

What drives major tax reform? Implications for taxing the rich

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Abstract:

This paper examines some drivers behind substantial changes in tax policy in recent decades. Using existing theories and our definition of ‘beneficial major tax reforms’, we discuss three case studies: the US in the 1980s, the UK in the 1980s, and the UK’s failed ‘mini-budget’ of 2022. Our analysis reveals that the US’s TRA86 has, to some degree, improved efficiency, while the UK reforms may have exacerbated inequality with ambiguous effects on efficiency. Finally, we outline the potential for future reforms and conclude that political conditions are more likely to instigate major change than economic motivations.

Keywords: tax reforms, reforms’ drivers, inequality, policy analysis

JEL classification: D63 E65 H11 H21

The views of policy-makers are rarely susceptible to dramatic change from the force of reasoned argument, however cogently documented and lucidly expressed. They are determined by the climate of opinion of the time, and that climate is itself the product of a process of intellectual evolution in which good ideas tend to develop and bad ideas fail to survive. It is not a rapid process, but it is a continuing one. John Kay (1980, p. 47)

I. Introduction

Two defining economic patterns mark the beginning of the 2020s: (i) back-to-back economic downturns that placed a large strain on public finances, and (ii) rising income and wealth inequality¹ (Saez and Zucman, 2016; Piketty *et al.*, 2017; Smith *et al.*, 2022; Delestre *et al.*, 2022). The recent economic downturns, starting with the Global Financial Crisis (GFC), followed by the economic shock due to Covid-19 and the energy crisis in Europe in 2022, exacerbated the rising trend in inequality within developed countries. Economic fluctuations and changes in inequality trends can both be a cause or a consequence of major policy reforms, each with implications for politics and policy.

Against the backdrop of economic downturns, rising inequality may substantially increase the society’s demand for governments to redesign the taxation of the rich. Risk-averse policy-makers, on the other hand, opt for incremental tax changes over fundamental reforms. Our discussion in this paper shows that this preference is often the result of political considerations rather than a thorough analysis of what may be good policy aimed to increase efficiency or redistribution.

¹ Auten and Splinter (2019) highlight that the estimates of the extent of inequality vary depending on assumptions and methods across different studies.

In this section, we outline trends in rising inequality in the US and the UK and compare these trends with those of France and Germany. We highlight the relatively stable composition of tax revenue in each of these countries before focusing on possible major US and UK reforms. We then review theories of reform in the literature by defining the motivations and conditions for reform (section II). We discuss what constitutes major reform with a specific view on the motivations for economically beneficial major reform (section III). We then present three case studies from the US and the UK to examine periods of reforms that are often referred to as ‘major’ in public discourse (section IV). Finally, we conclude by linking our discussion to the current debates on major reform proposals about how governments may tax the rich in the future (section V).

Current trends in inequality in the US and the UK are remarkably similar (Delestre *et al.*, 2022; Zidar, 2022). In Figure 1, we document patterns of redistribution captured by pre-tax and post-tax inequality measures in Germany, France, the US, and the UK, with pre-tax and post-tax inequality normalized to 100 in 1980 for comparability across the two series in each country. As a benchmark case, redistribution in France has risen consistently since the 1990s. In the US, post-tax inequality rose in the early 1980s, and this trend continued until the GFC. However, after the GFC, this pattern in redistribution shifted, and post-tax inequality decreased compared to the changes in pre-tax inequality. In the UK, a similar trend to the US is observed, where post-tax inequality saw a relative rise in the 1990s and then remained stable until after the GFC. After the GFC, post-tax inequality dropped in relation to the changes in pre-tax inequality.

Instigating major changes in tax policy takes commitment and an appetite for risk-taking by the policy-maker. Policy-makers are highly risk-averse, and rightly so; irresponsible use of public funds may have devastating economic, political, and social consequences. We inspect broad patterns in components of tax revenue in Figure 2. We decompose each of the four countries’ tax revenues into subcomponents of various direct and indirect taxes. Our



Figure 1: Pre- and post-tax inequality in the US, UK, France, and Germany.

Note: Definition of pre- and post-tax national income from the World Inequality Database for European countries and for the US, the inequality dataset from Auten and Splinter (2022): the statistical unit is the adult individual, with income equally split between the adults of the same household (i.e. equal-split). The pre-tax national income is the sum of the pre-tax income flows from capital and labour before taxes and transfers, but after applying the social insurance system. Pensions are counted on a distribution basis. The post-tax national income is the net national income aggregate, namely the sum of post-tax disposable income, the individual and the collective consumption expenditure of the government, and the surplus or deficit of the government. Gini coefficient in the graphs: the crude measures of the Gini coefficient have been log-transformed. The obtained values have been then re-scaled by setting the national values of the log-Gini in 1980 to 100. The re-scaling procedure was a simple proportion.

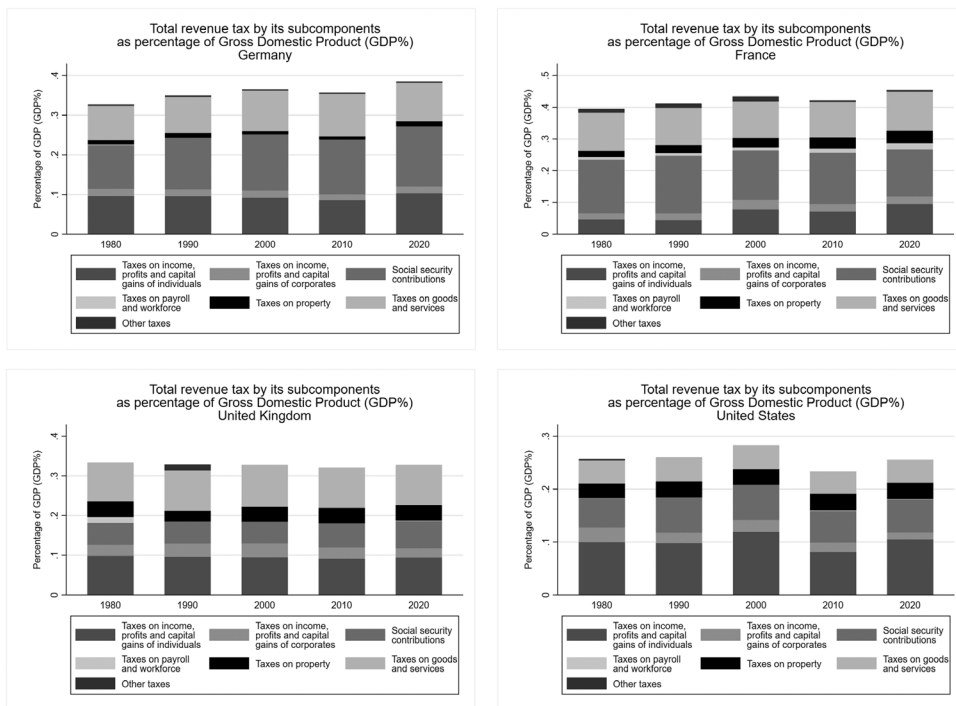


Figure 2: Tax revenue decomposition.

Source: OECD: Global Revenue Statistics Database and Revenue Statistics of OECD countries. Data were collected on the aggregate tax revenue and its subcomponents. The lowest level of detail was chosen to retain the categories of tax revenue (e.g. 1000, 2000). An exception to this rule is the tax on income, profits, and capital gains of individuals (i.e. 1000). In this case, the taxes applied to individuals (i.e. 1100) and corporates (i.e. 1200) were also selected. The time period spans from 1980 to 2020. Tax statistics for the years preceding 1990 were collected from the Revenue Statistics of the OECD countries and then pooled together with the Global Revenue Statistics Database, which reported the variables of interest as a percentage of GDP only for the years after 1990. Given that the figures before 1990 were available only in terms of the national currency, the ratio between the taxes on revenues and the national GDP calculated on a yearly basis was carried out so as to allow the comparison with data ex-post 1990.

first observation is that the total tax revenue as a share of GDP did not change substantially in these countries, nor did its composition. Second, the US has the lowest tax revenue/GDP ratios. Third, all four countries are more reliant on direct taxes than indirect taxes. Finally, these broad trends do not point towards any major change in the last few decades.

II. Theories in the existing literature

In this paper, we examine the intrinsic and extrinsic economic drivers of major tax reform. The intrinsic drivers include efficiency gains and the improvement of vertical equity (different treatment of individuals based on their ability to pay) and horizontal equity (equal treatment of individuals with similar means to pay). The extrinsic drivers of reform include economic downturns, such as the GFC, and fluctuations in supply and demand caused by the pandemic. We also explore tax system characteristics and tax competition as factors contributing to tax reform.

In this section, we provide a brief summary of political and economic theories of drivers for reform. [Clark *et al.* \(2020\)](#) highlight theories of political power (namely, median voter and policy drift) to describe the reasons behind the abolition of wealth taxes. We draw on their literature overview and refer to empirical papers on public finance that explore the drivers of tax reforms, including tax competition and policy-makers’ incentives ([Romer and Romer, 2010](#); [Castanheira *et al.*, 2012](#); [Foremny and Riedel, 2014](#); [Brühlhart and Parchet, 2014](#); [Jensen, 2022](#); [Robinson and Tazhitdinova, 2022](#)). We distinguish the intrinsic and extrinsic drivers collected from these two streams of literature into two categories: motivations and conditions for reform. We define motivations as the factors prompting policy-makers and politicians to carry out tax reforms, while we refer to conditions as the institutional and legal frameworks influencing the ability to put these reforms into action.

(i) Motivations for reform

Competition

Jurisdictions try to attract mobile, productive factors by simplifying the tax system and reducing tax rates. Anecdotally, tax competition offers a clear explanation for the long-run reduction in corporate tax rates or other measures in personal taxation, such as the abolition of wealth taxes (despite the relatively inelastic tax base with respect to tax rates (Brülhart and Parchet, 2014)). Tax policy is often 'influenced' by either neighbouring countries or countries that compete for international capital flows. In the context of sub-national tax policy, Robinson and Tazhitdinova (2022) document convergence in tax rates across jurisdictions over the 1950–1980s as states adopted new taxes. However, the authors conclude that since the 1980s, race-to-the-bottom competition (nor the opposite case of Tiebout sorting) does not have a major role in tax reforms.

Response to economic downturns

Directly or indirectly, severe downturns bring about policy packages that respond to them. Naturally, we expect major macroeconomic events to drive major reforms and discuss broad macroeconomic patterns in our case studies in section IV. However, based on their data-driven methodology examining legislation in US states, Robinson and Tazhitdinova (2022) argue that economic or political events are not strong indicators of tax reforms.

Response to an inherited deficit

Romer and Romer's 2010 textual analysis of US tax reforms reveals four categories of motivators for tax reform, one of which is the response to an inherited deficit. They categorize an inherited deficit as an 'exogenous' motivator of tax reform and, for the US, they point out the prominence of deficit-driven tax rises during the 1980s. It is not surprising that some taxes needed to rise over the 1980s to compensate for the budget deficit. However, almost all the deficit-driven tax changes of the 1980s are simultaneous to other large tax reforms that we study in section IV. Large deficits can plausibly drive major tax reforms, and we highlight the importance of deficits in our case discussion.

Promoting long-run growth

Growth effects of tax cuts across varying tax brackets are subject to an ongoing debate. While Romer and Romer (2010) find that tax cuts that are exogenous to economic conditions support growth, recent empirical evidence by Zidar (2019) presents a more nuanced view. Zidar (2019) finds statistically significant evidence on the growth effects of tax cuts for lower-income brackets, but limited support for any growth impact of tax cuts for higher-income households. Promoting growth is the stated motivation for all the tax cuts that we study in case studies of section IV.

(ii) Conditions for reform

Median voter

When inequality is growing, voters' preferences for redistribution may also rise. This has been seen as evidence in support of a median voter theorem explanation of political leaders' choices on taxation. We show patterns of rising inequality in the UK in the 1980s, which did not manifest in a change in the ruling party in the early 1990s. This suggests no evidence towards a median voter explanation for UK tax policy in the 1990s, although we cannot formally rule it out. Clark *et al.* (2020) point at studies (e.g. Kuziemko *et al.*, 2015) that show voters not demanding redistribution even under increasing inequality and favour a 'policy drift' point of view.

Policy drift

This class of theories (e.g. by Culpepper, 2010) covers the role of interest groups, such as lobbyists, in driving policy decisions. By blocking the adaptation of a policy to evolving circumstances, these groups can promote their advantages. This silent and pervasive mode of policy change has become a common tool in preserving the status quo and avoiding policy changes.

Political cycles

Expenditure rises, but tax burdens decline in the lead-up to elections. However, this gap in public finances needs to be closed after elections; there is empirical evidence for post-election rises in taxation (Foremny and Riedel, 2014).

(iii) Implications

The causal link between economic motivations reform and a resulting tax reform is difficult to establish. Often, rising inequality and economic fluctuations take place in tandem, reducing our ability to identify the causal chain.

The three case studies we discuss in section IV show that a single channel driving major reform is difficult to pin down. We use case studies to describe the economic context and some possible political drivers of reform efforts. Economic downturns, the burden of inherited deficits, and a prioritization of growth for the wealthy and large businesses all feature in the three case studies that we discuss.

Changes to the way in which the US and the UK governments tax the rich feature in all of the three case studies. In all of them, the top rate of marginal tax for high earners is reduced following efficiency arguments. While a policy drift argument can be made in each of these cases, economic motivations such as tax competition and promoting long-run growth (in line with the efficiency goal) cannot be ruled out.

III. Defining major reform

To ask why we do (or do not) observe major reform in taxation, we first have to define what constitutes major reform. It is useful to start by discussing what we do not mean by major reform.

Over the years, tax administration capability improved significantly, enabling higher revenue through a broader base, even without changes in the statutory definition of what constitutes the tax base. Information on trades, transactions, incomes, sales, and value-added became increasingly traceable and therefore taxable over recent decades. We take developments in technology in this regard as given and define reform outside the boundaries of tax administration capability.

It is trivial to state that major reform in and of itself is never the objective. Major reform should improve the tax system, and improvements can be made towards a definition of a ‘good tax system’. The [Meade Committee \(1978\)](#) Report characterized a good tax system along the following dimensions:

1. incentives and economic efficiency,
2. distributional effects,
3. international aspects,
4. simplicity and costs of administration and compliance,
5. flexibility and stability,
6. transitional problems.

We simplify these categories for the sake of practicality and consider all items (3)–(6) above under ‘efficiency’ while summarizing distributional effects under the objective of vertical equity. Necessary conditions for desirable major reform are then to achieve at least one of the following objectives while holding the other constant:

1. improve vertical equity,
2. improve efficiency, through:
 - corrective taxes,
 - simplification of the tax system,
 - minimizing behavioural responses.

These two goals often represent the principal trade-off in optimal tax theory, but in systems characterized by inefficiencies and below-target redistribution, desirable major reform may also achieve both goals at the same time. The tools that may be used to achieve higher efficiency or redistribution can be summarized as:

- (a) base broadening, including introducing new types of taxes,
- (b) changing tax rates,
- (c) changing re-distributive transfers.

How do goals (1) and (2) relate to the tools (a)–(c)? Theoretical answers exist in the optimal tax literature ([Ramsey, 1927](#); [Mirrlees, 1971](#); [Atkinson and Stiglitz, 1976](#); [Diamond, 1980](#); [Saez and Stantcheva, 2016](#)). A closer link to the literature on optimal taxation can be found in [Diamond and Saez \(2011\)](#), who draw practical lessons from theory.

We begin by exploring the redistribution objective. Advanced economies have relatively progressive tax systems, where rising incomes typically lead to a larger effective tax rate for taxpayers ([Piketty and Saez, 2013](#)). We will assume that some progressivity of the tax system is desirable. But assuming a utilitarian social welfare function,

how should progressivity change as a result of a reform for such reform to be considered major and beneficial to society overall? Empirical public finance literature documents large behavioural responses to tax reforms (Saez *et al.*, 2012). This renders large base-broadening reforms (such as the US TRA86 or the UK reforms in the 1980s) to be candidates for major reforms as they may increase efficiency through simplification.²

Only with hindsight can we assess whether a reform process has resulted in what can be considered major reform or not. That said, it does not take place without the will to make a major change. There has to be an understanding of what changes a reform package might trigger at the outset. In the example of the UK's 'mini budget' of September 2022, the proposed reform caused capital flight and a large rise in the government's financing needs due to a substantial deterioration in markets' expectations about the financial stability and sustainability of the UK's public debt. The proposed reform aimed for simplicity and efficiency at the expense of redistribution. The proposed reform also underestimated markets' potential reaction to unfunded tax cuts. Had the policy package gone through, could we have considered it to be major reform? Had the package not involved large amounts of unfunded spending, would it have generated its objectives of improved efficiency and trickle-down growth? We will never know, but history and the recent empirical finance literature provide us with guidance that we study in section IV(iii).

Despite the broadness of our overview of the drivers of major tax reform, we highlight that lasting beneficial economic effects are only possible if policy design and 'details' are spelt out carefully in legislation. Often, political compromise means that game-changing aspects of proposed reforms cannot be implemented. In such cases, the reform processes remain incomplete, and hence the reforms do not achieve their objectives.

IV. The past and the present: case studies of major reform proposals

In this section, we present three case studies and discuss each along the dimensions of efficiency and equity. The first two cases are those of reforms that passed, and the third case is one of a 'failed reform', a recent reform that was proposed but did not pass. We provide a brief comparison of the cases at the end of this section and discuss some reasons why the TRA86 can be considered an attempt at a major reform while the mini-budget failed and marked the end of the shortest stint for a Prime Minister in the UK.

(i) UK: Thatcher's economic programme of the 1980s

In Figure 3, we show a very broad timeline of the economic events in the 1970s that led to the election and the reform programme of Thatcher starting in 1979. As Thatcher was elected Prime Minister, unemployment was rising (it peaked in 1984 at 12 per cent), and inflation had seen highs of around 25 per cent (in 1975). A promise to get the economy under control was welcome news. The circumstances that led to the election of Margaret Thatcher allowed her enough flexibility to take radical steps to reform the labour market and lower taxes. In parallel to the economic programme, the discovery of commercial North Sea oil (in 1970) and the start of production in 1976 were a blessing to help the economy get back on its feet.

On taxation, the Meade Committee Report of 1978 clearly recommended a comprehensive overhaul of the direct taxation system (Meade Committee, 1978). However, these recommendations were not acted upon in the election campaigns. The goal of Thatcher's reform programme was not equity (or fairness), it was efficiency. The programme aimed to improve efficiency by reducing the government's role through privatizations and deregulation, limiting the power of trade unions and promoting competitiveness (Matthews and Minford, 1987). The focus on efficiency created a favourable business environment for entrepreneurs and highly skilled domestic and foreign labour, reduced regulations, and led to increased profits and opportunities for income and wealth accumulation. The personal and corporate tax rate changes illustrate these goals in Thatcher's programme. In 1980,

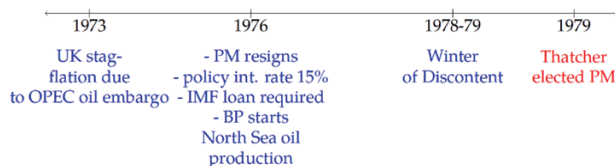


Figure 3: Timeline of events leading up to the Thatcher economic programme

² Altig *et al.* (2001) simulate five reform proposals that they label as major reforms.

the top personal income tax rate came down from 83 to 60 per cent. The basic income tax rate came down from 33 to 30 per cent. These rates were later lowered to 40 per cent for top incomes and 25 per cent for the basic rate taxpayers. The corporate income tax rate was reduced from 52 to 34 per cent, and the VAT rates of 8 per cent and 12.5 per cent rose to a single rate of 15 per cent. The benefits were consolidated and redirected to favour families with children.

Despite an increase in productivity from 1979 to 1990 (Layard and Nickell, 1989), the new tax system reinforced the existing income inequality, with the benefits disproportionately going to the top earners. As demonstrated in Table 1 (by Johnson and Stark (1989)), the estimated distribution of tax and benefit gains over the period 1979–89 accrued disproportionately to people with incomes above £1,000 per week that constituted only 0.5 per cent of the sample in Johnson and Stark (1989).

The Thatcher programme was an extensive and radical set of reforms aimed at revitalizing the UK's competitiveness in the global economy by prioritizing productivity and efficiency. This marked a departure from the post-Second World War economic policies that emphasized the social state. The programme therefore faced significant public and political resistance. However, despite the strong opposition to her reforms and methods, Thatcher served as Prime Minister for 15 consecutive years. Through her distinctive step-by-step approach, the then-Prime Minister had the willingness, power, and appetite for risk to reshape the political setting (or conditions) in which her reforms were implemented. With a series of strict but successful reforms, Thatcher effectively navigated the UK during the 1980s, earning the support of her opponents and temporarily silencing criticisms.

We cannot end this section without mentioning the Community Charge or the 'poll tax' that led to widespread protests across the country and marked the end of the Thatcher era. The reforms in this period greatly impacted the country's social, political, and economic outlook. By our definition in section III, however, we cannot categorize the reforms of this period as satisfying the necessary conditions for desirable major reform. In Figure 4, we show the time series of total tax revenue as a share of GDP and indicators of pre-tax and post-tax inequality captured by the Gini coefficients scaled to equal each other at the start of the series in 1980. We observe a sharp decline in tax revenue as a share of GDP starting in the late 1980s until 1996. Over the same period, the rescaled post-tax Gini coefficient displays a sharp rise relative to rescaled pre-tax Gini coefficient, signalling a drop in the redistributive capacity of the tax and benefit system.

(ii) US: Tax Reform Act of 1986

The Tax Reform Act (TRA) of 1986 is arguably the most fundamental change to the US tax system of the post-Second World War era. With over three decades of hindsight, its impact can be evaluated with a reasonable degree

Table 1: Redistribution over 1979–89; average gains by pre-tax and -benefit income range as estimated by Johnson and Stark (1989)

Income range, £p.w.	Average gain, £p.w.	% of sample	% of expenditure
Below 10.00	1.65	18	4
10.00 to 49.99	0.33	10	0.5
50.00–99.99	1.42	6	1
100.00–149.99	3.57	7	3
150.00–199.99	4.27	8	5
200.00–249.99	4.20	10	6
250.00–299.99	4.79	9	6
300.00–399.99	5.85	14	11
400.00–499.99	9.17	8	10
500.00–599.99	14.12	5	10
600.00–999.99	34.98	5	24
1,000.00 and above	286.53	0.5	20
All	7.18	100	100

Note: The leftmost column shows the per-week income range, and the second column shows the average gain in tax and benefits per week for the given income range. The third and fourth columns capture the share of that income group in the sample data available to the authors.

Source: Johnson and Stark (1989, Table 2).

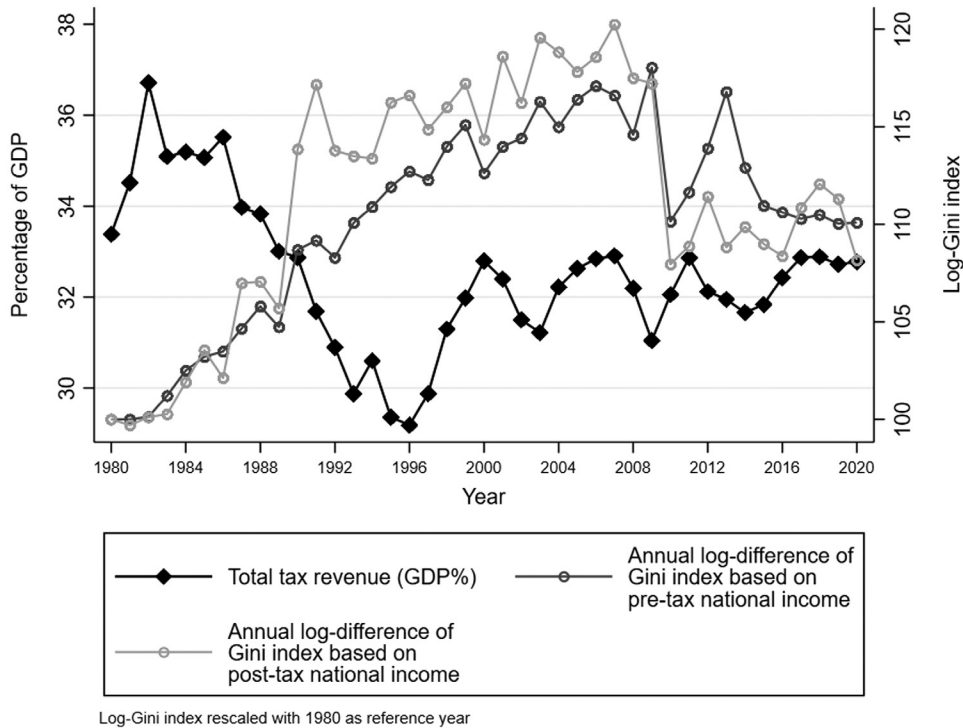


Figure 4: Tax revenue, pre-tax and post-tax inequality in the United Kingdom, 1980–2020.

Source: World Inequality Database and authors' calculations. The Gini index series are both calculated in logs, with the value for the first year in the series (1980) normalized to 100 for ease of comparability.

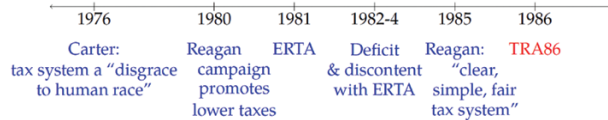


Figure 5: Timeline of the Tax Reform Act of 1986 in the United States

of accuracy. In [Figure 5](#), we depict the timeline of events that led up to the enactment of TRA86 ([Auerbach and Slemrod, 1997](#)).

The 1970s marked a period of economic turbulence with the oil crisis and high inflation, which led to increased scrutiny of the US's fragmented and complex tax system. By the late 1970s, bipartisan support was for simplifying the US income tax system,³ leading to the Economic Recovery Tax Act of 1981 (ERTA). The ERTA was a large programme of tax cuts that honoured Reagan's campaign promise. However, it resulted in the significant deepening of the federal budget deficit, which grew from -2.6 per cent to -5.7 per cent of GDP between 1980 and 1983.⁴ The tax system leading up to TRA of 1986 allowed the rich to reduce their taxable income from certain types of capital through tax shelters and interest deductions, leading to the widespread perception of an unfair system. To address these issues, the US Treasury recommended base-broadening measures, including repealing state and local tax deductions, introducing a deduction for 50 per cent of dividends paid, and indexing depreciation, capital gains, and interests ([US Treasury, 1984](#)). [Auerbach and Slemrod \(1997\)](#) provide a detailed account of the developments in the 1980s, the recommendations of the 1984 report of the US Treasury, and the simplification and base-broadening measures adopted under TRA86. We draw on [Auerbach and Slemrod \(1997\)](#) in our assessment.

The reform had the clear objectives of 'fairness, simplicity, and growth'. We examine the stated objective of 'fairness' under our categorization of equity and 'simplicity and growth' under our dimension of efficiency as in section

³ Kemp and Kasten proposal; Bradley-Gephardt Bill, 1983.

⁴ <https://fred.stlouisfed.org/series/FYFSGDA188S>.

III. On fairness, the reform emphasized horizontal equity by removing tax shelters and implementing varying tax brackets for different income levels. Additionally, exceptions for capital gains taxes were also eliminated, and a wider range of realized capital gains was included in the tax net. Since these measures targeted some specific groups of taxpayers or businesses, they came with the cost of a higher degree of complexity, partially offsetting the goal of simplicity.

Given its objective of revenue neutrality, TRA86 did not aim at modifying vertical equity. Instead, all its provisions were crafted to preserve the relative tax burden among different income levels. For example, the reductions of the top marginal income tax rate, from 46 to 34 per cent for corporations and from 50 to 34 per cent for individuals, lessened the tax burden for many high-income taxpayers. However, this provision was offset by other elements of the reform, such as the Alternative Minimum Tax, by imposing additional taxes on high-income individuals.

On efficiency, the major step towards improvement arose from simplifying the tax code and eliminating major distortions by closing tax avoidance loopholes. In addition, the top marginal tax rate went down from 50 to 28 per cent. At the bottom of the income distribution, the lower limit to enter tax-paying status increased to exempt a larger portion of low-income individuals from tax liability, and the earned-income tax credit rate was increased. The corporate base was broadened substantially by removing certain deductions and exceptions. The decrease in personal tax rates, in combination with the broader base, did not present a strong additional incentive to work more. Overall, the evidence of the increase in labour supply in response to the tax cut is mixed. There were strong timing responses in capital gains realizations. On net, the assessments found evidence of efficiency gains at varying degrees (Auerbach and Slemrod, 1997).

The prevailing circumstances played a crucial role in shaping the success of TRA86. The original design, as represented by the 1984 recommendation by the Treasury, was a more sweeping reform. However, political compromise ultimately limited the scope of what eventually passed under the TRA of 1986. For the reform to deliver on its promise of increased welfare, it required (i) a coordinated effort from independent political interests and (ii) a durable grand coalition to avoid its erosion post-passage. The former was successful, as evidenced by the suggested improvements to efficiency while keeping vertical equity roughly stable. The tax legislation implemented shortly afterwards called the redistributive neutrality into question. Despite its limited long-term impact, we consider TRA86 a ‘major beneficial reform’.

(iii) UK: the mini-budget of 2022

Fast-forwarding to the final quarter of 2022, our third case study is one of a failed reform attempt (see Figure 6). In September 2022, the government of Liz Truss came to power with a promise of ‘growth, growth and growth’.⁵ The then-Prime Minister stated that the government would: ‘first of all... lower our tax burden’ and argued that ‘cutting taxes [was] the right thing to do morally and economically’. With this clear motivation of increased efficiency by inducing people to work more, save more, and invest more, the UK’s Growth Plan, or the ‘mini-budget’ of 2022 (UK Treasury, 2022) featured: (i) a reduction of the top income tax rate from 45 to 40 per cent, eliminating the top bracket that applied to incomes above £150,000; (ii) a repeal of the rise in corporate income tax from 19 to 25 per cent, (iii) a reduction in the UK’s basic rate of income tax from 20 to 19 per cent, (iv) a reversal of the planned 1.25 per cent rise in employees’ national insurance contributions. These tax reductions came at a time of economic stagnation and spiralling inflation driven by the energy (and food) crisis triggered by Russia’s invasion of Ukraine. The government had already announced an energy price guarantee projected to cost the government between £60 billion and £100 billion. Collectively, these measures meant a steep rise in borrowing.

It is no secret that Liz Truss took Thatcher’s reforms as an example to increase hours worked, stimulate entrepreneurship, and generate growth. The central motivation behind the mini-budget was an aggressive promotion of growth through efficiency and competition, regardless of any implication for vertical or horizontal equity.



Figure 6: Timeline of the reform attempt in the UK.

⁵ Conservative Party Conference, 2022. Speech by Prime Minister Liz Truss, 5 October 2022.

Achieving this objective included favouring top-income earners, attracting domestic and foreign investments, and enticing a high-skilled workforce to the UK's economy.

Despite the similarity in goals, there were some major differences between the economic conditions of the mini-budget era and the Thatcher tax cuts. First, the mini-budget came at a period of historically fragile public finances following the Covid-19 era (Figure 7). Second, the decade following the Global Financial Crisis was one characterized by a very low-interest-rate environment. The low base in rates sharpened the rise in yields in response to the unfunded tax cuts. Third, the 1980s' tax cuts followed higher-tax environments relative to 2022; in 2022, the UK headline corporate rate was 19 per cent, the top marginal income tax rate was 45 per cent, and most UK personal income taxpayers fell in the marginal tax rate bracket of 20 per cent.

Furthermore, a key difference between the political circumstances in which Margaret Thatcher and Liz Truss operated sets their respective reforms apart. First, the Truss government argued that, by not calling their reform package a 'Budget', they did not require the projections and estimates generated by the independent Office for Budget Responsibility (OBR). The absence of OBR forecasts in the announcement of the reform package was perceived as a serious deviation from convention and one that undermined the prevalent institutional setting at the time of the announcement of the mini-budget. Second, Truss had come to power not after a general election, but through her election to party leadership after the resignation of Boris Johnson on 7 July 2022. The process through which the Conservative Party elected its leader led to a debate regarding democratic legitimacy for undertaking such a large package of reforms. Finally, September 2022 (when Truss became Prime Minister) was a period of deep economic recession and a cost of living crisis unprecedented in decades. Even though this period was often likened to the 1970s, the pace of reform proposed by the Truss government was very different from that of the Thatcher government. The Thatcher reforms took place over a decade, whereas Truss announced her reforms only a month after becoming Prime Minister.

Matthews and Minford (1987) argue that, during Thatcher's time as Prime Minister, the reduction in inflation and unemployment allowed her to gain trust, solidify her political standing, and overcome criticisms. By contrast,

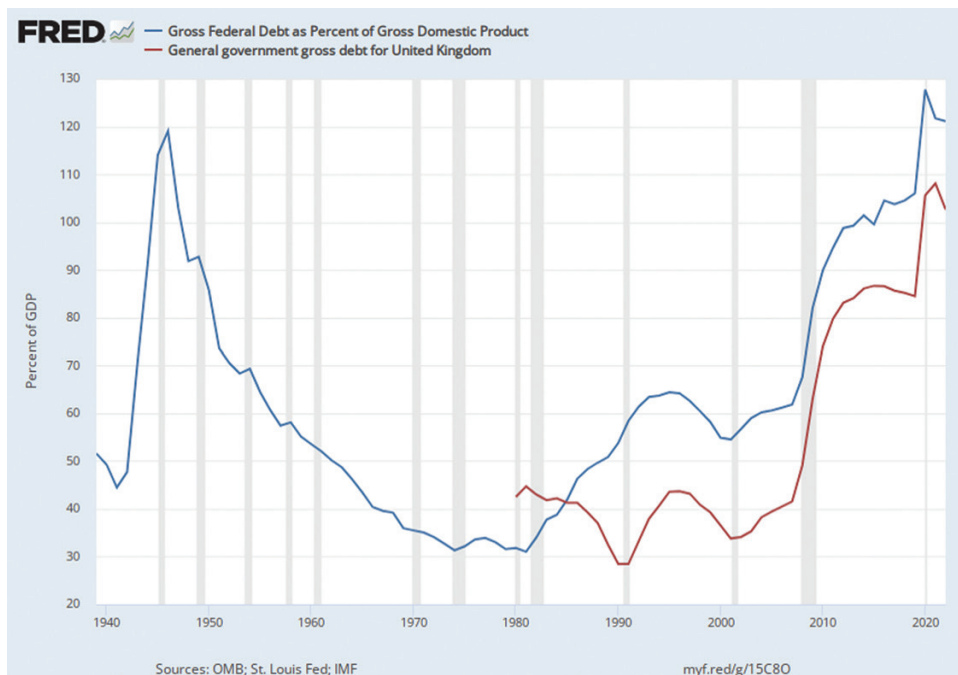


Figure 7: Government debt-to-GDP for the US and the UK, 1980–2022.

Source: US Office of Management and Budget and Federal Reserve Bank of St Louis, Gross Federal Debt as Percent of Gross Domestic Product [GFDGDP188S], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://protect-eu.mimecast.com/s/cwGaC60k3fjDw2SBymP2?domain=fred.stlouisfed.org>; <https://fred.stlouisfed.org/series/GFDGDP188S>, 11 May 2023.

International Monetary Fund, General government gross debt for United Kingdom [GGGDTAGBA188N], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://protect-eu.mimecast.com/s/gOKsC7AlgS4q75h22dpt?domain=fred.stlouisfed.org>; <https://fred.stlouisfed.org/series/GGGDTAGBA188N>, 11 May 2023.

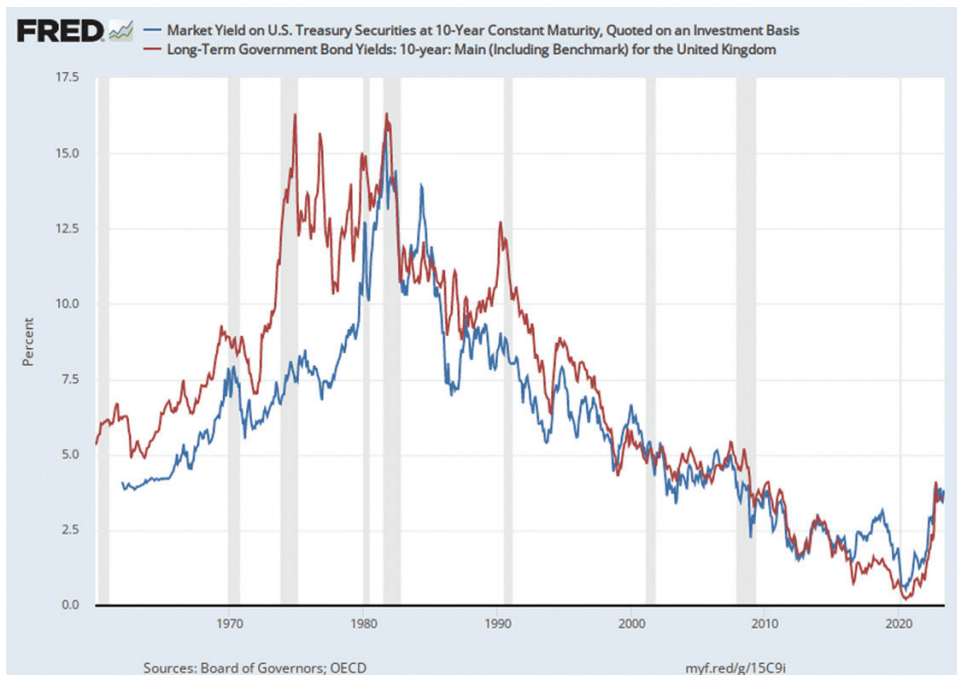


Figure 8: Long-term (10-year) government bond yields for the US and the UK, 1960–2022.

Source: Board of Governors of the Federal Reserve System (US), Market Yield on US Treasury Securities at 10-Year Constant Maturity, Quoted on an Investment Basis [DGS10], retrieved from FRED, Federal Reserve Bank of St. Louis; https://protect-eu.mimecast.com/s/_p-UC92nkfL17yfQoLuU?domain=fred.stlouisfed.org; <https://fred.stlouisfed.org/series/DGS10>, 11 May 2023.

Organization for Economic Co-operation and Development, Long-Term Government Bond Yields: 10-year: Main (Including Benchmark) for the United Kingdom [IRLTLT01GBM156N], retrieved from FRED, Federal Reserve Bank of St. Louis; https://protect-eu.mimecast.com/s/KZ0pC094Wfq8POcpX_r2?domain=fred.stlouisfed.org; <https://fred.stlouisfed.org/series/IRLTLT01GBM156N>, 11 May 2023.

Truss acted quickly, generating market turmoil that eventually led to her resignation and a rapid reversal of the mini-budget by her successor.

There were some similarities between the reaction to ERTA and the mini-budget. Figure 8 shows the high cost of government debt in both periods. Similarly to the mini-budget, ERTA deepened the US budget deficit and resulted in tax increases and spending cuts the following year. TRA86 then had to include base-broadening measures and a commitment to revenue neutrality. The mini-budget ended the short stint of the Truss government, aggravated the already-deteriorating deficit of the UK government by increasing the cost of government debt, and resulted in a complete reversal of its measures followed by an Autumn Statement on 17 November 2022. The November Budget marked a historical rise in the UK government's tax take and a cut in government spending.

The mini-budget generated concerns about the future of Britain's public finances. The markets responded with a large-scale sell-off that sharply increased the UK's Treasury bond yields. Within a month, all the tax changes were reversed, and a plan for tax rises and spending cuts was announced by the new government. CPI inflation hit 11.1 per cent in November 2022.

For completeness, we benchmark the reforms of the mini-budget against the necessary conditions of improvements in efficiency and horizontal equity. The mini-budget was designed to benefit the higher-income individuals in the short run with the stated aim of stimulating entrepreneurship and work. Given the economic circumstances of the era and the rising cost of debt, it was unlikely to achieve either goal.

V. Conclusion

What does our discussion imply for the prospects for major reforms to how governments tax the rich in the future? As advanced economies are recovering from three major economic crises, with first the GFC, then the global pandemic, followed by Russia's invasion of Ukraine in February 2022, governments are desperately seeking to raise revenue to address the cost-of-living crisis while maintaining debt sustainability (Figure 7). Income and wealth

inequality both within advanced economies and across different countries is rising rapidly. What avenues of reform are likely in such an environment?

We highlighted the risk-averse nature of policy-makers, leading to the political environment determining the conditions for reform. We have also outlined possible motivations and conditions for reform. Drawing on the existing literature, we concluded that the economic drivers of reform rarely lead to major changes while the political conditions tend to dictate the direction of policy in a range of areas including the way governments tax the rich.

We have defined the necessary conditions for beneficial major tax reform as increased efficiency or improved vertical equity in the medium-to-long run. It is, of course, difficult to causally identify long-term effects, but we examined revenue, debt, and inequality patterns to provide a descriptive analysis. We zoomed in on three case studies: the Thatcher reform programme in the UK, the TRA86 in the US and the failed mini-budget of 2022 in the UK. We found that neither UK reform had the potential to satisfy the necessary conditions to be categorized as beneficial major reform. We have highlighted the present challenges of rising inequality and deteriorating economic conditions as possible drivers for future reform efforts.

In the cases of both TRA86 and the Thatcher economic programme that we outlined in section IV, the period of reform followed at least a decade of devastating economic conditions, characterized by high inflation, soaring government debt (although at much more modest levels than at present), and rising unemployment. The UK reform favoured efficiency over redistribution, manifesting in a deterioration in post-tax inequality (based on the Gini coefficient measures outlined in section I).

Similarities with the present day are remarkable. This might indicate that there are opportunities for major reform. However, as the example of the mini-budget in the UK has shown, markets are very quick to punish irresponsible fiscal positions that, in turn, deteriorate public finances further. Policy-makers need to carefully craft every reform effort and navigate the political process to improve efficiency or equity in times of hardship such as the one we are currently going through.

An effort to establish causal drivers of major reform may be bound to fail because of the multitude of variables that change in tandem with major tax changes. However, future work may focus on textual analysis of legislation in combination with descriptions of long-run patterns in administrative data.

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