

Article

# The economic consequences of major tax cuts for the rich

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## Abstract

The last 50 years has seen a dramatic decline in taxes on the rich across the advanced democracies. There is still fervent debate in both political and academic circles, however, about the economic consequences of this sweeping change in tax policy. This article contributes to this debate by utilizing a newly constructed indicator of taxes on the rich to identify all instances of major tax reductions on the rich in 18 Organisation for Economic Co-operation and Development (OECD) countries between 1965 and 2015. We then estimate the average effects of these major tax reforms on key macroeconomic aggregates. We find tax cuts for the rich lead to higher income inequality in both the short- and medium-term. In contrast, such reforms do not have any significant effect on economic growth or unemployment. Our results therefore provide strong evidence against the influential political-economic idea that tax cuts for the rich 'trickle down' to boost the wider economy.

**Key words:** taxation, inequality, income distribution, economic growth, unemployment

**JEL classification:** D31 personal income, wealth, and their distributions, E62 fiscal policy, O47 empirical studies of economic growth, aggregate productivity, cross-country output convergence

## 1. Introduction

The past half century has been a period of substantial change in tax policy in the advanced democracies (Steinmo, 2003; Kiser and Karceski, 2017). A particularly prominent part of this transformation has been the dramatic fall in taxes on the rich across the Organisation for Economic Co-operation and Development (OECD) countries (Ganghof, 2006; Hope and Limberg, 2021). While this sweeping policy change has been well documented, its consequences for the economy are less well understood.

Proponents of the tax cuts for the rich often argue for their beneficial effects on economic performance. This line of reasoning, focusing on efficiency gains and the removal of behavioral distortions, has been central to the arguments made for several major tax reforms in the USA

(Auerbach and Slemrod, 1997; Bartels, 2005; Gale and Samwick, 2017). There are few macro-level empirical studies exploring the relationship between taxes on the rich and economic performance, however, and the evidence we do have is mixed. While some studies find higher top marginal income tax rates and tax progressivity adversely affect economic growth (Padovano and Galli, 2002; Gemmill et al., 2014), a number of other studies find no significant association (Lee and Gordon, 2005; Angelopoulos et al., 2007; Piketty et al., 2014).

On the other side of the debate, many opponents of tax cuts for the rich argue that they simply further concentrate income in the hands of the affluent. The pioneering work of Piketty and co-authors charting the evolution of top incomes over the course of the 20th century has shown that reductions in tax progressivity in recent decades have gone hand-in-hand with soaring income inequality, especially in the Anglo-Saxon countries (Atkinson and Piketty, 2007; Alvaredo et al., 2013; Piketty, 2014). This is supported by evidence from cross-country panel studies that have found that lower taxes on the rich, especially top marginal income tax rates, are strongly associated with rising top income shares (Roine et al., 2009; Volscho and Kelly, 2012; Piketty et al., 2014; Huber et al., 2019).

Given the lack of consensus in existing empirical analyzes and the difficulties of making causal inferences from macro-level panel data analyzes, it remains an open empirical question how cutting taxes on the rich affects economic outcomes. We believe the question is best answered by looking at the effects of major tax cuts packages, as the story of taxing the rich in the advanced democracies over the past 50 years is one of discrete and stark changes in policy. For example, Ronald Reagan implemented two major packages of tax cuts for the rich in his time in the White House, one in 1981 and another in 1986. A similar pattern of large, infrequent tax cuts characterized Thatcher's tax reforms in the UK, as well as reform trajectories in many other advanced democracies (see Section 3).

Focusing on the effects of individual reforms also allows us to apply a new statistical approach for causal inference in observational studies that applies a novel matching method to pooled time series data. This is particularly pertinent in this case, as there is a large literature on the power of rich voters and organized business interests to shape public policies (including tax policies) in their favor (Gilens, 2005; Bartels, 2009; Hacker and Pierson, 2010; Svallfors, 2016; Emmenegger and Marx, 2019), which suggests reverse causality could be a major issue in empirical studies lacking a clear identification strategy.

There are only a handful of existing macro-level studies exploring the economic consequences of specific tax cuts for the rich and their external validity is constrained by focusing on a small number of tax cuts (Saez, 2017; Rubolino and Waldenström, 2020) or on tax reforms in a single country (Zidar, 2019). This article takes a wider lens, looking at *all* major reductions in taxes on the rich across 18 OECD countries from 1965 to 2015. We also draw on a more comprehensive indicator of taxes on the rich, which takes into account changes across an array of taxes on top incomes, assets, and capital. This approach allows us to draw more generalizable conclusions. It also provides researchers with a new dataset of major tax cuts for the rich that can be utilized for future empirical analyzes.

Our results show that major tax cuts for the rich increase income inequality in the years following the reform ( $t + 1$  to  $t + 5$ ). The magnitude of the effect is sizeable; on average, each major reform leads to a rise in top 1% share of pre-tax national income of over 0.7 percentage points. The results also show that economic performance, as measured by real Gross Domestic Product (GDP) per capita and the unemployment rate is not significantly

affected by major tax cuts for the rich. The estimated effects for these variables are statistically indistinguishable from zero, and this finding holds in both the short and medium run.

Our findings on the effects of growth and unemployment provide evidence against supply side theories that suggest lower taxes on the rich will induce labor supply responses from high-income individuals (more hours of work, more effort, etc.) that boost economic activity (see standard models of optimal labor income taxation in [Saez, 2001](#) and [Piketty and Saez, 2013](#)). Relatedly, they also show little support for the influential political-economic idea that tax cuts for the rich ‘trickle down’ to boost wider economic performance ([Sowell, 2012](#)). They are, in fact, more in line with recent empirical research showing that income tax holidays, windfall gains and tax cuts targeted at the top decile of the income distribution do not lead individuals to significantly alter the amount they work ([Akee et al., 2010](#); [Jones and Marinescu, 2018](#); [Martínez et al., 2021](#); [Zidar, 2019](#)).

Overall, our analysis finds strong evidence that cutting taxes on the rich increases income inequality but has no effect on growth or unemployment. We employ a measure of top 1% share of pre-tax national income that includes both labor and capital income, which makes it less likely that tax shifting and avoidance are driving the results. In fact, our results are more in line with [Piketty et al. \(2014\)](#), who suggest that lower taxes on the rich encourage high earners to bargain more forcefully to increase their own compensation, at the direct expense of those lower down the income distribution.

The remainder of the article is structured as follows. Section 2 explores the existing literature on the economic effects of cutting taxes on the rich. Section 3 sets out our data and empirical strategy. We present our headline results in Section 4, before carrying out a variety of robustness tests in Section 5. Lastly, Section 6 concludes.

## 2. The economic effects of cutting taxes on the rich

The 20th century was one of immense change in the tax systems of advanced democracies. Highly progressive income taxes arose in the wake of the two World Wars, with average top marginal income tax rates still standing at around 60% in the early 1980s. That decade proved to be a major turning point, however, and average rates have since fallen to under 40% ([Scheve and Stasavage, 2016](#); [Kiser and Karceski, 2017](#)). This trend was mirrored in other taxes on the wealthy and corporations, which also dropped sharply over the past half century ([Hope and Limberg, 2021](#)).

A large body of work that spans economics, sociology and political science has sought to explore the causes and consequences of this widespread and significant reduction in tax progressivity. [Scheve and Stasavage’s \(2010, 2012, 2016\)](#) pioneering historical research argues that progressive systems emerged due to mass conscription for war, but that the strength of these compensatory demands for fiscal fairness have weakened over time, leading to falling progressivity. Other scholars point to the role of major structural changes in the advanced democracies, such as capital mobility and trade ([Swank and Steinmo, 2002](#)), international tax competition ([Genschel and Schwarz, 2011](#)), and the rise of the knowledge economy ([Hope and Limberg, 2021](#)), in undermining the highly progressive tax systems of the post-war era. Lastly, [Blyth \(2002\)](#) and [Swank \(2006, 2016\)](#) find evidence that the diffusion of neoliberal economic ideas from the USA was crucial to driving the major tax reductions seen elsewhere.

There is already a substantial theoretical literature on the economic effects of cutting taxes on the rich. There are a number of lines of reasoning in that literature that predict

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