policy with the sole purpose of stabilizing money's value (anti-inflation); and removal of obstacles to capital accumulation, including reducing or eliminating capital gains tax (Jones, 2012). The aphorism "A rising tide raises all boats" summarizes this effect. This aphorism rationalizes market-based income inequality with the belief that all Americans will benefit from the economic growth caused by neoliberal policies.

Reagan's administration brought on board several neoliberal adherents, including Friedman and Greenspan. The latter became chair of the Federal Reserve Board with these principles firmly in mind and stayed in that position through several presidential administrations. Additionally, Reagan's economic team was influenced by the famous "Laffer" curve, named after the economist who created it, stating that tax revenues would increase even as tax levels dropped since tax-avoidance incentives would be minimized. Also, the wealthy's investment in productivity would increase; thus, "job creators" would have additional funds to invest in start-up firms. This "trickle-down" effect would raise the poor's income levels; and thus, lower taxes for wealthier Americans would translate into real economic growth for the poor (Harvey, 2005; Chomsky, 1999; Jones, 2012). The 1980s began the decades of financial deregulation legislation, starting with a Carter-sponsored law that passed immediately after the 1980 election and continued until the 2009 financial crisis. Therefore, while deregulatory actions slowly unfolded in government regulatory agencies and individual state laws, federal legislators added velocity to this deregulatory stream by passing neoliberal-type laws.

Neoliberalism and Finance after the Reagan Era

Providing a comprehensive history of neoliberalism is beyond this project's scope; thus, only the very broad strokes of its origins, ascendency, and dominance in the last two decades is provided. One political movement embracing most of these neoliberal ideals was the formation of the New Democrats after the Democratic debacle in 1988. Central to the New Democrats' ideology was an embrace of the "business-friendly" ideas that previously seemed to favor just the Republican Party (Hacker & Pierson, 2010;

Connaughton, 2012; From, 2013). The politics will be discussed later in this chapter; thus, suffice to say, in this section both political parties embraced many of the neoliberal ideas that were transformed into legislation and/or bureaucratic guidance. For example, regarding banking regulations, Alan Greenspan firmly believed in the idea of market discipline, whereby the market regulates banks, both investment and commercial, engaging in high-risk operations by either fleeing with their money or demanding higher interest rates to mitigate risk. Since the FDIC creates a "moral hazard" by underwriting losses, Greenspan believed the FDIC limited market discipline or self-regulating financial markets from being totally efficient. Allowing "shadow banking" to remain unregulated in 2000 is congruent with this neoliberal concept of a totally efficient market disciplining high-risk banks (Min, 2014). Hence, the Federal Reserve Board's decision-making regarding banking regulation was guided by its chairman's neoliberal belief in strong, efficient market theory (as advocated by Fama) and its logical conclusion of strong market discipline.

President Clinton's decision to retain Greenspan as well as embrace the New Democrat ideology meant he would assume their same beliefs in market fundamentalism (From, 2013; Harris, 2006; Connaughton, 2012). The political battles over the deregulatory bills in 1997-1999 were not about more or less banking regulation per se, but about the role of the Community Reinvestment Act of 1977 in the proposed law (Records, 1997; Record, 1999). During the debates about deregulating the banking industry, both Republicans and Democrats referred to such concepts as improving competitiveness, increasing banking efficiency by allowing the market to work, and even

removing potential regulatory actions on swaps and derivatives. For example, Senator Gramm testified in the Conference Report of 1999:

> We currently have literally trillions of dollars of swaps and derivatives in the global economy that have become the underpinning of the financial structure of the country….We went to great lengths in this bill…to see that we did not create any new laws giving anybody any new, or removing any existing jurisdiction over swaps and derivatives. (Record, 1999, p. S13784)

This same neoliberal attitude was, of course, seen in other sectors, such as trade, transportation, and manufacturing. Another example of this attitude is President Clinton's strong support of the North America Free Trade Agreement (NAFTA) over the labor unions' objections in 1994 (Reich, 1997). Neoliberalism ideology strongly supports removing trade barriers to enable the free market to work more efficiently, and this rationale was frequently used in justifying political support of NAFTA (Harris, 2006; Reich, 1997). However, as will be seen below, it was in the financial sector that neoliberal ideology was able to strongly infiltrate the financial policies that came from the government, leading to a phenomenon that became evident in the 1980s: financialization.

In considering the recent rise of market-based income inequality and its relation to neoliberalism, one important point needs to be emphasized. Political scientists, in studying the dynamics of policymaking, tend to focus on the individual policymaker's economic self-interest. Thus, a politician's main goal is to get re-elected; and the bureaucrat's main goal is to expand power or influence, assuming each is an economic

rational actor with maximizing utility as the primary motive. Any action taken, according to the rational actor model, is only taken to further the self-interest of the politician or bureaucrat. However, as Moss and Oey (2010) noted, policymakers' primary motivation for service could be the public good; thus, economic self-interest would not translate into political self-interest. These researchers used three policy outcomes as examples of this transcendence above self-interest: the Voting Rights Act of 1965; Medicare legislation in 1965; and the Comprehensive Environmental Response, Compensation, and Liability Act (Superfund Act) of 1980. Given this mixture of potential motives for policy construction, it is conceivable that both are at play for any political actor. While some individuals work within bureaucracies or in legislative bodies for purely selfish motives, most have a mixture of economic self-interest and a desire to serve the public good.

Neoliberal capture allows the policymaker to accomplish both goals. Pro-corporate policy making can be rationalized as the best possible method to achieve the public good while rewards are given to those supporting corporate interests with the famous "revolving door" (McCarty, Poole, & Rosenthal, 2013). As mentioned above, a symbiotic relationship seemed to exist between the private financial sector and government agencies. This relationship is certainly worthy of investigation and thus is tested in this study because the financial sector's importance grew (in both income and profits as percentage of overall GDP relative to other industries).

This chapter has provided the relevant background to begin empirically exploring market-based income inequality, financial deregulation, and partisan politics. As this

review shows, this study is complex covering a wide range of topics, related to this exploration in an intricate dance of elite political actors, bureaucratic actions, economic factors, and the flow of market-based income to individual American households. Three graphs (2-J, 2-K, and 2-L) illustrate these relationships nicely. These graphs show similar curves, indicating a possible relationship between them. Federal financial deregulation through legislation (see figure 2-K), financial growth in the overall GDP (see figure 2-L), and the now-familiar U-shaped curve of market-based income inequality (see figure 2-B) point to a possibility. The next chapter will then outline the methodology used to analyze the steps of this highly complex dance and learn more about these relationships.

Chapter 3

Research Methods

"The second of these enlargements depends mainly upon intelligence. It may only go so far as sympathy with suffering which is portrayed vividly and touchingly, as in a good novel; it may, on the other hand, go so far as to enable a man to be moved emotionally by statistics."

Bertrand Russell, *"Education and the Good Life"*, 1926

"We are just statistics, born to consume resources"

Horace (65 B.C. – 8 B.C.)

Section 1: The Theory of Market Conditioning and Financial Deregulation

As previously noted, financial deregulation has contributed to market-based income inequality through financial market conditioning (i.e., governmental actions) creating a market environment that can be either Pareto efficient or less than Pareto efficient through several devices, such as permitting an elite financial actor's compensation to exceed what an efficient market would give (Philippon & Reshef, 2012). Market conditioning could also be Pareto efficient, for example, by creating a national health care system with additional taxes, but with the expanded free health benefits offsetting the loss of market-based income. Governmental conditioning originates from legislation and then from bureaucratic actions stemming from legislation, either to reinforce or undermine the legislator's intent. For example, the Commodities Act of 2000 forbids the regulation of over-the-counter trading. This forbiddance was in line with the Federal Reserve's thinking at the time; thus, the Fed reinforced that legislation with a strict "hands-off" approach to swap defaults and other derivative trading (Blinder, 2013). However, in the 1990s, a series of the Fed's bureaucratic decisions began

undermining the Glass-Steagall Act's prohibition against mixing investment and commercial banking. Increasing the number of securities that commercial banks can hold as assets enabled those banks to increase their investment strategy by using those securities as collateral for bank-to-bank short-term loans (Smith, 2011). These examples of market conditioning combine the government's legislative and bureaucratic "shaping" actions. This study argues that, over time, market conditioning caused both government and market failures in terms of market-based income. These failures are considered Pareto inefficient since the higher income deciles increased their market-based income at the lower income deciles expense. Of the many societal mechanisms contributing to this market conditioning (and thus market/government failure) identified in chapter two, this study focuses on one such mechanism: financial deregulation.

This chapter presents the formal hypotheses for statistical analysis followed by a section discussing the statistical methodology used: time-series error correction modeling. Justification for choosing this method as well as the specific models being tests is also included. Next is a detailed description of the quantitative dependent, explanatory, and control variables. Many of the explanatory variables are ratios created to reflect bureaucracies' (the Federal Reserve System and the Securities Exchange Commission) influence on market-based income inequality. Looking at market activity, (i.e., total value of bank deposits and assets as well as total stock value in all exchanges) and then determining bureaucracy's effect on market activity provide a key clue to market-based income inequality's cause. In the process, one assumption is made: an agency's increase in full-time employees, total expenses, and investigations opened, plus

brokerages registered indicate that agency's greater influence in the financial market. Making this assumption is a very crude way of measuring this effect; thus, hopefully further research will "break the code" in finding a better way to explore a regulatory agency's effect on the financial market. Meanwhile this measurement provides enough information to draw tentative conclusions.

Hypotheses for Statistical Analysis

The following hypotheses are designed to determine if increased financial deregulation increases rents in the top market-based income earners:

H1: An increase in legislative financial deregulation, over time, will increase market-based income concentration in the top 5% and .01% income brackets

H2: An increase in bureaucratic financial deregulation, over time, will increase market-based income concentration in the top 5% and .01% income brackets.

H3: An increase in the combined legislative and bureaucratic financial deregulation, over time, will increase market income concentration in the top 5% and .01% income brackets with a steeper curve than each in isolation.

Of interest here is determining the effect financial deregulation has on income concentration over time. The hypotheses support the theory that deregulating finance has both an immediate and long range effect on concentrating income at the top income brackets. This would then illustrate a governmental market conditioning mechanism that shapes the open market, in this case, favoring the very wealthy. Whereas this chapter focuses on the statistical methodology used to test these hypotheses, it is important to remember the other part of this study.

After determining the effect of the conditioning mechanism, the next question is why the government would choose to shape the open market to create such outcomes. The second part of my theory is the neoliberal ideological capture of both legislators and regulators gave the needed justification for financial deregulation as being for the common good. With legislators, neoliberal economic thinking captured both parties, so Republicans and Democrats worked enthusiastically to deregulate finance, believing deregulation would create a more just outcome than an inefficient regulatory structure would. In the government's financial bureaucracy, this ideological capture, supported by academia and think tanks, would be seen as good governing. Thus, regulators would rely on banking and securities institutions to self-regulate since the market would create the need to do so. The Office of the Comptroller of Commerce (OCC, created to support national banks, tended to favor a light regulation throughout the decades. With the SEC, this deregulatory stance was a strong cultural element since inception while the Federal Reserve began to move towards strong neoliberalism during the 1970s and certainly during Alan Greenspan's long tenure. Other agencies, such as the FDIC and the OCC, had less of a power base in the regulatory system and thus were more muted during the regulatory era.

My theory does not preclude other motives, such as greed, quid pro quo agreements, partisan maneuvering, and pressure from the financial industry's interest groups. With something as large and complex as the United States' financial sector, it is doubtful any single cause would create the wholesale market and legislative failure with

two negative outcomes: severe market-based income inequality and the 2009 financial crisis.

Time-Series Error-Correction Analysis

This study examines explanatory variables' effect on dependent variables over time, from 1914 to 2010. . As Ostrom (1990) stated, "The great advantage of time-series regression analysis is the possibility for both explaining how variables behaved in the past and predicting future variables of interest" (p 5). One aspect of statistical analysis Keynes discussed is the difficulty in reflecting the very complex societal reality with econometrics. As Syll (2013) wrote in an essay on statistical inference and causality, "To apply 'thin' methods we have to have 'thick' background knowledge of what is going on in the real world, and not in idealized models. Conclusions can only be as certain as their premises- and that also applies to the quest for causality in econometrics and regression analysis" (p.82). In a study like this, examining political and economic realities, both quotes above apply. To infer causality from the time-series analysis is difficult at best and without the information in chapter two, virtually impossible with reasonable certainty. Despite that difficulty, time series has a strong advantage: it can look at how variables react over time with other related variables. This advantage is important because dynamic econometric analysis coupled with the "thick" description given provides a narrative flow backed by empirical analysis. Thus, when transitioning to the process trace, this study continues this narrative with a qualitative technique designed to examine the difficulty with time- series analysis: causality.

However, time-series analysis is used to solve a serious issue with analyzing data over time; serial correlation or autocorrelation (terms used interchangeably), meaning past errors influence the present error term and are thus correlated. Autocorrelation violates one of the main assumptions in using Ordinary Least Squares regressions, which requires uncorrelated errors. Most of the variables used in this study are integrated (i.e., have a unit root. They are non-stationary. Virtually all the variables containing a unit root are integrated in the first order {I (1)}. A few of the variables are stationary (i.e., do not contain a unit root), and the past does not correlate with the present. Regardless, statistical techniques, such as differencing a variable or using a lagged dependent variable, exist for coping with this inherent difficulty in time-series analysis (Becketti, 2013; Keele & Kelly, 2006; Ostrom, 1990; Cromwell, Hannan, Labys, & Terraza, 1994).

Of special interest is the effect of financial displacement events during the years since their shock would have some influence on market income. As banking, commodities, and securities legislation change, whether increasing or decreasing regulatory strength, so would those sectors' income flow. Additionally, this displacement would have both an immediate and a long-term effect on market-based income flow. The equilibrium existing before the financial displacement would change with that shock and, over time, either return to the original equilibrium or stabilize into a new one. Regardless, a displacement's effect can be analyzed with econometric methods, specifically error-correction designed to capture a shock's immediate and long-term effects on an equilibrium.

However, serious problems can be noted in using most economic data with serial correlation over time that has cointegration, Cointegration is "when two time series variables…have the same order of integration and error process from the regression performed on untransformed variables is stationary" (Cromwell, Hannan, Labys, & Terraza, 1994). Said differently, it is when two variables, that are themselves integrated, move together in a constant, long-term equilibrium. The error correction method (ECM) is designed to work with cointegration and, in fact, was originally thought to be useful for estimates containing only non-stationary variables that are cointegrated. But, De Boef and Keele showed ECM is appropriate for both integrated and stationary data which then can show the long-term dynamics among variables (De Boef & Keele, 2008).

ECM Variable Analysis

Using the Augmented Dickey-Fuller test (using STATA statistical software), variables were tested to determine if they had a unit root and if so, to what degree. The majority were integrated (first-order integration) with the exceptions being the financial ratios created from the Federal Reserve Board's Annual Minutes and the Security Exchange Commission's Annual Reports. Appendix 1 provides the results of testing with each variable. As ECM models were created, each was tested to determine cointegration's presence by using two techniques. The first technique was the Engle-Granger two-step test, which levels the differenced variables and then uses OLS regression to produce residuals. Then the Dickey-Fuller test examined the residuals to insure the residuals are stationary, thus determining if the particular model is specified incorrectly and therefore not appropriate for ECM (Kelly, 2013). Using Johansen's

technique to determine each model's number of cointegrated equations, the following were determined: the null's maximum rank, the trace statistics as well as the 5% critical value of that statistic, and the eigenvalue (Becketti, 2013). Each model was checked for robustness using two post-estimate tests: the Breusch-Godfrey test for autocorrelation and the test for ARCH effects in the residuals to check for heteroskedasticity.

ECM Modeling

As mentioned earlier, ECM displays immediate and long-term effects, permitting an analysis of how, for example, financial deregulation affects top-income percentages immediately and over time (Kelly, 2009). This information is theoretically useful since any regulatory action has an immediate effect, but also has an effect continuing over time until repealed or degraded through bureaucratic or legislative action. Hence, ECM is used here with Ordinary Least Squares (OLS) regressions for each model since there was no evidence any model had residual autocorrelation. The following is the generic ECM:

$$\Delta Y_t = \alpha_0 + \alpha_1 Y_{t-1} + \beta_1 \Delta X_t + \beta_2 X_{t-1} + \varepsilon_t$$

This model provides much information. First, for each explanatory variable (X), two parameter estimates are provided β_1 provides a given shock's immediate impact, for example, enacting a new banking regulation like the Bank Act of 1933. The variable is differenced to allow for the integration found in the data β_2 and the lagged dependent variable parameter α_1 provide the shock's long term-effect, which is the error correction mentioned in the method's title. The shock is felt until a new equilibrium is established. As discussed earlier, in this study, the shock is actually financial displacement whereby a deregulatory action changes the existing equilibrium (whether by a new law or policy

decision). The error correction rate (α_1) is used on the explanatory variable parameter (β_2) to give the total long-term impact, which is computed $\frac{\beta_2}{\alpha_1}$. In addition, the error-correction rate provides the rate at which the shock is dissipated with the parameter being between 0.0 and -1.0. The closer the parameter is to -1.0, the faster the shock dissipates. With this effect in mind, the model to be estimated in this study is

$$\Delta \text{ top income percentage} = \alpha_0 + \alpha_1 \text{top income percentage}_{t-1} + \beta_1 \Delta X_t + \beta_2 X_{t-1} + \varepsilon_t$$

where X equals all the economic explanatory variables to include the variables of interest, legislative and bureaucratic financial deregulation (Kelly, 2013; Keller & Kelly, 2014).

Statistical Analysis Design

The dependent variables are market-based income concentration metrics. Two sets are considered, the top 5% and the .01% of income earners to determine if a significant difference exists between the affluent and the very wealthy in terms of this analysis. The explanatory variables are also found in two sets: legislative and bureaucratic. Using ratios created from various metrics, the explanatory variables are designed to determine the impact of legislators and bureaucracy on top market-based income distribution. Finally, the control variables are also in two sets with financial controls in one and labor controls in the other. Some exceptions to this general description are involved; for instance, union density is used in both sets due to its theoretical centrality in market distribution. In addition, one constructed explanatory variable is the combination of the legislative and the bureaucratic metrics, and another is an interactive variable of these two metrics. As will soon be evident, many variables and ratios create a host of time-series ECM results for consideration.

Financial Deregulation and Top Income Variables

This section will present each variable used in the study. It is organized by first explaining the dependent variables and then the explanatory variables. The latter present both variables of interest and the control variables used in the estimating.

Economic Dependent Variables

Top 5%, 1%, .05%, ,01%, of pre-tax income including capital gains: This income is pre-tax, pre-transfer income shares, including capital gains accruing to the appropriate percentage tax unit, which is either a married couple living together with dependents or a single adult with dependents. Income can be wages and salaries, small business and farm income, partnership and fiduciary income, interest, rents, dividends, royalties, capital gains, and miscellaneous sources (Piketty & Saez, 2004) (Volscho & Kelly, 2012). The estimates use percentages beginning with the top 5% (translating to the top 5% income earners in the United States) and slowly move up until concluding with the top .01% of income shares. This data is from Piketty and Saez's updated dataset found on Emmanuel Saez's webpage at http://elsa.berkeley.edu/~saez/)

Gini Coefficient: This common index includes all income in the United States for a particular year and compares the cumulative percentage of population and the cumulative percentage of income earned by using the Lorenz curve. A score of 1 is prefect inequality and a score of 0 is perfect equality. While not used in the final models, the Gini Coefficient was used for comparison with this study's financial deregulation

modeling. This data is from Robert Plotnick, Smolensky, and Evenhouse (1998), who calculated the Unites States' historical Gini scores[10]

Economic Explanatory Variables

Financial Deregulation: This variable) uses four measures to create a deregulation index that spans from 1914 to 2010: 1) percentage of U.S. population who lived in a state that permitted interstate branching, 2) separation of commercial and investment banks (Glass-Steagall indicator),showing these types of banks' decrease in regulatory separation; 3) interest rate ceilings, capturing the ceilings in effect from 1933 to 1983; and 4) separation of banks and insurance companies, allowing for the Bank Holding Act of 1956, which was repealed in 1999. These four measures are used as follows deregulation = (1) – (2) – (3) – (4).[11] This data is from Philippon and Reshef (2010).

Financial deregulation is the primary variable of interest, focusing more on deregulation in banking than in other financial sectors, such as securities, real estate, and bonds. However, since banking is a major component of the industry, and as such is the primary intermediation agent, this variable is conducive to gaining a better understanding of financial regulation's short- and long-term effects on income. One possible issue is including state branching in this variable, mixing state regulatory actions with federal regulatory actions. One correction is to remove the states' branching data, which creates a separate variable. Then a regression was performed on the entire variable, the residuals

[10] Dr. Plotnick kindly emailed his historical gini data to the author.
[11] Dr. Ariell Reshef kindly sent his data to the authors via email. In addition, his wisdom and advice have been invaluable in working with this data.

were captured, and a new variable was created: federal financial deregulation, which is only the federal actions' effect. (See Figure 2-J.).

Dow Jones Industrial Average (DJIA): To convert into a constant variable, the Consumer Price Index's historical values (InflationData.com) were used to create a deflator/inflator using 2005 CPI as the base. This variable captures the stock market's influence on market conditioning, assuming that DJIA values influence pre-tax decision-making in the United States' market and thus is a control variable. This variable is also one of interest, especially in terms of its dynamic relationship with financial deregulation. This variable comes from the Federal Reserve Bank of St. Louis Federal Research Office, which supplies the DJIA's historical values.

Dow Jones Industrial Average Annual Returns: This variable gives the annual DJIA percentage of returns from 1914 to 2012. This data is from FORECASTCHART (www.forecast-chart.com/historical-dow-industrial.html). This is a control variable

Standard and Poor's 500 Index (S&P) Average Annual Yield: This variable is closely correlated to the DJIA variable (R = -.8622) and is used as a control variable for the same reason as the DJIA. This variable is from measuringworth.com. The methodology for creating this index to account for the various changes in the S&P since 1914 is found on the website.

Natural Log Real GDP Per Capita (2005 dollars): This control variable captures the market's macroeconomic environment from 1914 – 2010. This information comes from measuringworth.com as well as from the Bureau of Economic Analysis,

NIPA, Section I and United States'. Census, Income, Expenditures, Poverty, & Wealth: Gross Domestic Product.

Natural Log Real GDP (2005 dollars): See above.

Union Density: Percent of workforce in unions or labor associations. Previous inequality literature about the United States identified union membership's decline in the U.S. as a major factor in explaining income inequality and thus is used here as a control variable. This data is from United States' Census, Labor Force, Employment, and Earnings as well as from the Bureau of Labor Statistics in their Union Affiliation statistics.

Unemployment: The percent of workforce unemployed annually. Previous inequality literature found unemployment is extremely important as a possible cause for income inequality and is used as a control variable here. This information is from the Bureau of Labor Statistics.

Federal Interest Rate: Annual measure of the long-term United States' long-term (30 years) Treasury bond yields. . An important factor in market conditioning since interest rates are vital in GDP growth, this rate is used as a control variable here and is of major interest. This information is from the United States' Census, banking, finance, and insurance.

Capital Gains Tax: The top capital gains rate for long-term gains, a major source of income for the very wealthy. This tax is another possible influence on market conditioning if higher tax rate means the top income earners alter their financial behavior. This information is from the Citizens for Tax Justice (http://www.ctj.org) and from the

National Journal Data Center (http://federal-tax-rates.nationaljournal.com). This is a control variable.

Top Marginal Income Tax Rate: As with capital gains tax, higher taxes may influence top earners' behavior.[12] This information is from the Citizens for Tax Justice). This is a control variable.

Inflation: U.S. inflation rates used as a control variable. This information is from http://www.usinflationcalculator.com/inflation/historical-inflation-rates/.

Over 65: U.S. population over 65 in a given year from 1914 to 2012. This information is from the United States' Census and is used as a control variable.

Total Days of Work Stoppage: Expressed in thousands of days by total number of workers on strike times the total number of days on strike in a given year. This control variable provides a metric of when union activity stopped work at any site in a given year and represents strikes. From 1914 to 1922, the U.S. Census only gave the coal industry's strike/work stoppage data. This information is from the United States' Census.

Educational Attainment: Total number of U.S. college graduates who received a bachelor's degree in a given year from 1914 to 2012. (From 1914 to 1930, every even year was reported. Thus, the values for the odd years were imputed using the average of preceding and succeeding years. This information is from the United States' Census and is used as a control variable

[12] There is an on-going debate among scholars on the influence of higher marginal income taxes on the very wealthy. One perspective notes high taxes mean high income earners do not participate in making more due to the tax disadvantage, while another perspective notes high income earners still wish to earn more unless the tax rate exceeds 70%. However, this debate is beyond this study's scope.

Relative Finance Wages: Average wage in the financial industry relative to the average wage in the private sector (non-farm). This information is from Wages and Human Capital in the U.S. Finance Industry (Philippon & Reshef, Wages and Human Capital in the U.S. Financial Industry, 2012).

Trade Openness: Imports and exports as a percentage of the GDP. This control variable comes from Kelly and Volscho who used the Bureau of Economic Analysis 2012, Table 1.1.5)

Shiller PE Ratio: Another measure of stock value, the price of a stock divided by an average of ten years' earnings while being adjusted for inflation. This is a control variable. This information comes from Robert Shiller's book *Irrational Exuberance* (http://www.econ.yale.edu/~shiller/data.htm).

Federal Reserve Annual Expenditures: The Federal Reserve System's expenditures from 1914 to 2012, calculated using constant 2012 dollars. This variable serves as a proxy of agency activity. This information is from the Federal Reserve Board of Governors Annual Minutes (http://fraser.stlouisfed.org/publication/?pid=117&tid=49).

Federal Reserve Personnel: Annual number of full-time employees working in the Federal Reserve System from 1914 to 2012. This variable serves as a proxy of agency activity. This information is from the Federal Reserve Board of Governors Annual Minutes.

Federal Reserve Member Banks: Total number of member banks, both national and state, in any year from 1914 to 2012. This is a proxy for agency activity. This information comes from the Federal Reserve Board of Governors Annual Minutes.

Total Commercial Bank Deposits: A product of various sources: *All Bank Statistics, 1896-1955* provided total deposits for all commercial banks (both members and nonmembers). *Banking and Monetary Statistics 1914-1941 and 1941-1970*, provided the same information up to 1970. *Statistics on Banking, 1934 to 1996* was used to gather data to 1996. The FDIC historical statistics on banking provided the data to 2012. The first three sources are from FRASER, and the last is from FDIC.gov. Data used to represent the financial market activity.

Total Commercial Bank Assets: Same method as above with deposits. Also used to represent financial market activity.

SEC-initiated Investigations: Consists of annual investigations from 1935 to 2012 that the SEC's enforcement division launched. These annual reports are on the SEC website at http://www.sec.gov/about/annrep.shtml. This is used as a proxy from agency activity.

SEC Broker-Dealer Registrations: Broker-dealers who registered in a given year under the Securities Act of 1934. This information comes from the SEC's annual report. This is used as a proxy for agency activity.

SEC Total Number of Full-Time Employees: This information comes from the SEC's 1935 to 2012 annual reports. This also is a proxy for agency activity.

Total Stock Value: The "Value of Stocks Listed on Exchanges" changed dramatically when SEC liberalized opening competitive exchanges. In the later years (2007-2012), all the exchanges, except the NASDAQ and its affiliates, were added. This

information is from the 1935 to 2012 SEC's annual reports. This is used to represent the securities' market activity.

Financial Sector's Income Share in United States' GDP: From dataset created by Philippon who used NIPA sources to create a metric providing the finance sectors' (minus real estate) income portion in the United States' non-farm GDP. (Philippon, *Has the U.S. Finance Industry Become Less Efficient? On the Theory and Measurement of Financial Intermediation*, 2012)

Total Private Wealth: Net wealth (assets minus liabilities) of households and non-profit institutions serving households, including non-financial and financial assets except for individual households' durable goods. This information is from Piketty and Zucman's *Capital is Back: Wealth-Income Ratios in Rich Countries 1700-2012*, 2013.

Ratios

The FED and SEC data described above were converted into ratios using total commercial bank deposits and total commercial bank assets for the former and total stock value for the latter in the numerator. Additionally, the financial sector's share of income in the GDP was also used as a numerator for both FED and SEC variables to explore these ratios' effects on the financial sector. The ratios were created by using various agencies' metrics, which could then be seen as indicating those agencies' market activity. For the Federal Reserve System, annual data from 1914 to 2012 were used. The Federal Reserve Board's annual minutes included the number of full-time employees, number of member banks, and expenses the Federal Banking System incurred for a given year. These indicators were used as the denominators in creating ratios. For example, \ the

annual commercial bank deposits for a given year were divided\ by the number of full-time employees for the same year, yielding a value which was then used as part of the Federal Reserve System's ratio. Thus, to continue with the Federal Reserve System, the number of full-time employees' value was added to another value created by dividing a given year's total commercial bank deposits by the Federal Banking System's annual expenses. The combined total was then divided by two to create the Federal Reserve's average ratio variable. The annual number of member banks was not used since mergers from the 1970s to the present created larger banks that absorbed smaller ones. Including this member banks' data in the analysis might skew the market activity's calculation and underestimate the Federal Reserve System's financial-market activity over the 98 years being considered. Two separate average ratios were created for testing by using commercial banks' deposits and assets as separate numerators while using the same denominators. These ratios are the **Federal Reserve Average Ratio,** created from deposits, and the **BA Federal Reserve Average Ratio,** created from assets. Most estimates included the former because bank deposits are considered a debit in banking (since they can be retrieved on demand) while the banking assets indicated both equity and loan activity. Interestingly enough, the estimates were not very different between the two numerators. Another ratio created to test the Federal Reserve System's activity in the financial sector was the **Sector Federal Reserve Average Ratio**, which used the financial sector's percentage of the United States' GDP as the numerator and the same denominators as that of the first two ratios.

The SEC ratio was created using only one numerator and three denominators. The annual stock values of all exchanges from 1935 to 2012 were used as the numerator while the denominator was one of three metrics. First, the number of registered broker-dealers of a given year were divided into that same year's stock value to produce a ratio. This ratio was then added to the ratio created by dividing the stock value of a given year by the number of instigated investigations (or opened cases) and to the ratio created by dividing the stock value divided by the number of full-time employees. These combined values were then divided by three to produce the variable, **SEC Average Ratio**.

Finally, the Federal Reserve System variable (**Federal Reserve Average Ratio**) was added to the **SEC Average Ratio** to create the **Bureaucratic Ratio**. This final variable was used to test the market activity of the United States' two largest regulatory agencies to determine their effect on market-based income inequality. Estimates were done using the Federal Reserve System variables; the bureaucratic variable; and the SEC variable, both separately and combined. These variables were also used with the Philippon/Reshef legislative financial deregulation variable to determine financial deregulation's overall effect with legislative and agency activity combined. Therefore, the variables of interest in this study are the following:

1. **Federal Reserve Average Ratio** = (Commercial Bank Deposits ÷ Federal Reserve full-time employees) + (Commercial Bank Deposits ÷ Federal Reserve total annual expenses) ÷ 2

2. **BA Federal Reserve Average Ratio =** (Commercial Bank Assets ÷ Federal Reserve full-time employees) + (Commercial Bank Assets ÷ Federal Reserve total annual expenses) ÷ 2
3. **SEC Average Ratio** = (Total Stock Value ÷ SEC full-time employees) + (Total Stock Value ÷ SEC total annual registered broker-dealers) + (Total Stock Value ÷ SEC annual initiated investigations) ÷ 3
4. **Bureaucratic Ratio** = Federal Reserve Average Ratio + SEC Average Ratio
5. **BA Bureaucratic Ratio** = BA Federal Reserve Average Ratio + SEC Average Ratio
6. **Financial Deregulation Ratio** = Bureaucratic Ratio + Federal Financial Deregulation

The ratios are designed so that the larger the number, the more deregulation occurred. For instance, if the Fed employed 20 people and the total commercial bank deposits for that year were $100 (bad year for banks!), then the ratio would yield a value of 5. If the Fed deregulated and laid off 10 of its workers with 10 remaining, but the bank deposits remained the same ($100), then the ratio would yield a value of 10. These calculations work with annual expenses, investigations opened, or whatever variable is used as the denominator. Based on a comparison of the graph 2-A above, the legislative financial deregulation is “U” shaped, which is closely the same as that of market-based income inequality. However, when combined with the Federal Reserve ratios, the first six years of the Federal Reserve Board’s existence skew the curve, showing a dramatic drop due to World War I’s effects. These years were then removed in creating the graph

(Figure 3-A) below which begins in 1919 and shows a very interesting curve. The curve now resembles the legislative graph (Figure 2-A) which indicates a possible association.

Given that the larger the number, the more the deregulation, a very large spike in deregulation occurred around World War II. This spike dropped after WWII and continued to drop until 1982. Then deregulation began to climb with one downward trench corresponding to the Savings and Loan debacle of the late 1980s. Then deregulation climbed again until the 2009 crash, which brought the curve back down to stronger regulation. The spike in World War II shows that the war required manpower and money, which shrank the Federal Reserve System. As the banking industry grew, the Federal Reserve should have grown with it; however, the graph shows that growth did not happen immediately, but only slowly corrected to New Deal era regulatory strength. In the 1970s, one puzzling spike occurred, corresponding with stagflation's beginning.

The SEC ratio graph (Figure 3-B) reveals a different curve, which began strongly and then over the intervening years, slowly declined in regulatory strength. Again, given that the higher the number, the weaker the regulatory strength, the curve generally moves toward deregulation except for several dramatic dips indicating a stronger regulatory environment existed. The most dramatic is obviously after the 2009 financial crisis; however, the dot.com crash of 2000 also yielded a strong regulatory response. Finally, during the stagflation years, the SEC reigned in the securities industry. However, these dips, while very steep, were short lived. Overall, the SEC deregulated over time. The next chapter will provide the results of the econometric analysis to determine exactly how financial deregulation affects market-based income inequality.

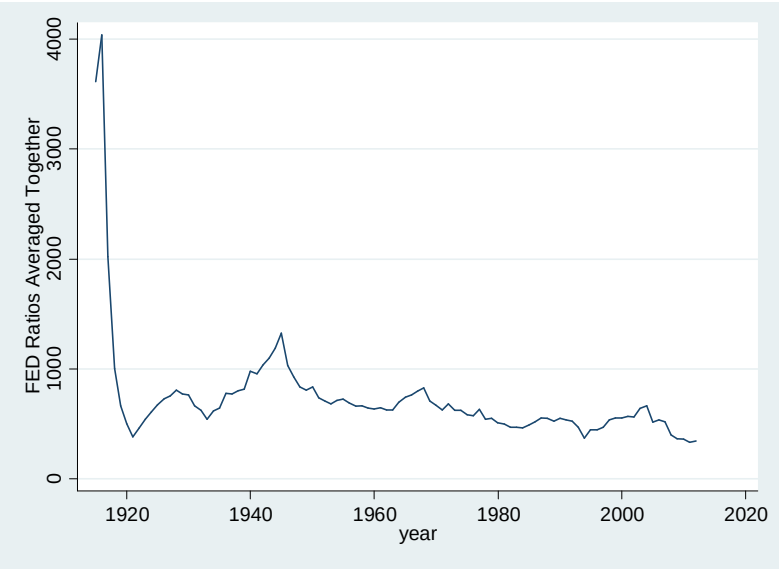

Figure 3-A: FED Averaged Ratios: 1914-2012

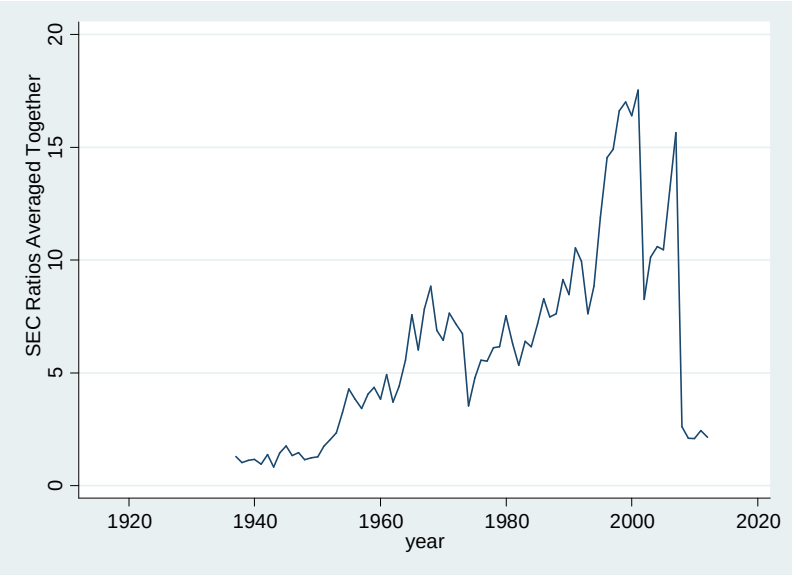

Figure 3-B: SEC Averaged Ratios: 1935-2012

Chapter 4

Time-Series Error Correction Estimate Results

Before discussing the analysis and results, reiterating this study's core theoretical expectations is worthwhile. Using financial and/or labor control variables, financial deregulation and top-income shares are expected to have a dynamic relationship. Both increased financialization and decreased union political power, as discussed in chapter two, are powerful potential causes for the dramatic increase in market-based income inequality. As will be shown, increased financial share of income in GDP and increased financial worker's compensation are strong predictors of market-based income inequality. In addition, union density's decline also predicts unequal distributional outcomes. Legislative and bureaucratic financial deregulation logically assists in the financialization process and thus indirectly contribute to market-based income inequality. Since financialization came at the expense of labor and manufacturing (Krippner, 2011), labor political power logically declines as a result of the financialization process. As Power Resource Theory (PRT) would predict, capital's increased ability to influence political outcomes (political power) would mean labor's decreased political power with the result being increased capital for the very wealthy. Based on the Federal Reserve Board's report looking at changes in family income from 2010 to 2013, the only income bracket that had significant growth of median and mean income was the very top.[13]

The advantage of analyzing a long period is the ability to capture two very strong deregulatory eras and one very strong regulatory era. I expect that increased financial

[13] Federal Reserve Bulletin 14, *Changes in U.S. Family Finances from 2010 to 2013: Evidence from the Survey of Consumer Finances*, September 14, 2014.

deregulation increases top-market income. This financial deregulation comes from two sources; legislation and the bureaucracy. The latter is considered especially important since government agencies are tasked with executing the laws Congress passes, yet this execution may not follow the legislation's intent. Due to the financial sector's centrality in American history, especially since 1914, the bureaucracy is expected to tend to favor the banking and securities industry. Thus, the bureaucratic variables are expected to substantially increase market-based income concentration for the very wealthy (top .01%) as well as the affluent (top 5%). The Federal Reserve System, which deregulated financial controls mainly in the commercial banking sector, is expected to increase market-based income inequality. Also, the Securities and Exchange Commission, which deregulated securities, is expected to increase market-based income inequality. Later, the process analysis attempts to determine if concentrated market income in the top 5% and higher income deciles statistically causes more financial deregulation or if more financial deregulation causes more market-based income concentration. With these expectations in mind, the results of the time series ECM analysis can be examined.

Section 1: Federal Reserve System Analysis

The Federal Reserve Banking system is a tremendously complex bureaucracy, which conditions the market as defined earlier. This complexity requires multiple metrics to show the Federal Reserve System's impact on the market. I create two measures of the Federal Reserve's regulatory activities in the market by using the total deposits and assets of all commercial banks (by year from 1914 to 2012) to represent the financial market. The first measure uses total commercial bank deposits and is divided

by two Federal Reserve metrics: the number of full-time employees and the annual expenses (using 2012 constant dollars). The second measure does the same except it uses commercial bank assets as the denominators. This produces four separate ratios of the Federal Reserve's activity in the financial market. Again, deposits and assets are reflections of banking market activity because assets are essentially loans while deposits are essentially investments. The federal average variable consists of the commercial bank deposits as the denominator and the two numerators of employees and annual expenses first combined and then averaged. The bank asset federal average is the same except it uses commercial banking assets instead of deposits in the variable creation. Both deposits and assets reveals similar results in the analysis so commercial bank deposits, reflecting investor's confidence in the banks, are used the majority of the time.

In the analysis, this variable of interest has multiple control variables from both finance and labor. The dependent variable consists of the top 1% and top 5% of household income earners to include capital gains with the expectation of positive bureaucratic deregulation variable coefficients. However, in one model, the bottom 90% is used as the dependent variable while being compared to the same explanatory variables that are previously used in the models of the top 5%. The expectation with the bottom 90% is converse to the effect of the top income brackets. With the bottom 90% of all income earners, financial deregulation will increase the top 1 and 5 percent of income earners' income at the expense of the bottom 90% so the bureaucratic deregulation variables' coefficients should be negative. While the primary variable of interest tends to be the Federal Reserve's commercial banking deposits average (Federal Reserve's

average ratio), variations of that variable are used in several instances (for example, the Bank Asset Federal Reserve Average Ratio, which uses assets instead of deposits). Finally, estimates are made using different eras to determine how these models might change in specific historically interesting time segments. For example, during the Great Compression from 1934 to 1979 or the Neoliberal Phase of 1980 to 2012, the estimates considered above might produce different results. All of the models are tested for robustness using the Breusch-Godfrey LM test for serial correlation and the Engle-Granger two-step method for cointegration.[14] With the exception of several Securities and Exchange Commission models (which were estimated differently as will be discussed later), all the ECM contains cointegrated relationships and do not have serial correlation after estimation. Table 4-A contains the Federal Reserve System's averaged variable regressed on the top .01% of household income earners.

This model tests one of the primary theories of this study. It examines the extent the top .01% income share changes as a result of deregulatory activity in one central government agency, the Federal Reserve Banking System, in the U.S. financial sector's bureaucracy. As stated above, I expect the top income shares, either of the very wealthy (top .01%) or the very affluent (top 5%) to rise as the Federal Reserve participates in deregulation. The models do not show if the deregulatory activity is due to legislative fiat or ideological activity of the bureaucrats nor does it show if rising top income concentration creates bureaucratic deregulation or deregulation creates rising income concentration.

[14] Additionally, the STATA VEC Rank (vecrank) was used to determine the number of cointegrated relationships within a model.

Table 4-A: Federal Average Ratio and the Top .01% Market-based Income Share
Dependent Variable = Top .01% Market-based Income Share

Variable		N = 96; R^2 = 0.103
Top .01% Income	$_{t-1}$	-.091**
		(.044)
Federal Reserve Average Ratios	Δ	.001**
		(.0004)
	$_{t-1}$	.0001
		(.0002)
Constant		.378
		(.392)

An immediate effect of Federal Reserve deregulatory activity is slightly increasing the top .01% share of income. Taking the coefficient of .001, I translate it by multiplying it by the top .01% standard deviation to determine an increase of .024 while the long-term effect was statistically insignificant. So a unit increase in short term deregulation increases the top income share by .001 "points" which translates into a .024 standard deviation increase in the top .01% income share. Over the 98 year time period under consideration, as the Federal Reserve System's deregulatory activity increases by one "unit," the market-based income share of the top .01 percent's mean (over the 98 year time period) increases by .024 from 5.79 percent to 5.81 percent. This increase points to a possible relationship between the deregulatory activity of the Federal Reserve System and the top .01% of market-based income concentration. Of course, this is without controlling for the many other factors contributing to income inequality. This estimate provides a univariate model indicating a potential relationship does exist

between the Federal Reserve System's market activities and the very wealthy's income concentration.

The next set of models uses those controls with the variable of interest again being the Federal Reserve's average ratios along with labor and finance control variables. The first model in this set uses a combination of labor and finance controls theoretically suggested from the literature discussed in chapter two. Financialization is represented by the finance sector's share of United States' GDP (minus real estate). Additionally, the Shiller price/earnings ratio and the S&P's annual yield are used to reflect financialization with the idea that the healthier the stock exchange is, the more robust the financial infrastructure will be. Additionally, high stock values are one of the goals of neoliberalism, which claims that a self-regulating securities and banking system will produce higher stock market productivity. Union density, as mentioned in chapter two, is mentioned as one of the primary mechanisms for reducing income inequality while globalization is normally thought of doing the opposite. The second model in this set adds Federal long-term bond yields as another financial indicator. The third and fourth model uses the same controls as the second, but examined the top 5% instead of the top .01%. Thus, a comparison is possible to determine if financial deregulation benefits the very wealthy more than the far more numerous affluent or if both benefit equally. Since political activity by the affluent is strong, I expect the 5% cohort will benefit from financial deregulation as much as the very wealthy do. The question is if one or the other (or both) Federal bureaucracy differs in their effects as they deregulate.

Table 4-B: Federal Average Ratio and the Top .01% and Top 5% Market Income Shares

Variable		Model F1 N = 96 R^2 = 0.417	Model F2 N= 96 R^2 = 0.452	Model F3 N= 96 R^2 = 0.463	Model F4 N=96 R^2 = 0.503
Dependent Variable		Top .01%	Top .01%	Top 5%	Top 5%
Top .01% Income	t-1	-.305***	-.384***		
		(.078)	(.083)		
Top 5% Income	t-1			-.383***[15]	-.525**
				(.077)	(.094)
Federal Reserve Average Ratios	Δ	.001**	.001*	.002	.003**
		(.0003)	(.0003)	(.001)	(.001)
	t-1	.0003*	.0003*	.002**	.001**
		(.0002)	(.0001)	(.001)	(.001)
Finance's Share of GDP	Δ	76.462**	80.943**	194.711***	
		(33.917)	(53.024)	(48.033)	
	t-1	46.347**	48.544**	77.24**	
		(18.306)	(18.461)	(26.10)	
Union Density	Δ	-.121	-.158*	-.262**	-.296**
		(.085)	(.083)	(.116)	(.104)
	t-1	-.042	-.050*	-.178***	-.187***
		(.028)	(.027)	(.050)	(.043)
Trade Openness	Δ	.115	.152**	.208**	-.020
		(.077)	(.076)	(.103)	(.102)
	t-1	-.028	-.0004	.059	-.055
		(.032)	(.032)	(.048)	(.083)
Shiller P/E Ratio	Δ	.160***	.165***	.179***	.192**
		(.036)	(.034)	(.048)	(.102)
	t-1	.023	.033	-.061	.057
		(.029)	(.029)	(.039)	(.061)
S&P Yields	Δ	.305*	.3139*	.211	
		(.173)	(.168)	(.237)	
	t-1	.272*	.337**	.056	
		(.141)	(.140)	(.191)	
Long Term Fed Rate	Δ		-.315**	-.634**	
			(.153)	(.210)	
	t-1		-.100*	-.390***	
			(.054)	(.095)	

Continued

[15] Both of the binary FEDAVG/SECAVG variables and top 5% tested negatively with ECM with the lagged dependent variable not being significant. However, when used with control variables, the issue disappeared.

Table 4-B Continued

Variable		Model F1 N = 96 R^2 = 0.417	Model F2 N= 96 R^2 = 0.452	Model F3 N= 96 R^2 = 0.463	Model F4 N=96 R^2 = 0.503
Dependent Variable		Top .01%	Top .01%	Top 5%	Top5%
National Private Wealth	Δ				.002** (.0001)
	t-1				.0002*** (.0001)
Dow Jones Industrial Average	Δ				.001 (.0003)
	t-1				-.0003 (.0002)
Constant		-1.358 (1.440)	-1.118 (1.412)	10.589*** (3.022)	36.943*** (7.684)

Interesting to note is the movement of both the coefficients and the statistical significance as the models move to the right. In the long run, the variable of interest (Federal Reserve's average ratios), the effect of the Federal Reserve System's financial deregulation actions, is statistically significant in all four models. Deregulation's immediate impact is seen with the very wealthy when long-term bond yields are low with a slightly decreased coefficient when the yields are higher. It would seem that the Fed's deregulatory actions are more substantial for the top 5% looking at the coefficients; however, the scale is important. The threshold income for the top .01% market income, including capital gains, is $10,591,501 while the threshold income for the top 5% is $166,715 and the median income is $53,093 (all in 2014 dollars). In 2012, the total United States' gross national income (GNI) was 14,409,323,057,169.70 or 14.4 trillion dollars. The top .01% income share in 2012 was 5.47%, which was $787,680,000,000 or

787.68 billion dollars. Table 4-B, Model F1's standard deviation immediate effect was .478, meaning for every increase of one standard deviation in Federal Reserve's financial deregulation, overall income of the top .01% increased .478, which was an additional 46.85 billion dollars (2012 dollars). This is determined by multiplying the coefficient of the Federal Reserve average (.001) by the top .01% standard deviation (758.1536). The IRS currently provides statistics for only the top .1% number of households up to 2011, when there were about 137,000 individual tax units. The 2011 number of households is used as a conservative estimate, which means an increase of about $350,000 per tax unit for every unit increase in the Fed's deregulatory actions. Of course, the real number of households in the top .01% would be fewer than the 2011 figure, so dollar amount is under-estimated.

Especially noteworthy among the controls is the union density variable, which was not significant to the top .01% until the long-term bond yields were added as a control. Then, looking at the top 5% (Table 2-B, model F3), union density became significant and substantial in its impact on reducing the top 5% income's share. The "unit" increase of union density (or percentage of workers in a union or association) decreased the top 5% (the affluent) income share by 1.81%. In 2012, the top 5% income share was 35.56%. Using the same calculations as above, the income share of the top 5% was 5.122 trillion dollars. Increasing union density by one unit decreases to 33.75% of total income distribution to the top 5% income earners, translating to 4.86 trillion or a loss of 262 billion dollars. The number of tax units in 2011 for the top 5% was 6, 289,286, averaging to a decrease of $43,000 per tax unit (2012 dollars). Given the

threshold income in the top 5% in 2012 was $166,175, this amount is not insignificant. The fourth model (Table 2-B, model F4) had even higher coefficients for union density and their negative effect on income concentration with the top 5% income earners.

Figure 4-A compares all the statistically significant variables in the last model with each other to gauge the relative impact of each. Of specific interest is the long-range impact of the Federal Reserve Board's actions and how it compares with several key variables. By dividing the lagged dependent variable's coefficient (.525) into the Federal Reserve's deregulation variable long term coefficient (.001) and then taking that value (.0019) to multiply by the standard deviation of the Federal Reserve deregulation variable (758.1536), the long term effect on the top income is determined (1.44). This is then divided by the standard deviation of the top 5% (5.132) and this shows the real standard deviation increase in the top 5% (.028). The coefficients used are statistically significant and have long-term effects to determine their relative impact on the income distribution changes for the top 5%. As seen in Figure 4-A, compared to overall national wealth, Fed's deregulation actions pales in comparison. To be fair, it is logical to expect that capital begets more capital and thus is a strong predictor of income concentration with the top 5% of all income earners. Compared to the negative predictors, the finance sector share of GDP and union density, The Federal Reserve deregulation variable has a fairly small effect. Thus, this Federal Reserve's ratio would seem to provide a minor effect in terms of increasing the top 5% income share when compared to other long range variables.

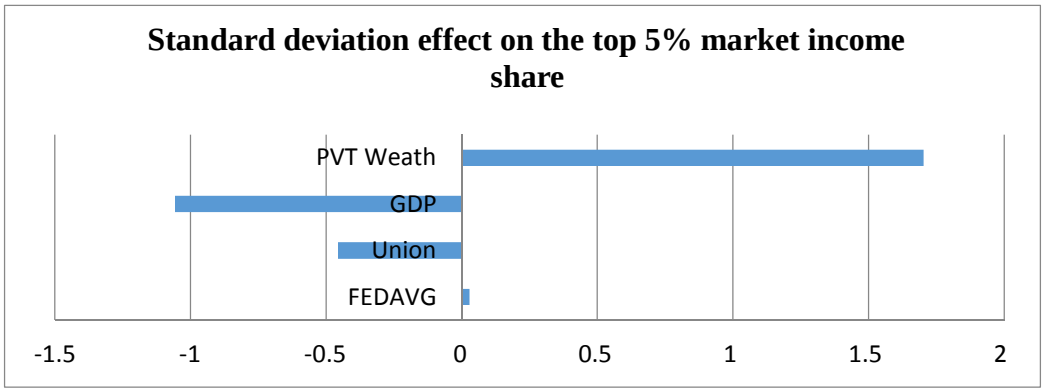

Figure 4-A: Comparative long-term impact of Fed in F4. Reflects one σ shift in explanatory variable on the dependent variable

However, the major muscle movement in the other three models is the financial sector's share of the overall GDP. As seen in Table 2-B, model F2, when this variable increases, so does market-based income inequality. Again, using the one "unit" increase in the financial sector's share of the United States' GDP, the income share of the top .01% increased 1.32%. As stated earlier, the 2012 income share of the top .01% was 5.47%, which would then be transformed to 6.79% with the growth of the financial sector's GDP share. This amount translates to 977.760 billion dollars, increasing their wealth by 190.08 billion dollars compared to the increase of about 47 billion dollars with the Federal Reserve Board's financial deregulation. This increase makes sense. The Federal Reserve deregulatory movement favored this sector; and as financialization grew, so did the inequality associated with it. Figure 4-B shows the same comparison of long-range effects of statistically significant variables except with the top .01%, this time in Table 2-B, model F2. It is worth noting the stock market performance and the financial sector's growth (as measured as percentage of GDP) have a much strong effect than financial deregulation. However, both of those factors tend to be less controllable by

politics while financial policies are controllable, hence the focus here on deregulatory policies in the Federal Reserve System. The very strong affect the financial sector's share has on increasing income concentration is quite interesting and worthy of study unto itself.

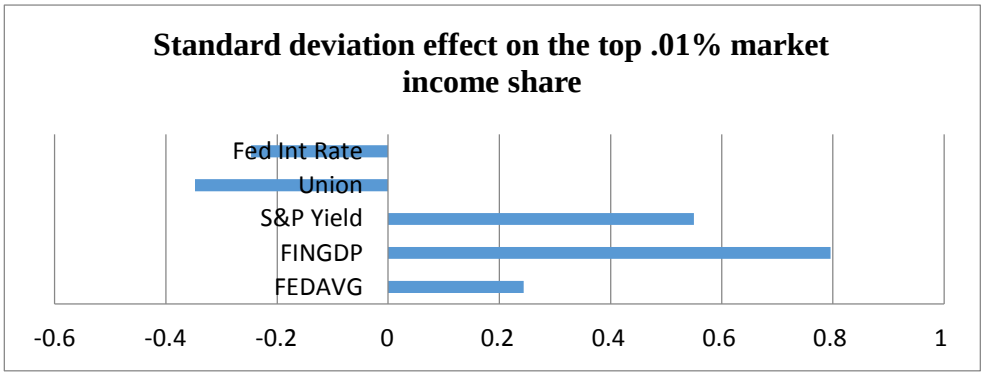

Figure 4-B: Comparative long-term impact of Fed in F2, which reflects one σ shift in the explanatory variable on the dependent variable

The financial sector's growth is a strong predictor of increased income inequality while the Federal Reserve Board's deregulation movement as well as the long-term federal interest rates that the Board sets have less effect. This result would seem to point to an issue of casualty since it is not known whether the Federal Reserve creates the financial sector's growth or the financial sector's growth creates the Fed's deregulatory movement. Based on the discussion of financialization in chapter two, it could be argued that financial deregulation precedes the financial sector's explosive growth since many of the wealth-producing innovations came as a result of loosening the Federal Reserve's regulatory guidelines (Krippner, 2011). However, as will be seen in the later analysis of Clinton's administration, the Federal Reserve Board chairman gained tremendous

political power after the stagflation of the 1970s and the major figure, Alan Greenspan, openly supported neoliberal ideation. To continue this exploration, examining the other bureaucracy, the Securities and Exchange Commission (SEC) is now useful to examine.

Section 2: SEC Analysis

The next set of models examines the SEC deregulation's effect on income inequality. As with the Fed, a series of ratios are designed to reflect the SEC's impact on the market. The stock value variable (annual total stock value from all stock exchanges over time) reflects the market and thus is the denominator. The SEC indicators are the number of full-time employees, the number of registered broker-dealers, and the number of opened investigations for a given year. These are the numerators and, as with the Fed, are calculated separately and then combined to create an average ratio value (SEC Average Ratio). The control variables are similar to the ones used with the Fed. However, more labor variables are used to control for labor's influence on the stock market and obviously more securities-related controls are needed. For example, the maximum capital gains tax is examined since theory would indicate the higher the tax, the lower the incentive for investors to realize their capital gains. This relationship would affect market income since unrealized capital gains would lower the top income earners' share. As with the Fed, first the binary relationship is examined. The ECM estimate, using OLS, showed that serial correlation still exists post-estimate; so the Prais-Winston method is used.

The estimate shows a strong statistical significance with the SEC deregulation and with increased top-income share. The transformed Durbin-Watson statistic is close to the ideal of the two; thus, the estimate shows no sign of autocorrelation.

Table 4-C: SEC Average Ratio and Top 1% Market Income Share

Variable		N = 74 ; R^2 = 0.3334 Durbin-Watson statistic = 1.847469
Top .01% Income	$_{t-1}$	-.085** (.036)
SEC averaged ratios	Δ	.221*** (.045)
	$_{t-1}$	.077*** (.020)
Constant		-.055 (.170)
Rho		-.461

This binary estimate, while incomplete without controls, points to the possibility the SEC is more influential in increasing of the overall market-based income's top share than the Federal Reserve System is. The models in Table 4-D below explores that possibility by examining two types of control variables. The first pertains to the financial market and uses such variables as the Standard & Poor Index and the Shiller Price/Earnings Ratio. The second tests the idea that the labor and demographic variables influence income inequality and thus must be accounted for when testing the SEC's average ratio variable of interest.

One important caveat pertains to of serial correlation with much of the SEC analysis. The first set of models in Table 4-D uses ECM/OLS to estimate the

coefficients; however, many of the other control variables introduces another level of autocorrelation, requiring the use of the Prais-Winston method as above with the binary estimate.

Table 4-D: SEC Average Ratios and the Top .01% Market Income Share
Dependent Variable: Top .01% and 5 % Market Income Share

Variable		Model S1 N = 74 R^2 = 0.360	Model S2 N= 74 R^2 = 0.469	Model S3 N= 74 R^2 = 0.251
Dependent Variable		Top .01%	Top .01%	Top 5%
Top .01% Income	t-1	-.489***	-.531***	
		(.109)	(.107)	
Top 5% Income	t-1			-.234***
				(.066)
SEC Averaged Ratios	Δ	.124**	.220**	.186**
		(.054)	(.067)	(.068)
	t-1	.083	.180**	.027
		(.054)	(.064)	(.055)
Finance's Share of GDP	Δ			7.088
				(53.974)
	t-1			57.658**
				(22.378)
Union Density	Δ	-.230*	-.139	
		(.120)	(.106)	
	t-1	-.111**	-.124**	
		(.054)	(.056)	
Max Capital Gains Tax	Δ			-.066
				(.057)
	t-1			-.042
				(.028)
Trade Openness	Δ	.357***	.086	
		(.099)	(.094)	
	t-1	.196**	-.134*	
		(.081)	(.076)	
Shiller P/E Ratio	Δ		.107*	
			(.059)	
	t-1		-.022	
			(.068)	

Continued

Table 4- D Continued

Variable		Model S1 N = 74 R^2 = 0.360	Model S2 N= 74 R^2 = 0.469	Model S3 N= 74 R^2 = 0.251
Natural log of U.S. GDP	Δ	4.827	-2.347	
		(3.188)	(2.863)	
	t-1	2.279*	-2.036***	
		(1.178)	(.585)	
Long Term Federal Interest Rate	Δ			-.489**
				(.229)
	t-1			-.092
				(.084)
Population % over 65	Δ	-64.660		
		220.027		
	t-1	-101.386**		
		35.461		
Population % with college Degree or higher	Δ	-.001		
		(.002)		
	t-1	-.002**		
		(.001)		
Inflation	Δ	-.120**		
		(.046)		
	t-1	-.117**		
		(.042)		
U.S. Total Private Wealth	Δ		-.0001	
			(.0001)	
	t-1		.0001**	
			(.0001)	
Constant		-5.345612	20.865***	4.961**
		(6.283)	(4.905)	(1.702)

The Securities and Exchange Commission, while being responsible for regulating the stock exchanges and other securities transactions, traditionally relied on the financial industry's capability to self-regulate (Acharya, Cooley, Sylla, & Walter, 2011). Also, except for several decades (1920s, 1990-2012), the stock exchanges were mainly used by more affluent Americans rather than the banking system, which served virtually all of the

population during the time analyzed. Thus, the results would seem to affect the very wealthy rather than the less affluent. Additionally, the stock market is tied very closely to macroeconomic indicators, especially labor since it reflects industrial (to include services) movement. As seen in the models above, the results are interesting.

The first model focuses on labor controls. While the SEC's averaged ratios are statistically insignificant for the long-term effect, they do have an immediate impact. By multiplying the SEC coefficient with its standard deviation, it gives the standard deviation increase of the top income's share (.545). The same type of dollar analysis is used as with the Fed (i.e., adding .545 to the 2012 top .01 income share of 5.47, which comes to 6.01%). Thus, using 2012 as an example, if one "unit" of SEC financial deregulation increases, then the income share of the top .01% also increased to 6.01%. This effect translates to an increase of 47.34 billion dollars which, using the 2011 number of tax units in the top .1%, amounted to approximately the same $350,000 per unit. Of course, combining the Fed and the SEC figures would mean an increase of $700,000 per unit, which is an underestimated number since fewer tax units are in the top .01% than in the top .1%. Also, some sectors, such as in the financial industry, would benefit far more than others; so some industries gain little from financial deregulation while others benefit hugely. Regardless, a combined total of an approximately 100 billion dollar increase in the overall distribution of market income to the very wealthy is hardly insignificant.

As with the Federal Reserve analysis, it is useful to compare all the significant variables' long-term effects with the SEC ratio's to determine relative effect. As seen in figure 4-C, national private wealth is powerful predictor of increased market-based

income inequality with SEC deregulation lagging behind it. On the negative side, increased exports/imports over the long term are about the same as union density (contrary to expectations and density's short-term effects), and GDP growth again decreases economic inequality.

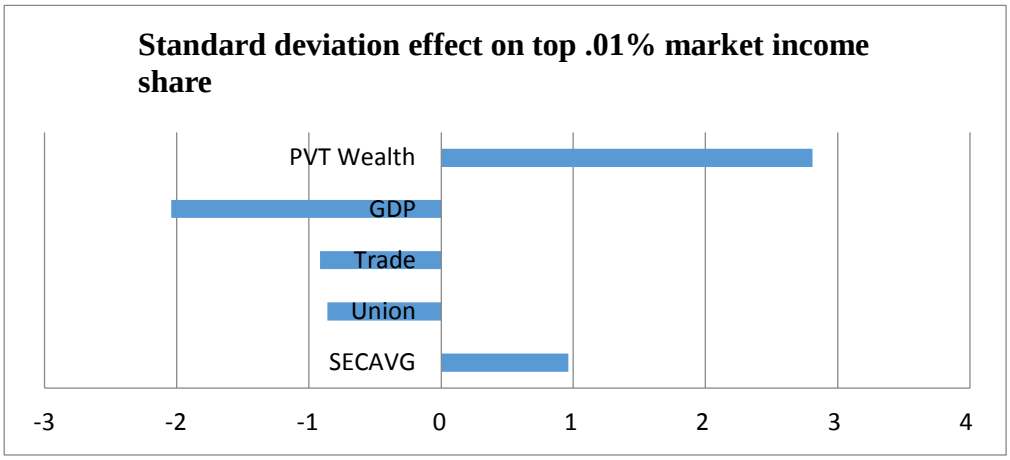

Figure 4-C Comparative long-term impact of SEC in S2, which reflects one σ shift in the explanatory variable on the dependent variable

Another variable of interest combining all three deregulatory organizations—the legislators, the Federal Reserve System, and the Securities Exchange Commission—was presented to determine if there was a cumulative effect on top income share. First, the SEC Prais-Winston results are provided in Table 4-E to further explore the SEC's impact. The Prais-Watson estimate is a feasible generalized least squares (FGLS) method that yields different coefficients than Ordinary Least Squares (OLS). However, it accounts for heteroscedasticity and autocorrelation by transforming the equation to one using sample error data to represent the theoretical error term. Whereas it is the preferred method for this study, nonetheless, it is still useful.

Table 4-E: SEC Ratios & the Top .01% Income Share using Prais-Winston

Variable		Model DW1 N = 74 R^2 = 0.669	Model DW2 N = 74 R^2 = 0.427	Model DW3 N = 74 R^2 = 0.408	Model DW4 N = 74 R^2 = 0.397
SEC Averaged ratios	Δ	.176***	.269***	.275***	.275***
		(.043)	(.073)	(.074)	(.072)
	t-1	.132**	.124*	.160**	.176***
		(.051)	(.071)	(.062)	(.051)
Long Term Fed Interest Rates	Δ	-.075	-.218	-.147	
		(.127)	(.142)	(.151)	
	t-1	-.100	.098	.066	
		(.065)	(.092)	(.066)	
Shiller P/E ratio	Δ	.0533	.064	.044	
		(.039)	(.052)	(.055)	
	t-1	-.089**	-.075	-.089*	
		(.037)	(.045)	(.045)	
Financial deregulation (Legislative)	Δ	.198			
		(.423)			
	t-1	-.257*			
		(.150)			
Trade Openness	Δ	.123*	.269**	.181	.090
		(.072)	(.118)	(.111)	(.091)
	t-1	-.135***	.025	-.007	-.023
		(.029)	(.047)	(.031)	(.050)
Max Capital Gains Tax	Δ	-.104***			
		(.027)			
	t-1	-.047***			
		(.013)			
Natural Log GDP	Δ		7.667	-.940	-1.311
			(5.338)	(2.190)	(2.166)
	t-1		-1.249**	-.985**	-.666*
			(.599)	(.430)	(.374)
Dow Jones Industrial Average	Δ		-.001		-.0001
			(.001)		(.001)
	t-1		.001*		.001
			(.0001)		(.0001)

Continued

Table 4-E Continued

Variable		Model DW1 N = 74 R^2 = 0.669	Model DW2 N = 74 R^2 = 0.427	Model DW3 N = 74 R^2 = 0.408	Model DW4 N = 74 R^2 = 0.397
Unemployment Rate	Δ		.241* (.132)		
	t-1		-.021 (.045)		
National Private Wealth	Δ				-.0000349 (.0000641)
	t-1				.0000113 (.0000293)
Constant		.631 (1.266)	8.990** (4.170)	7.627** (3.219)	5.598* (2.916)
Durbin-Winston Statistic		2.098	1.960	2.023	1.99

This method should produce an unbiased, efficient, and consistent estimate. While ECM/OLS is the preferred method in this study, FGLS will work with second-order autoregressive variables. By using a scale from one to four, the Durbin-Watson statistic tests the estimate to determine if autocorrelation is removed. When the D-W statistic is close to or exactly two, it is a non-spurious estimate and passes the test. All of the models above have an acceptable D-W statistic, indicating they were non-spurious.

Table 4-E, model DW1 is complex, using the SEC average ratio as the variable of interest and the top .01% of income distribution as the dependent variable. As the model shows, the SEC average ratio increases income at the top in both the short and long term. Using the conversion of coefficients to standard deviations as explained above, this increase is .7746 in the short term and .5816 in the long term. This model mainly uses financial control variables, such as the S&P annual yields (over time), Federal long-term

interest rates, the Shiller Price/Earnings ratios, and other significant indicators. Of the controls, the S&P yields, along with the maximum capital gains tax, has interesting results. There is a substantial immediate increase in income for the very wealthy with a unit increase of the S&P yield, while increasing the capital gains tax decreased the top earner's income by a considerable amount in both the short and long terms.

Another interesting quandary is trade openness, representing globalization. In the short term, it increases the top share; while in the long term, increased export/imports decreases the top share. This pattern is seen with the Fed's averaged ratios models (even if trade openness is statistically insignificant most of the time), but is not seen with the SEC's average ratio ECM estimate above (Table 4-D, model S1). In fact, all of the significant control variables decreases inequality except SEC financial deregulation. As chapter two noted, globalization is one of the factors many believe contributes to economic inequality, as Table 4-D, model S1 shows; but the other models do not show that same effect. One possible explanation is that these estimates are over a very long time, about 100 years for the Fed and 76 years for the SEC. This encompasses two world wars and the post-World War I compression with international trade which might skew the results.

Model DW2 retains many of the same financial controls (but substituted the DJIA for the S&P), and adds macroeconomic indicators as controls to determine the SEC financial deregulation's effect lessened or heightened. As the estimate reveals, the SEC average ratio's short- term coefficient sizably increases while the long-term coefficient slightly decreases.

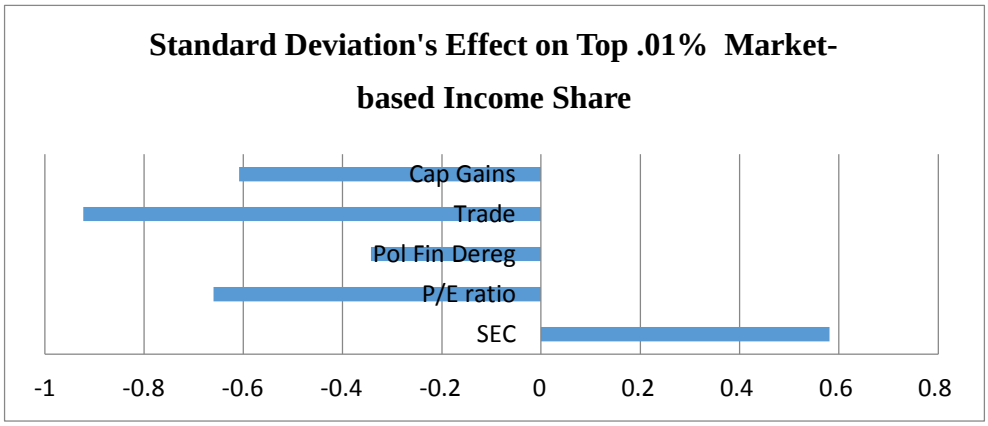

Figure 4-D: Comparative Long-term Impact of SEC in Model DW1: Reflects one standard deviation shift in the explanatory variable on the dependent variable

The third model, DW3, drops both the S&P and the DJIA to determine if including stock- exchange controls masks the true effect of the SEC average ratios. As can be seen, both long- and short-term coefficients increases slightly, but not to the degree that would confirm the stock exchanges were influencing the estimates.

The final model, DW4, uses the DJIA again as a control, but adds overall annual national wealth as another control with the theory being the higher the national wealth, the more influence the SEC would have in increasing income inequality through financial deregulation. Since national wealth distribution is even more uneven than income with the very wealthy holding a much larger share than the rest, it stood to reason this wealth would flow to what gave the highest return. Financial deregulation (by both the Fed and SEC) would enable bankers, brokers, and dealers to create instruments (for instance, high yield or junk bonds as well as consumer debt-backed securities) that deliver such high yields. As the last model shows, that expectation is precisely what results with the SEC

averaged coefficients being the largest of the four models' (as well as the ECM SEC models). In the short term, an increase of one "unit" of financial deregulation increases the top short-term income distribution by 1.2092 standard deviations and the long-term income distribution by .7731 standard deviation. Thus, the immediate share increases for the top .01% is from 5.47% to 6.672%, and the long-term increase brought the overall 2012 share to 6.24%.[16] Using the same monetary numbers (2014 dollars) from the previous analysis results in an immediate increase of 961 billion dollars and a long-term increase of 898 billion dollars for about 150,000 households. Interestingly, the controls are not significant in this final model.

Section 3 Bureaucracy Analysis

The above detailed analysis of the Fed and SEC average ratios led one to wonder what the combined effect of all the deregulatory institutions would be. Thus, a variable was created combining the ratios of the Federal Reserve System's ratios with those of the Securities and Exchange Commission. This variable, labeled "bureaucracy deregulation," represents overall financial deregulation from the two principle bureaucracies; thus, it would be expected to exert more influence in redistributing top income than any of the indexes in isolation. As with the others, first the binary relationship between this variable and the top .01% income is examined.

[16] The top .01% income share's overall mean could easily be used to calculate these percentages; however; they are close to the 2012 percentages, and noting financial deregulation's impact in the very recent past seems more interesting.

Table 4-F: Bureaucracy Financial Deregulation
Dependent variable = Top .01% Market Income Share

Variable		N = 74 R^2 = 0.028
Top .01% Income	$_{t-1}$	-.103**
		(.051)
Bureaucratic Deregulation	Δ	.001
		(.001)
	$_{t-1}$	-.001
		(.001)
Constant		.886
		(.594)

As seen above, this estimate has some serious issues. It is statistically insignificant; and the sign for the long-term effect is reversed from all the other estimates, showing a negative influence on top income. The ECM/OLS estimate fails the Breusch-Godfrey test, meaning second-order auto-regressive effects are present. Thus, the Prais-Watson method is used for the binary estimate with the following results outlined in Table 4-G.

Whereas bureaucratic deregulation is significant, the Durbin-Watson statistic is just on the cusp of acceptable; therefore, the results are still possibly spurious with the binary model above. Interestingly, the sign reversal on the long-term effect is still present. The models identified in Table 4-H used control variables and passed the Breusch-Godfrey test for serial correlation post-estimate. The estimates given below test the theory that combining the Federal Reserve and SEC deregulatory effects will produce a greater effect overall than when they are tested separately.

Table 4-G: Bureaucracy Financial Deregulation, Durbin-Watson
Dependent variable = top .01% of market income share

Variable		N = 74 R^2 = 0.284
Top .01% Income	t-1	-.074**
		(.035)
Bureaucratic Deregulation	Δ	.001***
		(.0001)
	t-1	-.0001***
		(.0001)
Constant		.-114
		(.184)
Durbin-Watson Statistic		1.843

Then the analysis is conducted with control variables. These variables focus on activities in the financial sector.

Table 4-H: Bureaucracy Financial Deregulation
Dependent Variables = Top .01% and Top 5% Market-based Income Share

Variable		Model BD1 N = 74 R^2 = 0.566	Model BD2 N= 74 R^2 = 0.593	Model BD3[17] N= 74 R^2 = 0.251	Model BD4 N=74 R^2 = 0.584
		Top .01%	Top .01%	Top .01%	Top 5%
Top .01% Income	t-1	-.658***	-.608***	-.465***	
		(.102)	(.097)	(.094)	
Top .05% Income	t-1				-.452***
					.104
Bureaucracy Interaction	Δ		.0001**		
			(.0001)		
	t-1		.0001		
			(.0001)		

Continued

[17] The Breusch-Godfrey Test gave a 0.0952, which is borderline with the post-estimate serial correlation. A Durbin-Watson FGLS estimate yielded similar results, so the ECM/OLS was retained.

Table 4-H Continued

Variable		Model BD1 N = 74 R^2 = 0.566 Top .01%	Model BD2 N= 74 R^2 = 0.593 Top .01%	Model BD3[18] N= 74 R^2 = 0.251 Top .01%	Model BD4 N=74 R^2 = 0.584 Top 5%
Bureaucracy Combination	Δ	.001		.002*	.002
		(.001)		(.001)	(.001)
	t-1	.001*		.002**	.002**
		(.001)		(.001)	(.001)
Finance's Share of GDP	Δ	39.426	10.405	57.132	158.911**
		(44.561)	(45.316)	(40.818)	(49.301)
	t-1	108.749***	75.667**	117.518***	133.994***
		(28.048)	(24.430)	(27.030)	(32.548)
Union Density	Δ	-.014	-.028	-.050	-.140
		(.108)	(.105)	(.110)	(.135)
	t-1	.033	-.030	.046	-.015
		(.072)	(.059)	(056)	(.101)
S&P Yield	Δ	.4381**	.476**	.449**	
		(.196)	(.186)	(.180)	
	t-1	.308**	.311**	.359**	
		(.150)	(.145)	(.134)	
Trade Openness	Δ	.106	.139	.114	.424**
		(.100)	(.097)	(.089)	(.129)
	t-1	-.073	-.130	-.031	.048
		(.098)	(.083)	(.049)	(.098)
Shiller P/E Ratio	Δ	.172***	.138**	.158***	
		(.042)	(.046)	(.037)	
	t-1	.035	.006	.032	
		(.029)	(.040)	(.029)	
Natural log of U.S. GDP	Δ	-.801	-2.137		-.4785944
		(3.405)	(3.273)		(3.751435)
	t-1	.033	-1.080		-3.174***
		(.072)	(.702)		(.710)
Long Term Fed Interest Rate	Δ	-.224	-.193	-.343**	-.683***
		(.153)	(.149)	(.148)	(.186)
	t-1	.126	.087	-.044	.048
		(.076)	(.083)	(.058)	(.098)

Continued

[18] The Breusch-Godfrey Test gave a 0.0952, which is borderline with the post-estimate serial correlation. A Durbin-Watson FGLS estimate yielded similar results, so the ECM/OLS was retained.

Table 4-H Continued

Variable		Model BD1 N = 74 R^2 = 0.566 Top .01%	Model BD2 N= 74 R^2 = 0.593 Top .01%	Model BD3[19] N= 74 R^2 = 0.251 Top .01%	Model BD4 N=74 R^2 = 0.584 Top 5%
Pop % with college Degree or higher	Δ	-.001 (.002)	-.001 (.002)		
	t-1	-.002* (.001)	-.002** (.001)		
S&P 500 Returns	Δ				.065*** (.015)
	t-1				.075*** (.019)
U.S. Total Private Wealth	Δ	-.00001 (.0001)	.0001*** (.0001)		
	t-1	.0001** (.0001)	-.0001 (.0001)		
Constant		3.001 (4.998)	7.714 (5.210)	-7.524** (2.677)	28.413*** (6.995)

In the second model, Table 4-H, BD2, which is the interaction variable between the Federal Reserve Index ratio and the Securities and Exchange Commission ratio, the lack of any significant long-range effect is interesting. This model has a fairly weak immediate effect, which is somewhat stronger in the third model, Table 4-H, BD3, the combination variable. The first model, Table 4-H, BD1, is the largest one using both labor and finance controls to allow for the other influences on inequality. This model shows a long-term .426 standard deviation effect on the top .01% income share. Returning to the third model, the bureaucratic combination variable shows an immediate and long-term effect slightly stronger than in the first two models. The standard

[19] The Breusch-Godfrey Test gave a 0.0952, which is borderline with the post-estimate serial correlation. A Prais-Watson FGLS estimate yielded similar results, so the ECM/OLS was retained.

deviation effect on income concentration for the top .01% is .589. As in the earlier models, the .589 is added to the income share of the top .01% to determine its overall influence and then translated into a monetary figure varying by year. In this case, if the top .01% income share mean (5.79 over 99 years) is used and the .589 effect from bureaucratic financial deregulation is added, the increase is fairly large: a new mean of 6.379%.

Including the top 5% income earners with the bureaucratic combination variable, Table 4-H, model BD4 reveals a very strong positive effect with the total GDP's financial share as well as with the annual earnings of the S&P 500 stock index. This model also shows GDP growth's strong negative effect on income inequality. However, bureaucratic financial deregulation variable's long-term effect is much weaker as Figure 4-E shows.

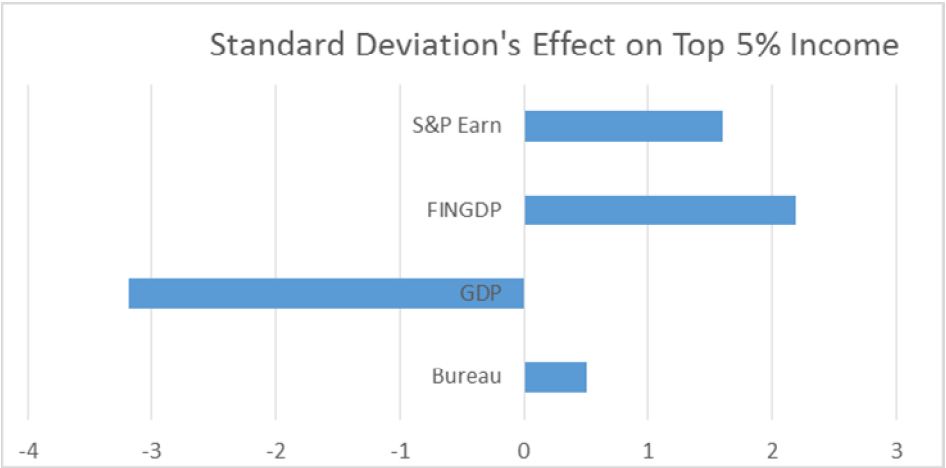

Figure 4-E: Comparative Long-term Impact of Variables in Model BD4: Reflects one standard deviation shift in the explanatory variable on the dependent variable

Despite the variation in the models, it is useful to compare the highest Federal Reserve ratio effect, the Securities and Exchange Commission ratio effect, and the bureaucratic combination effect. Using the top .01% income share mean (over the 99 years), each variable's standard deviation effect is added to create a comparison chart.

As predicted, the combined bureaucratic variable has the largest effect; however, the difference among all of them is not large. The gap between the Fed ratio and the bureaucratic combination comes to a little more than one-tenth of a percentage.

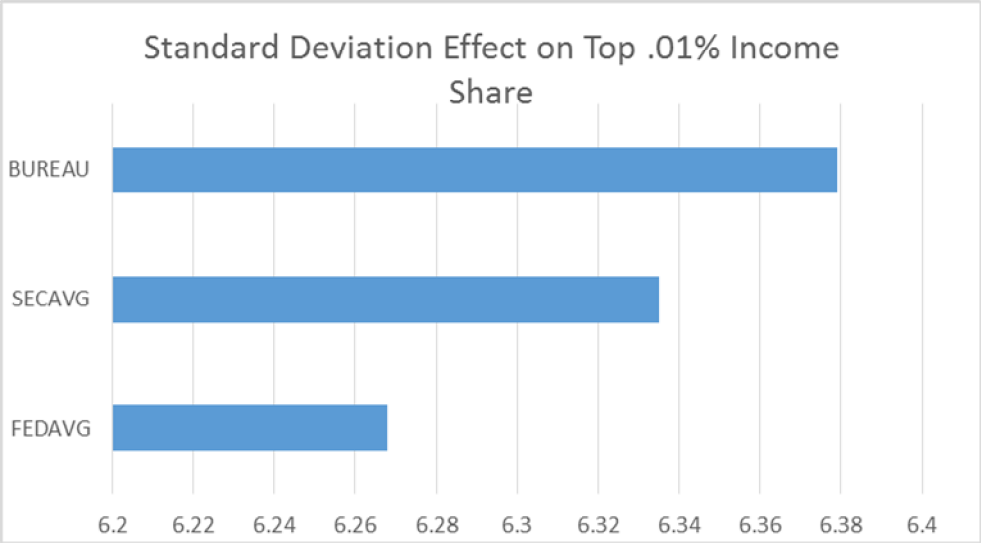

Figure 4-F: Comparison of Standard Deviation Effect on Top .01%: Reflects one standard deviation shift in the explanatory variable on the dependent variable

However, given the very long time span examined, even allowing for the SEC analysis' shorter time span, this slight difference does have a significant impact on the very wealthy's income concentration. For instance, the minimum income share of the top .01% over 99 years is 2.56 while the maximum is 12.28. Adding an additional .12% to

each one can be then translated into dollar increases, which again is considerable considering the small population within the top .01%. Does this increase merely reflect the reality of the "income pie" getting larger so that all benefit, or did this increase come at a cost to the bottom 90% of all income earners?

Section 4: Bottom 90% Market-Based Income Analysis

The bottom 90% of all income earners are analyzed and then compared, using the same control variables as the top .01% for comparison. As is expected, the income share of the bottom 90% is reduced and thus has negative coefficients as shown in Figure 4-I. The bureaucratic combination and interaction variables are both problematic with ECM/OLS with the lagged dependent variable being insignificant. However, the Fed's and the SEC's averaged ratios works well even if they both need different control variables. Theoretically, the Fed would be sensitive to financial indicators as controls and somewhat less sensitive to macroeconomic indicators.

Table 4-I: Financial Deregulation and the Bottom 90%
Dependent Variable = Bottom 90% of Market-based Income Share

Variable		Model B1 N = 94 R^2 = 0.531	Model B2 N= 96 R^2 = 0.519	Model B3 N= 74 R^2 = 0.471	Model B4[20] N=74 R^2 = 0.471
					DW Statistic= 1.92
Bottom 90% Income	t-1	-.443*** (.081)		-.233** (.098)	
Top .01% Income	t-1		-.514*** (.085)		

Continued

[20] Due to post-estimate ECM/OLS serial correlation with top .01% as dependent variable, the Durbin-Watson FGLS method was used without a lagged dependent variable.

Table 4-I Continued

Variable		Model B1 N = 94 R^2 = 0.531	Model B2 N= 96 R^2 = 0.519	Model B3 N= 74 R^2 = 0.471	Model B4[21] N=74 R^2 = 0.471
Federal Reserve Ratios (Deposits)	Δ	-.003**	.0004		
		(.001)	(.0003)		
	t-1	-.002**	.0003*		
		(.001)	(.0001)		
SEC Averaged Ratios	Δ			-.208***	.210***
				(.060)	(.046)
	t-1			-081	.067**
				(.055)	(.026)
Finance's Share of GDP	Δ	-172.622**	58.288*		
		(57.486)	(33.453)		
	t-1	-104.586**	34.364		
		(36.966)	(21.987)		
Union Density	Δ	.119	-.151*		
		(.115)	(.081)		
	t-1	.036	-.070**		
		(.068)	(.035)		
Trade Openness	Δ	-.065	.120	-.522***	.344**
		(.114)	(.075)	(.137)	(.107)
	t-1	-.081	-.078	-.149	.051
		(.106)	(.062)	(.093)	(.041)
Shiller P/E Ratio	Δ	-.191***	.176***		
		(.054)	(.035)		
	t-1	.067	.031		
		(.038)	(.028)		
Unemployment	Δ			-.285	.243*
				(.202)	(.135)
	t-1			-.186**	-.040
				(.074)	(.036)
GDP	Δ			.944	9.641*
				(8.158)	(5.223)
	t-1			.178	-.939**
				(.785)	(.440)
S&P Yields	Δ	-135	.382**		
		(.245)	(.167)		
	t-1	.187	.318**		
		(.196)	(.137)		

Continued

[21] Due to post-estimate ECM/OLS serial correlation with top .01% as dependent variable, the Durbin-Watson FGLS method was used without a lagged dependent variable.

Table 4-I Continued

Variable		Model B1 N = 94 R^2 = 0.531	Model B2 N= 96 R^2 = 0.519	Model B3 N= 74 R^2 = 0.471	Model B4[22] N=74 R^2 = 0.471
Long Term Fed Interest Rate	Δ	.536**	-.193	.786***	-.217
		(.0001)	(.153)	(.207)	(.135)
	t-1	.060	.048	.207*	.096**
		(.113)	(.067)	(.116)	(.036)
National Private Wealth	Δ	-.0001**	-.0001		
		(.0001)	(.0001)		
	t-1	-.0001**	.0001**		
		(.000)	(.000)		
Percent Population with college degree or higher	Δ	-.002	-.001		
		(.003)	(.002)		
	t-1	-.003*	-.003**		
		(.001)	(.001)		
Constant		1.504	.831	15.065**	6.012*
		(5.664)	(1.61)	(6.436)	(3.09)

However, the SEC (reflecting securities) would be somewhat more sensitive to macroeconomic variables, such as inflation, unemployment and GDP growth.

The models discussed above provides juxtaposed comparison with the bottom 90% and the top .01% as the dependent variables, removing any chance of mathematical artifacts creating statistical significance. The SEC's top .01% model (B4) needs to be estimated with the Durbin-Watson method due to autocorrelation issues. The Fed's models has no such issues and, as such, provides a direct comparison with each other. As expected, the bottom 90% of overall income share decreases when the Federal Reserve's increases financial deregulation while, as noted many times above, it increases with the top .01%. The SEC shows less direct comparison in the long-term effect due to the bottom 90% effect being statistically insignificant, yet the other SEC coefficients shows

[22] Due to post-estimate ECM/OLS serial correlation with top .01% as dependent variable, the Durbin-Watson FGLS method was used without a lagged dependent variable.

the same pattern of reversal. The SEC shows a very similar pattern which is quite suggestive of market-based income being transferred from the bottom to the top.

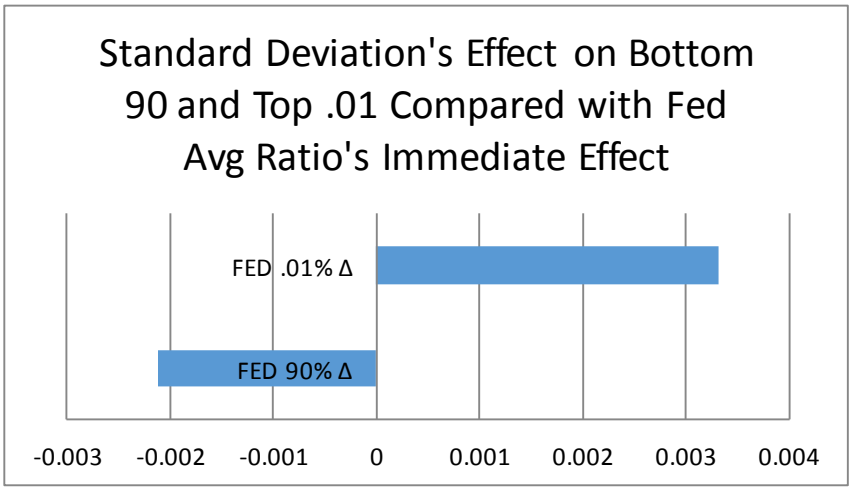

Figure 4-G: FED Comparison of 90% and .01%: Immediate

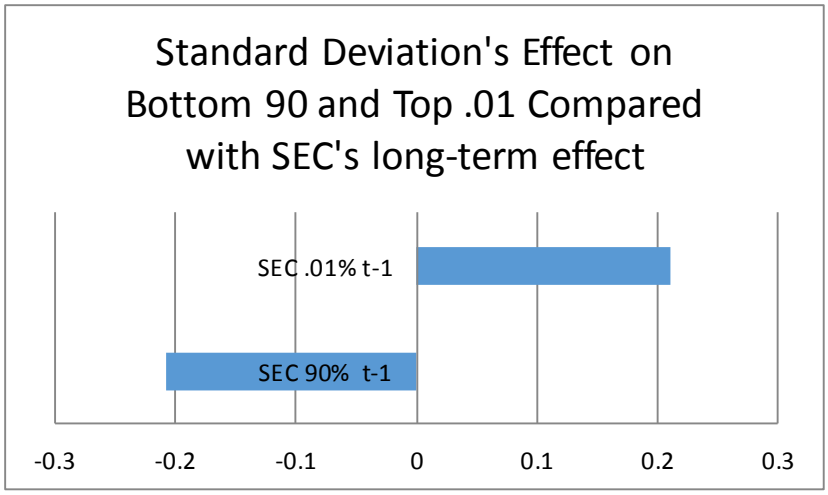

Figure 4-H: SEC Comparison of 90% and .01%: Long-term

Time Segment Analysis

One final part of this analysis examines whether the legislative and bureaucratic deregulation variables has different influences during different time frames. For example, the SEC was a creation of the New Deal in the 1930s, so it would be expected to have a strong influence for a period of time before it potentially became degraded through neoliberalism. Another example is the Federal Reserve System, which was created as the lender of last resort for banks and had a minor regulatory role in the early 20th century. The New Deal gave it greater regulatory powers and strengthened its role in finance, but the political system still played a major role in determining its actions until the mid-1970s when President Carter appointed Paul Volcker as chair. This appointment created the era of a more independent Federal Reserve Board with much stronger influence over banking. Of course, this independence does not mean the Federal Reserve used this influence. As mentioned earlier, Alan Greenspan believed in the neoliberal idea of a light touch on the financial market. Thus, it is interesting to see what the regressions show regarding time eras. Using the three deregulatory variables—the SEC average, the FED average, and the legislative financial deregulation—the same time-series data is regressed with the appropriate control variables transportation. Two of the time eras begin in 1933 when the financial regulatory acts were enacted and end in 1982 when neoliberalism became dominant in Reagan's administration. Two other time eras begin in 1978 with Carter's first deregulatory declaration (in transportation) and ends in 2012. The final two eras begin in 1935 with the SEC's creation during the Great Depression and concludes in 2012. The dependent variable is the very wealthy, the top .01 of

market-based income earners and as apparent in Table 4-E, the variables of interest depend on the particular time era under analysis. Of interest are the decades during and immediately after the Great Depression when financial regulation was at its strongest compared to the decades after the 1980s when neoliberal ideology began to justify financial deregulation.

Table 4-J (A) FED and SEC Historical Eras and the Top .01%

Time Era Variable Model Data		1933-1982 N=49 R^2=.503	1933-1982 N=44, R^2=.523	1978-2012 N=34 R^2=.690
Top .01% Income	t-1	-.562***	-.732***	-.716***
		(.155)	(.196)	(.129)
Fed Reserve Ratios (Deposits)	Δ	.0011**		-.00067
		(.0008)		(.002)
	t-1	.0008*		.0025
		(.0004)		(.002)
SEC Averaged Ratios	Δ		.196**	
			(.056)	
	t-1		.275**	
			(.086)	
Legislative Financial deregulation	Δ	.474	.212	-.838
		(.310)	(.294)	(.743)
	t-1	.166	.099	-2.737**
		(.185)	(.217)	(.746)
Finance's Share of GDP	Δ	176.961**	93.544*	70.313
		(51.933)	(51.425)	(76.211)
	t-1	48.656**	-35.294	189.964**
		(22.081)	(21.126)	(63.625)
Union Density	Δ	-.068	-.053	-.200
		(.045)	(.047)	(.383)
	t-1	.004	-.033	.638**
		(.029)	(.041)	(.256)
Trade Openness	Δ	.045	.151**	.159
		(.063)	(.059)	(.198)
	t-1	-.035	.067	-.219
		(.038)	(.059)	(.269)

Continued

Table 4-J (A) continued

Time Era Variable Model Data		1933-1982 N=49 R^2=.503	1933-1982 N=44, R^2=.523	1978-2012 N=34 R^2=.690
Real GDP	Δ	5.487**	4.192*	28.791**
		(4.433)	(2.406)	(9.846)
	t-1	-1.422**	-3.239***	23.205**
		(.526)	(.727)	(9.177)
Long Term Federal Interest Rate	Δ	.034	-.073	-.386
		(.129)	(.125)	(.247)
	t-1	.156*	.259**	.734**
		(.088)	(.078)	(.232)
Constant		10.361**	27.551***	-232.572**
		(3.659)	(6.321)	(81.299)

Table 4-J (B) FED and SEC Historical Eras and the Top .01%

Time Era Variable Model Data		1978-2012 N=34 R^2=.690	1935-2012 N=74 R^2=.406	1935-2012 N=77 R^2=.388
Top .01% Income	t-1	-.665***	-.499***	-.496***
		(.130)	(.107)	(.102)
Federal Reserve Ratios (Deposits)	Δ			.002*
				(.0011)
	t-1			.0019**
				(.0007)
SEC Averaged Ratios	Δ	.0387	.148**	
		(.062)	(.049)	
	t-1	-.0336	.122**	
		(.079)	(.052)	
Legislative Financial deregulation	Δ	-.602	.869*	.683
		(.754)	(.506)	(518)
	t-1	-2.4907**	.534**	.131
		(.799)	(.232)	(.231)
Finance's Share of GDP	Δ	141.454*	12.163	88.717*
		(81.532)	(54.369)	(45.651)
	t-1	255.046**	67.151**	121.005***
		(75.107)	(27.990)	(28.783)

Continued

Table 4-J (B) continued

Time Era Variable Model Data		1978-2012 N=34 R^2=.690	1935-2012 N=74 R^2=.406	1935-2012 N=77 R^2=.388
Union Density	Δ	-.055	-.034	-.075
		(.360)	(.116)	(.098)
	t-1	.649**	.079	.098*
		(.263)	(.068)	(.058)
Trade Openness	Δ	.300	.294**	.341***
		(.216)	(.098)	(.099)
	t-1	-.165	.046	.081
		(.265)	(.069)	(.073)
Real GDP	Δ	25.709**	3.043	6.399*
		(10,221)	(3.565)	(3.354)
	t-1	18.690*	-1.721**	-1.589**
		(9.343)	(.578)	(.568)
Long Term Federal Interest Rate	Δ	-.358	-.323*	-.368**
		(.244)	(.167)	(.171)
	t-1	.692**	.035	.036
		(.231)	(.068)	(.067)
Constant		-194.783**	11.147**	4.461
		(82.255)	(3.757)	2.952

Note: all models showed no signs of post-estimate autocorrelation according to the Breusch-Godfrey LM test.

Interesting to note is the bureaucratic variables' influence from 1933 to 1982 while the legislative variables are insignificant. This influence reverses from 1978 to 2012, when the legislative variable (at least in the long term) becomes significant while none of the bureaucratic variables are significant. Finally, both bureaucratic variables' overall effect are significant from 1933 to 2012. These models indicate the legislative process's ebb and flow in relation to the financial deregulatory movement. Before the neoliberal era, government agencies had a strong effect where any deregulatory movement increased the market-based income share of the top .01%. During the

neoliberal era, the legislation that was passed (or repealed) deregulating finance strongly increases the top share of income while the Fed and SEC plays a more restrained role. In addition, the models above show the bureaucracy does sustainably increase market-based income inequality.

It is worth noting one more time how the figures and the text arrived at the numeric results based on the regressions. By dividing the coefficient of the variable of interest with the coefficient of the lagged dependent variable, I determine what one unit increase/decrease in the variable of interest will increase/decrease in the dependent variable. Next, that result (increase/decrease in the dependent variable) is multiplied by the standard deviation of the variable of interest to convert it to the long term increase/decrease in the dependent variable (assuming I am looking at the long term effect- for the immediate effect I stop after the first step). The long term increase/decrease in the dependent variable is then divided by the standard deviation of the dependent variable to arrive at the real standard deviation increase/decrease of that same variable. Thus, I can compare effects as well as determine the monetary impact of the reported effect.

Section 6 Putting It All Together

Looking at this data over time, about one hundred years, yields a complexity that is difficult to follow. With all of the models, variations of the dependent variables, and the plethora of control variables, the ultimate purpose of this analysis is easy to forget. This section provides a summary of the analysis above and how it fits with the theories presented in the first chapter. Again, this study argues that, over time, financial

deregulation of the financial sector, by either legislation or by bureaucratic methods, increases market-based income inequality. The above analysis examined this claim. The follow-on argument that neoliberal ideology captured both parties to allow this financial deregulation to happen, is analyzed in the next chapter. Three basic hypotheses are embedded in the theory that financial deregulation increased market-based income inequality:

H1: An increase in legislative financial deregulation, over time, will increase market income concentration in the top 5% and higher income deciles.

H2: An increase in bureaucratic financial deregulation, over time, will increase market income concentration in the top 5% and higher income deciles.

H3: An increase in the combined legislative and bureaucratic financial deregulation, over time, will increase market income concentration in the top 5% and higher income deciles with a steeper curve than each in isolation.

The estimates strongly support the first two hypotheses, even if their effect are not as large as other societal forces in increasing market income inequality. With the Federal Reserve System's financial deregulation, income-generating mechanisms—such as stock market earning, amount of previous wealth, and the financial sector's overall output—has a much stronger effect on income inequality. However, the consistent factor in this inequality generation is the Federal Reserve Board's decision to deregulate, by fiat or informal lack of enforcement, the banking industry. Another fascinating aspect of the Federal Reserve's effect on increasing inequality is the fact the top 5% (the affluent)

benefit from it proportionally more than the top .01% (the very wealthy). As shown, the dollar amount of the increased concentration certainly highly rewards the top .01%, but the deregulatory influence is stronger with the affluent than with the very wealthy. Since the affluent have a great say in policy decisions and tend to be politically active, this result is not surprising. The dominant financial narrative is neoliberalism, unfettered free markets with the self-regulating banks, and financial innovations designed to incentivize banking profits (Stiglitz, 2010). The affluent, as seen above, benefit from this narrative. Thus, financial interest groups and associations are, in essence, "preaching to the choir" when talking to political representatives since those same representatives have an influential voting bloc supporting the neoliberal financial narrative.

The results for the Securities and Exchange Commission, however, are different. Its range of influence seemed to be with the very wealthy (top .01%) with the top 5% estimates not being significant during analysis. Additionally, the control variables tend to be effective with the macroeconomic mechanisms, such as GDP growth, union density, and exports/imports, actually decreasing market-based income inequality in the long term for the very wealthy with SEC deregulation being one of the few market mechanisms working to increase their income share. Interestingly, both the Fed and the SEC share the reality that existing wealth distribution is the strongest predictor of increasing market-based income inequality. Many already know intuitively that "the rich get richer while the poor get poorer," but this compelling evidence suggests that intuition is harsh reality

The Durbin-Watson estimates show some curious variations compared with the analysis shown in the previous tables, whereby existing private wealth becomes less

significant; trade openness, legislative financial deregulation, a higher price/earnings ratio and higher capital gains tax decrease the top income's distribution while SEC deregulation is the only variable that increases it. In many ways these results are counter-intuitive since globalization (trade openness), political deregulation through fiscal policy, and a stronger price/earnings ratio would seemingly increase the gap between the top .01% and the rest. Important to note that trade openness overall tended to decrease market-based income inequality in the long term while increasing it in the short term. A possible explanation is reduced consumer prices through increased global trading (of electronics, for instance), which would tend to benefit people in the lower income brackets who need to consume more lower priced goods than people in the higher brackets who consume less of the same goods.

The Shiller P/E ratio reducing income inequality is a puzzling since the lower socio-economic brackets tend not to be invested in the market, thus having a strong securities market would seem to assist the wealthy the most. One potential explanation is that a higher percentage of income earners benefit from a strong market, including those vested in 401k retirement funds, which might reduce the effect for the very top of the income bracket. If the top 10%, for example, gain at a higher rate than the top .01%, this would level off inequality in the top 10% decile. Truly puzzling is the legislative financial deregulation result which shows a decrease of income for the very wealthy. More work needs to be done to determine if this is a true result or a statistical artifact. As to the strong effect of increasing capital gains tax on decreasing the market-based income share of the very wealthy, that would make perfect sense. Higher capital gains tax means

more wealthy investors or top executives who are compensated with stock will not realize those gains immediately with the hopes that future politicians will reduce capital gains taxes later date.

The third hypothesis predicted that the combined SEC and Fed financial deregulation ratios would exert a stronger influence than each one separately. As seen with the chart above showing the three variables' impact on the top .01% income share mean, the combined bureaucratic variable have a stronger effect than either individually. Considering that the Fed and the SEC are only two (albeit the most influential two) regulatory agencies in the financial sector and that the legislative financial deregulation variable only covered a couple of key deregulatory laws, these results are probably understated. The neoliberal discourse of deregulation and free flow of capital existed in the FDIC, OCC, and other such agencies. These results make a very strong argument that financial deregulation, regardless of source, decreases the bottom share of income to increase the top share. Bureaucratic decisions are mechanisms that condition the market by a neoliberal captured government and, as predicted by power resource theory, benefit capital. The next chapter examines this capture closely, looking at how neoliberal theory captured political parties and the presidency ideologically.

Chapter 5

Content Analysis and Process-Tracing Results

***"No, because it wasn't a complete deregulation* [Gramm-Leach-Bliley Financial Services Modernization Act of 1999] *at all. We still have heavy regulations and insurances for banks…I have really thought about this a lot. I don't see that signing that bill had anything to do with the current crisis"*[23]**

President Bill Clinton, 2008

***"…So I don't think President Clinton can walk away from responsibility for the deregulation, when he knew that the person responsible for enforcing regulation really didn't believe in it".*[24]**

Joseph Stiglitz, member and then chair of President Clinton's Council of Economic Advisors, 2010

"One of the issues on which an extraordinary amount of time was spend and which for 99.99 percent of the American people would be meaningless is the whole issue of swaps and derivatives. We went to great lengths in this bill not to upset the current regulatory environment for these products, to see that we did not create any new law giving anyone new, or removing any existing jurisdiction over swaps and derivatives. I thank Chairman Levitt and Chairman Greenspan for their help on this issue".

Senator Phil Gramm (R-TX), Financial Services Modernization Act of 1999-Conference Report, 3 November 1999

The three quotes above highlight the difficulty in determining cause and effect merely from econometrics. In theory, assuming strong regulatory safeguards were still intact after the Glass-Steagall Act's repeal in 1999, an econometric study of that era should reflect a lower concentration of market income in the top decile. However, as the Nobel-winning prize economist Joseph Stiglitz noted, keeping Greenspan as chairman of the Federal Reserve Board for Clinton's entire presidency meant keeping a powerful

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[23] Maria Bartiromo, "Bill Clinton on the Banking Crisis, McCain and Hillary," *Business Week*, September 24, 2008

[24] Michael Takiff, "A Complicated Man: The Life of Bill Clinton by Those Who Knew Him, 2010, Yale University Press, pp. 422.

bureaucrat, with formal and informal decision-making authority, who believed in a self-regulating financial system (Takiff, 2010). In the final quote above, a powerful Republican Senator thanks Greenspan for helping swaps and derivatives remain unregulated, confirming the accusation in the second quote. In theory, assuming the majority of regulators followed the lead of Greenspan in his deregulatory actions, an econometric study of that era should reflect a higher concentration of market income in the top decile. As has been seen, that is precisely the case. However, two questions are raised: Did previously high-income earners create this deregulatory stance, or did the deregulatory stance create more high-income earners? This chapter is designed to answer the latter question because this study's time-series analysis has shown increased market income for those in the top-earning brackets. However, this study does not focus exclusively on the Clinton era; in fact, others have found a slightly decreased market-based income inequality during his administrations (Piketty & Saez, 2004). Yet the word *slightly* is important since the economic policies from 1992 to 2000 did not reverse the trend of the very wealthy accumulating more market-based income at the lower-income brackets' expense. The sections below answer the question of causality and, in fact, show a systemic feedback system by which the financial elites used their wealth to influence President Clinton's choice of economic advisors/executers. Their financial regulation's political outcomes would then create even more wealth for the growing number of financial actors. Therefore, while the answer is really a "both/and" statement, it is reasonable to think t that the financial sector's wealth moved the New Democrats to embrace neoliberalism more than the other way around.

The first section of this chapter examines process tracing, the research method used for this thick analysis. After presenting this method's basic mechanics, the next section provides a political/financial overview of the context before President Clinton's presidency. Section two discusses the legislative activity surrounding the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 and the Gramm-Leach-Bliley Act of 1999. Section three begins with the first significant financial legislation that passed under Clinton's purview and ends with the last piece of financial legislation to conduct the process trace. The process tracing will show a somewhat reluctant president who, nonetheless, believing his economic advisors, deregulated the financial sector with a multitude of motivations. However, it is important to note where the reluctance lay since President Clinton did not reject the idea of financial modernization. The main objections came from his strong support of the Community Reinvestment Act and consumer privacy protections. His primary motivation to eventually sign both bills was a sincere belief in some of economic neoliberalism's core tenants, such as the free market's sanctity and of the government's diminished role in the market. Once those two concerns were dealt with legislatively, his signature was guaranteed (Rubin, 1993). This chapter's final section provides a summary as well as a brief discussion of President Obama's administration from 2008 to 2012.

Section One: Process Tracing Methodology

Process tracing is a qualitative tool designed to determine a phenomenon's causality. Simply put, it closely examines qualitative data to determine if X did cause Y, by what mechanisms, and with what potential interactions with other variables. So if X

did cause Y, did Z contribute to this causation and if so, to what extent? Is there an interaction where Y then potentially provides feedback to X? Again, if X causes Y, are critical variables needed between X and Y? Thus, does X create Y when U and V are present, or can it do so alone? In this study, process tracing is critical since multiple systems are involved. The financial sector, the government sector, and the market are a series of systems interacting with one another to create processes. These processes can be visualized since they are created by people to accomplish particular tasks, for example, to pass a financial law or to lobby a legislator to pass that financial law. Some processes are relatively transparent with "everyone knowing" what to do and how to do it so the process is understood and not written down. This makes it difficult to retrieve for study. For instance, in commercial banking, lending money to a household consumer has very apparent processes in writing as well as transparent, informal processes that might be difficult for a scholar to perceive. In macroeconomics and in political science, processes are both apparent and transparent, thus the need for process tracing in this project. This method connects the dots in a highly visible fashion to make better sense of the econometric analysis conducted alongside it.

Process tracing occurs within a "case" which, in this study, is bounded by both space and time. The case in question is financial legislation within the Democratic Party's political context in the 1990s. Furthermore, the case is delineated into specific bills that moved through the legislative process during the 1990s with a focus on the Democratic politicians who worked with these bills. Second, process tracing is a research tool using data and analysis to determine empirical results. Thus, to quote

Bennett (2010), process tracing is "…the examination of "diagnostic" pieces of evidence within a case that contribute to supporting or overturning alternative explanatory hypotheses" (p. 208). Bennett also notes that h this tries to determine a particular process's mechanisms and sequences. . However, as illustrated below, this determination is much easier said than done.

Case Selection

Selection bias is an ever-present danger in process tracing since finding favorable data to support a particular hypothesis at the expense of ignoring data that falsifies it is a very human tendency. Thus, case selection is critical to mitigate this tendency. For example, if I chose only those successful financial bills that deregulation the banking and/or securities industry while overlooking unsuccessful deregulation bills, then I would quickly show ideological capture of both parties. However, the research outcome would then be flawed because the policy-making process in the House and the Senate tends to start-stop over time until the right coalition passes a carefully modified bill. Thus, examining the notable financial bills moving through the government from 1994 to 1999 is useful. This examination begins with the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 and ends with the Gramm-Leach-Bliley Act of 1999 (Sherman, 2009). In addition, the Federal Reserve Board reinterpreted the Glass-Steagall Act multiple times, slowly degrading the separation between commercial banks and investment banks (Hendrickson, 2011). The Gramm-Leach-Bliley Act of 1999 passed at the end of President Clinton's second term; and although several critical deregulatory actions occurred in the 2000s, they were under the Republican administration of

President George W. Bush, who would be expected to support financial deregulation per Republican ideology. Noteworthy are the Commodity Futures Modernization Act of 2000, which forbade regulating over-the-counter trading of derivative contracts and the SEC's move in 2004 to have voluntary regulation under the Consolidated Supervised Entities program (Komai & Richardson, 2011; Sherman, 2009). Both of these actions occurred under President Bush's administration even though the groundwork was laid much earlier. However, this study is interested in the ideological capture of the Democrats by neoliberal economic theory; thus, the legislation under President Clinton's administrations is of primary interest. In 1979 President Carter began the deregulatory movement in transportation using very similar reasons, for example, efficiency and competitiveness, as President Clinton used 20 years later with financial deregulation. While this movement will be discussed, it will not be part of the process tracing analysis.

Hypotheses Testing

Hypothesis testing using process tracing relies on four "gates" through which evidence passes to determine if a statement or a series of statements confirms or denies the hypothesis. In other words, the statements comprising the causal-process observation (CPO) are tested just as the data set above was tested, just with a different methodology. Collier's (2011) four tests are used in a process trace:

The first "gate" is the "Straw-in-the-Wind," a statement (s) that is "neither a necessary nor a sufficient criterion for accepting or rejecting a hypothesis, and they only slightly weaken rival hypotheses" (p. 826). For example, in Clinton's administration, a Treasury staffer might have suggested that President Clinton's economic theories were

important and shaped how much he listened to his economic advisors. This made-up statement then is tested with straw in the wind first to see if it is supportive of the basic hypothesis that President Clinton was captured by neoliberal economic theory in his decision making. This would give some support, but since it is so general about the type of economic theory, it is not decisive. Thus, the statement analysis ends here in the first gate.

The second "gate" is the "hoop" test, which tightens the criteria for passage. According to Collier (2011), "Although not yielding a sufficient criterion for accepting the explanation, it establishes a necessary criterion. Hoop tests do not confirm a hypothesis, but they can eliminate it" (p. 826). Thus, if a statement passes through the hoop, the alternate explanations begin weakening. Using the above example, if that same staffer said that President Clinton listened carefully to his second-administration Treasury Secretary publically known to favor neoliberal economic theory, then this statement passes through the hoop. An alternate hypothesis, perhaps one that stated President Clinton was unaware of economic theories regarding finance and thus "floated" wherever political expediency took him, would be weakened.

As the testing becomes more stringent the third "gate" is the "smoking gun." As the name implies, it begins to point to a hypothesis with strong evidence behind it. According to Collier (2011), "…this provides a sufficient, but not necessary criterion for accepting the causal inference. It can strongly support a given hypothesis, but failure to pass does not weaken it" (p. 827). If a statement passes through this gate, the other explanations are significantly weakened. Since the smoking gun test is ultimately the

optimal outcome of this process, it is worth looking closely at its implications. Using the above example again, if the same staffer then recorded that President Clinton told him privately that he (Clinton) recently read a piece on neoliberal financial theory and was favorably impressed, this statement would pass the smoking gun test. It is sufficient in one sense that President Clinton was aware and was impressed with the neoliberal proposition of financial deregulation and thus, on his own, supported the relevant political action (for instance, financial deregulation). The statement, however, is not necessary since President Clinton could conceivably have known nothing about the basics of neoliberal theory, but blindly trusted his advisors to give him the best political guidance on any relevant political action.

The final "gate" is one rarely seen in process tracing: the "doubly decisive" test, meaning the statement is both necessary and sufficient for establishing causation and thus all others are eliminated (Collier, 2011). To follow the old Army adage that no horse is too dead to beat, the above example is used once again to illustrate. If that same staffer recorded that President Clinton said, "I am going to support financial deregulation regardless of political cost because neoliberalism is correct and thus all will benefit when we use its recommendations,"; only one hypothesis is supported, and the others are no longer useful. However, the doubly-decisive observations are extremely rare and, unfortunately, none were seen in this project. Thus, the other three gates must carry the analysis, and no strongly definitive answers are offered for any of the hypotheses.

Sources

Since this study's intent is examining financial deregulation with its neoliberal ideology and its relationship with market-based income inequality and partisan politics, a very detailed analysis of the Democratic and Republican political environment is beyond the scope of this qualitative analysis. Such detail would require documentation from all the presidential libraries as well as a very close examination of the Congressional Record. Instead, this process trace focuses only on the Clinton administration (despite the first Obama administration's continuation of neoliberal ideals through choice of financial advisors). Again, a more detailed examination would mean visiting and digging into the William J. Clinton Library for all the non-digital documentation. Such a visit was not part of this study. However, by using the digitized l open-source documents available in the William J. Clinton Presidential Library and Museum, multiple biographies/autobiographies, journalistic analyses in contemporary news accounts, and key White House staff's accounts, enough information is available to conduct a reasonably comprehensive process trace.

Hypotheses about President Clinton

The hypotheses to be examined revolve around this transformation of the Democratic Party under Clinton's leadership. Despite the focus on Clinton, many other political actors gave economic and political advice that must also be taken into account. However, "the ultimate decision maker," to use President George W. Bush's phrase, is the president. From his election in 1992 to his final year in 1999, Clinton was the Democratic Party's agenda setter despite all the very strong, influential personalities

surrounding him (Harris, 2006). This political reality leads to several potential explanations for the movement from strong financial regulation, mainly in banking, to a deregulatory stance. The hypotheses examine a primary motivation even though the reality of political decisions means multiple motives are normally present. However, examining deregulatory decision-making motives are important in understanding how neoliberalism became dominant in the United States' government and thus conditioned the market to financially deregulate. To determine if President Clinton truly believed in financial deregulation and thus wanted it to happen because he firmly believed it was best for the American people is very different than if President Clinton reluctantly supported financial deregulation. The latter would imply continual presidential resistance to financial deregulation legislation or overt deregulatory acts in the bureaucracy while the former would imply, at the very least, strong verbal support of financial deregulation. This study's argument is that President Clinton supported neoliberal ideas in his economic thinking and thus encouraged passing of legislation that deregulated finance. Thus, the first hypothesis is the one of research interest:

H1: President Clinton supported neoliberal economic ideals and wished to enact them legislatively in the financial sector.

The hypotheses below are variants on the question of motive. If, as argued, President Clinton did support neoliberal ideals, then why?

H1a: (finance): President Clinton supported neoliberal economic ideals mainly to placate the financial industry, especially Wall Street liberals who provided the majority of financial support for campaigning.

H1b: (new democrat): President Clinton supported neoliberal economic ideals mainly to placate a Congressional mandate from his party wishing for them to be enacted.

H1c: (GOP): President Clinton supported neoliberal economic ideals mainly to accommodate the Republican Party to gain support for other legislative priorities.

H1d: (force): President Clinton did not support neoliberal economic ideals and was forced to sign the deregulatory bills due to strong Congressional, public, or financial-sector pressure.

Again, it is worth repeating that President Clinton is a complicated man who was quite capable of having multiple motives in signing the two main deregulatory bills that passed during his tenure. Most certainly elements of all the hypotheses were present as he contemplated his political actions; however, one of the above hypotheses was probably the primary driver of his decision to sign those bills. Thus, as mentioned, hypotheses H1a-H1d are really one hypothesis, which is one of motivation. As the motives are being unraveled, the expectation is that President Clinton did believe that the ideas found in neoliberal economic thinking were valid and that enacting them was in the nation's best interest.

As seen earlier in chapter 2, neoliberalism has both a robust history in the United States and a strong set of advocates in academia as well as in business. When Clinton became president, he created the National Economic Council, consisting top economic figures from Wall Street, academia, and banking. Robert Rubin chaired the NEC while Lloyd Bentsen became the Secretary of the Treasury, both of whom favored banking deregulation justified by neoliberal arguments, such as increasing competitiveness,

decreasing government's interference in the market, and allowing the market to benefit consumers. For instance, an internal memo that the NEC wrote in 1993 and that both Robert Rubin and Lloyd Bentsen endorsed, concluded, in part, with the following:

> Although much is being done to reduce needless regulatory burdens on banks though administration actions, some steps require legislative changes. Bills have been introduced in both the House and the Senate based on a 'laundry list' from the banking associations to provide 'regulatory relief.'…Although we believe that there is merit in supporting the constructive elements of these regulatory relief bills, we have great concern that, if laden down with the full laundry list, the CDFI [Community Development Financial Institutions Bill] bill would get mired in long and vehement Congressional disputes….we have been able to get a more focused version of the regulatory relief legislation incorporated into the Senate version…and to reach an agreement with the American Bankers Associate that this focused approach is wise. (as cited in Newman & Ludwig, 1993, p.9).

This memo included the National Governors Association's endorsement that spoke of how Governor Clinton believed in the economic benefits of deregulation. Throughout this memo, neoliberal ideology is embedded with appeals to modernizing, becoming more competitive both globally and domestically, increasing efficiency in capital allocation by freeing the financial market, and providing advantages to banks merging to increase "competitive services to consumers" (Newman & Ludwig, 1993, p. 11). Note that deregulatory language was used with the intent to better Americans' financial

services and thus financial deregulation was justified to benefit American consumers. Interestingly, the American Banking Association approved.

Later, in 1997, President Clinton received a memo from Gene Sperling, who replaced Robert Rubin as director of the National Economic Council and also worked for the Obama administration in the same role in 2011 – 2014. Sperling stated,

> Yet all the old statutory regulations [referring to the Glass-Steagall Act] remain on the books – imposing needless regulatory and management costs, and impeding competition, innovation, and consumer choice. Allowing financial firms of all types to affiliates holds promise that consumers will benefit as fair competition – less hindered by regulatory restrictions – will drive firms to achieve and pass savings on to consumers. (p.5)

As stated in chapter one, this study's basic theory is that financial deregulation creates, perhaps as an unintended consequence, higher market-based income concentration for the very wealthy. This deregulatory movement was (and still is) powered by a strong neoliberal ideology, which believes government creates inefficiencies and thus hurts consumers. The final piece of this theory is that while the Democratic Party of the New Deal believed in strong financial controls, the post-1980 Democratic Party was captured by the neoliberal ideology. President Clinton's two administrations stand out as prime examples of this capture; and the process tracing, along with the thick description of the two major regulatory bills he signed, will show this capture.

With this background, the analysis below will be organized as follows. First, a baseline financial regulatory legislation is examined which was the last of gasp of

strengthening financial constraints during the late 1980s. This is followed by a close examination of two major banking deregulatory laws that were enacted soon after the failure of the earlier regulatory bill that was designed to strongly regulate banking. By using content analysis, these deregulatory bills are examined to determine the ideology that supported them. After this Congressional legislation section, the process-tracing of President William J. Clinton's decision-making in terms of financial deregulation will be presented. Each proposed hypothesis is tested with the results given in this section. Finally, a brief conclusion provides the overall results of the process tracing.

Section Two: Congressional Financial Legislation in the 1990s

The "baseline" legislation is a bill that had the support of a Democratic Congress and a Republican President and that was designed to strengthen financial regulation. However, it failed to pass. By looking at this process more closely, the dominate narrative regarding financial regulation immediately before President Clinton's election in 1994 can be determined. One might think a Republican president would object to new regulatory tightening of the banking sector but that the Democrats in Congress would support such a bill. As will become obvious, that scenario was not the case. Both parties appear to have supported strong financial constraints on banking. This baseline narrative is followed by the analysis of two legislative acts that became law, one in 1994 and the other in 1999. These laws are also examined closely to determine if the dominant narrative changed from 1994 when President Clinton first took office to 1999 when he left. Using context analysis, the verbiage of neoliberalism is used in a frequency

analysis. If neoliberal ideas began to dominate congressional discussion, the needed Congressional context for the process-tracing portion of this chapter will be provided.

Baseline Financial Legislation with Republican President

This section is to provide a baseline of the Congressional environment before the Democrats took over the presidency and determine what the previous Republican administration was able to accomplish with a Democratic congress in terms of financial regulations. In many ways, this baseline also reveals the convoluted process of legislation in the House of Representatives as they grappled with banking regulations. In July of 1990, Representative Brooks, a Democrat from Texas, introduced two bills: "Banking Law Enforcement Act of 1990" and the strangely named "To provide for the better enforcement of criminal and civil law relating to banking matters."[25] The latter had one co-sponsor, Representative Schumer, another Democrat from New York. This act created strong sanctions for criminal actions related to bank examinations, for instance, concealing assets from the FDIC. Sanctions included disengagement from banking affairs, large fines, and an increase in the maximum prison term by ten years for bank fraud and embezzlement. More importantly, considering the events of 2009, act prohibited using "golden parachute payments" for banks that became insolvent.

This bill was referred to the House Judiciary Committee, who gave it to the Subcommittee on Criminal Justice. In turn, it was referred to the House Banking, Finance, and Urban Affairs Committee, who passed it to the Subcommittee on Financial Institutions Supervision, Regulation, and Insurance. It later died in that committee. This

[25] THOMAS, Bill Summary & Status, 101st Congress (1989-1990), http:Thomas.loc.gov/cgi-bin/bdquery/z?d101:HR05387:@@@L&summ2=m& and House and Senate Congressional Records for the 101st Congress

bill, however, was introduced a few days after the Banking Law Enforcement Act by the same congressman, but had 25 co-sponsors, both Republicans and Democrats including the minority leader (Democrats controlled the House). Both acts focused on the Savings & Loans debacle and were designed to increase regulatory oversight to include a new agency called the "Financial Institutes Fraud Unit." Interestingly, the main opposition came from the Democratic chair of the Committee on Banking, Finance, and Urban Affairs who objected to placing more regulation on top of the previous legislation, the 1989 Financial Institutions Recovery and Enforcement Act (FIRREA). He railed against both acts, but focused primarily on the Banking Enforcement Act, which contained strong criminal sanctions as well as the means to stop banking executives from profiting during a banking crisis by having a golden parachute or moving compensation overseas.

Despite his concerns, which involved his belief that the bill granted too much power to regulators and also denied private citizens the ability to sue Savings and Loan Banks for compensation, the bill passed by 424 to 4 with 4 no votes. After it went to the Senate for consideration, it went to the Committee on Judiciary and then was placed on the Senate Legislative Calendar under General Orders along with a bill created by Senator Biden (a Democrat) that replicated the House bill in most respects. To date, that is the last status of the bill[26]. Despite strong support from both parties, the bill did not become law and was not signed by President Bush. Apparently, Congress meant to send to the American public a non-binding signal that it would take strong punitive action after the Savings and Loan debacle, but failed to do much more. Explanations to how and why

[26] THOMAS, Bill Summary & Status, 101st Congress (1989-1990), http:Thomas.loc.gov/cgi-bin/bdquery/z?d101:HR05387:@@@L&summ2=m& and House and Senate Congressional Records for the 101st Congress

this bill failed with so much support from the floor of both the Senate and the House are elusive and can only be speculative. Regardless, it did not go onto the floor when scheduled, and further searching for information about its fate remains futile. This failure of regulation illustrates the difficulty of creating, shepherding, and passing a bill through the legislative process, especially in the arcane world of financial regulation. It also illustrates the dominant narrative of outrage at the banking industry and the public desire to regulate it after the Savings and Loan failures. Both parties spoke strongly in support of stronger regulations with banking for the Congressional Records and thus were publically identified with strong financial regulation. Considering the fate of the Banking Law Enforcement Act of 1990, it is now useful to begin with a brief contextual summary of President Clinton's two administrations and the Congressional actions related to finance with which he worked.

Congressional Context under President Clinton

President Clinton was elected in 1992 with a minority of the popular vote due to Ross Perot's candidacy. Thus, the Republican Party, as represented in Congress, did not believe he had a particular mandate from the electorate for his agenda. Running as a "New Democrat," he essentially moved to the center-left during the campaign, which, nonetheless, was still left of the most Republicans. The 103nd Congress, which ran from 1993 to 1995, had Democrat majorities in both the House and the Senate. However, with only 57 Democratic senators, they were not filibuster proof. While lack of a filibuster majority was not as much an obstacle as it would become during President Obama's administration, it was still a major obstacle for Democratic legislation. In 1994, in a

historic election, the Republican Party routed the Democrats and took control of both the House and the Senate. The House went from 59.2% voting control of the Democrats to 45.6% voting power while the Senate had 53 Republican senators. Thus began a confrontational era between the two parties with the Speaker of the House, Newt Gingrich, pushing the Republican "Covenant with America" and President Clinton still pursuing a center-left policy environment. In 1996, President Clinton was reelected with a large majority of the electoral votes, but still with a slight minority of the popular vote, again due to Ross Perot's third-party run. The 105th Congress, which began the first two years of President Clinton's second administration, still retained Republican control of the Senate and House even if some seats were lost in the 1996 election. Finally, the 106th Congress, which finished the Clinton era, showed the Republicans still holding on to an even smaller majority with the Democrats in the House having 48.5% voting power.[27]

Financial Context under President Clinton

With these dynamics in mind, during President Clinton's eight years the financial sector underwent significant changes, which trended towards a more deregulated and consolidated banking system as well as a more "hands off" approach the SEC used in its regulatory actions with the securities sectors. Beginning with the "too big to fail" banking consolidations, several major banks merged to form the beginnings of the "mega" banks. For instance, Chemical Bank, which had assets valued at 1.98% of the GDP, merged in 1996 with Chase Manhattan with its assets 1.35% of the GDP. Another example is the expansion of Citigroup which merged with Travelers, Inc. (which had bought Salomon Brothers in 1997) in 1998 to form Citigroup, Inc. with assets of 3.22%

[27] THOMAS, Library of Congress, http://thomas.loc.gov/home/

of the GDP. Other commercial banks—such as Wells Fargo; Bank of America; and an investment bank, Morgan Stanley—experienced the same type of consolidation (Murdock, 2012). These consolidations can be placed within the larger context of the financial sector's growth and influence. The history of banking in the United States traditionally pitted the small community commercial banks against the large metropolitan banks (which the Federal Reserve leadership tended to favor); however, mergers and purchases began degrading this competition. Therefore, the banking industry started to lobby as one voice (Prins, 2014). Given the neoliberal ascendency during the previous decade which advocated minimal regulations, free market efficiency, and belief in a self-regulating market, the banking industry had an economic argument which dovetailed with its objective of decreasing government agencies' banking interference (Harvey, 2005; Levitin, 2014; Prins, 2014; McCarty, Poole, & Rosenthal, 2013). Figure 2-A shows the significant financial laws passed by Congress and signed by President Clinton during his eight-year tenure. Of these laws, two were critical to the deregulatory environment that emerged during his administration and thus are critical to examine closely (Levitin, 2014; Prins, 2014): the Riegle-Neal Interstate Banking and Efficiency Act of 1994 and the Gramm-Leach-Bliley Act of 1999. The branching bill enabled larger banks that were previously restrained from interstate growth to acquire banks from other states and thus form mega-banks. Glass-Steagall's formal repeal was accomplished with the Gramm-Leach-Bliley Act of 1999, enabling these large banks to consolidate investing, commercial banking, and insurance into one large company. In essence, both bills were the infrastructure of the "too big to fail" banks of 2009 and the present (Groton, 2009;

Prins, 2014; Scheer, 2010; Johnson & Kwak, 2010). The first bill went through a Congressional majority of Democrats while the latter was passed with a Congressional majority of Republicans.

1994: Home Ownership and Equity Protection Act 1994: Riegle-Neal Interstate Banking and Efficiency Act 1996: Credit Repair Organization Act 1996: Deposit Insurance Funds Act 1996: National Securities Markets Improvement Act 1998: Home Owners Protection Act 1999: Gramm-Leach-Blilev Act

Figure 5-A: Major Financial Acts during President Clinton's administration
Source: Matthew Sherman, *A Short History of Financial Deregulation in the United States,* 2009

Legislative Analysis Methodology

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 and the Gramm-Leach-Bliley Act of 1999 are analyzed using content analysis. Using the QSR NVivo 10 software, both the actual text of the bills and the congressional debates surrounding them as found in the U.S. Congressional Records are analyzed to determine what, if any, neoliberal ideology came into the deliberations that eventually passed both bills into laws. Coding is accomplished using the node system (i.e., using key words or phrases that derive from neoliberal economic beliefs and determining how prominent they were in the deliberations). This coding is done by combining computer-assisted coding and hand coding to insure the results are both reliable and valid. Some problems arise when coding by key words/phrases with the main issue being multiple contexts

surrounding a key word as well as its intensity (importance) to the debate. For example, the word *consumer* is frequently found in House and Senate debates, but with two very different contexts surrounding it. One context is consumer protection from banks' misusing their deposits or abandoning the poorer regions while the other context is assisting consumers in acquiring reasonable credit due to the enhanced competition that comes with financial deregulation. The first calls for more regulation while the obvious deregulatory focus of the second stands in stark contrast. But the same word, *consumer*, is used. Thus, the computer assists in finding the word while the hand coder codes it by context to determine if it strengthens regulation, weakens regulation, or has no effect. The intensity issue is a much harder problem to solve. It is difficult to determine which words/phrases are more influential in promoting the deregulatory stance and/or influencing legislators to support deregulation. Again, the phrase, "opt-out" was rarely used in the debate; yet, in context, it provided the compromise that pushed the Riegle-Neal Act of 1994 through both houses and thus was critical in enhancing the deregulatory movement. Based on existing research on these bills, the values assigned to any node is what would appear to be the best way to reflect its deregulatory characteristic.

This analysis will show that both Democrats and Republicans used virtually the same language and belief set to support deregulating the commercial and then the investment banking industry. Any opposition to both bills came from Democrat legislators, and it is interesting to note their contrary verbiage as it reflects an alternative mindset to neoliberalism. Thus, the deliberations analysis of both bills, one at the beginning and one at the end of President Clinton's tenure, provides a rich backdrop to

better understand President Clinton's congressional environment as it relates to the financial industry.

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994

The American banking experience, as described in chapter two, included a public mistrust of large banks; thus, bank branching was severely limited in American banking's early history. This restriction had support of small banks, which were primarily state regulated, while the national banks, along with larger state banks, fought to have branching expanded. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 eliminated restrictions on interstate banking and limited branching capabilities (Calomiris, 2000; Hendrickson, 2011; Sherman, 2009). To provide the Congressional Context, the bill was a product of the 103rd Congress, which still retained Democratic majorities in both the House and the Senate. However, soon after President Clinton signed this bill into law, that year's November elections resulted in Republican majorities for the 104th Congress. Thus, it would be reasonable to expect a polarized 103rd Congress with Republicans resisting Democrats' initiatives to include this bill. However, a brief timeline of the bill shows no substantial resistance from either party. Again, according to the Congressional Records, the bill (H.R. 3841) was first introduced by Representative Neal (a North Carolina Democrat) with 21 co-sponsors (8 Republicans and 13 Democrats) on March 22, 1994, under the title of "Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994." The original bill's intent as introduced was to permit bank-holding companies to acquire out-of- state bank branches within some state

limitations (taxation, capitalization, and bank age law).[28] In essence, this bill repealed the anti-interstate branching laws over time and even with the state "opt-out" provision included in the bill resulted in all the states allowing interstate branching. This deregulatory movement of bank branching was done in the name of enhancing efficiency, increasing competition, and allowing banks to function as other industries would. It was introduced in the Democrat- controlled House under suspended rules for passage. Another Democrat from New Jersey (Kweisi Mfume) opposed the bill while many other Democrats supported it as written. Henry Gonzalez (1994), a Democrat from Texas, discussed one reason why it finally was presented to the House: "Competition among financial services providers, a divided banking industry, and other unrelated issues previously spelled doom to such legislation. This year, at long last, all obstacles have been surmounted" (p. 5996). The Republican minority in both the House and Senate banking committees voted for the bill without dissent. The dissent from Mr. Mfume and Mr. Joseph Kennedy (Democrat from Massachusetts) revolved around an amendment they fought for in committee to strengthen consumer rights regarding providing better credit for rural and poor urban communities.

Out of the many counter-arguments to this dissent, one of the primary ones involved the desire for banking to gain more capital in these acquisitions to become more competitive with each other and with foreign banks. The theory was that more competition would lead to more branches in lower-income areas and thus to more efficient banking to provide credit for poorer clients (Beck, Levine, & Levkov, 2010; Calomiris, 2000; Strahan, 2003). Thus, James Leach, a Republican from Iowa, required

[28] THOMAS: Bill Summary & Status 103rd Congress (1993-1994) H.R. 3841, CRS Summary

banks to have at least 5% capital before they could acquire an out-of-state bank which is a historically low requirement. To place this requirement in perspective, the 2004 Basel agreement required Tier 1 banking equity and reserves (capital in banking refers to equity) to be at least 5%, which most banking analysts later attributed to contributing to the 2009 financial crisis (Admati & Hellwig, 2013; Groton, 2009; Johnson & Kwak, 2010). The lower equity requirement for the banks meant the interbank loans could use non-equity collateral (like mortgage-backed securities) to get their loans. If that collateral's value is questioned, as what happened with MBS, then short-term lending becomes more expensive or is not given at all, placing the debtor bank in crisis since the short-term lending is the operations' lifeblood. When this collateral became nearly worthless and lending dried up, the other securities, such asmoney market funds, were affected. When the money market fund "broke the buck," their value dramatically decreased (one of their dollars was worth less than a dollar on the market), and the financial market crashed. Thus, in retrospect, Congressman Leach's desire to lower equity requirements was less than useful to the American economy in the long run. After the debate, which consisted of the two dissenters trying to hold the line on their concerns, the House passed the bill without any further amendments as per the rule's suspension.

In 1994, the bill then went to the Senate, who eventually transformed the House version to their own (referred to as S. 1963) after due consideration. Before referring the matter to committee, the Senate heard from the banking industry. A letter from a small banking association, The Independent Bankers Association of America, was introduced by Senator Riegle, the chair for the Senate Committee on Banking, Housing, and Urban

Affairs. In this letter, foreign banks were identified as being exempt from the capitalization requirement as well as the community-reinvestment requirement, which the state bankers believed gave foreign banks a competitive advantage. This letter was followed by reading multiple letters from state bankers associations, who strongly urged H.R. 3841 be modified to insure foreign banks had no competitive advantages over the local banks. These requests stemmed on the community reinvestment requirement coupled with existing U.S. banking laws, which enabled foreign banking to have a lower cost of capital and thus provide loans to American borrowers at a lower interest rate. Virtually all the Senate agree with this reasoning; yet one senator from North Dakota, a Democrat named Bryon Dorgan, foreshadowed the financial crisis of 2009. He went late into the chamber; and after telling the Senate president his vote would have been "no," he proceeded to tell them why: "I am concerned when I read about banks involved in trading derivatives and have speculative losses of substantial amounts of money… more concentration in the industry is not going to serve this country's interest" (Dorgan, 1994, p. 8643).

On 4 August, the House passed the Conference Report with little debate. The one hour of debate allocated to it primarily consisted of members from both parties praising the bill and giving their support. Representative Joe Kennedy (D-MA) was the only semi-dissenting voice, who gave his "cautious support" to passing the bill. Interestingly, several representatives spoke of the next law they hoped to change, which was the Glass-Steagall Act. They considered it obsolete, too restrictive, and anti-competitive. The conference papers went to the Senate on 13 September where it passed 94-4. President

Clinton signed it on 21 September. The word cloud below, based on the Senate debate over the conference report in 1994, shows the relative concerns of those who commented for the Congressional Record. The large words indicate they were used more frequentl. As to be expected, “state,” “bank,” “branch,” “federal,” and “interstate,” are more frequently used than any ideological justification. The focus concerned the banks and their relationship with the state after interstate branching is allowed. This focus does not require much justification since branching laws are obscure and technical with little public interest. This is not to say that neoliberal ideas were not verbalized during the debate, but that they were not dominant in this bill. As shown later, the 1999 financial deregulation bill had a very different dominant narrative.

In looking at both bills, neoliberal terminology was used in a content analysis of key documents found in the Congressional Records and Conference Reports with the intent of comparing the frequency the neoliberal terminology used in both bills to see if Congressional neoliberal thinking evolved, at least in seeing if there was increased neoliberal justification for banking deregulation.

The QSR NVivo analysis of the 1994 banking bill used seven key documents from the 103rd Congress’s Congressional Records. The first is the bill’s final version that was signed into law. The other documents come from the House debates, first when the bill was introduced and the second after the conference report was given. The final three are from the Senate debates. The first document reflects the debate that sent the House version to committee/conference and the latter two show the debate to approve the conference report. The expectation is that neoliberal terminology and philosophy

dominated the deliberations with the main focus on increasing the American banking industry's competitiveness. Figure 5-B below shows the results of the textual analysis of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. As seen in the word cloud below (Figure 5-B), neoliberal arguments were not the Congressional debate's mainstay in allowing interstate branching to occur.

Figure 5-B: Word Frequency Cloud Based on Senate Debate on Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 on 24 April 1994

The Gramm-Leach-Bliley Act of 1999

The Gramm-Leach-Bliley Act of 1999, introduced by Republican Senator Phil Gramm of Texas is best known for formally repeal of the Glass-Steagall Act even though it consisted of far more deregulatory actions than just the repeal. According to Sherman (2009), "The act repealed all restrictions against the combination of banking, securities, and insurance operations for financial institutions. The deregulation was a boon for national commercial banks, allowing the formation of 'mega-banks'" (p. 10). For

example, Citigroup, Inc. was created virtually days before the bill passed Congress and was signed into law by President Clinton in November 1999 with the strong expectation that all three financial industries would be permitted to function under one corporation (Murdock, 2012). . Despite the seeming quickness of this bill's passage, it was a culmination of a long Congressional history of attempts to repeal Glass-Steagall (Prins, 2014). Additionally, unlike the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, the path from bill to law was far more contentious in Congress due to concerns about consumer protections and the Community Reinvestment Act.

After Senator Gramm introduced the bill in April 1999, it went to the Committee of Banking, Housing, and Urban Affairs, where it was re-introduced in May 1999 with several amendments. It passed the Senate with a 54-44 vote and was then sent to the House. There, Representative Leach substituted a similar bill, H.R. 10, which was then returned to the Senate. The Senate disagreed and went into conference at the end of July 1999. The House instructions to the conference committee, who focused on insuring consumer privacy protections, passed the House with a vote of 241-132. September and October were dedicated to the work of the conference committee, who then filed the conference report to the House and the Senate. The Senate agreed to the conference report with a vote of 90-8; the House passed the report by 362-57. President Clinton signed it on 12 November 1999 as one of his last acts as president.

The discussion above needs expansion to better capture the debate surrounding this act's passage, particularly since neoliberal ideology was prevalent in the debate and both Republicans along with many Democrats used this ideology to justify this act's

passage. An excellent example of the ideological transmission is found in a statement by Laurence Meyer, who was a member of the Federal Reserve Board of Governors, to the U.S. House Committee on the Judiciary in June of 1998. As he briefed the representatives, he proudly noted three trends American banking exhibited at that time:, "Yet those U.S. banks that compete in world markets are consistently the most profitable, and best capitalized in the world, as well as being ranked as the most innovative" (Meyer, 1998, p. 2). His was one of several statements to the committee as they considered an earlier version of the Financial Services Modernization Act that was presented to the House (H.R. 10). Other testimony was given by the Anti-Trust Department of the U.S. Attorney General's office, the Federal Trade Commission, the President of the Independent Bankers Association, the President of the National Wheat Growers Association, the attorney for the Consumer's Union, and a professor of economics from Miami University. Citigroup & Traveler's Insurance, NationsBank & BankAmerica, First Chicago National Bank Corporation, and Banc One Corporation also provided a joint statement.

A quick word analysis of the testimony, which lasted three days and concluded with the Federal Reserve System testimony, resulted in the following word cloud:

Figure 5-C: Word Frequency Cloud from Testimony to United States House Committee on the Judiciary on June 3-6, 1998 Concerning H.R. 10, the Financial Services Modernization Act.

Figure 5-C shows the primary concerns of those giving the testimony centering on mergers, financial competition, competitive markets, and banking. Interestingly, law enforcement, banking stability, and even antitrust (which was the testimony's topic) pales in comparison to the neoliberal ideas found in the center of the cloud. In reading the content, with the exception of the Consumer's Union (who were very concerned about regulating banking if H.R.10 passed), the main message matched the above cloud. This word cloud was created using the same word set as seen in the 1994 analysis; however; there is a significant difference in the frequency of neoliberal verbiage used in the debate. To be fair, unlike in 1994, this bill generated much debate with traditional liberal legislators having many problems with Glass-Steagall's deregulations. The verbiage used by both the Republicans and the pro-deregulation Democrats includes the neoliberal

concept of increasing competitiveness, market-driven dynamics, and market mergers without government interference. Thus, the word cloud above clearly differs from the earlier 1994 version and thus might reflect neoliberalism's growing influence in the Democratic Party. Most of the testimony involved this theme: the bill needed to pass to make American banks more competitive globally by removing Glass-Steagall's artificial walls. The financial institutions, thus freed from government interference, would then be able to innovate and use the financial markets to increase efficiency. This increased efficiency would then assist both the financial stakeholders as well as the consumer, so it would be a win-win bill (Record, 1999). Similar language is found in the National Economic Council's memos sent to the President and referred to previously. Again, they reflect a neoliberalism which undergirded the deregulatory debate and which both Congress and the President seemed to support. This neoliberal ideology directly leads to President Clinton's thinking and thus the need to understand why he signed these two bills.

Section Three: Process Tracing Analysis of President Clinton

President Clinton's quote at the beginning of the chapter, given after the financial crisis of 2009, seemingly indicates he supported strong regulation of banking and did not agree with his old economic advisor, Joseph Stiglitz, that his presidential tenure supported financial deregulation. This section examines this premise by examining the hypotheses stated above using the two legislative actions analyzed in the previous section. In exploring these hypotheses, several types of sources were used. The main sources were books, autobiographies, biographies, scholarly analysis, and journalistic

analysis. For instance, President Clinton's autobiography as well as Hillary Clinton's latest autobiography were used to glean their public thoughts regarding finance. Additionally, several excellent books by Bob Woodward, John Harris, Joe Klein, and Michael Takiff provided a journalistic examination of the Clinton era's policies and politics. Al Form, Robert Reich, and Jeff Connaughton gave more insight in their personal autobiographies from the insiders' perspective of President Clinton's decision making. Supplementing these books were both journalistic and scholarly articles, minutes from the Economic Council of Advisors (1994-1999), Paul Rubin's Congressional testimony, and comments gleaned from the 1994/1999 Congressional Records.[29] The William J. Clinton Presidential Library and Museum provided a wealth of material relating to financial deregulation, including President Clinton's speeches as he signed both bills and, more importantly, internal memos from key advisors giving recommendations about those bills.

As mentioned above, this discussion is far from exhaustive; and a detailed process analysis of President Clinton's administration is worthy of being an independent project. The intent of this analysis is to augment the statistical work done earlier in chapters 3 and 4 as well as to provide a reasonable argument about causality. The latter states neoliberal ideology preceded increased financial deregulation, which in turn increased unequal distribution of market-based income. The sources were carefully chosen to represent both traditional liberalism as well as the pro-business New Democrat movement.

[29] Detailed list of sources are found in Appendix

The first hypothesis is really a simple yes/no question. Did President Clinton support neoliberalism in his actions as president? These actions would have been appointing neoliberal supporters to key economic positions, publically advocating the passing of the 1994 and 1999 financial deregulation bills both directly to Congress and indirectly to the public, and by not vetoing financial deregulatory legislations. If the answer is "yes," then the questions move to the follow-on hypotheses: What were his reasons for supporting neoliberal ideas as they pertained to financial deregulation? The next four hypotheses look at those motives with full knowledge that determining a president's personal motives is very difficult. No one single motive would have driven President Clinton's decision-making, especially in complex decisions such as banking deregulation. Industry pressure, congressional pressure, influential advisors' opinions, partisan considerations, his wife's views, and his idealistic desire to do well for the American people were all considerations as he decided whether to support either one of those bills. Given this difficulty, process-tracing at least provides a reasonable roadmap of his thinking, which, coupled with the statistical analysis conducted on financial deregulation's influences on market-based income inequality, might provide some answers as to why both parties were willing to deregulate the financial sector despite the associated social costs. With these caveats in mind, the first hypothesis is considered since a "no" answer would end this section rather abruptly.

Hypothesis 1: President Clinton believed strongly in the neoliberal economic ideals and wished to enact them through the legislative process in the financial sector.

Supporting both the 1994 and the 1999 banking deregulation bills, President Clinton expressed concern over any degrading of a banking officers' ability to lend to minority or low-income communities (as expressed in the CRA debates); however, he ultimately indicated through his administration officials that he supported both bills (Prins, 2014; Reich, 1997; Rubin, 1999; McLaughlin, 1999; Ferguson, 2010; DeLong & Eichengreen, 2001). This support alone would appear to confirm the first hypothesis. However, just pointing to that fact alone is not enough since political policymaking is a complex phenomenon requiring a more detailed analysis, hence the process-tracing tests below.

The first test is the straw in the wind, which determines if evidence is neither necessary nor sufficient to pass the hypothesis in question, but will slightly weaken any alternate hypothesis. This is, at best, weak support for the primary hypothesis. Before elected president, Clinton was a follower of the "New Democrat" movement as well as the chairman of the Democratic Leadership Council, which represented this way of thinking (Clinton B. , 2004; From, 2013; Woodward, 1994). This Democratic ideology differed from the old New Deal ideology in several significant ways with the strong "pro-business" stance being the one difference that is most pertinent to this hypothesis. In a policy book the Democratic Leadership Council published, two chapters discuss economic leadership with specific policy recommendations embedded in each (Marshall & Schram, 1993). Multiple references use neoliberal ideas such as enhancing global competitiveness with smaller, more efficient government; supporting enlargement of global free trade laws; and creating a more competitive banking system (Marshall &

Schram, 1993; From, 2013). Given President Clinton's obvious connection with and leadership of the Democratic Leadership Council, it is safe to claim this hypothesis passes the first test.

The second test, the hoop test, needs to show a necessary criterion that, however, does not need to be sufficient. Again, the *Mandate for Change* report published by the Democratic Leadership Council contains a strong statement for financial deregulation: "First, President Clinton should seek amendment of the Glass-Steagall Act of 1933 to permit banks to take and exercise long-term ownership positions in smaller, closely held U.S firms" (as cited in Marshall & Schram, 1993, p. 72). This deregulation was restricted to smaller banks and would allow branching as well as acquiring securities/insurance divisions. The recommendation was only a partial amendment of the 1933 Banking Act; regardless, the two provisions were deregulatory in nature. Additionally, the recommendation calls for a five-year repeal of the all capital gains taxes on equity investments for new businesses to enhance capital growth. Both of these neoliberal ideas, while advocated by the Democratic Leadership Council, does not mean President Clinton strongly believed in them. While he was certainly associated with the DLC and used several of their ideas, he did not as president blindly adhere to their doctrine (From, 2013; Woodward, 1994; Harris, 2006; Reich, 1997). The background ideas supported by a significant number of Democrats (including Vice-President Al Gore) are necessary, but not sufficient to support his hypothesis. The alternate hypothesis can still stand since it has not yet been determined if President Clinton's actions showed strong support for these neoliberal financial deregulatory ideas.

The final test is the smoking gun. It is very unusual in social science to go beyond this test, which established criteria that is sufficient, but not necessary to support the given hypothesis. Here the analysis gets somewhat murky. In 1993/1994, President Clinton had other agendas that took priority, such as the NAFTA treaty, reformation of the welfare system, healthcare, and deficit reduction (with the latter being a reluctant priority); therefore, the branching liberalization bill was not emphasized in public communications. Additionally, he had three economic advisory sources consisting of economists, bankers, and other experts who did not necessarily give consistent advice. His Council of Economic Advisors included academics, such as Alan Blinder; Joseph Stiglitz; and the chair, Laura Tyson, all of whom did not subscribe to strict adherence to neoliberal ideals (Treadway, 2001). A 1998 *Financial Times* article noted that President Clinton—normally letting his finance ministers determine fiscal policies— nonetheless listened carefully to both Joseph Stiglitz, who advocated stronger financial regulation, and institutionalist George Soros (Baker, 1998). However, the National Economic Council (NEC), established by President Clinton, had a more important role in advising the president. It was chaired by Robert Rubin, who very much supported domestic financial liberalization (DeLong & Eichengreen, 2001) and who received considerable input from Vice-president Gore and Robert Altman, both supporting the neoliberal concept of financial liberalization and the market's primacy. Finally, the U.S. Treasurer, Lloyd Bentsen, received strong support from Wall Street and was a strong supporter of the market. The same could also be said for the OMB appointments, who were Leon Panetta and Alice Rivlin (Brownstein, 1992).

Based on the above advisory emphasis, which Robert Reich (1997) also confirmed in recounting his time as Labor Secretary for President Clinton, the evidence is sufficient enough to support the first hypothesis that President Clinton did pursue neoliberal financial/banking policies and thus supported them in legislation. A quote from Leon Panetta provides the smoking gun:

> He listened to a lot of people at the table, but the actual decisions usually came from a smaller group. He listened a great deal to what Bentsen had to say, what Gore had to say, what Rubin had to say, as well as myself. (as cited in Takiff, 2010, p.209)

To look a little deeper, when Secretary of the Treasury Robert Rubin testified to the House Committee on Banking and Financial Services on February 1999, he said, "With the lessening of regulatory barriers, financial services firms are offering customers a wide range of financial products…all of which increases competition and thus benefits consumers" (p.1).

Finally, in the signing speech of the 1994 Riegle-Neal Interstate Banking and Efficiency Act, President Clinton stated,

> You already heard people say it will make us stronger economically, it will be better for consumers, it will make us more efficient. It represents another example of our intent to reinvent Government by making it less regulatory and less overreaching and be shrinking it where it ought to be shrunk and reshaping it where it ought to be reshaped (p.2).

This statement in support of banking deregulation using neoliberal justification was then bookended in 1999 by another speech President Clinton gave during the signing of yet another banking deregulatory bill. When signing the Gramm-Leach-Bliley Financial Modernization Bill into law, President Clinton stated,

> You heard Senator Gramm characterize this bill for freedom and free markets. And Congressman LaFalce characterized this bill as a victory for consumer protection. And both of them are right. And I have always believed that one required the other (p.5).

Given these quotes, along with President Clinton's strong public support of NAFTA over the wishes of labor (Reich, 1997), it is reasonable to claim he believed the neoliberal idea of minimal economic regulation and government interference even if his belief did not extend as strongly as the Republican Party would have liked. The next question, asked in the series of hypotheses at the beginning of this chapter, is "Why"? Motivations are always difficult to determine in elite political actors, and President Clinton was a master at dissembling (Harris, 2006).

The next few hypotheses probe the motivations that might have moved President Clinton to support neoliberal deregulation in 1994 and 1998. To reiterate, they are the following:

H1a: President Clinton did not support neoliberal economic ideals and was forced to sign the deregulatory bills due to strong Congressional, public, or financial sector pressure.

H1b: President Clinton supported neoliberal economic ideals mainly to accommodate the Republican Party to gain support for other legislative priorities.

H1c: President Clinton supported neoliberal economic ideals mainly to placate a Congressional mandate from his party supporters, mainly the New Democrats, who wished for them to be enacted.

H1d: President Clinton supported neoliberal economic ideals mainly to placate the financial sector industry, especially Wall Street liberals, who provided the majority of financial support for campaigning.

H1a and H1b both fail to pass the "straw in the wind" test and thus are unlikely to be the President Clinton's primary motives for supporting the deregulatory legislation analyzed above. They are not necessary or sufficient by themselves or even in combination. Evidence against them is fairly strong. Whereas they were more than likely part of the criteria for decision making, based on two very strong indicators, they can't be primary motivators.

First, H1a is the opposite of H1. Since the evidence given above conclusively shows President Clinton supported neoliberal policies pertaining to banking as long as the Community Reinvestment Act was left intact, this hypothesis fails. It is not necessary or sufficient for the hypothesis to pass the straw in the wind test.

Secondly, H1b, President Clinton confronted the Republican Congress to the point of government shut-down in 1995 due to his opposition to Medicare cuts in Newt Gingrich's budget (Takiff, 2010). Even with his adoption of the Republican goal of deficit reduction (which is not solely a neoliberal ideal since Keynesian economics

believes in deficit reduction albeit differently than neoliberals), President Clinton obviously was willing to take a political risk to protect his budgetary objectives. Vetoing either deregulatory financial bill would have carried less political risk; thus, H1b is not supported at all.

H1c passes the first test since President Clinton's adherence to the "New Democrats" pro-business agenda might indicate a willingness to enact legislation they supported, even if Clinton personally did not feel a strong need to sign either bill. Several of his key advisors, including Vice-president Al Gore, were New Democrats and thus were favorably inclined to support deregulatory legislation (From, 2013). In 1993, the Progressive Policy Institute, which served as the "think tank" for the New Democrats, produced a book called *Mandate for Change*. In it, they specifically call for amending the 1933 Glass-Steagall Act to allow commercial banks to acquire "closely held U.S. firms" (Marshall & Schram, 1993, p. 72). Additionally, President Clinton's top economic advisors (especially Larry Summers and Robert Rubin) during his second term strongly favored deregulation and thus were in a position to be key allies with Congressional Democrats who were in favor of deregulation. In his 1996 State of the Union speech, President Clinton said, "I believe our newer, smaller government must work together in an old-fashioned American way…" (as cited in From, 2013, p. 223). Al From interpreted these words as a declaration against big government and traditional Democratic liberalism. However, in both bills, especially in 1994, the New Democrats did not completely dominate the Democratic platform. For example, when the Republican-controlled Congress shut down the government in 1996 over the budget,

President Clinton vetoed two consecutively proposed Republican budgets due to welfare cuts. In the third proposed budget, the Democratic leadership and many in his administration urged Clinton to veto it due to its violation of traditional Democratic ideals regarding welfare. When the DLC urged President Clinton to sign it despite many Congressional Democrats' objections, he did and thus defied the majority of his party. For example, Richard Gephardt, the Democrat Minority Leader, he led about half of the House Democrats to vote against the bill President Clinton would eventually sign (From, 2013). Thus, it would be safe to say that Congressional pressure from the Democrats in both the House and the Senate would not be necessary for President Clinton to push for financial deregulation. Counterfactually, if the Democrats in both 1994 and 1999 had wished to deregulate finance, enough political coverage would have been provided for President Clinton to sign them even if he didn't have a strong desire to do so. Regardless, H1c fails the "hoop test" since President Clinton obviously did not sign bills to placate his party members in Congress or even follow the mandate from the New Democrats. Despite his adherence to much of the New Democrats' way of thinking, as chronicled above, he was certainly not above defying their will (Woodward, 1996; Takiff, 2010). This failure of H1c to pass the testing leaves the last hypothesis to be examined, that President Clinton signed both bills due to pressure from the financial sector, which supported his professional political career.

In President Clinton's 2011 book, *Back to Work: Why We Need Smart Government for a Strong Economy*, he argued the Republican Party's antigovernment campaign is destructive for a host of reasons, including their strong desire to deregulate.

He writes of financial regulations' importance and how lax regulation led to the 2009 financial crisis. Given that politicians can certainly grow and change their viewpoints, this book nonetheless raises the question of why he supported and signed both the 1994 and 1999 financial deregulation bills. As seen above, political pressure from his party, his ideological base (the New Democrats), and the Republicans did not pass the necessary tests of process tracing to be considered a primary cause. H1d, however, remains a very plausible hypothesis since money was badly needed and the Democrats' traditional financial support from labor began to wane as labor unions declined in the late 1980s and in the 1990s (Scheer, 2010; McCarty, Poole, & Rosenthal, 2013).

In a 2001 analysis of the Clinton administration's international financial policies, University of Berkeley economist Brad DeLong noted,

> …was all part of a 'New Democratic' agenda that placed more faith in and emphasis on the private sector—on market forces—than had been true of previous 20th century Democratic administrations. In an era of financial liberalization, this in turn meant relying on financial markets. Symbolic of this commitment was the President's reliance on Robert Rubin. (as cited in DeLong & Eichengreen, 2001, p. 5)

Rubin first served as the head of Clinton's National Economic Council in 1993 and then became his Treasury Secretary in 1995 and served until 1999, when Lawrence Summers (his previous deputy) succeeded him. Before Rubin worked for Clinton, he came up through the ranks of Goldman Sachs to eventually serve as co-CEO. As DeLong pointed out, Rubin's background in the financial securities industry informed his thinking on

domestic financial liberalization; thus, he firm believed in the financial market. This reliance on Rubin is reinforced in multiple accounts, including an analysis from a *Washington Post* columnist, Mary McCrory, writing about Rubin during the Paula Jones' scandal: "It's the Dow Jones, not Paula Jones, that determines his standing" (as cited in Harris, 2006, p. 328). Rubin was considered one of Clinton's pillars; and while not a "friend of Bill" type of insider, he was far more influential than most of Clinton's advisors (Takiff, 2010; DeLong & Eichengreen, 2001; Harris, 2006; Reich, 1997; Scheer, 2010). Thus, the first test, "straw-in-the-wind," is passed since the financial sector's close access to President Clinton is a necessary condition for 1d.

Additionally, the "hoop" test is passed since having this type of access to Wall Street was is a necessary condition for President Clinton to support banking's financial liberalization included in the 1994 and 1999 bills. Without this access and just relying on academia for financial consultation, President Clinton would have risked alienating the very resource base that he relied on for support (Woodward, 1994). Bob Woodward (1994) relayed one example of this concern in his interview with Hillary Clinton about her husband's first major economic speech to the nation on February 15th, 1993. Mentioning the importance of Alan Greenspan's approval of the president's agenda, she also gave three major reasons why she believed that speech was so important. Pleasing Wall Street and the bond market was one of those reasons, reinforcing just how important Wall Street was to President Clinton. The argument can be made that President Clinton's concern had more to do with insuring that his priority, progressive policy of health-care reform, did not become side-tracked due to a large budget deficit or high interest rates

Wall Street set rather than with either believing in neoliberal financial liberalization or placating financial donors (Takiff, 2010). When discussing the initial decision to balance the Federal budget after it had been discovered how large the Federal deficit had become under President Reagan, Joseph Stiglitz commented, "But the deficit-cutting view held sway in the administration…even though I think that President Clinton was never emotionally on that side. I think he became convinced it was necessary as practical politics" (as cited in Takiff, 2010, p. 172). In 1993, Rubin and Greenspan linked financial liberalization with deficit reduction, thus possibly explaining Hillary Clinton's remark above. Thus, while H1d is supported enough to pass the "hoop" test, it still remains to be determined if it can pass the "smoking gun" or the "doubly-decisive" test.

As noted above, Paul Rubin had extraordinary access to President Clinton and served as one of the pillars in the president's understanding of the banking/finance system. In testimony given to the House Committee on Banking and Financial Services on 12 February 1999, Rubin supported the bill (H.R. 10), which later became the Gramm-Leach-Bliley Act with three caveats. One centered on the Community Reinvestment Act and expressed the administration's concern that it remain intact. A minor one concerned the insurance industry and, in essence, asked for status quo on various technical practices. Rubin (1999) expressed the following important caveat:

> …although creating wholesale financial institutions may be an appropriate step, we believe that the developments in financial markets over the last year raise serious concerns. We need to carefully consider the consequences of giving them [wholesale financial institutions] certain of the same benefits of the federal safety

> net for banks- the payment system and discount window, albeit not deposit insurance B while subjecting them to diminished banking regulation. (p.1)

The developments he was referring to in 1998/1999 in the financial market had to do with financial meltdowns in the Asia markets, particularly in Malaysia. As known now, the exact concern Rubin was discussing happened when the 2009 financial crisis required using the federal safety net for the investment banking system, which arose from this bill's passage. These "wholesale financial institutions" failed in a similar fashion to Malaysia with over-leveraging, freezing bank-to-bank credit, and crashing assets (Malaysian currency in 1998 and Mortgage Backed Securities in 2009); "diminished banking regulation" played an important part of that failure. The quote above does, however, create a paradox for H1d. Rubin is understood as having been too sympathetic with Wall Street; yet his testimony, while providing official support for this bill's passage, contained this prescient warning. President Clinton listened carefully to Rubin, who expressed his concern in an official testimony; yet President Clinton signed the bill. Hence the paradox. It is useful to trace the decision making from the first mention of repealing the Glass-Steagall Act to the Rubin testimony seen above.

In contrast to his remarks above, Rubin gave multiple indications that he strongly supported financial deregulation even with the expressed concern about the federal safety net and the new wholesale financial institutions. In a detailed memorandum to the President in 1997, Gene Sperling provided an analysis and a recommendation about repealing Glass-Steagall. In it, he described the concerns of the FDIC and Federal Reserve Board about federal deposit insurances being applied to the new bank-holding

companies' non-bank subsidiaries (such as securities and insurance). Sperling stated in rebuttal,

> …the efficacy of the Treasury's proposal depends on effective, but not overbearing, regulation by the Fed. Politically, the Treasury's proposal provides the Fed with more authority over diversified holding companies than do either the Roukema or D'Amato, but it is unlikely that the Fed will ever be satisfied with a level of regulatory authorities that Treasury believes is limited enough to keep securities and insurance firms support of the legislation. (Sperling, 1997, p. 11).

Sperling was analyzing the Rubin proposal to repeal Glass-Steagall Banking Act with a new piece of legislation called the Financial Modernization Act. The Roukema, D'Amato/Baker proposals looked at totally repealing Glass-Steagall with no restrictions while the unions, consumer organizations, the Independent Bankers Association of America (small banks), and ACORN opposed full repeal. The financial industry's congressional organizations tended to support the full repeal with one notable exception. The American Bankers Association supported the Treasury proposal and eventually the Alliance for Financial Modernization, including all of the financial organizations that earlier had advocated full repeal, decided to support the Treasury proposal.

Earlier in 1995, Bo Cutter wrote a memorandum to the President introducing the idea of repealing Glass-Steagall after the successful deregulation of the interstate branching laws. Rubin, as Treasurer, made this recommendation and needed approval before he testified before the House Banking Committee. Cutter, as the Deputy Assistant to the President for Economic Policy, summarized all the issues surrounding this

proposal, including the strong move from the Republican Party to complete deregulation and the strong opposition from small banks, unions, and consumer groups. According to Cutter (1995), Rubin's proposal was as follows:

> It is therefore critical that the Administration not get too invested in passage of Glass-Steagall reform too early, while simultaneously using our support of reform to strengthen our position with those who would attempt to extract unacceptable terms. With Treasury leading, the Administration walked with fine line last year in getting both community development financial institutions and interstate banking legislation passed. Even with the changes in the Hill, we believe we can do it again (p.2).

Even earlier, in 1993, a series of memoranda that included memos by Lloyd Bentsen (Secretary of the Treasury) and by Rubin (NEC chair) broaching the subject of banking deregulation. Bentsen (1993) began with an alarming discussion of an American banking crisis, "The U.S. banking system is facing secular decline…" and prefaces his memo with a pitch for his proposal which will "…simultaneously delivering benefits to a broad range of consumers and businesses. The approach described in the memo should expand productive lending, helping distressed communities, increase U.S. competitiveness internationally, and improve the financial condition of the industry" (p.1). The memo provides a very detailed account of the various proposals to improve banking, including the Community Reinvestment Act. However, he recommends supporting banking interstate branching consolidation to increase "the safety and soundness of the system" and notes that "…increased efficiency should aid in capital

formation," enabling banks to move investing dollars more efficiently to companies needing those dollars (Bentsen, 1993). Also included in this very technical and detailed memo are multiple recommendations to, in essence, repeal the Glass-Steagall Act. For example,

> We recommend that we tell the Fed that we would support a technical regulatory change that would modestly expand the opportunities for banking organizations to engage in underwriting activities under existing law… [and] …we recommend that the Administration support on public-interest grounds the notion that banks ought to be allowed to continue to sell insurance as current law permits and work to develop further the idea of insurance sales by banks in and from inner cities. (Bentsen, 1993, p.8).

In other words, the Secretary of the Treasurer was recommending to President Clinton that banks be permitted to branch out of state and that they be allowed to underwrite securities and sell insurance. These are the major deregulatory actions found in the two bills the President Clinton eventually signed in 1994 and 1999 and publicly supported in the signing speeches.

This memoranda shows a cautious move to repeal Glass-Steagall that began in 1993. This move used neoliberal ideology, such as increased efficiencies, economy of scale, increased competitiveness and deregulation, to create a better financial system for enhancing consumer and business opportunities. As the above series of internal memorandums show, critical elite actors in President Clinton's administration supported these actions. Also, the financial industry organizations eventually began to support the

administrations' proposals as deregulation's specifics began to move more towards more deregulation rather than less. Finally, the culmination is President Clinton's praising the passage of both bills during the signing speeches. However, while these memos seem to provide necessary and sufficient support for H1d, there is still a lingering question of whether President Clinton's deregulatory support extended beyond banking.

Jeff Connaughton, a staffer working as an assistant in the President's Office of the Counsel, wrote about an incident in 1995. Senator Frank Dodd, who was then the Democratic National Committee's chair, proposed a bill that would weaken the SEC's ability to prosecute securities fraud. This bill was opposed by President Clinton who acted on the advice of his staff, including Connaughton, on the grounds it would undercut the SEC director, who also opposed it. The securities industry fiercely lobbied against this presidential opposition. . Despite pressure from Wall Street, however, President Clinton vetoed the bill. The veto went back to the Senate, where it was overridden with significant Democratic support, including that of Senator Ted Kennedy. As Connaughton (2012) noted,

> Some have speculated that Clinton wanted to have it both ways: he vetoed the bill, but also signaled to Dodd that he wouldn't be overly displeased if two-thirds of Congress voted to over-ride it. I don't know whether if that's true or false. Regardless, that's exactly what happened. (p.109)

A *Washington Post* article at that time provided the following analysis:

> The securities bill forced Clinton to choose between two constituencies that supported him in 1992: trial lawyers who oppose litigation curbs and high-tech

> entrepreneurs, who complain they are particularly vulnerable to meritless lawsuits. His veto satisfied one side and 'the other side went away happy because they got their bill' observed Sen. John B. Breaux (D-La). (Dewar, 1995, p. 2).

The banking industry supported the high-tech entrepreneurs (Connaughton, 2012); thus, they were part of the intense lobbying to override the presidential veto. This "threading the needle" displayed by President Clinton might have been deliberate or accidental.

The *Washington Post article* also claimed President Clinton called legislators who were undecided or changing their vote only to find Senator Dodd had already done so and secured their vote. The White House's statement that President Clinton had called to ask lawmakers to support the veto showed a powerless president with his own party or a president who did not try very hard. Assuming that President Clinton did have the political power to thwart an override of this particular bill, then the financial industry seemingly had an enormous influence on his decision-making. Connaughton left the administration soon after this incident, but still worked in Washington D.C. as a financial lobbyist and then as an assistant to Joe Biden's replacement in the Senate. As such, he was still able to provide insight into President Clinton's stance on financial deregulation and thus strongly believed that Wall Street "captured" the White House during Clinton's second administration.

The financial sector's influence is necessary for H1d since congressional pressure would not have been enough by itself to move President Clinton to adopt a particular course of action. It is also sufficient since, given the assumption above, the financial industry would have been able to strongly influence policy outcomes related to their

interests. Given the above analysis with both banking and securities, it is reasonable to grant H1d the final status of a "smoking gun" hypothesis. This stance does not mean it stands alone without any doubts as to its causality, but merely that it is strongly supported by the evidence while the alternate hypotheses are weakly supported.

This process-tracing analysis leaves the following conclusion: President Clinton permitted strong influences from the financial industry, either through his staff—such as Paul Rubin, Larry Summers, Gene Sperling (or even his first Treasurer, Lloyd Bentsen)—or through the financial sector's lobbying efforts, to mold his final policies related to finance. However, as noted above, he was not above defying Congress, the New Democrats, or any lobby if he personally believed a course of action was correct. While being very pragmatic in governing, he also had lines he would not cross. Therefore, this study argues that he permitted this influence for multiple reasons, but mainly because he believed a more deregulated financial sector was ultimately best for Americans. As seen with the economic language's evolution from 1994 to 1999, the neoliberal narrative slowly became more dominant in with both parties. In their manifestos, The New Democrats were very clear that being more pro-business meant following many of the neoliberal ideas, including the idea of a smaller government, which meant a smaller regulatory footprint in the financial sector. While holding on to several key traditional liberal ideas, such as education and health care reform, President Clinton generally bought into the New Democrats' ideal of a smaller government that was pro-market. Along with Greenspan, Rubin believed the financial sector needed some government control (according to the quote above), but also strongly believed that control

should be lightly applied. President Clinton later backtracked on some of his earlier notions of allowing the financial markets to be less regulated as seen with the quote at the beginning of the chapter as well as with his later statements after the 2009 financial crisis. This backtracking does not detract from the argument that in the mid- to-late 1990s, President Clinton and his influential financial advisors believed the neoliberal argument of a smaller governmental footprint in the market. This smaller footprint translated into liberalization of the New Deal's financial regulations found in both bureaucracy and legislation.

To provide an ancillary analysis of financial deregulation, this chapter used two qualitative techniques: market-based income inequality and partisan politics. The first few sections provided a thick description of legislation that deregulated the commercial and investment banking industry. The two bills, later laws that were analyzed, were key to forming the current banking system as well as to creating the financial crisis of 2009. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 and the Gramm-Leach-Bliley Act of 1999 both enabled the creation of the "too big to fail" banking systems existing today (Admati & Hellwig, 2013; Calabria, 2009; Groton, 2009; Guillen & Suarez, 2010; Johnson & Kwak, 2010; Prins, 2014; Sherman, 2009). Based on the process trace's results, the following seem clear: 1) President Clinton supported the neoliberal deregulatory stance that resulted in passing the two key bills mentioned above and 2) President Clinton, for various reasons, gave an enormous amount of influence to the financial industry, especially the banking sector, resulting in his adopting the neoliberal concept of financial deregulation to create a smaller government presence in

the financial market. As seen with the statistical analysis, this financial deregulation was partially responsible for market-based income's unequal distribution with income concentrating in the top deciles. This process trace also reinforces the narrative that after 1980, the Republican and Democrat Parties converged in terms of financial legislation, resulting in the policy outcomes discussed above. While this process trace ended with the election of President George W. Bush in 1999, President Obama's first administration used many of the same financial elites, such as Larry Summers and Paul Rubin, found in President Clinton's administration (Suskind, 2011). As the Frank-Dodd Act of 2010 slowly unfolds, it would be interesting to conduct a similar analysis of President Obama's first and second administrations.

Chapter 6

Conclusion

"The things that will destroy America are prosperity at any price, peace at any price, and safety first instead of duty first and love of soft living and the get-rich-quick theory of life."

Theodore Roosevelt, 1910

"Wall Street owns the country. It is no longer a government of the people, by the people, and for the people, but a government of Wall Street, by Wall Street, and for Wall Street."

Mary Lease, 1890

"When life itself seems lunatic, who knows where madness lies? Perhaps too much practical is madness. To surrender dreams—this may be madness. Too much sanity may be madness—and maddest of it all: to see life as it is, and not as it should be!"

Miguel de Cervantes Saavedra, *Don Quixote,* 1605

In 1890, during the height of the Gilded Age, the Farmer's Alliance ran a series of political campaigns, eventually leading to the formation of the Populist Party of 1892 and to well-known reformer Mary Lease giving speech after angry speech expounding on her quote above (Goodwin, 2013). Considering Lincoln's words at the beginning of chapter one, Lease's words are fitting to conclude this study. As this dissertation was written (December 2014), Congress passed a budget changing the Frank-Dodd Act of 2010 to enable "mega-banks" created from the Glass-Steagall Act's repeal to do derivative trading with FDIC insured funds (O'Keefe, 2014). At times, it seems that money will always make the rules, the market will always be rigged, and the moneychangers will never be driven from the temple. Yet Cervantes' quote above provides the final context for this project. Throughout this study, the objective has been to pragmatically and

realistically portray why market-based income inequality rose to such a dramatic height after falling, for a time, from a high precipice. Using both carefully compiled data as well as historical narrative, this study has attempted to reveal the reasons and the consequences of this political (a word carefully chosen) phenomenon, to see life as it is. However, Cervantes's plea doesn't need to stop there.

An unspoken (and explicit) norm among political scientists is that we (to boldly include this writer in their number) must always be objective and never normative. To paraphrase Cervantes, that we should see life as it is and not as it should be, is the height of insanity. That is not to say political scientists do not have values or write normative missives; in fact, many of the books read for this study cried out for fairer political outcomes far better than this writer ever could. This writer now join with those ranks by following the rest of Cervantes' statement: to look at life as it should be. What is the answer to this savage market-based income inequality? Better policies? Reducing governmental market restraints? Social Democracy or Conservative Republicanism? While this chapter does not provide definitive answers to this question and might leave the reader frustrated, some normative truths can be derived from this research.

Ideology both blinds and illuminates. The process-tracing of Clinton's administration shows a Democratic and Republican leadership that deeply cared for the poorer members of our society and truly believed that unfettered markets would bring a new prosperity benefiting all Americans. The neoliberal ideology illuminated its claims' benefits: free trade enables prices to be reduced for some consumers; free flow of capital enables investors to help the economy grow; deregulation produces financial efficiency.

Politicians stated those benefits many times as they deregulated financial legislation. Yet the same illumination blinded them to neoliberalism's darker side: free trade produces losers who suffer; free flow of capital creates speculation and financial crises; financial deregulation contributed greatly to income inequality; and the United States' political system closely resembles a plutocracy. Not that Keynesian adherents are exempt from the same phenomenon. The 1970s stagflation, which brought neoliberalism to the forefront, originated from the same ideological blindness that believed in the ability of "fine tuning" the macro economy with combined fiscal and monetary policies that would maintain full employment while not creating high inflation. Regardless of this reality, ideas matter a great deal. Economic ideology is unavoidable since it guides policy making and bureaucratic activity; as Keynes said, "Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist" (1936, p.241). Thus, we are ideologues in economic decision making in one sense with all the perceptual bias that comes with cognitions shaped by unconscious ideas. Yet awareness of this reality provides the potential of overcoming its inherent tendency to blind policymakers since it calls for an ability to transcend these blinders with logical and comprehensive analysis.

To quote another economic reformer, this time from the political world, Theodore Roosevelt thundered in 1910 to Americans what he believed to be the central issue to their economic well-being. In a speech called "the New Nationalism," Roosevelt defined his role as "the executive power as the steward of public welfare," emphasizing that the system the United States' political structure at that time needed to be "changed so as to

work for a more substantial equality of opportunity and of reward for equally good service" (as cited in Goodwin, 2013, p. 644). This goal stays the same from the beginning of the 20th century to the beginning of the 21st century. In December 2014, the Pew Research Center published a report about wealth distribution in America which concluded "…the gap between America's upper-income and middle-income families has reached its highest level on record" (as cited in Fry & Kochhar, 2014). To be fair, the research used data beginning in 1983, so the Gilded Age is not part of this research. Yet, based on what has been shown earlier in this study, America is approaching, if is not already there, the Gilded Age of inequality. The 2009 crash closed the inequality gap, but it is rapidly widening again and soon with surpass its previous record in the 21st century. It is as if Teddy Roosevelt and the progressive movement never existed, as if trust-busting and muck-racking never happened, at least in terms of market-based income inequality. While America obviously has social structures supporting its citizenry that are far more robust than at the turn of the 20th century and labor has far more protections now than in the first Gilded Age, relative inequality is as strong now as it was then. America has come full circle such that once again, normative political science is needed to redress what many would consider an unfair and severe inequality in wealth and income (McCall, 2013).

Thus, what should Americans' economic life be like? Before that question can be answered, further research is needed in several areas to help illuminate the path ahead. Returning to the financial river metaphor, there still are unknown rapids and obstacles that need to be navigated, as well as the ever-present fog that continues making social-

science prediction so perilous. Regarding this project, two areas should be explored in much greater depth. The first concerns measuring bureaucracy's effect on market income, and the second involves partisanship after 1980 when both parties appeared to converge to produce financial (especially banking) policy outcomes, thus increasing market-based income inequality.

The metric used in this study to measure the Federal Reserve System's and the Securities Exchange Commission's effects on the financial market were crude to say the least. By creating ratios of total commercial banking deposits (for example, with the Federal Reserve's number of full-time employees or total real expenses), a rough sketch of the Fed's impact on regulating the banking environment was captured. However, the FOMC's actions, a given FED chair's periodic statements, the macroeconomic context, and a whole host of other variables are potentially far more precise than the ones used in this study,. Accurately measuring a government agency's impact on the open market may be extremely difficult, but not impossible. Further research should be conducted by combining content analysis with time-series statistical analysis to produce a reasonably valid and reliable metric. Specifically, contextual analysis could be conducted on documents produced by a particular agency, coding them according to classic liberal or neoliberal economic terminology and assigning a quantitative value to that coding's results. Depending on the documentation's complexity, these values could then be used to create a more precise measure of neoliberal influence in a governmental financial bureaucracy. Matching the results with the current deregulatory metric that were used in this study of market-based income inequality would be useful. If the cruder measures

used here are any indication, the more a regulatory agency uses neoliberal terminology to describe its activities, the less that agency is inclined to adjudicate a financial action in the open market. Again, using the SEC as an example, the values produced from the process above should correlate with the number of investigations opened in a given year. Thus, one of the SEC ratios created in this study, which used total stock value of all exchanges divided by the number of opened investigations, should correlate with elite SEC actors' classic liberal/neoliberal usage. This time-consuming project would be a long-range one, but potentially could illuminate the impact of the government on financial markets through agencies that work its political will. This research goal leads to the second research stream that needs further work.

The process-tracing in this study was not a "stand alone" endeavor, but was designed to support the quantitative analysis conducted with the time-series work. However, the process-trace is worth further expanding, not only in the number of sources used (for instance, expanding the search in the William J. Clinton Presidential Library) but also in the timeframe to include the Obama administration. The former would involve a prolonged stay in Little Rock, Arkansas, to study all the non-digital documentation pertaining to President Clinton's financial actions and thoughts while the latter would involve a detailed, real-time study of President Obama's first administration, if not the second, after January 2017. The pattern between the two presidents is striking. Both inherited troubled economies (Clinton with the dot.com crisis and large deficit, Obama with the Great Recession and large deficit). Both were pragmatic leaders who used Wall Street for both advice and personnel in managing the financial sector from the

government's perspective. Both had "take no prisoners" Republican opposition, which influenced regulatory decision making. Finally, both managed to improve the macroeconomic indicators without seeing a large, if any, decrease in market-based income inequality. Process-tracing would assist in understanding why those patterns exist.

Two areas needing further exploration are just the beginnings of understanding this complex dance of finance: market-based income inequality and partisanship. Old assumptions, such as Democrats support labor and unions while Republicans support capital and management, are no longer useful. The New Deal regulatory framework for banking and securities no longer exists as written and the legislation that replaced it is more fragmented and complex. The financial industry itself has not only grown in proportion to the overall GDP but also has become far more complex than President Franklin Roosevelt could imagine. Shadow banking, international trade agreements, Basel banking laws, and internet finance's strong dynamics all create a financial market Glass-Steagall's framers could not visualize. However, to continue the river metaphor introduced in chapter one, there are navigation assists that can help the government move its people downstream in finance's unruly waters.

This project, with its intense focus on just one potential cause of market inequality— financial deregulation— seems to offer few answers. However, the one finding that provides some idea of redressing this savage inequality is found in this study's two theoretical explorations: power resource theory and ideology's power. As neoliberal ideology began to spread in America's narrative, it became acceptable for the

very wealthy to increase their wealth at others' expense. The neoliberal narrative of small government, few social supports, deregulation, and privatization completely empowered the wealthy to enact political policies that benefited themselves. The dominant narrative provided the needed justification, so much so that even the Democratic Party of the 1990s and early 2000s used those policies as they deregulated finance. This narrative must be transformed. The unintended consequences, as seen in chapter four, of increased market inequality with increased legislative deregulation and decreased watchdog bureaucratic activity are too dangerous to our society for that narrative to remain unaltered. However, it must be noted that the Keynesian economy preceding the neoliberal era also created stagflation with its staggering effect on the working poor and middle class.

Thus, a new narrative is needed, but not one that destroys the very village it is trying to save: a narrative balancing the resources available to both labor and capital without giving one or the other too many advantages in the economic tug-of-war, a narrative effectively regulating banking and other financial institutions while enabling them to innovate and fulfill their societal function of insuring capital efficiently moves where it provides the greatest good for all of society. This proposed narrative sounds utopian and delusional, as though advocating tilting at windmills with the belief they really are giants to be conquered. Don Quixote may be inspirational, but the windmill's blades still knocked him head over heels off his donkey—just as the United States has been over the centuries as it has searched for the right mix of government regulation of finance and capitalism.

Finance must be regulated. Banking, securities, insurance, and real estate are all too powerful and too important to permit an imperfect market to dictate who should get what. Yet, finance must also be free from unreasoned constraints and/or requirements. Innovations can be useful, and capital must flow to those who will use it to create and grow businesses. Consumers need affordable and trustworthy banking; and to a certain degree, the market helps provide this benefit. However, a unfettered free market, like Frankenstein's monster, destroys households and businesses as Americans discovered to their dismay in 2009. As the Frank-Dodd Act of 2010 continues to be shaped by politicians with both financial lobbyists and consumer advocates shouting to be heard, remembering some of this study's basic lessons is important.

Deregulated finance does tend to produce a steeper market-based income inequality as an unintended consequence (to give politicians the benefit of the doubt). This study not only showed this correlation, but also determined the cause-effect using both statistical and process-tracing techniques. Both parties were captured by neoliberal economic thinking, meaning income inequality increased without political hindrance, even after the Great Recession. Neoliberal ideas applied to regulating finance, as just mentioned, increased income concentration for the very wealthy. Hence, prudently regulating finance should produce the opposite effect.

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Appendix

Appendix 1: Stationary Tests for All Variables

Variable	KPSS Test	Dicky-Fuller Test	Conclusion
Top .01% Market Income	1.62***	-2.513	Integrated
Top 5% Market Income	1.99***	-1.144	Integrated
Bottom 90% Market Income	1.97**	-0.649	Integrated
Federal Reserve (FED) Ratios Average	.358***	-7.124***	Mixed Results
SEC Ratios Average	.306***	-2.255	Integrated
Bureaucracy (FED + SEC)	.399***	-1.095	Integrated
Legislative Financial Deregulation	1.95**	-0.461	Integrated
Federal Leg. Financial Deregulation	1.69**	-1.497	Integrated
State Branching Financial Deregulation	1.81**	1.247	Integrated
Union Density	1.76**	-1.370	Integrated
Federal Long-Term Interest Rate	1.1	-1.065	Mixed Results
Maximum Capital Gains Tax	.863***	-0.0086**	Mixed Results
Top Marginal Income Tax	1.5***	-2.231	Integrated
Trade Openness	1.49**	-0.025	Integrated
% Earned Bachelor's Degree	.48***	1.69	Integrated
% Over Age 65	1.37***	-0.499	Integrated
Finance Sector % of Total GDP	1.56**	-0.8371	Integrated
Private Wealth Concentration	1.83***	2.003	Integrated
Dow Jones Industrial Average (2005)	.988***	-0.1	Integrated
Shiller Price & Earnings Ratio	.445***	-2.298	Integrated
S & P Yield	.36***	-1.981	Integrated
Total Commercial Bank Deposits	.517***	2.452	Integrated
Total Commercial Bank Assets	1.52***	5.245	Integrated
Total Stock Value (all exchanges)	.305***	-1.973	Integrated
Inflation	.527***	-4.568***	Mixed Results
Unemployment	.414***	-2.403	Integrated
Natural Log of GDP (2005)	.923***	-1.033	Integrated
Natural Log of GDP per cap (2005)	.682***	-0.918	Integrated
Real Financial Sector Wage	1.8***	-0.079	Integrated
Total FED expenses (2012)	.673***	4.909	Integrated
FED Full-Time Employees (FTE)	1.28***	-3.46**	Mixed Results
Total FDIC Banks	1.43***	2.602	Integrated

Appendix 1 continued

Variable	KPSS Test	Dicky-Fuller Test	Conclusion
Total Com. Bank Assets/FED FTE + Total Com. Bank Assets/Fed expenses (BAFEDAVG)	1.28***	-3.46**	Mixed Results
Total Commercial Bank Assets/FED FTE	1.28***	-3.46**	Mixed Results
Total Commercial Bank Deposits/FED FTE	.894***	6.665***	Mixed Results
Total Commercial Bank Deposits/FED Expenses	.358***	-5.539***	Mixed Results
Total SEC Average (PER+OPEN+REG	.717***	-0.923	Integrated
DJIA Returns	.0337	-10.810***	Stationary
Total Brokers Registered w/SEC	.505***	-1.657	Integrated
Total SEC investigations opened	.686***	-2.052	Integrated
SEC Full-Time Employees (FTE)	1.27***	-0.409	Integrated
Total Stock Value/SEC Opened Cases (1)	.315***	-2.275	Integrated
Total Stock Value/SEC FTE (2)	.337***	-2.175	Integrated
Total Stock Value/ Brokers Registered w/SEC (3)	.275***	-2.340	Integrated

Appendix 2
Node Analysis Key Words for the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 and the Gramm-Leach-Bliley Financial Modernization Act of 1999

U.S. State Authority	Neoliberalism	Consumer Protection	Banking Supervision	Banking Stability
-Taxation	-competition	-closing	-antitrust	-adequately
-permit	-consolidation	-consumer	-assurances	-capitalized
-Nonmember	-mergers	-communities	-compliance	-capital
-intrastate	-modernizing	-help	-comply	-danger
-existing state	-opportunities	-homestead	-enforcement	-practices
-preempts	-promote	-loans	-examinations	-safe
	-competitive	-moderate	-proceedings	-uninsured
	-efficiency	-protect	-register	-unsafe
	-credit increase	-protection	-requirement	-unsound
	-permissible	-income limits	-responsible	-risk
	-profits	-equal opportunity	-regulated	
	-interstate	-rights	-regulation	
	-acquiring		-requirement	
	-branching		-standard	
	-economic		-supervisory	
	-foreign bank		-prohibited	
	-subsidiaries			
	-unfair			
	-limiting			
	-permit			
	-permitted			

Vita

Chaplain (Lieutenant Colonel) Eric Reed Keller (retired) served 24 years as a U.S. Army chaplain before retiring in 2008. He worked as a battalion and brigade chaplain, an Observer/Controller at the Combat Maneuver Training Center, Family Life chaplain, instructor/Officer in Charge of Officer Training at the U.S. Army Chaplain Center and School, and finally as an action officer in operations/strategy at the Chief of Chaplain's office in the Pentagon. Before active duty, he served as a pastor in a rural parish after ordination in the Presbyterian, USA church. He briefly served in the U.S. Air Force as a navigator before attending seminary at San Francisco Theological Seminary at Berkeley, California.

His schooling includes a BA in Psychology/Anthropology from Indiana University of Pennsylvania in 1976, a Masters of Divinity from San Francisco Theological Seminary in 1984, a Master's of Science in Human Development and Family Studies from Kansas State University and a Masters of Military Arts and Science from the U.S. Army Command and General Officer School in Leavenworth, Kansas.

He is married to Dr. Diane Petrilla, M.D. after a previous marriage to Diane Lowery Keller. He has two children, Erika and Joshua. He and Diane live in Oak Ridge, Tennessee and both love to hike, read, and take care of their collie.