

CHAPTER ONE

# WHY MIGHT GOVERNMENTS TAX THE RICH?\*

When and why do countries tax the rich? It's hard to think of a timelier question today or one for which there are more sharply colliding views. We know that taxes on the rich today aren't what they were half a century ago, but how did we get from there to here? We know even less about how those high taxes of the twentieth century happened in the first place. Was it the effect of democracy, or a response to rampant inequality? Much of what is written today about taxing the rich takes the form of advocacy that is focused above all on the present. We do something different by taking a step back and showing what the long history of taxing the rich can teach us about our current situation.

What a country decides about taxes on the rich has profound consequences for its future economic growth and the distribution of economic resources and opportunities. Given the stakes, it's surprising how few comparative studies exist of taxation of the rich over the long run. Many people have asked this question only for recent decades, or for a single country. The last book to treat the question extensively was published more than a century ago, by Edwin Seligman.

\* The online appendix, data, and replication material for all analyses in this book can be found at <http://press.princeton.edu/titles/10674.html>.

We argue that societies do not tax the rich just because they are democracies where the poor outnumber the rich or because inequality is high. Nor are beliefs about how taxes influence economic performance ultimately decisive. Societies tax the rich when people believe that the state has privileged the wealthy, and so fair compensation demands that the rich be taxed more heavily than the rest.

When it comes to thinking of what tax policy is best, few would disagree with the notion that governments should be—in part—guided by fairness. It is a term used frequently by those on both the political left and right.<sup>1</sup> How can this be? History suggests that the concept of fairness is up for grabs. Standards of fairness in taxation vary greatly across countries, over time, and from individual to individual.

When scholars write about fairness and taxation they most often adopt a normative point of view; that is, they ask what governments should do. But fairness isn't just a normative standard; it also matters for what governments do in practice because it influences the policy opinions of citizens. Ordinary people are more likely to support heavy taxation of the rich if it adheres to the fairness standards that they themselves hold. While many theories of politics assume people are concerned only with maximizing their own income, there is abundant evidence that humans are also concerned about issues of equity and fairness. These concerns don't mean that people aren't also concerned about self-interest—no one likes paying taxes—or even that self-interest isn't their prime concern. Individuals may also care about the efficiency of a tax system and whether it taxes people so heavily that they stop producing at all. Opinions about tax policy can be informed by both self-interest and efficiency, as well as fairness.

Political support for taxing the rich is strongest when doing so ensures that the state treats citizens *as equals*. Treating citizens as equals means treating them with “equal concern and respect,” to use the phrase adopted by Ronald Dworkin.<sup>2</sup> The idea that people should be treated as equals is, of course, part of the bedrock of modern democracy. This criterion narrows the field for what counts as an effective fairness justification for a tax. It cannot be an argument that refers to how people are inherently different or how some are inherently more worthy than others. Nor, of course, can it refer to pure

self-interest. Even so, simply saying that people should be treated “as equals” or “with equal concern and respect” does not allow us to proceed deductively to identify the precise tax policies that satisfy this criterion. There are multiple ways to plausibly treat people as equals in taxation, and this is what debating tax fairness is all about. We take an inductive approach and focus on the three arguments that have been the most common and the most persuasive in political debate: *equal treatment*, *ability to pay*, and *compensatory* arguments. We refer to these arguments as three ways to treat people *as equals*.

The greatest political support for taxing the rich emerges when *compensatory* arguments can be credibly applied in policy debates. This happens when it is clear that taxing the rich more heavily than the rest serves to correct or compensate for some other inequality in government action. Compensatory arguments are most likely to emerge in democracies precisely because the very idea of democracy is that citizens should be treated as equals. If the rich have been privileged by some government intervention while others have not, then it is fair that they should be taxed more heavily to compensate for this advantage. Symmetrically, if the state has asked others to sacrifice while the rich have not borne the same burden, then again taxation of the rich can compensate. Compensatory arguments push policy toward heavier taxation of the rich, but in many cases the straightest route to fairness is to remove the initial privilege in the first place. Therefore, compensatory arguments are most powerful in cases when a government is obliged to take an unequal action that somehow favors the rich.

The compensatory theory is not the only fairness-based argument for taxing the rich. Over the past few centuries, the most common fairness-based argument for taxing the rich has been the *ability to pay* doctrine. According to this doctrine, a dollar in taxes for someone earning a million dollars a year represents less of a sacrifice than it does for someone earning a more average salary.<sup>3</sup> Ability to pay arguments have existed since at least the sixteenth century, and they underpin the contemporary theories of optimal taxation most favored by economists.

For many, the ability to pay doctrine suffices as a reason to tax the rich more heavily than the rest. Others object to this notion. They

may question how the ability to pay doctrine can be applied in practice. How much more should a rich person pay? They may also ask why ability to pay says nothing about how disparities in income or wealth emerged in the first place. Maybe the rich were just more talented or exerted more effort than others? People who criticize the ability to pay doctrine do not deny that a dollar in taxes represents less of a sacrifice for a rich person than for someone else; they simply do not accept that this is the right criterion by which to judge fairness.

In the face of doubts about ability to pay, a salient alternative is to suggest that the fairest system involves *equal treatment* for all. Both rich and poor should pay the same tax rate—a “flat tax.” We use the phrase “equal treatment” to refer to fairness arguments suggesting that the same exact policy be adopted for all. Since the sixteenth century, opponents of progressive taxation have suggested that the basis of a republic is equal treatment for all, as illustrated by the norm of one person one vote. Therefore the same exact policy should be applied to taxation. The logic that equal treatment requires a flat tax is not perfect; having all pay a lump-sum tax, where each person pays the same amount, would also respect equal treatment, yet many today would consider such a tax unfair. Nevertheless, arguments based on equal treatment have carried great power in debates about taxing the rich.

Some of the earliest examples of *compensatory* arguments involve suggestions that the rich ought to pay a higher rate of income tax because the poor bear the brunt of indirect taxes on common consumption goods. The idea is that to maintain themselves, the poor must consume a greater share of their income each year. However, over the last two centuries the most powerful compensatory arguments have involved a different sort of tax—military conscription. This one simple fact goes a long way toward explaining both the rise of heavy taxation of the rich in the early and mid-twentieth century and the subsequent move away from this policy over the last several decades. The mass wars of the twentieth century were fought in a way that had a strong economic rationale but which privileged the rich along two dimensions. First, labor was conscripted to fight

while capital was not. Second, owners of capital benefited from high wartime demand for their products. Heavy taxation of the rich (owners of capital) became a way to mitigate these effects and to restore at least some degree of equality of treatment by the government. This was what those on the political left claimed and what those on the right were forced to concede. It was a powerful new argument for progressive forms of taxation, and it shifted mass and elite opinion on the question of taxing the rich in a leftward direction. Other scholars before us have investigated the effect of war on tax fairness, particularly in the United States and the United Kingdom. We show that this war effect can be explained by the compensatory theory of progressive taxation and that it is a more general phenomenon across countries and time.<sup>4</sup>

Compensatory arguments are less credible in the case of more limited wars of the sort that the United States has fought of late. If the bulk of the population is not sacrificing for war, then how is it credible to ask the rich to pay a special sacrifice as compensation?

Finally, the choice between limited war or mass mobilization has been dependent on the state of military and related technologies. In the twentieth century the advent of the railroad made mass mobilization possible. When mass mobilization did eventually occur in 1914, compensatory arguments for taxing the rich emerged. In the twenty-first century the advent of precision weapons and drone technology means that mass armies are no longer necessary and may even be undesirable. Therefore, we are unlikely to see a repeat of the twentieth-century forces that led to heavy taxation of the rich. The compensatory theory explains why it was the wars of the early and mid-twentieth century that brought heavy taxation of the rich and not prior or subsequent wars.

Over the last two centuries, when circumstances have made compensatory arguments less credible, debates about taxation of the rich have boiled down to a conflict between the two competing visions of ability to pay and equal treatment, as well as efficiency. The outcome of this conflict has generally been for the rich to not be taxed much more heavily than the rest of the population. But, when circumstances have allowed for wartime compensatory arguments

to be made, opinion has shifted in favor of taxing the rich. While those who adhere to ability to pay have continued to support taxing the rich, many of those who have preferred equal treatment have thought that the compensatory argument must be taken into account to achieve this goal. In such situations political parties of the left have used compensatory arguments to reinforce their arguments for taxing the rich. Political parties of the right have been forced to cede ground in order to remain electable.

It is also the case that political parties can and have used compensatory arguments instrumentally. If you personally are already convinced by the ability to pay rationale for taxing the rich, you may gain greater support for your proposal by making compensatory arguments that win broader support. Once external circumstances change and compensatory arguments lack credibility, then debates about taxing the rich return to a conflict between the competing notions of equal treatment, efficiency, and ability to pay.

## **THE RISE (AND DEMISE?) OF TAXES ON THE RICH**

We can learn a great deal by studying changes in taxation over the long run. A look at broad trends can help us tease out the most important factors at play. To do this we, and the research assistants who helped us, have collected information on taxation in twenty countries, located principally in North America and Western Europe, over a period of two centuries.<sup>5</sup> We focus on these countries for feasibility in data collection, but the conclusions we draw apply more generally.<sup>6</sup> In an ideal world we would know all taxes due by a rich person and an average person in each year for each of the cases; unfortunately this is not possible. For most countries, even statutory rates of taxation are not widely published and must instead be verified by consulting original legislation. This is a time-consuming process.

We have been able to construct a unique database tracking statutory top marginal rates of income and inheritance taxation across the twenty countries. By statutory top marginal rates we mean the tax rate that would apply by law on the last dollar of income (or wealth) for someone in the highest tax bracket. This information

is mostly drawn from original legislation. The top marginal rate provides an indication of what a rich person would be likely to pay. However, a focus on top statutory rates alone can provide misleading conclusions, and to deal with this problem we have also collected much additional information. First, we have the full schedules of tax rates (i.e., not just those at the top) for half of the countries. This shows whether an increase in the top rate represented a move to tax just the rich or whether it was just part of a move to tax everyone more heavily. A look at these schedules also reveals something more specific about who was being taxed. Rather than simply referring to “the rich” and “the rest,” we can refer to individuals earning incomes or having fortunes of a specific size relative to the national average. What do we mean by a “rich” person? Extensive research has shown that much of the recent rise in inequality has been attributable to movements within the top 1.0 percent of the income distribution or even between the top 0.1 percent and the rest of the population. We adopt a similar categorization. Our focus on the rich also means that we are asking a question that is related to but distinct from those asked by the many scholars who have focused more generally on the politics of redistribution and/or social insurance.<sup>7</sup>

Second, we also compare statutory rates with effective rates of taxation. This is critical because effective rates are what people actually pay. The effective rate for the income tax is found by taking total income tax paid and then dividing this by gross income. Information on effective rates is, on the whole, not easy to come by, particularly for a broad set of countries over a long time period. We do, however, have long-run effective rates of income taxation for six of the study countries. Using these we show that top statutory rates tend to be good proxies for how much the rich actually pay. There are important exceptions to this, however, that will be pointed out.

As a way of introducing the data, figure 1.1 shows the average top statutory marginal rate of income and inheritance taxation in all twenty countries from 1800 to the present. The picture invites us to think of the world in three stages. First taxes on the rich were very low, then they rose to dramatic heights, and then they fell again, very

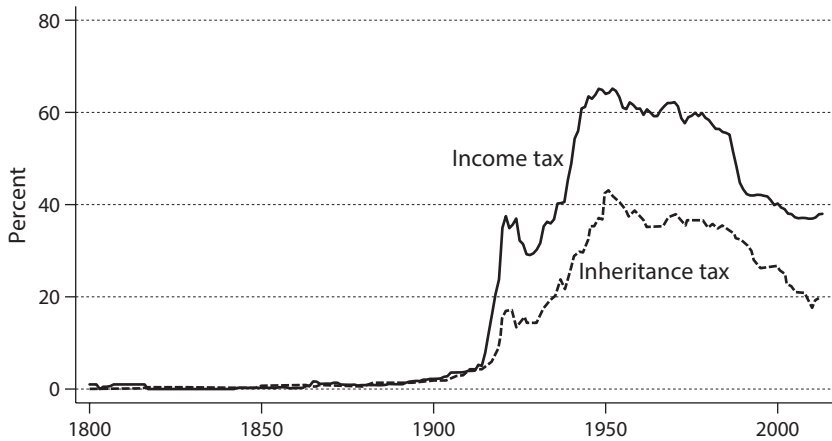


Figure 1.1. Average Top Rates of Income and Inheritance Taxation, 1800–2013.

dramatically. But a look at figure 1.1 does not immediately suggest why this was the case. The rise of progressive taxation coincided with a period of democratization across the western world. But it also coincided with an era of massive military conflict as well as other changes to the political and economic landscape. To be sure, the rich had been taxed in wars of past centuries, but all evidence suggests this twentieth-century taxation was something entirely new.<sup>8</sup> In chapter 5 we also show that our conclusion that there was little taxation of the rich during the nineteenth century remains unaltered when one takes into consideration a broader range of taxes, including property taxes and annual taxes on wealth.

One way in which figure 1.1 may be misleading is that it takes no account of the growth of government over time. Perhaps the rich were more heavily taxed in the twentieth century, compared to the nineteenth, because citizens demanded more from government, and all had to contribute? Average tax revenue as a percentage of gross domestic product increased from 9 percent to 20 percent from 1900 to 1950, consistent with this conjecture. However, government revenue continued to increase over the remainder of the twentieth century—to an average of 43 percent of gross domestic product—while top rates on the rich declined over this period.<sup>9</sup> The rich have been



taxed less even though governments have increased in size. Scholars who work on public spending sometimes speak of a “ratchet” effect whereby each of the two world wars led to a permanent increase in the size of government.<sup>10</sup> When it comes to long-run trends in taxing the rich there has been no ratchet; the period of high taxes on the rich was temporary. We explore the role of the size of government further in chapters 3 and 5.

Another point missing from the figure is a discussion of how governments spent their money. This certainly ought to have some impact on what taxes citizens support and whether they consider them “fair.” In an ideal world we would use two centuries of evidence to chart how much the rich and the rest benefited from government spending across the twenty countries. That, however, is a task that lies beyond the data that we have available. Fortunately, history has provided us with a convenient laboratory for studying taxation separately from the impact of the government transfers that are commonplace today. Prior to 1945 the governments in our study spent relatively little apart from providing basic public goods and fighting wars. Looking at taxation alone will therefore not give us a biased picture. Moreover, we show in chapter 8 that after 1945, wartime compensatory arguments applied to spending every bit as much as they applied to taxation. Therefore, a look at government spending only reinforces our main conclusions.

Combining the information on top tax rates with extensive political data allows testing of several alternative arguments about when and why governments have taxed the rich. Data on when governments expanded the suffrage, as well as other institutional details, might explain why the rich were taxed more heavily in some cases than others. We also use data on income and wealth inequality to ask whether countries taxed the rich when inequality was high.

Our analysis will go well beyond a simple examination of top tax rates and their correlates. We devote three separate chapters to asking why governments raised taxes on the rich during mass mobilization for war. This is critical because the main lesson is not that war mattered; it is instead that if the rich were taxed so heavily during wartime, then this tells us something about the broader question of fairness in taxation.

## COMMON IDEAS ABOUT TAXING THE RICH

Taxation of the rich is a hotly debated topic. So it should come as no surprise that there are several theories that might explain why some societies tax the rich heavily. Each of them is inadequate for the task at hand. The very plausible assumptions underlying these hypotheses are first that individuals do not like paying taxes; second that decisions are influenced by the prevailing type of political representation; and finally that decisions also depend on beliefs about economic efficiency. The received wisdom is then that progressive taxation is natural in a democracy because the bulk of the population wants it, unless people believe that the adverse incentive effects of doing so will be too great, or unless democracy somehow becomes “captured” by the rich.

### “DEMOCRACIES TAX THE RICH MORE HEAVILY”

There may be many ways in which citizens can pressure governments to tax the rich, but having the vote certainly shouldn't harm their chances of doing so. In a democracy it should be numbers that count, and the poor and middle classes outnumber the rich. Among political scientists and economists today it is common to suggest that democracies are more likely to redistribute income from the rich to the rest, and progressive taxation is one means of doing so. Current scholars are in good company in making this argument. Sometime between the years 1521 and 1524, Francesco Guicciardini composed a dialogue among several fictitious speakers debating the merits of popular government in Florence. One of the opponents of democracy spoke as follows:

As far as methods of taxation are concerned, I can assure you that the people's [*sic*] will normally be much worse and more unjust, because by nature they like to overburden the better-off; and since the less well off are more numerous, it is not difficult for them to do this.<sup>11</sup>

Five centuries later, in a new era of expanding democracy, Edwin Seligman expressed a very similar opinion, but unlike Guicciardini,

he saw this as an entirely good thing.<sup>12</sup> Seligman's view was that as societies became more infused with democratic ideals, people naturally favored progressive taxation because it is simply the sensible and desirable thing to do. An alternative view from this time was that within democracies, the choice for progressive taxation was an outcome of political conflict. In 1926, William Shultz suggested the following:

In legislatures, progressive taxes are proposed by representatives from "poorer" districts, they are fought tooth and nail by representatives of the propertied classes, and usually they are passed by legislatures only when the political influence of the poorer majority of the electorate outweighs the influence of the richer minority. By means of new radical parties or radical blocs growing up within older parties, the poorer classes of the nations have come to exercise more or less control over legislatures, and in this country and abroad progressivity in tax rates is an established order. This is an incidental parliamentary victory of the poorer classes over the richer—just as the retention of proportional rates would have been a defeat—in the present veiled economic and political struggle between the two.<sup>13</sup>

Many subsequent scholars have emphasized the effect of universal suffrage on redistribution, and on progressive tax policies as part of the equation.<sup>14</sup> What does the evidence say? There is some support for the idea that the introduction of income taxation was associated with the expansion of the suffrage.<sup>15</sup> However, we ask not only whether governments have created an income tax, but also whether they have used it to tax the rich heavily. Chapter 3 considers a series of simple tests to answer this question, backed by more extensive statistical analyses that can be found in the online appendix to the book.<sup>16</sup> Though all of the twenty countries eventually established universal male suffrage, this happened at different times. If universal suffrage led to heavier taxation of the rich, then we should expect that those countries that expanded the suffrage at an earlier date also adopted more progressive tax policies at an earlier date. We examine this proposition using evidence on both income taxation and

inheritance taxation. Taxing incomes requires a high level of administrative capacity. Therefore, if we see that a democratizing country fails to levy income taxes on the rich, then it might be because of lack of capacity and not because the democracy hypothesis is wrong. Historically less administrative machinery has been required to tax inheritance. If a democratizing country also fails to tax the rich through inheritance, this suggests that something about the democracy hypothesis is invalid.

The evidence shows that democracy's effect on progressive taxation has been overstated. As noted, though the expansion of the suffrage and the adoption of progressive taxation happened around the same time in many countries, one needs to distinguish between the adoption of progressive taxation and the choice of high marginal tax rates for the rich. After the basic principle of progressive taxation was adopted, many countries took a very long time before choosing top statutory marginal tax rates that we would think of today as being high. Some countries never took this step at all. One explanation for this finding is that granting ordinary people the vote didn't result in progressive taxation because they didn't want it. They may have subscribed to a version of treating citizens as equals that is inconsistent with this policy.

It is also possible to extend the analysis by looking at institutions other than suffrage. Universal suffrage might arguably only have an impact on progressive taxation when elections of representatives are direct, when the ballot is secret, and when there are not additional institutional obstacles in place to prevent a majority from expressing its will. We investigated a host of such possibilities and came up with surprisingly little. Democracy alone was insufficient to produce heavier taxation of the rich.

#### “DEMOCRACIES TAX THE RICH WHEN INEQUALITY IS HIGH”

Many observers remark that our current situation seems abnormal. Inequality is rising just as taxes on the rich are low and perhaps falling further. The implicit assumption behind this claim is that governments in “normal” times will raise taxes on the rich to fight inequality. There are three reasons they might do this.

The first reason is that as the amount of income or wealth of those at the top increases relative to the rest of society, voters will find it in their self-interest to tax the rich more heavily as long as the negative incentive effects from doing so are not too large.<sup>17</sup> Voters might also favor this choice if they subscribe to the ability to pay doctrine.

The second reason why people might demand taxation of the rich when inequality is high is if they believe that inequality of outcomes derives from inequality of opportunity.

The third reason why governments might tax the rich when inequality is high is that they fear the consequences of inequality for the political system. They fear that inequalities of income and wealth will lead to the political process being captured by a wealthy elite or oligarchy. This is a very old idea. It was a common fear expressed by the U.S. Founding Fathers.<sup>18</sup> It was also a view emphasized by the proponent of progressive taxation in Francesco Guicciardini's discourse on sixteenth-century Florence's progressive income tax, the *decima scalata*. Excess inequality of wealth would undermine the republic by sapping citizens of their virtue, perhaps even leading to tyranny.<sup>19</sup> Finally, some authors, such as Jean-Jacques Rousseau, have emphasized that extreme inequality is a danger for a republic both because the rich can overcome legal restraints and also because the poor are more likely to revolt. As Rousseau suggested:

The greatest evil has already been done where there are poor people to defend and rich people to restrain. The full force of the laws is effective only in the middle range; they are equally powerless against the rich man's treasures and the poor man's misery; the first eludes them, the second escapes them; the one tears the web, the other slips through it.<sup>20</sup>

The big question is whether voters prompt democratically elected governments to take corrective policy actions so that levels of inequality remain in the "middle range" to which Rousseau referred.<sup>21</sup>

Evidence from top incomes and top wealth shares suggests that democracies do not, in fact, tax the rich more heavily when inequality is high. In chapters 3 and 4 we consider the relationship between inequality and top rates of income and inheritance taxation. Using

data on top incomes and top wealth shares, we show, first, that there is only very weak evidence that governments, on average, respond to high prevailing levels of inequality by increasing taxes on the rich. Second, high taxes on the rich are indeed associated with lower subsequent levels of inequality. This means that high top tax rates can be a powerful tool to address inequality, but the mere presence of inequality is insufficient to prompt governments to pursue this strategy. This also implies that ability to pay arguments were insufficient to carry the day. Therefore we must think of why governments might respond to inequality in some cases but not others.

### “DEMOCRATIC POLITICS CAN BE CAPTURED BY THE RICH”

The rich in a democracy have one vote just like everyone else. But it would of course be naïve to think that wealth would bring zero additional advantage. A modified version of the democracy hypothesis is to suggest that democracy only results in greater taxation of the rich when the rich are unable to use their wealth to capture the political process. As we noted previously, theorists of republican government have long feared that inequalities in wealth would lead to the wealthy imposing their policies. It is possible today to think of multiple channels through which this effect might take place. The rich will logically be in a better position to lobby and give campaign contributions. They may also be better informed about how specific policies will influence them. Maybe they are also simply more likely to travel in the same circles as those who make policy.

When considering this problem many observers are quick to refer to the example of the United States today. For decades American political campaigns have relied on very substantial campaign contributions, and this phenomenon has only increased since the U.S. Supreme Court’s 2010 *Citizens United* decision. Perhaps this is why careful studies by survey researchers, such as Martin Gilens and Larry Bartels, show that members of the U.S. Congress tend to vote in a manner that is most consistent with the views of their high-income constituents, as opposed to the general electorate.<sup>22</sup> The fact that the American government taxes the rich less heavily than it did may

simply be a result of this broader phenomenon of capture. Some authors have examined this issue extensively, finding clear support for a link between money contributed and policy choice.<sup>23</sup> Others have claimed that capture helps to explain developments with regard to specific taxes, such as the estate tax.<sup>24</sup>

The capture hypothesis seems ideally suited for explaining recent events in the United States; private campaign finance is abundant and private expenditures on lobbying are arguably even more significant.<sup>25</sup> But if reference to campaign finance and lobbying is to be a convincing explanation for the big picture, then this hypothesis should also hold true for other democracies that have reduced taxes on the rich. A number of countries have actually gone further than the United States by abolishing inheritance taxation entirely. Top rates of income taxation have also come down dramatically elsewhere. The problem for the capture hypothesis is that these developments have included countries where the role of private money in politics is much more limited. So, even though Canadian electoral campaigns have, until recently, been publicly financed, the Canadian government abolished its inheritance tax in 1971. Sweden took a similar step in 2004 despite the fact that there is far less money in Swedish politics than in the United States.

Now, just because we fail to find a relationship between how campaigns are financed and how heavily the rich are taxed does not mean that there is no truth to the capture hypothesis. Nor does it mean that campaign lobbying by the wealthy has had no effect on taxation of the rich in the United States in recent decades. As an example, lobbying by members of the financial sector is no doubt preserving the policy through which hedge fund managers are able to classify their income as carried interest so as to reduce taxes due. Overall, though, the capture hypothesis is inadequate for explaining the broad variation in tax rates across many countries over time. Convincing evidence for the capture hypothesis would have to show that in a broad set of cases where democracies failed to tax the rich heavily, this failure was attributable to the persistence of elite power in a manner that has been suggested by Daron Acemoglu and James Robinson.<sup>26</sup> Such an account would also have to show that it was

variation in the extent of capture that explained variations in taxing the rich between countries over time.

“GOVERNMENTS AVOID TAXING THE RICH WHEN THEY  
THINK IT IS SELF-DEFEATING”

A major claim in many arguments against taxing the rich is that this policy is self-defeating. Levying high taxes on the rich, it is suggested, will prompt them to work less, invest less, and, in a world of mobile capital, to shift their wealth abroad. Therefore it is better to not do it in the first place. Our goal is not to assess the plausibility of these claims.<sup>27</sup> We instead ask how much force these arguments have had in the political arena and whether they can account for changes in top rates of taxation over time. It may be that knowledge about these incentive effects changes over time, perhaps because of new theories or new evidence about how the economy functions. For example, when an economy’s growth rate slows, people may infer that taxes on the rich should be cut because incentive effects are having a negative impact. In chapter 8 we analyze this possibility and fail to find evidence that governments in recent decades have, on average, cut top tax rates as growth slows.<sup>28</sup>

Another possibility is that until recent decades, people simply didn’t believe incentive effects could be a major drag on the economy. Even astute observers sometimes suggest this.<sup>29</sup> History shows that nothing could be further from the truth. It is indeed the case that as economic theory has advanced, scholars have been able for the first time to construct mathematical models in which incentive effects from taxation are directly incorporated. The most salient contribution here is that by James Mirrlees in the early 1970s. However, it is certainly not true that incentive arguments began with Mirrlees, and he made no attempt to claim this. As early as 1897, we can find a clear statement by Francis Edgeworth that what might seem an ideal policy based on equalization of incomes should be more nuanced because of incentive effects. As Edgeworth put it: “The *acme* of socialism is thus for a moment sighted; but it is immediately clouded over by doubts and reservations.”<sup>30</sup> Chapter 2 will show that arguments about incentive effects actually extend back to the sixteenth century.



Since the first date at which modern progressive tax systems were proposed, opponents have argued that they would harm investment and employment. However, we find little evidence to suggest that changes in beliefs about the importance of these effects can account for the major changes in policy that we observe during the nineteenth and twentieth centuries.

## TREATING CITIZENS AS EQUALS

A basic principle of democracy is that people ought to be treated as equals, but when it comes to taxation, people often disagree about what “as equals” means. We argue that the most politically powerful arguments for taxing the rich have been compensatory arguments; the rich should be taxed to compensate for the fact that they have been unfairly privileged by the state. Compensatory arguments have come in different guises, and we will discuss all these, but over the last two centuries the most powerful compensatory arguments have been those associated with mass mobilization for war.

The arrival of an era of mass warfare in 1914 created the possibility for powerful new arguments for taxing the rich. If labor was conscripted then fairness demanded that capital be conscripted as well. Having the rich pay higher taxes than the rest was one way to achieve this goal. Mass warfare has been the main force shaping the development of progressive tax policies during the last century. In emphasizing this, we are in keeping with other recent work that emphasizes the effect of war on domestic politics.<sup>31</sup> However, this doesn’t just tell us something about war; it also tells us that the most politically powerful arguments for taxing the rich are those based on compensation to restore treatment as equals.

The two world wars of the twentieth century involved mobilization of manpower on an unprecedented scale by both great powers and smaller states. Armies had once been recruited from a small segment of the population as volunteers or through limited conscription. Suddenly they were selected by universal conscription from the broad population. When raising a very large army, a state may find it necessary to recruit in this manner because the tax burden for

paying volunteers would be unbearable. There is also a fairness argument for universal conscription. As Margaret Levi has demonstrated, universal conscription itself emerged from prior systems of limited conscription as a result of demands for equal treatment.<sup>32</sup>

The problem with even a system of universal conscription is that it does not truly ensure equal treatment, even in an *ex ante* sense before a draft lottery is run. In virtually any universal conscription system there are reasons for exemption from service, and it is likely that the rich will be more apt to have access to these opportunities than the rest. Age presents yet another reason for exemption in any universal conscription system, and it is well known that age is highly correlated with wealth. Finally, universal conscription satisfies only a state's need for labor while saying nothing about how capital is to be raised for the war effort. If those with capital benefit from increased demand for the products of companies in which they have invested, then this too can violate widely shared commitments to equal treatment.

During the twentieth century, the inability of even a system of universal conscription to ensure citizens were being treated as equals gave proponents of progressive taxation a new and powerful compensatory argument for taxing the rich. If there was unequal sharing of the war burden, then the rich should be taxed more heavily than the rest. In other words, instead of having to rely only on arguments involving ability to pay, advocates of progressive taxation could now say that without heavily taxing the rich they would not be doing their fair share for the war effort. The clearest exposition of this argument was offered by the Labour Party in the UK in its call for a "conscription of wealth" to match the conscription of labor. During the two world wars this same argument was made in many other venues.

Mass mobilization for war presented new possibilities for making compensatory arguments for taxing the rich. Because such arguments could only be made for a limited time, the compensatory theory helps explain not only why taxes on the rich went up but also why they eventually came down. As we show, in the wake of World War II compensatory arguments emphasizing war sacrifice were ubiquitous in former belligerent countries. As had been the case after World

War I, compensatory arguments remained prominent in discussions of how to repay war debts and, to a much greater degree than after World War I, with the provision of veterans' benefits. But ultimately, after mass mobilization wars ended, such arguments faded from view. Instead, high taxes on the rich became a new status quo that had to be defended strictly by referring to "ability to pay" or by saying that taxing the rich was "fair" without explaining why. In this environment it was inevitable that taxes on the rich would eventually come down. This does not explain the exact moment when taxes on the rich came down, but it does show why this evolution was inevitable.

If mass warfare created a new compensatory argument for taxing the rich, we need to recognize that not all wars open up this possibility. Some commentators have found it odd that the Bush administration lowered taxes on the rich during the recent wars in Iraq and Afghanistan. Others have even wondered why there aren't calls for a new conscription of wealth.<sup>33</sup> Yet there is a fundamental problem with such an argument. Most of the U.S. population has not been asked to sacrifice during these recent wars, so why should the rich be singled out for sacrifice? Today the United States fights limited wars in which a small percentage of the population is mobilized and those in the armed forces are recruited voluntarily. Therefore, arguments about conscripting wealth no longer carry the same weight.

There is also a final critical element to our interpretation of the history of progressive taxation. The way that countries like the United States have fought wars is to a very great extent dependent on the state of military technology and on the type of enemies being fought. The emergence of the railroad first made it possible to mobilize armies on the scale that occurred during the two world wars. Over the last fifty years technological developments have pushed in the opposite direction. It is still possible to field a mass army, but the invention of weapons like the cruise missile, the laser guided bomb, and the drone mean that it is no longer necessary to do so.

Our finding about military technology and international rivalry is important for two reasons. First, it tells us more about the deeper reasons why steeply progressive taxation happened when it did, and why it is more difficult to achieve political support for it

today. Compensatory arguments did not become credible by accident. They became credible because the pattern of international rivalry and military technology changed the type of wars that states fought. Second, our finding also sheds more light on the question of whether taxation of the rich during the twentieth century, and perhaps even trends in inequality, was accidental, as Thomas Piketty has prominently argued.<sup>34</sup> While agreeing with his emphasis on war, our conclusions suggest that rather than high taxation of the rich being a simple accident, it was ultimately driven by long-run trends involving international rivalries and the technologies available for fighting wars.

## THE FUTURE FOR TAXING THE RICH

Mass warfare mattered because it gave birth to new ideas and new arguments for why taxing the rich was fair. The extent of war mobilization was itself dictated by prevailing war technologies of the time. What does all this suggest for today's debates about taxing the rich? First, as technological change has led to a more limited form of warfare, there is unlikely to be a simple repeat of the twentieth-century conditions in which powerful compensatory arguments led to very high top marginal rates of income and inheritance taxation.

What about the effect of rising inequality? Won't this fuel demands for taxing the rich? Today it is most common to hear arguments in favor of taxing the rich simply because inequality is high and getting higher. In essence this is an invocation of the ability to pay doctrine. Yet two centuries of evidence show that governments, on average, do not tax the rich just because inequality is high. The rich are taxed when people believe not just that inequality is high but also that it is fundamentally unfair because the deck is stacked in favor of the rich, and the government did the stacking. In other words, they believe in compensatory arguments.

Based on current trends, future debates about taxing the rich will likely follow the familiar cleavage between those who adhere to ability to pay and those who emphasize equal treatment and/or economic efficiency. It is unlikely that such a debate will result

in significant increases in taxes on those in the top 1.0 percent or the top 0.1 percent. Change would instead depend on whether proponents of taxing the rich are able to develop compensatory arguments for an era of peace. We consider several such possibilities in chapter 9, concluding that those who want to tax the rich might do better to look at the type of compensatory arguments made in the nineteenth century rather than the twentieth. This was an era where many argued that income taxes needed to be progressive to offset the regressive incidence of other state levies. Such old arguments in a new era could lead to moderately increased taxes on the rich, though not to a repeat of the twentieth century. Change may also ultimately depend on whether those who want to tax the rich are themselves able to appeal to the logic of equal treatment. In some cases today those who are at the very top are paying a lower effective rate of tax than those who are merely well off. There is no need to appeal to ability to pay or rising inequality to argue against this. Such outcomes go against the basic equal treatment principles of fairness that opponents of taxing the rich have themselves espoused.