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The long read

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'Socialism for the rich': the evils of bad economics

The economic arguments adopted by Britain and the US in the 1980s led to vastly increased inequality – and gave the false impression that this outcome was not only inevitable, but good.

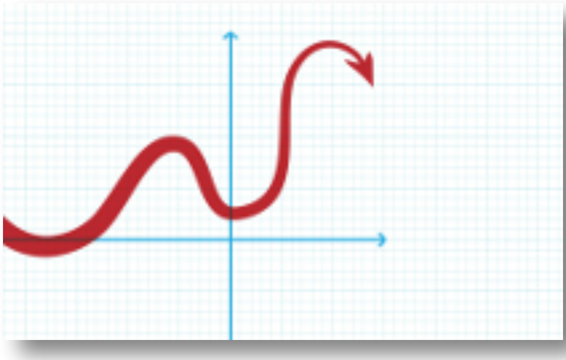

Illustration: Guardian Design/Christophe Gowans

In most rich countries, inequality is rising, and has been rising for some time. Many people believe this is a problem, but, equally, many think there's not much we can do about it. After all, the argument goes, globalisation and new technology have created an economy in which those with highly valued skills or talents can earn huge rewards. Inequality inevitably rises. Attempting to reduce inequality via redistributive taxation is likely to fail because the global elite can easily hide their money in tax havens. Insofar as increased taxation does hit the rich, it will deter wealth creation, so we all end up poorer.

One strange thing about these arguments, whatever their merits, is how they stand in stark contrast to the economic orthodoxy that existed from roughly 1945 until 1980, which held that rising inequality was not inevitable, and that various government policies could reduce it. What's more, these policies appear to have been successful. Inequality fell in most countries from the 1940s to the 1970s. The inequality we see today is largely due to changes since 1980.

In both the US and the UK, from 1980 to 2016, the share of total income going to the top 1% has more than doubled[1]. After allowing for inflation, the earnings of the bottom 90% in the US and UK have barely risen at all over the past 25 years. More generally, 50 years ago, a US CEO earned on average about 20 times as much as the typical worker. Today, the CEO earns 354 times[2] as much.

Any argument that rising inequality is largely inevitable in our globalised economy faces a crucial objection. Since 1980 some countries have experienced a big increase in inequality (the US and the UK); some have seen a much smaller increase (Canada, Japan, Italy), while inequality has been stable or falling in others (France, Belgium and Hungary). So rising inequality cannot be inevitable. And the extent of inequality within a country cannot be solely determined by long-run global economic forces, because, although most richer countries have been subject to broadly similar forces, the experiences of inequality have differed.

The familiar political explanation for this rising inequality is the huge shift in mainstream economic and political thinking, in favour of free markets, triggered by the elections of Ronald Reagan and Margaret Thatcher. Its fit with the facts is undeniable. Across developed economies, the biggest rise in inequality since 1945 occurred in the US and UK from 1980 onwards.

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[1] https://wir2018.wid.world/executive-summary.html

[2] https://www.epi.org/publication/ceo-pay-2012-extraordinarily-high/

The power of a grand political transformation seems persuasive. But it cannot be the whole explanation. It is too top-down: it is all about what politicians and other elites do to us. The idea that rising inequality is inevitable begins to look like a convenient myth, one that allows us to avoid thinking about another possibility: that through our electoral choices and decisions in daily life we have supported rising inequality, or at least acquiesced in it. Admittedly, that assumes we know about it. Surveys in the UK and US consistently suggest that we underestimate[3] both the level of current inequality and how much it has recently increased. But ignorance cannot be a complete excuse, because surveys also reveal a change in attitudes: rising inequality has become more acceptable – or at least, less unacceptable – especially if you are not on the wrong end of it.

Inequality is unlikely to fall much in the future unless our attitudes turn unequivocally against it. Among other things, we will need to accept that how much people earn in the market is often not what they deserve, and that the tax they pay is not taking from what is rightfully theirs.

One crucial reason why we have done so little to reduce inequality in recent years is that we downplay the role of luck in achieving success. Parents teach their children that almost all goals are attainable if you try hard enough. This is a lie, but there is a good excuse for it: unless you try your best, many goals will definitely remain unreachable.

Ignoring the good luck behind my success helps me feel good about myself, and makes it much easier to feel I deserve the rewards associated with success. High earners may truly believe that they deserve their income because they are vividly aware of how hard they have worked and the obstacles they have had to overcome to be successful.

But this is not true everywhere. Support for the idea that you deserve what you get varies from country to country. And in fact, support for such beliefs is stronger in countries where there seems to be stronger evidence that contradicts them. What explains this?

Attitude surveys have consistently shown that, compared to US residents, Europeans are roughly twice as likely to believe that luck is the main determinant of income and that the poor are trapped in poverty. Similarly, people in the US are about twice as likely as Europeans to believe that the poor are lazy and that hard work leads to higher quality of life in the long run.

Ronald Reagan and Margaret Thatcher in 1988. Photograph: Reuters

Yet in fact, the poor (the bottom 20%) work roughly the same total annual hours in the US and Europe. And economic opportunity and intergenerational mobility is more limited in the US than in Europe. The US intergenerational mobility statistics bear a striking resemblance[4] to those for height: US children born to poor parents are as likely to be poor as those born to tall parents are likely to be tall. And research has repeatedly shown that many people in the US don't know this: perceptions of social mobility are consistently over-optimistic.

European countries have, on average, more redistributive tax systems and more welfare benefits for the poor than the US, and therefore less inequality, after taxes and benefits. Many people see this outcome as a reflection of the different values that shape US and European societies. But cause-and-effect may run the other way: you-deserve-what-you-get beliefs are strengthened by inequality.

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[3] https://www.taxjustice.net/2014/10/17/reminder-everyone-underestimating-inequality/

[4] https://www.nytimes.com/2002/11/14/business/economic-scene-the-apple-falls-close-to-the-tree-even-in-the-land-of-opportunity.html

Psychologists have shown that people have motivated beliefs: beliefs that they have chosen to hold because those beliefs meet a psychological need. Now, being poor in the US is extremely tough, given the meagre welfare benefits and high levels of post-tax inequality. So Americans have a greater need than Europeans to believe that you deserve what you get and you get what you deserve. These beliefs play a powerful role in motivating yourself and your children to work as hard as possible to avoid poverty. And these beliefs can help alleviate the guilt involved in ignoring a homeless person begging on your street.

This is not just a US issue. Britain is an outlier within Europe, with relatively high inequality[5] and low economic and social mobility. Its recent history fits the cause-and-effect relationship here. Following the election of Margaret Thatcher in 1979, inequality rose significantly. After inequality rose, British attitudes changed. More people became convinced that generous welfare benefits make poor people lazy and that high salaries are essential to motivate talented people. However, intergenerational mobility fell: your income in Britain today is closely correlated with your parents' income.

If the American Dream and other narratives about everyone having a chance to be rich were true, we would expect the opposite relationship: high inequality (is fair because of) high intergenerational mobility. Instead, we see a very different narrative: people cope with high inequality by convincing themselves it is fair after all. We adopt narratives to justify inequality because society is highly unequal, not the other way round. So inequality may be self-perpetuating in a surprising way. Rather than resist and revolt, we just cope with it. Less Communist Manifesto, more self-help manual.

Inequality begets further inequality. As the top 1% grow richer, they have more incentive and more ability to enrich themselves further. They exert more and more influence on politics, from election-campaign funding to lobbying over particular rules and regulations. The result is a stream of policies that help them but are inefficient and wasteful. Leftwing critics have called it "socialism for the rich". Even the billionaire investor Warren Buffett seems to agree:

> "There's been class warfare going on for the last 20 years and my class has won," he once said[6].

This process has been most devastating when it comes to tax. High earners have most to gain from income tax cuts, and more spare cash to lobby politicians for these cuts. Once tax cuts are secured, high earners have an even stronger incentive to seek pay rises, because they keep a greater proportion of after-tax pay. And so on.

Although there have been cuts in the top rate of income tax across almost all developed economies since 1979, it was the UK and the US that were first, and that went furthest.

In 1979, Thatcher cut the UK's top rate from 83% to 60%, with a further reduction to 40% in 1988. Reagan cut the top US rate from 70% in 1981 to 28% in 1986. Although top rates today are slightly higher – 37% in the US and 45% in the UK – the numbers are worth mentioning because they are strikingly lower than in the post-second-world-war period, when top tax rates averaged 75% in the US and were even higher in the UK.

Some elements of the Reagan-Thatcher revolution in economic policy, such as Milton Friedman's monetarist[7] macroeconomics, have subsequently been abandoned.

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[5] https://www.theguardian.com/inequality/2019/may/14/britain-risks-heading-to-us-levels-of-inequality-warns-top-economist

[6] https://www.washingtonpost.com/blogs/plum-line/post/theres-been-class-warfare-for-the-last-20-years-and-my-class-has-won/2011/03/03/gIQApaFbAL_blog.html?utm_term=.b99288f7ab17

[7] https://www.theguardian.com/commentisfree/2014/mar/22/monetarism-economic-theory-bank-of-england-government

But the key policy idea to come out of microeconomics has become so widely accepted today that it has acquired the status of common sense: that tax discourages economic activity and, in particular, income tax discourages work.

This doctrine seemingly transformed public debate about taxation from an endless argument over who gets what, to the promise of a bright and prosperous future for all. The *"for all"* bit was crucial: no more winners and losers. Just winners. And the basic ideas were simple enough to fit on the back of a napkin.

One evening in December 1974, a group of ambitious young conservatives met for dinner at the *Two Continents* restaurant in Washington DC. The group included the *Chicago University* economist Arthur Laffer, Donald Rumsfeld (then chief of staff to President Gerald Ford), and Dick Cheney (then Rumsfeld's deputy, and a former *Yale* classmate of Laffer's).

While discussing Ford's recent tax increases, Laffer pointed out that, like a 0% income tax rate, a 100% rate would raise no revenue because no one would bother working. Logically, there must be some tax rate between these two extremes that would maximise tax revenue. Although Laffer does not remember doing so, he apparently grabbed a napkin and drew a curve on it, representing the relationship between tax rates and revenues. The *Laffer curve*[8] was born and, with it, the idea of trickle-down economics.

The key implication that impressed Rumsfeld and Cheney was that, just as tax rates lower than 100% must raise more revenue, cuts in income tax rates more generally could raise revenue. In other words, there could be winners, and no losers, from tax cuts.

But *could* does not mean *will*. No empirical evidence was produced in support of the mere logical possibility that tax cuts could raise revenue, and even the economists employed by the incoming Reagan administration six years later struggled to find any evidence in support of the idea.

George Osborne, who lowered the UK's top rate of tax from 50% to 45% in 2013. Photograph: Matt Cardy/PA

Yet it proved irresistible to Reagan, the perennial optimist, who essentially overruled his expert advisers, convinced that the

"entrepreneurial spirit unleashed by the new tax cuts would surely bring in more revenue than his experts imagined", as the historian Daniel T Rodgers put it.

(If this potent brew of populist optimism and impatience with economic experts seems familiar today, that might be explained in part by the fact that Laffer was also a campaign adviser to Donald Trump.)

For income tax cuts to raise tax revenue, the prospect of higher after-tax pay must motivate people to work more. The resulting increase in *GDP* and income may be enough to generate higher tax revenues, even though the tax rate itself has fallen. Although the effects of the big Reagan tax cuts are still disputed (mainly because of disagreement over how the US economy would have performed without the cuts), even those sympathetic to trickle-down economics conceded that the cuts had negligible impact on *GDP* – and certainly not enough to outweigh the negative effect of the cuts on tax revenues.

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[8] https://www.theguardian.com/commentisfree/2012/jun/27/laffer-curve-tax-cuts-rich-funny

But the Laffer curve did remind economists that a revenue-maximising top tax rate somewhere between 0% and 100% must exist. Finding the magic number is another matter: the search continues today. It is worth a brief dig into this research, not least because it is regularly used to veto attempts to reduce inequality by raising tax on the rich. In 2013, for example, the UK chancellor of the exchequer George Osborne reduced the top rate of income tax from 50% to 45%, arguing Laffer-style that the tax cut would lead to little, if any, loss of revenue. Osborne's argument relied on economic analysis suggesting that the revenue-maximising top tax rate for the UK is about 40%.

Yet the assumptions behind this number are shaky, as most economists involved in producing such figures acknowledge.

Let's begin with the underlying idea: if lower tax rates raise your after-tax pay, you are motivated to work more. It seems plausible enough but, in practice, the effects are likely to be minimal. If income tax falls, many of us cannot work more, even if we wanted to. There is little opportunity to get paid overtime, or otherwise increase our paid working hours, and working harder during current working hours does not lead to higher pay. Even for those who have these opportunities, it is far from clear that they will work more or harder. They may even decide to work less: since after-tax pay has risen, they can choose to work fewer hours and still maintain their previous income level. So the popular presumption that income tax cuts must lead to more work and productive economic activity turns out to have little basis in either common sense or economic theory.

There are deeper difficulties with Osborne's argument, difficulties not widely known even among economists. It is often assumed that if the top 1% is incentivised by income tax cuts to earn more, those higher earnings reflect an increase in productive economic activity. In other words, the pie gets bigger. But some economists, including the influential Thomas Piketty[9], have shown this was not true for CEOs and other top corporate managers following the tax cuts in the 1980s. Instead, they essentially funded their own pay rises by paying shareholders less, which led in turn to lower dividend tax revenue for the government. In fact, Piketty and colleagues have argued that the revenue-maximising top income tax rate may be as high as 83%.

The income tax cuts for the rich of the past 40 years were originally justified by economic arguments: Laffer's rhetoric was seized upon by politicians. But to economists, his ideas were both familiar and trivial. Modern economics provides neither theory nor evidence proving the merit of these tax cuts. Both are ambiguous. Although politicians can ignore this truth for a while, it suggests that widespread opposition to higher taxes on the rich is ultimately based on reasons beyond economics.

When the top UK income tax rate was raised to 50% in 2009 (until Osborne cut it to 45% four years later) the composer Andrew Lloyd Webber, one of Britain's wealthiest people, responded bluntly:

> "The last thing we need is a Somali pirate-style raid on the few wealth creators who still dare to navigate Britain's gale-force waters."

In the US, Stephen Schwarzman, CEO of private equity firm Blackstone, likened[10] proposals to remove a specialised tax exemption to the German invasion of Poland.

While we may scoff at these moans from the super-rich, most people unthinkingly accept the fundamental idea behind them: *that income tax is a kind of theft, taking income which is rightfully owned by the person who earned it*. It follows that tax is, at best, a necessary evil, and so should be minimised

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[9] https://www.theguardian.com/books/2014/apr/28/thomas-piketty-capital-surprise-bestseller

[10] https://www.theguardian.com/business/andrew-clark-on-america/2010/aug/17/privateequity-secondworldwar

as far as possible. On these grounds, the 83% top tax rate discussed by Piketty is seen as unacceptable.

There is an entire cultural ecosystem that has evolved around the idea of tax-as-theft, recognisable today in politicians' talk about "spending taxpayers' money", or campaigners celebrating "tax freedom day"[11]. This language exists outside the world of politics, too. Tax economists, accountants and lawyers refer to the so-called "tax burden".

But the idea that you somehow own your pre-tax income, while obvious, is false. To begin with, you could never have ownership rights prior to, or independent from, taxation. Ownership is a legal right. Laws require various institutions, including police and a legal system, to function. These institutions are financed through taxation. The tax and the ownership rights are effectively created simultaneously. We cannot have one without the other.

'There's been class warfare going on for the last 20 years, and my class has won' … US billionaire Warren Buffett. Photograph: Kevin Lamarque/Reuters

However, if the only function of the state is to support private ownership rights (maintaining a legal system, police, and so on), it seems that taxation could be very low – and any further taxation on top could still be seen as a form of theft. Implicit in this view is the idea of incomes earned, and so ownership rights created, in an entirely private market economy, with the state entering only later, to ensure these rights are maintained. Many economics textbooks picture the state in this way, as an add-on to the market. Yet this, too, is a fantasy.

In the modern world, all economic activity reflects the influence of government. Markets are inevitably defined and shaped by government. There is no such thing as income earned before government comes along. My earnings partly reflect my education. Earlier still, the circumstances of my birth and my subsequent health reflects the healthcare available. Even if that healthcare is entirely "private", it depends on the education of doctors and nurses, and the drugs and other technologies available. Like all other goods and services, these in turn depend on the economic and social infrastructure, including transport networks, communications systems, energy supplies and extensive legal arrangements covering complex matters such as intellectual property, formal markets such as stock exchanges, and jurisdiction across national borders. Lord Lloyd-Webber's wealth depends on government decisions about the length of copyright on the music he wrote. In sum, it is impossible to isolate what is "yours" from what is made possible, or influenced, by the role of government.

Talk of taxation as theft turns out to be a variation on the egotistical tendency to see one's success in splendid isolation, ignoring the contribution of past generations, current colleagues and government. Undervaluing the role of government leads to the belief that if you are smart and hard-working, the high taxes you endure, paying for often wasteful government, are not a good deal. You would be better off in a minimal-state, low-tax society.

One reply to this challenge points to the evidence on the rich leaving their home country to move to a lower tax jurisdiction: in fact, very few of them do. But here is a more ambitious reply from Warren Buffett:

> "Imagine there are two identical twins in the womb … And the genie says to them: 'One of you is going to be born in the United States, and one of you is going to be born in Bangladesh. And if you wind up in

[11] https://www.theguardian.com/science/political-science/2013/may/30/tax-freedom-day-ridiculous

> *Bangladesh, you will pay no taxes. What percentage of your income would you bid to be born in the United States?' … The people who say: 'I did it all myself' … believe me, they'd bid more to be in the United States than in Bangladesh."*

Much of the inequality we see today in richer countries is more down to decisions made by governments than to irreversible market forces. These decisions can be changed. However, we have to want to control inequality: we must make inequality reduction a central aim of government policy and wider society. The most entrenched, self-deluding and self-perpetuating justifications for inequality are about morality, not economy. The great economist John Kenneth Galbraith nicely summarised the problem:

> *"One of man's oldest exercises in moral philosophy … is the search for a superior moral justification for selfishness. It is an exercise which always involves a certain number of internal contradictions and even a few absurdities. The conspicuously wealthy turn up urging the character-building value of privation for the poor."*

Adapted from Licence to be Bad: *How Economics Corrupted Us* by Jonathan Aldred, published by Allen Lane and available at guardianbookshop.co.uk

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