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Politics and Income Distribution

We take a closer look at how political reforms affect labor's share of national income.

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Macroeconomic policy is typically tasked with stabilizing the economy to soften the effects of downturns, and with providing an environment that allows for sustained economic growth. But, as the recent debate about the role of monetary policy and economic inequality shows, macroeconomic policy can also affect inequality, and policymakers may wish to take this into account.[1]

In this article, we focus on one aspect of inequality: how income is split between capital and labor. Labor income includes wages and salaries, but also various benefits paid for by employers. Capital income is all nonlabor income: pure profits as well as rent paid for the use of capital.[2] Because capital ownership is concentrated, the division of income between capital and labor also affects income inequality.[3] We focus on the capital share, because capital share data, unlike other measures of inequality, are available in many countries over long periods of time. Moreover, the capital share of income is crucial for the incentives of investors: A drop in the capital share can lower profits even when overall income rises.

In line with the general idea that policy can affect inequality, we document that the political process is an important driver of the distribution of income between capital and labor. Sometimes, policies are targeted to redistribute income. Examples include changes to the minimum wage or collective bargaining rules. Other policies may redistribute income inadvertently,

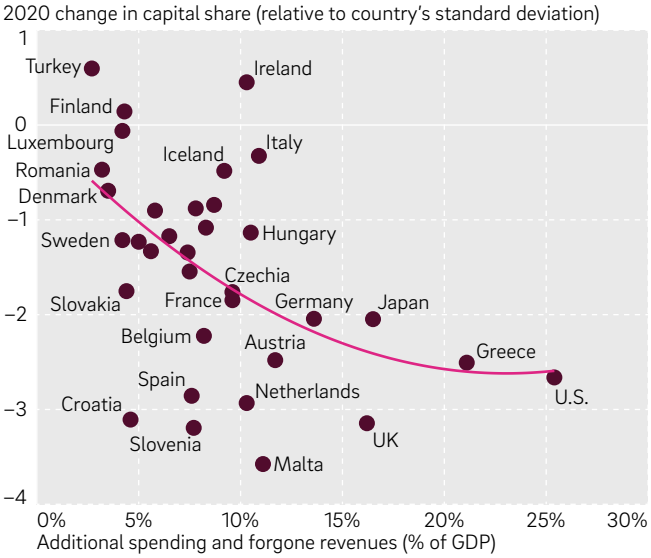
perhaps as a side effect of big policy interventions. To illustrate the idea that big policy interventions often redistribute income, it is natural to turn to the largest government interventions in recent history: The fiscal policy response to the COVID-19 pandemic.

Each country's fiscal policy response to the pandemic was designed to stabilize that country's economy, but these responses also redistributed income between capital and labor, probably inadvertently. Countries around the world responded to the pandemic with fiscal policy interventions on an unprecedented scale, as documented by the International Monetary Fund (IMF).[4] Even if we exclude unconventional fiscal policies with unclear costs such as credit guarantees,[5] many advanced economies spent more than 5 percent of gross domestic product (GDP) on additional spending or forgone revenue, with the U.S. spending as much as 25 percent of GDP (Figure 1). This spending has also been associated with sizable decreases in the capital share of income—that is, the fraction of national income that is compensation for capital.[6] In the U.S., the capital share in 2020 fell by 2.7 standard deviations—that is, it fell 2.7 times as much as the size of a typical one-year change in the capital share in the U.S. Romania, which spent 3 percent of GDP on fiscal policy interventions, saw its capital share decrease by only 0.5 standard deviation. On average, a country that had 10 percent higher spending relative to GDP had a capital share in 2020 that was 0.25 standard deviation lower. Cross-country variation in fiscal policies explains 26 percent of the cross-country variation in the change in the capital share.

FIGURE 1

Larger Fiscal Policy Responses to COVID-19 Were Associated with Larger Declines in Capital's Share of Income

Size of conventional fiscal stimulus in 2020 and changes in capital shares across countries



Source: IMF Fiscal Affairs Department (2021), AMECO (2021), authors' calculations.

Note: On average, a country that had 10 percent higher spending relative to GDP had a capital share in 2020 that was 0.25 standard deviation lower.

To understand the relationship between the political process and the distribution of income beyond the COVID-19 pandemic, we analyzed policy changes across several decades and countries. We paid particular attention to policy changes that have likely been "big," such as those following internal political transitions after coups or democratizations. Depending on the market structure, it is not always clear how policies could affect the labor share. In our mind, the labor market can be thought of as a frictional market—as opposed to a spot market, such as the stock exchange. Firms search for workers, and workers search for jobs. When they are matched, they bargain over the wage. Not all macroeconomic models allow policy to affect factor shares. For example, in the work of economists Philippe Aghion, Ufuk Akcigit, and Jesús Fernández-Villaverde, the capital share is given, and policies that are redistributive in other environments affect only the size of the pie, not its distribution. In contrast, in models with wage bargaining, many policies can be redistributive if they shift the effective bargaining power of workers relative to firms.[7]

In the first part of this article, we provide historical case studies for three countries. For each country, we examine how politics has affected the distribution of income to capital and labor since the end of World War II. In the second part of the article, we examine how changes in laws and regulations have affected the capital share of a large panel of countries since 1970. Third, we look further back to summarize related research on political and social forces that influence the capital share of income. We also provide additional details for the U.S. economy.

Historical Case Studies

Big policy interventions often trigger income redistribution. For instance, a common event after a coup, a democratic transition, or a party system realignment is a thorough modification of labor market regulations and rapid changes in the capital income share.

Each of our three case studies illustrates significant redistribution of income that can accompany big momentous political change (Figure 2). Each panel shows the evolution of the gross capital share in one country over time, along with vertical lines that mark major political events. To show that this phenomenon affects countries with different levels of income per capita, we selected one rich economy (France), one upper-middle-income economy (Portugal), and one lower-middle-income economy (Argentina). Each of these three countries underwent large political changes during our time of study. Although we did not conduct a formal econometric assessment, all three cases show that major political shifts immediately precede major shifts in the income distribution between labor and capital. This is consistent with the notion that economic policy can materially affect the income distribution.

Our first case study is France. After the big strikes of 1968, successive French governments introduced ambitious prolabor measures.[8] The capital income share declined continuously during this period, falling from a historically high 40 percent to around 24 percent at the beginning of the 1980s. This process culminated in 1981 when François Mitterrand was elected as the first socialist president of the Fifth Republic on a left-wing platform. We see the capital share fall slightly after his election.

The worsening economic conditions forced Mitterrand to appoint Laurent Fabius as his new prime minister in July 1984, drop his alliance with the French Communist Party, and inaugurate an era of more market-friendly policies, a focus on price stability, and wage moderation. After that change, the capital share of income grew.

Our second case study is Portugal. After the Carnation Revolution on April 25, 1974, in which a military coup ended the authoritarian Estado Novo (New State) regime, the capital share fell precipitously, dropping by 20 percentage points in a matter of months. The Carnation Revolution was followed by the Processo Revolucionário em Curso (the Ongoing Revolutionary Process), which saw widespread nationalizations, aggressive land reform, and a new collective-bargaining environment that favored workers. After the failed procommunist coup of November 25, 1975, and the return to more market-friendly policies that followed the democratic normalization, the capital income share quickly recovered (without ever reaching the levels seen during the rule of the Estado Novo).

Our third case study is Argentina. The principal political events were the coups against Juan and Isabel Perón on September 16, 1955 (the Revolución Libertadora, or Liberating Revolution), and on March 24, 1976, and the beginning of the current democratic era in 1983. According to the Peronist movement's anthem, the "Marcha Peronista," Juan Perón won over the people by fighting capital.[9] In contrast, both coups brought considerably more business-friendly governments to power, and these governments instituted anti-labor-union policies. The capital share of income clearly increases thereafter. After its defeat in the Falklands War (1982), the military called for general elections that led to the presidency of Raúl Alfonsín beginning on December 10, 1983, and a subsequent drop in the capital share.

Labor Regulation and Capital Shares

These case studies suggest that political changes are often followed by a redistribution of income between capital and labor, particularly via changes to labor regulation. But is this true more broadly? And through which channel do political events affect the capital share?

To address these questions, we turn to a panel data set that covers more than 100 countries. Although one could identify several mechanisms (such as fiscal and monetary policy, or competition policy) that link policy and income distribution, one channel in particular directly impacts income shares: changes in labor regulation. We thus use data on labor regulation, capital shares, and the timing of coups or democratic transitions for our systematic statistical analysis of politics and labor share changes.

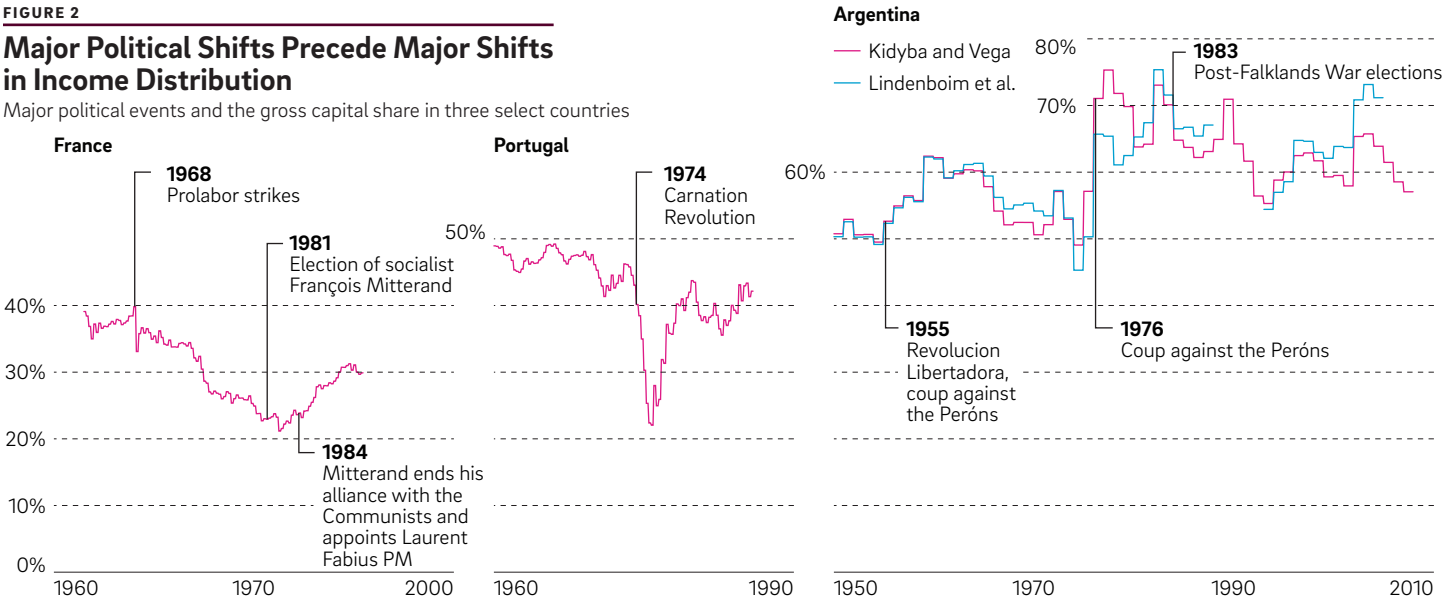
We use data from a group of legal scholars to measure labor regulation.[10] The data set contains 40 separate indicators covering five areas: the definition of employment, working time, dismissals, employee representation, and collective action. Some indicators are binary, some ordinal, and others cardinal. Each indicator measures the degree of worker protection on a scale from zero to one. We use a simple average of the different indicators to summarize the stance of labor regulation, with a higher value corresponding to higher worker protection. The measure is designed to cover both statutory and case law.[11]

To systematically capture major political events, we focus on successful coups and democratic transitions. These types of events are often dictated by exogenous shocks such as wars, internal conflicts, or the death of political leaders. Changes in labor regulation that happen around these political events are thus less likely to be triggered by economic downturns or other economic changes that could impact the labor share of income directly and thus distort our analysis.[12] We then look at transitions between

FIGURE 2

Major Political Shifts Precede Major Shifts in Income Distribution

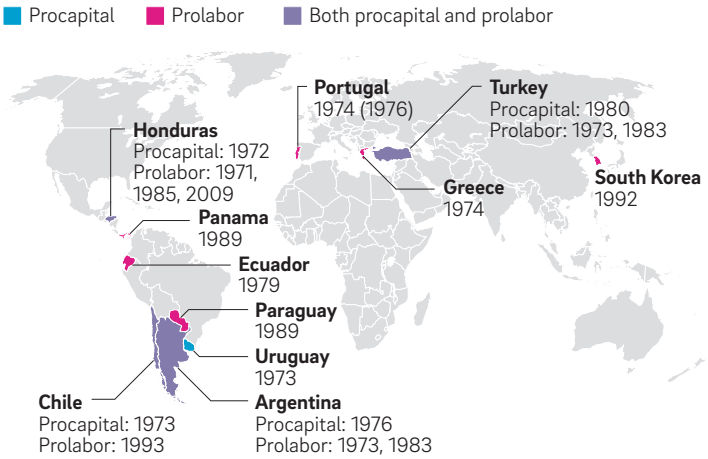
Major political events and the gross capital share in three select countries



Source: For Argentina, estimates are from Lindenboim et al. (2005) and Kidyba and Vega (2015). For France and Portugal, data are from the Organisation for Economic Co-operation and Development (2008).

FIGURE 3

Political Events Used as Predictors for Labor Regulation Changes



Source: Authors' classification.

a coup regime and a democratic regime. Our hypothesis is that a democratic transition tends to favor labor (as most voters are wage-income earners).[13] We can thus assemble a list of political events as computed by our algorithm for the Organisation for Economic Co-operation and Development (OECD) countries, and for Latin American countries for which we have good data on income shares and labor regulations (Figure 3).

We can now combine data on labor regulation and political events with data on changes in the capital share. We focus on cumulative three-year changes following the political event,[14] and we plot changes in the labor regulation against changes in the capital share (Figure 4a). We standardize the labor share change to ease interpretation. One standard deviation is a sizable change in worker protection. Just one example, which stands out in our findings: In 1975, Argentina's worker protections declined by 4 standard deviations (according to the simple average of the different legal measures) and its gross capital share increased by 20 percentage points.

We then focus our attention on data at the time of political transitions. When we chart capital share changes and labor regulation changes after coups and democratic transitions, we see that labor regulation weakly falls in all coups. In turn, democratic transitions mostly correlate with stronger worker protection and a decline in capital shares (Figure 4b). Uruguay is a clarifying example of how we separate observations. In our analysis of labor regulation changes, we include observations for this country for 1972 and 1973. In 1972, Juan María Bordaberry became president of Uruguay and initiated an aggressively conservative policy. However, Bordaberry's accession to power was democratic and is thus excluded from our analysis of any political event. In comparison, on June 27, 1973, Bordaberry closed the parliament and inaugurated a civic-military dictatorship that repressed trade unions and jailed many of their leaders. We code 1973 as a coup.

To help interpret our data, we use regression analysis. One regression technique, ordinary least squares (OLS), finds the line that best predicts the change in the capital share for a given change in labor regulation. Rather than just eyeballing the sign of the relationship between the two, the regression analysis allows us to see whether the relationship is strong enough to be economically significant, and to assess whether it is statistically significant.[15] Even without regard to political events, we find that there is an association between the change in capital share and the change in labor regulation. Specifically, for our analysis of changes in labor regulation, we estimate that the three-year change in the capital share tends to fall by 2.18 percentage points when we observe a typical (that is, 1 standard deviation) higher three-year change in labor regulation. This estimate is statistically significantly different from zero: Its t-statistic—that is, the ratio of the estimated slope of 2.18 to the standard error of that estimate—is 4.96 in absolute terms.[16] This value is well above the thresholds of 1.65 or 1.96 typically associated with statistical significance (at the 10 percent or 5 percent level, respectively). That is, if the slope were actually zero, the chance of obtaining an estimate such as ours would be less than 5 percent.

In general, it is hard to interpret OLS estimates such as ours in terms of cause and effect. Labor regulation may be tightened in response to an increase in the capital share, weakening the causal link running in the opposite direction. Or structural change in the economy may affect both variables at the same time. The direction of the bias (if any)—that is, the departure from the true causal relationship—could go in either direction. By focusing on political events, we can isolate deliberate policy changes in labor regulation (and exclude policy responses to other factors). Indeed, if we focus only on countries with political events, the estimated slope is steeper: Around the time of a political event, a 1 standard deviation higher three-year change in labor regulation is associated with a decline in the capital share of 5.21 percentage points. This estimate is again highly statistically significant, with an absolute t-statistic of 3.16. (That is, it is unlikely that we would observe data like ours if the true effect were nil or positive.)

To move beyond pure associations and to allow us to make causal statements, we further exploit the data on coups and democratizations. We find that labor regulation tends to change differently after coups than it does after democratic transitions: For coups, worker protection is eased, while the opposite tends to be true after democratic events. If we assume that a coup or democratic transition affects the capital share only via labor regulation—as opposed to, say, tax code changes or because both the regime change and the policy change are triggered by economic inequality—we can use "two-stage least squares" regression analysis to tease out a causal relationship between labor regulation and capital share changes.

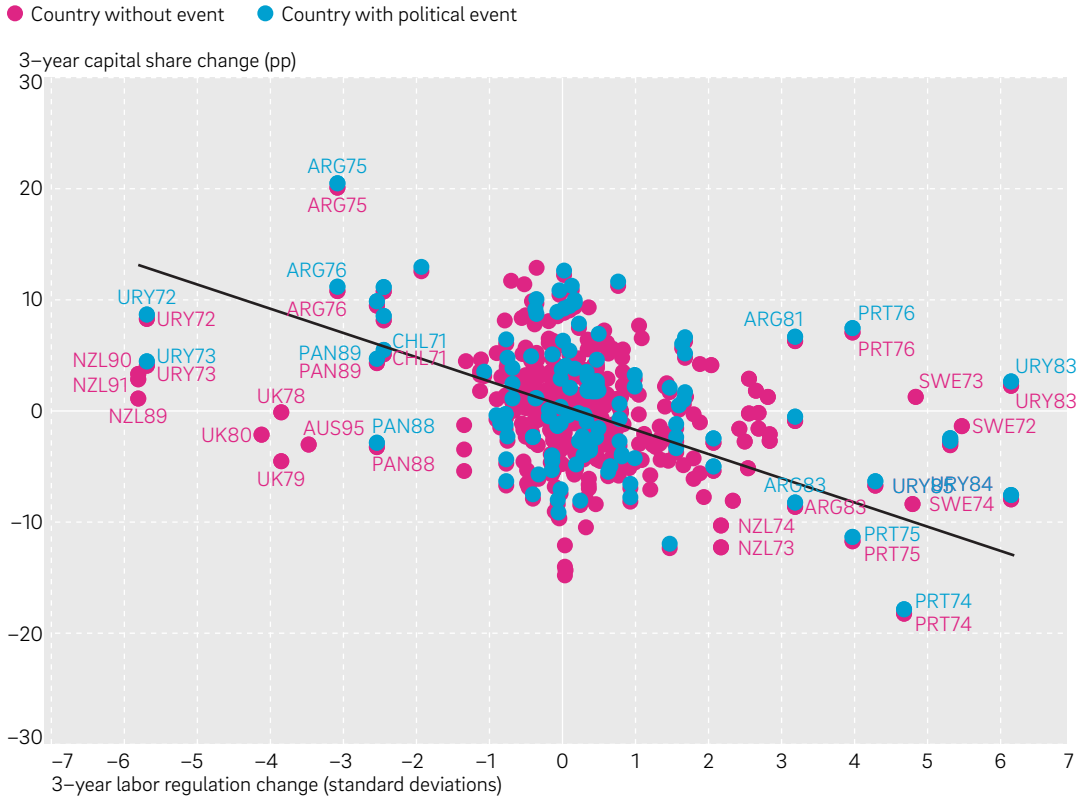
In the first stage of this regression analysis, we predict the change in worker protection with a variable indicating whether there was a coup or a democratic transition. To do so, we assign a value of +1 to democratic transitions and a value of −1 to coups. We estimate that a democratic transition tends to raise worker protection by one-third of a standard deviation. This predicted change in labor regulation then serves as an exogenous change in labor regulation in the second stage. This exogenous change is not plagued by simultaneity problems—for example, through omitted variables that might shift both the capital share and labor regulation. The estimate predicts that a tightening of labor

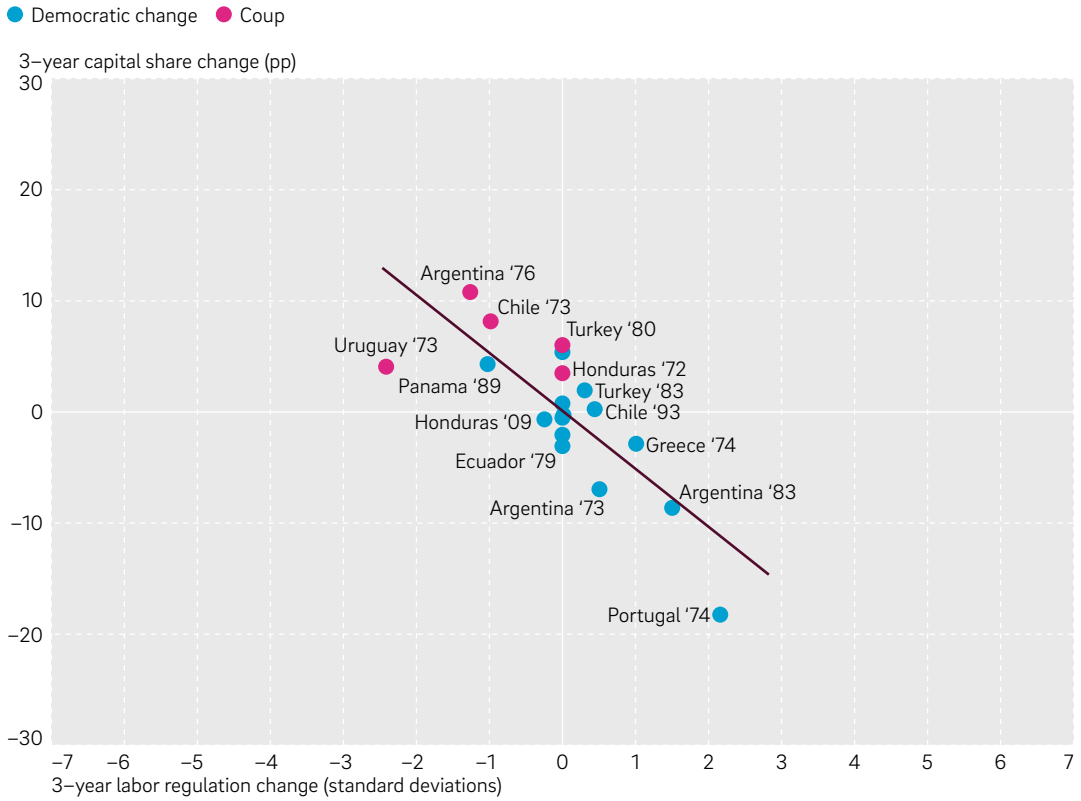
FIGURE 4

Labor Regulation and Democratizations Correlate with a Decrease in the Capital Share

In contrast, coups correlate with a decrease in labor regulations and an increase in the capital share.

Capital share changes and labor regulation changes





Notes: The regression line indicates that on average, a country with a 1 standard deviation increase in labor regulation saw its capital share fall by 2.2 percentage points and by 5.2 in the aftermath of a major political event.

The top panel omits periods of no variation in regulation, conditions on a nonzero change in labor regulation, and highlights countries with political events. The bottom panel conditions on a political event in the base year. Labor regulation changes are standardized to have a mean of zero and a unit standard deviation within each sample. Overlaid is the predicted relationship based on a linear regression.

Sources: Adams et al. (2016); Economic Commission for Latin America and the Caribbean (ECLAC) (2015); Organisation for Economic Co-operation and Development (OECD) Business Sector Database (2008).

regulation is associated, on average, with a large 6.9 percentage point drop in the capital share—slightly stronger than the OLS prediction. Given that a regime switch induces a change of one-third of a standard deviation, a political regime switch is associated with a change in the capital share of about 2.3 percentage points.[17]

Recent Work on Politics and Distribution

Other recent work reaches similar conclusions. For example, Lund University associate professor of economics Erik Bengtsson, IZA Institute of Labor Economics research fellow Daniel Waldenström, and University of Lausanne research fellow Enrico Rubolino analyzed political determinants of the capital share of countries. They focused on two political events—the introduction of universal suffrage and a narrow election victory for a left-wing party—in 20 countries that are complementary to the ones we analyzed.[18]

Since ownership of capital is concentrated, one may conjecture that the introduction of universal suffrage diminishes the relative political influence of capital owners. Similar to a democratic transition in our analysis, universal suffrage distributes political power more widely in the population. Their findings confirm this conjecture: The introduction of universal suffrage, they find, is associated with a drop in the net capital share of 4 percentage points. This effect diminishes over time but is still significant one decade after the policy change.

What's more, they find that the victory of a left-leaning political party also significantly lowers the capital share. Countries with left- or right-leaning governments typically also differ in terms of their economic and political conditions. A statistical analysis cannot fully control for these conditions, so the authors use a regression discontinuity design, which overcomes this challenge. According to their estimates, an election victory of a left-leaning party lowers the capital share by 1.6 percentage points.

Overall, these results are comparable to our estimates. The effect of a left-leaning election victory, according to Bengtsson, Waldenström, and Rubolino, is 30 percent smaller than our estimate of the effect of changes to labor regulation following regime change, but there is statistical uncertainty about the precise magnitude of these estimates. They also find that the effect of universal suffrage is about 70 percent larger than our estimate.

While the political events we have discussed may seem like distant possibilities for readers in advanced democracies, other social and political forces—such as the erosion of worker power—can still affect the capital share, even in countries like the U.S. that have enjoyed a stable democracy with universal suffrage for a long time. For example, Bengtsson, Waldenström, and Rubolino find that the 1984 Trade Union Act in the UK, which made it harder for unions to call strikes, raised the capital share by about 5 percentage points relative to a group of similar countries. Similarly, we found in 2021 that right-to-work legislation, which also aimed to weaken unions, was associated with higher capital shares in U.S. states.[19] In addition, MIT Sloan School of Management assistant professor of work and organization studies Anna Stansbury and Harvard Kennedy School professor Lawrence Summers, leveraging worker-level microdata as evidence of the role of worker power, find that the erosion of worker power has been associated with higher capital shares in the U.S. By combining microestimates of the union wage premium with the aggregate decline in unionization rates, they find that both forces together account for a 2.1 percentage point rise in the net capital share between 1982 and 2016. Defining worker power more broadly, they estimate that it accounts for a drop in the labor share of almost 6 percentage points over the same period, partly as a result of shifting employment shares across industries.

Conclusion

Although we have argued that politics affects the distribution of income, it is hardly alone in doing so. Even if we interpret political forces broadly to include social attitudes, politics is likely just one of several factors. As Nobel laureate in economics Robert Solow aptly put it:

> *The decay of unions and collective bargaining, the explicit hardening of business attitudes, the popularity of right-to-work laws, and the fact that the wage lag seems to have begun at about the same time as the Reagan presidency all point in the same direction: the share of wages in national value added may have fallen because the social bargaining power of labor has diminished. This is not to say that international competition and the biased nature of new technology have no role to play, only that they are not the whole story. Internal social change and the division of rent matter too.*

What other factors do economists consider as explanations for changes in the labor share? For example, what can explain the fact that the U.S. labor share has declined in recent years?[20] As we saw above, Stansbury and Summers relate this decline to the diminished power of workers, which is broadly in line with our argument that political forces matter for distribution.

University of Oxford graduate student J. Zachary Mazlish contrasts this explanation with six others that some have argued are important. First, new capital technologies may allow firms to substitute capital for labor; self-checkout counters are one example. Second, globalization and offshoring can mimic

new technologies by allowing domestic production to use relatively more capital and cheaper labor from abroad. One example is the Mechanical Turk platform, which allows even small businesses to hire remotely located workers to perform services such as data entry. Third, firms' market power allows them to extract greater profits in product markets or pay lower wages in labor markets, possibly increasing shareholders' income. This increased market power could come about through mergers of large firms, for example, or technological breakthroughs proprietary to a firm. Fourth, transitory "supercycle" effects may have shifted income between capital and labor. For example, demand may shift to producers who are temporarily able to charge premium prices and reap much of their income as profits rather than paying it to labor. Fifth, measurement issues such as the rise of stock options or the changing number of the self-employed can cause apparent changes in labor shares, even though absent stock options, wages or salaries would be higher. And sixth, the increased ability of firms to measure worker productivity could allow them to lower workers' pay on average. Mazlish concludes that despite measurement issues, declining worker bargaining power has likely reduced the labor share of income in the U.S.

In this article we have focused on distributional questions without discussing economic output—that is, who gets a slice of the pie, not the size of the pie. As we argue in our 2021 study of the U.S., these changes in social and political factors can be connected, because shifts in workers' bargaining power also induce fluctuations in economic output. EI

Notes

1 See Daly (2020).

2 While conceptually simple, the challenge lies in the details when measuring the labor share of income. This is because of the difficulty in classifying some real-world categories of income, such as a proprietor's income (is it a payment for labor or capital?), indirect taxes (does labor or capital benefit from subsidies?), intellectual property, and employee compensation via stock options. See Armenter (2015) for a discussion.

3 Díaz-Giménez et al. (2011) show that in the U.S., the wealthiest 10 percent own about 70 percent of the wealth in the economy.

4 See IMF Fiscal Affairs Department (2021).

5 Credit guarantees have an unclear cost because they do not affect the budget unless the guaranteed loan defaults.

6 We define the capital share as 1 minus the wage share, as reported in the AMECO database. For the COVID episode, we depart from the custom of measuring the capital share at factor prices. Instead, we use market prices to illustrate the effects that policy can have on distribution, because some large fiscal programs explicitly subsidized labor, which lowered the cost to business of employing labor more so than the cost of employing capital. This effect was particularly pronounced in the U.S., where the capital share at factor cost (that is, the share of earned income going to capital after subtracting subsidies and indirect taxes from the cost of production) remained about constant. Overall, at factor cost, we find a U-shaped relationship between the size of fiscal interventions and capital shares.

7 See Drautzburg et al. (2021) for details.

8 See Caballero and Hammour (1998) for a list of prolabor policy changes approved between 1968 and 1983.

9 The anthem's Spanish lyrics describe Juan Perón as follows: "¡Viva Perón! ¡Viva Perón! / Por ese gran argentino / que se supo conquistar / a la gran masa del pueblo / combatiendo al capital." ("Hurrah! Hurrah for Perón! Hurrah for a great Argentinian who knew how to conquer the great mass of the people by fighting against capital.")

10 Adams et al. (2016) compiled this annual data set, which quantifies labor regulation in 117 countries from 1970 to 2013.

11 The data set might not adequately cover case law—that is, law based on previous judicial decisions. For instance, in the U.S., the data set records only one change from 1970 to 2013, the Worker Adjustment and Retraining Notification (WARN) Act of 1988. However, Budd (2012) characterizes the recent history of U.S. labor law as "static" statutes and "dynamic and voluminous" case law. Incomplete coverage or miscoding of case law would bias our results toward zero and, therefore, against our hypothesis.

12 We adopt Powell and Thyne's (2011) definition of a successful coup. We adopt Bormann and Golder's (2013) definition of a democratic election as either a legislative election in a parliamentary system or a presidential election in a semiparliamentary or presidential system.

13 Although a coup can be proworker, no such coup appears in our sample. In particular, the Carnation Revolution in Portugal did not overthrow a democratic government, and thus our algorithm does not code it as a coup. Instead, the algorithm codes the election in 1976 as the democratic transition, even if history suggests that the actual event was the army rising against the dictatorship in 1974. We use 1974 for our benchmark results.

14 We take the capital shares from various sources, but we use only one measure per country to avoid splicing the data. Because of the varying quality of the data and possible residual correlation within countries, we cluster standard errors by country.

15 Economic significance corresponds here to a steeper slope of the "best fit"

line produced by the OLS regression. Statistical significance is a function of how dispersed the data are around this best fit line, and of how many independent observations we have.

16 The standard error measures the uncertainty associated with the estimated slope. Hypothetically, if we were given multiple data sets with samples like ours, we would expect the standard deviation of our slope estimates across these alternative samples to equal our estimated standard error.

17 The t-statistic of 2.3 is below the 3.2 threshold typically needed to dispel concerns related to a weak-instrument problem (that is, that the causal estimate is spurious). Using a placebo study, however, we show that the 19 political events are not spuriously related with capital share changes. For each country, we randomly pick dates for coups and democratizations with equal probability, respecting their alternating order. We code the first event date with equal probability as either a coup or a democratization. Each subsequent event, if any, is then coded as the other type. Thus, we have the same number of event dates per country as in our actual sample, and we can apply the same instrumental variables analysis as in our benchmark case. We repeat this process 1,000 times and show the distribution of placebo and actual t-statistics. The probability of finding a second-stage t-statistic of 2.3 is below 1 percent.

18 They also consider wars and decolonization, which they link to capital shares via the effects these events had on profitability.

19 Drautzburg et al. (2021).

20 As noted by Armenter (2015).

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