The confluence of ideas and interests in the process of rent destruction: the case of UK tax policy 1979-1997

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Abstract
A case study of UK tax policy from 1979 to 1997 is used to examine the role of ideas and interests in the destruction of political rents. Rent destruction has been typically understood as occurring when the battle for distributional advantage that normally characterises democratic politics has been temporarily superseded by policies informed by ideology pursued in the public interest. The benefits that resulted from the destruction of political rents by the Conservative governments of Thatcher and Major could have been distributed broadly across all taxpayers, but instead were targeted at specific groups of taxpayers. It is argued that this is evidence of the continued salience of distributional demands, even when rents are being destroyed. It suggests that political reforms that destroy rents require the support of a political coalition and the mobilisation of that coalition may require the promise of direct pecuniary benefits from the new arrangements.

Keywords: rent seeking; rent destruction; tax policy; interests; Thatcherism

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1 Introduction

Rent seeking is the attempt to obtain a non-compensated transfer, such as a direct payment, tariff or monopoly, via the political process. There is evidence that rent seeking is cyclical. After initial start-up costs have been met, there are increasing returns from rent seeking up to the point where the supply of new rents becomes depleted, after which rent seeking produces diminishing returns. In an open and competitive political system these diminishing returns produce a decline in rent seeking and the destruction of some existing rents, allowing the cycle to begin again. In a pluralistic polity this cycle may be relatively stable and in the absence of exogenous shocks may run for several decades without disruption. This process is said to explain the rise *and fall* of public expenditure in most advanced economies at different times as political rents are created (leading to a rise in public expenditure) and destroyed (leading to a reduction) (Alves and Meadowcroft 2014; Murphy et al, 1993; North et al 2009).

There is an extensive literature on the process of rent creation and rent extraction (for example Becker 1983; McChesney 1996; Tollison 1982), and the costs and consequences of political rents (for example Buchanan 1980; Krueger 1974; Tullock 1989), but much less scholarly attention has been devoted to the process of rent destruction. Where scholars have gone beyond meta-level analysis of levels of rent seeking and extraction in particular polities, studies of rent destruction have usually focused on the salience of non-interventionist ideas animating those who campaigned for free trade and the abolition of special privileges at those moments when rent seeking reaches the point of diminishing returns. For example, one of the most famous instances of rent destruction, the repeal of the Corn Laws in Britain in 1846, is usually explained in terms of the power of free trade ideas in motivating those who campaigned for Corn Law repeal and successfully convinced other political actors of the need for reform in the public interest (for example: Gordon 1971; Pickering and Tyrrell 2000; Trentmann 2008).

Another notable instance of rent destruction that is the subject of this article – the programme of reform intended to reduce public expenditure enacted by the UK Conservative administrations of 1979 to 1997 – has also been understood as a result of the ideological commitment of the relevant political actors to the reduction of public expenditure and the creation of a free enterprise economy (for example: Crewe and Searing 1988; Desai 1994; Gamble 1994; Jenkins 2007). Indeed, it was on this basis that one of Margaret Thatcher's key advisors described her premiership as ‘the Thatcher interlude’ – an interlude from the normal business of democratic politics in which interest groups competed for distributional advantage (Sherman 2005). Such an account also accords with the views of both Keynes (1936) and Hayek (1949) that ideas, not interests, were ultimately decisive in the political realm.

A notable exception to the standard approach to rent destruction is Anderson and Tollison’s (1988) account of the organised interests that agitated for the abolition of the Corn Laws in order to obtain the pecuniary benefits that they believed would follow from repeal. Anderson and Tollison argue that rent destruction, like rent production, should be understood in terms of the pecuniary benefits that accrue to those who benefit from and lobby for such policies. This analysis suggests that interests are always dominant in the political process, whatever ideas may be prevalent, and so analysis of rent destruction should focus on the interests that benefit from the destruction of rents.

This article uses a case study of UK tax policy from 1979 to 1997 to test these two accounts of the process of rent destruction. Tax policy during this period may illuminate the underlying dynamics of government policy because: (1) tax policy was central to the Thatcher-Major governments' agenda to reduce government spending and (2) tax cuts can be implemented so that the benefits can be either targeted at particular individuals or shared broadly across all taxpayers. It is contended that, if tax cuts were evenly spread, this would indicate an attempt to distribute the benefits of rent destruction without regard to the demands of specific interests, whereas if tax cuts were targeted this would indicate the continued salience of distributional demands.[1]

The article uses original analysis of historical UK government data of tax rates and allowances from 1979 to 1997. The analysis compares different ways of cutting taxes and finds that these tax-cutting governments decided to reduce taxes in very specific ways. There is some discussion in the literature of the extent to which Thatcher-Major governments reduced government spending and taxation; there is also some discussion about the shift from direct to indirect taxation (for example: Adam *et al* 2010; Smith 2006; Smith 2010). However, there is relatively little discussion of the alternative ways in which indirect taxes can be cut and were cut in practice. The evidence presented herein will show that the tax policy of this period was implemented in a way that targeted the benefits on particular individuals, indicating that politics remained primarily driven by interests. While there was a shift in the rhetoric of the governing party towards free market and non-interventionist ideas, it will be argued that this ideological shift should not be viewed in isolation from the continued operation of distributional politics. Rent destruction should be understood as part of a cycle of rent production and destruction in which the self-interested considerations of political actors remain salient. In this respect, our conclusions resonate with the conclusions of Schondhardt-Bailey (2006) in relation to the repeal of the Corn Laws. Schondhardt-Bailey argued that both ideas and interests (and also institutions) were important in explaining that event. We also suggest that such a confluence was at work here.

Before exploring tax policy during this period, a cautionary note should be sounded: the analysis of tax policy is fraught with difficulties. At any one time, a number of variables are changing and those variables can be defined in nominal terms, real terms or earnings-related terms. For example, in the 2013 Budget, the UK government proposed 90 different tax changes.[2] Taxes can be increased by 'stealth', as it has come to be known, by not increasing the levels of income that are free of tax in line with earnings, and in many other ways. Furthermore, it could be argued that, in some cases, tax

1 Alternative explanations of 'targeted' tax cuts are considered (and rejected) in Section 7.
2 See the Budget red book tables 2.1 and 2.2:
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/221889/budget2013_chapte2.pdf

decreases can lead to increased revenues and therefore there are no losers. For example, the 50 pence rate of tax on high earners in the UK was reduced to 45 pence in 2013 and this generated debate as to whether its reduction might not actually lead to lower revenues (see Seely 2014). It is possible, therefore, that some of the reductions in marginal tax rates in the Thatcher-Major era did not lead to revenue decreases.

2 The ideology of rent destruction 1979-1997

As in the campaign for the reform of the Corn Laws described by Anderson and Tollison (1988), a powerful ideological case was made for the reforms of the Thatcher-Major period – indeed, Pickering and Tyrrell (2000, p. 6) have noted the similarities between the free market ideology of the Anti-Corn Law League and that of the Conservative Party led by Margaret Thatcher. The rhetoric of the Conservative Party at this time was that UK government spending was too high and that the tax burden should be lowered. It was argued that there was a moral imperative to allow people to spend as much of their own income as possible and that a low-tax economy would create incentives that would lead private enterprise to flourish which would, in turn, drive economic growth. As two contemporary academic commentators summarised the ideology of the Conservative Party under Thatcher: 'Thatcherites believe that by giving new prominence to free enterprise, by rolling back the state from involvement in the economy, they can reverse Britain's economic decline' (Crewe and Searing 1988, pp. 261-2) .

Between 1979 and 1997 the Conservative governments of Margaret Thatcher and her successor John Major enacted a series of public policy reforms to reduce public spending and repeal economic regulation. The nationalised industries that had dominated the economy (electricity, gas, water and steel supply and production, telecommunications, the national airline British Airways, the national car producer British Leyland) were privatized; an 'internal market' was implemented within the National Health Service; compulsory competitive tendering was introduced to local authority service provision; large swathes of the civil service were moved into quasi-autonomous non-governmental agencies and foreign exchange controls were abolished. These reforms enabled significant reductions to be made to the tax burden (these are discussed in detail below). As a result, public spending as a proportion of GDP fell from 43% in 1980 to 36% in 2000 and the UK's economic freedom ranking went from 5.9 out of 10 in 1970 to 8.3 out of 10 in 2000 – then one of the highest in the world (Smith 2011, p. 47; Alves and Meadowcroft 2014, p. 9).[3]

3 As the theory of cyclical rent seeking would predict, however, the impact of these reforms was relatively short-lived. By 2010 UK government spending had risen to a new peacetime high of 51% of GDP and the UK's economic freedom ranking had dropped to 7.4 out of 10 (Miller, Holmes and Fuelner 2012).

The Conservative Party manifestoes of this period were unambiguous in setting out an ideological commitment to the reduction of public expenditure and the creation of a free enterprise economy in the public interest. The 1979 manifesto stated that, '[T]he balance of our society has been increasingly tilted in favour of the State at the expense of individual freedom', and argued that, the opposition Labour Party, 'by enlarging the role of the State and diminishing the role of the individual', had 'crippled the enterprise and effort on which a prosperous country with improving social services depends'. Among the solutions offered to these problems was an explicit commitment to lower income tax for all taxpayers: 'We shall cut income tax at all levels to reward hard work, responsibility and success'.[4]

The 1983 Conservative Party election manifesto similarly promised: 'Further improvements in allowances and lower rates of income tax remain a high priority'. And the 1987 manifesto stated: 'We are the only party that believes in lower taxation...It [lower taxation] encourages people to work harder, to be inventive and to take risks...There is a strong moral case for reducing taxation'.

Likewise, the 1992 manifesto of John Major's Conservative Party claimed:

> Economic growth is created by people's hard work, ingenuity, thrift and willingness to take risks. An enterprise economy rewards the industrious and thrifty. We believe that government should not gobble up all the proceeds of growth, and that those who create prosperity should enjoy it, through lower taxes and more opportunity to build up personal wealth….Our policy is therefore to reduce the share of national income taken by the public sector.

The Conservative governments of 1979 to 1997 were characterized by a rhetorical rejection of the post-war social democratic consensus; it was argued that the government should only be concerned with the maintenance of the broad framework within which private enterprise could flourish and create prosperity that would then be enjoyed throughout society. The question that now arises is how the benefits of rent destruction were distributed.

3 Neutral and non-neutral income tax policies

The tax burden can be reduced via what might be termed neutral and non-neutral means. That is, it can be achieved via changes that will impact relatively broadly across the population without targeting specific groups (neutral) or via reforms that have a more concentrated impact on particular taxpayers (non-neutral).

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4 All the manifestoes quoted herein are available as plain text documents here: http://www.conservativemanifesto.com (accessed 7 April 2014).

One way to achieve a reduction in the overall tax burden is to raise tax allowances. In the language of the UK tax system, the personal allowance is the amount of tax-free income that an individual can receive before paying income tax, normally at the basic rate. This may be considered a neutral mechanism because, notwithstanding the principle of diminishing marginal utility of income[5], reducing the tax burden by raising personal allowances distributes the benefit of the tax reduction evenly amongst all wage earners whose income exceeds the personal allowance. Another way to achieve a reduction in the overall tax burden is to cut specific marginal rates of taxation. This may be considered a non-neutral mechanism because lowering specific tax rates will target the benefit of the tax reduction on specific groups of taxpayers.

The ways in which alternative tax policies can impact on different parts of the electorate can be illustrated by a hypothetical decision to reduce the basic income tax rate by one penny in the pound (1p.) for the tax year 1990-1991. According to Robinson (1990), the fiscal cost of such a proposal would have been approximately equivalent to the fiscal cost of an increase in the personal allowance of 8 per cent above its 1990 value – that is an increase of approximately £240.[6]

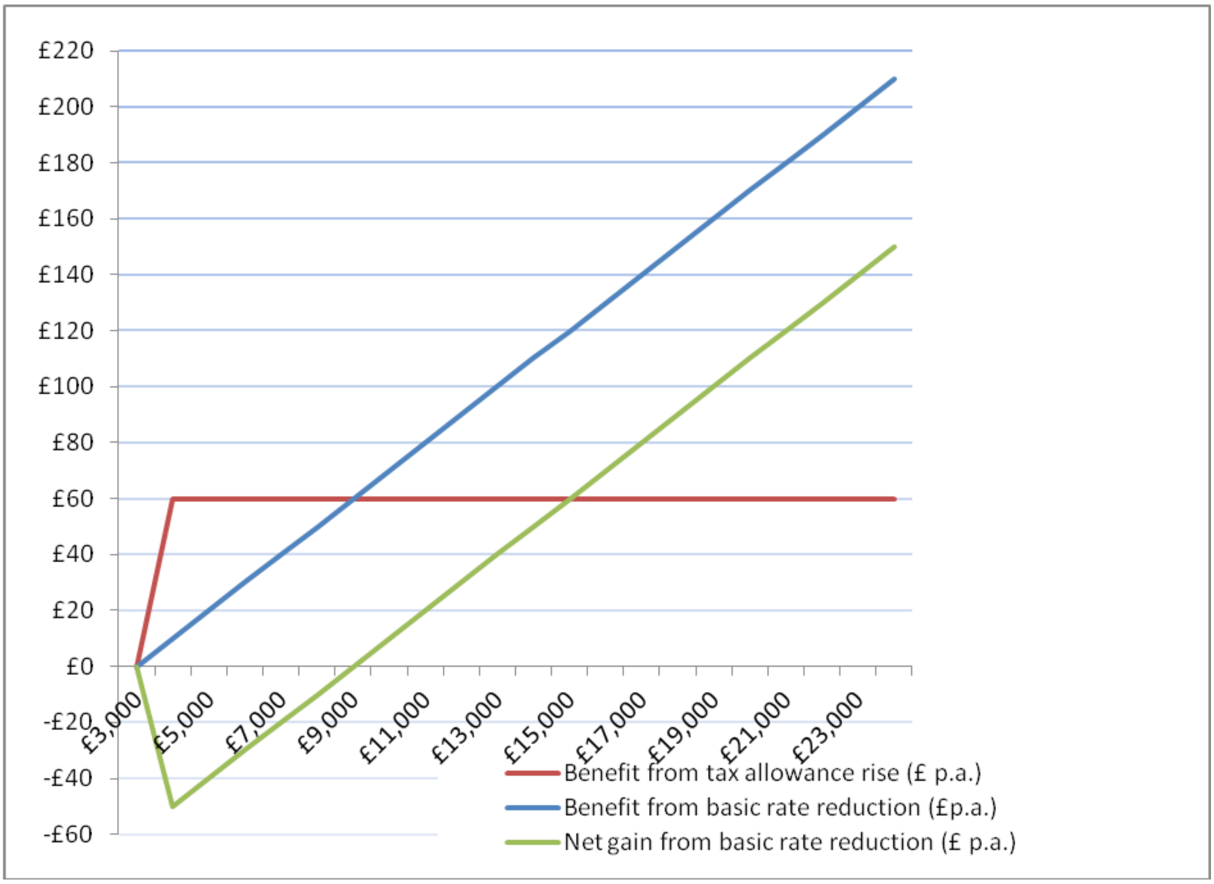
The policies of either reducing the basic rate of tax or raising the personal allowance affect different groups very differently (Robinson ed. 1990).[7] Anybody earning above £3,245 (i.e. anybody who earned above the new level of the personal allowance if it had been increased) would have gained £60[8] per annum from the additional increase in the personal allowance because their tax bill would have been reduced by 25 per cent of £240 in addition to the fall in tax arising from statutory price indexation of the personal allowance. Anybody earning between £3,005 (the personal allowance in 1990) and £3,245 would gain between zero and £60 per annum. Those earning below the personal allowance in 1990 would, of course, gain nothing from its increase. In other words, the vast majority of full-time workers would have gained exactly the same amount of money – £60 per year – in cash terms from a policy of increasing the personal allowance by 8 per cent.

5 It is often argued that individuals with different levels of wealth value an equal proportionate increase in their wealth equally (see, for example, Bernoulli, 1954, for the translation of the article written by Bernoulli in 1738). Though we do not follow up this here, it is worth noting that a cut in marginal rates not only reduces taxes by more in absolute terms for the better off, it reduces taxes more as a proportion of income too, though this depends on precisely which marginal rates are cut.
6 In fact, the figures in Robinson ed. (1990) related to an increase in the basic rate of income tax and a fall in the real value of the personal allowance. However, given the Treasury's static models, the figures for a change in the opposite direction would have been the same. This is confirmed by comparisons in the same publication for other years when the fiscal cost of increases in the allowance were compared with the fiscal cost of a fall in the basic rate of tax. 1990 is a convenient year to use because there were no radical changes to the tax system which would confuse the analysis and independent taxation of husband and wife had been implemented.
7 Indeed, the Institute for Fiscal Studies regularly discussed in their Green Budget documents in the 1980s the alternative ways by which taxes could be cut and the distributional effects of those alternative ways.
8 Approximately twice as much in current prices.

The alternative policy of a reduction in the basic rate of tax has quite different effects. The gain from this tax reduction increases linearly from nothing for those earning an amount exactly equal to the personal allowance to £207 per annum for those earning equal to or above £23,705 – the maximum amount of income that can be earned before tax is paid at higher rates. As is shown in Figure 1 the crossover point is about £9,000 so that all those earning between £3,005 and £9,000 would have gained more from the increase in the personal allowance and those earning above £9,000 would have gained more from the decrease in the basic rate of tax.

The difference between the effects of an increase in the personal allowance and those of a reduction in the basic rate of tax are shown in Figure 1.

Figure 1: Different effects of alternative tax policies on net income per annum



The question that now arises is whether the income tax policies pursued from 1979 to 1997 were implemented in non-neutral ways that benefited particular taxpayers more or if the benefits of tax reductions were spread more evenly.

4 The personal allowance from 1979 to 1997

In 1979, upon entering office, the Conservative government immediately increased the personal allowance over and above inflation. This was the fulfilment of a manifesto promise to raise tax thresholds to take some of the low-paid out of direct taxation altogether. The 1979 Conservative Party manifesto (Chapter 3) had stated:

> It is especially important to cut the absurdly high marginal rates of tax both at the bottom and top of the income scale. It must pay a man or woman significantly more to be in, rather than out of, work. Raising tax thresholds will let the low-paid out of the tax net altogether.[9]

The increase in personal allowance was double the level planned by the previous government and represented an 11 per cent real-terms increase. At the same time, the basic rate of income tax was also reduced by three pence and the rate of VAT was increased. However, from this point onwards, the policy changed.

We would argue that the best measure of the 'real' tax allowance is its level measured in earnings-adjusted terms. It is necessary for tax allowances to be raised in line with earnings to prevent 'fiscal drag' arising from people paying more tax as a proportion of earnings as earnings rise. It is also necessary to raise tax thresholds in line with rises in earnings to ensure that the government's tax revenue from income tax remains roughly constant as a proportion of incomes. If tax thresholds remain constant in real terms (that is, relative to prices), the proportion of income taken in tax will gradually rise as incomes grow. We would therefore argue that it is the level of earnings-adjusted tax allowances that one would expect to be raised by a self-defined tax-cutting government.

The 1979 budget represents the high point of the value of the personal allowance in earnings-adjusted terms during the period from 1979 to 1997. Indeed, after this budget, the personal allowance actually fell in price-adjusted terms under the first Conservative administration, though it did recover and increase under the following three Conservative governments whilst not recovering its ground in earnings-adjusted terms.

This drift downwards in the earnings-adjusted personal allowance was substantial (see Figure 2). By 1997, the personal allowance was worth only 88 per cent of its 1979 value in earnings-adjusted terms. There were considerable fluctuations within the period. These partly arose from the variability in inflation given that the allowances tend to be indexed to the previous year's inflation. The fluctuations also partly reflected an occasional freezing of allowances followed by some 'catch-up' growth at a later stage.

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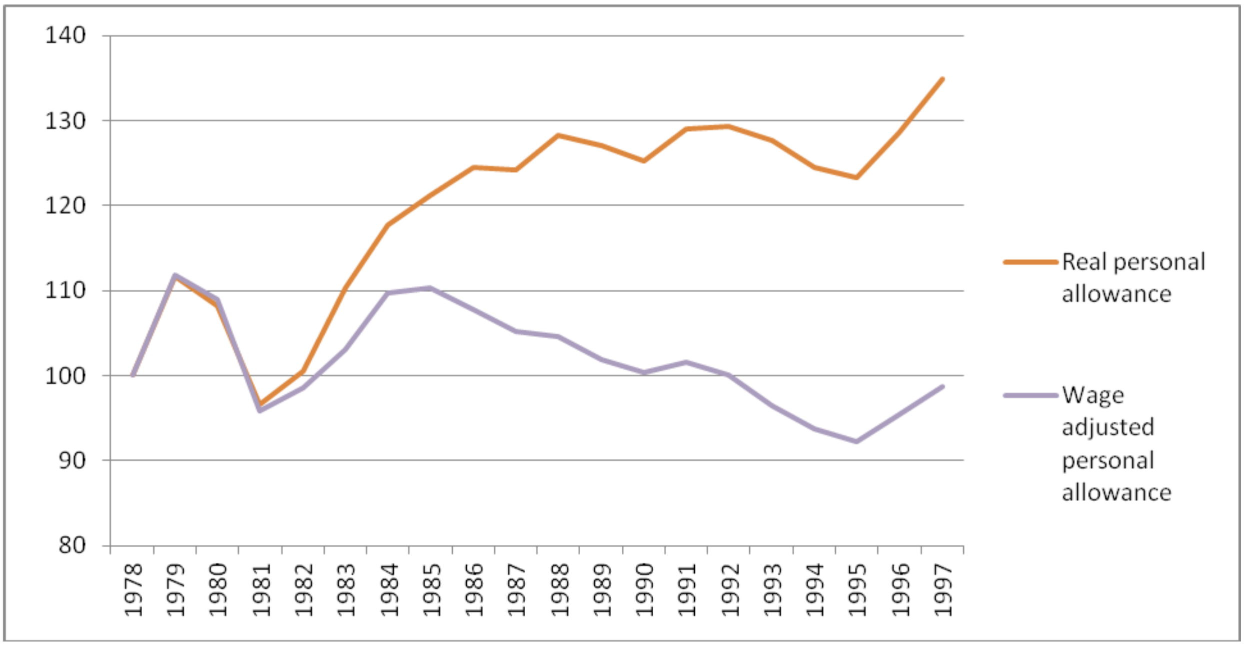
9 See: http://www.conservative-party.net/manifestos/1979/1979-conservative-manifesto.shtml (accessed 7th April, 2014).

Figure 2 Personal tax allowance in real terms and earnings-adjusted terms (1978=100)



In real terms (i.e. relative to prices) the personal allowance did rise. Again there were fluctuations – especially in the early years – caused by the method of indexation. But it is particularly notable that, during Chancellor of the Exchequer Nigel Lawson's 'tax-cutting' budgets of the mid-to-late 1980s when tax rates were cut dramatically, the personal allowance remained more or less unchanged even relative to price increases. In the five years from 1985, the real personal allowance increased by only 3 per cent despite the basic rate of income tax being reduced by five pence and all but one of the higher rates of tax being abolished. During this time, the personal allowance fell by around 9 per cent relative to earnings, suggesting considerable fiscal drag. In the ten years from 1986, the personal allowance actually fell slightly in real terms.

During the 1990s, despite some rise in the personal allowance in real terms, there was a continuing drift down of the allowance in earnings-related terms until the end of the Conservative government in 1997. Though it is not the main theme of this paper, it is worth noting that, under the Labour government from 1997, the personal allowance fell in real terms up to 2007 and fell dramatically in earnings-adjusted terms. This is an interesting phenomenon in itself because the Labour government was committed to reducing poverty and also to not increasing taxes. One way to reduce poverty and reduce taxes would have been to increase the basic personal allowance. However, the government eschewed a method of reducing taxes that would especially help the poor and, instead, continued to reduce the rates of income tax whilst introducing more comprehensive income transfer programmes for the poor.

Thus, overall, we see a tax-cutting government reducing the level of income at which individuals start to pay tax in earnings-adjusted terms by about 11 per cent after the initial increase in the tax allowance in 1979. Even if we include the increase in 1979, the personal allowance fell slightly in earnings-adjusted terms. Prima facie, this should hardly be the hallmark of a tax-cutting government. The policy of reducing tax allowances in relation to earnings was especially notable during the aggressive tax-rate cutting period of Lawson's budgets in the late 1980s.

5 The position of married couples from 1979 to 1997

For most of the period under consideration, the tax system for married couples was different from that for single people. The systems and the reforms to the system are discussed in Seely (2012). Until independent taxation of men and women was introduced in 1990, there were four different sets of tax allowances to which individuals or couples would normally have been entitled: single people would receive the single person's allowance; a cohabiting couple with two earners would have received a single person's allowance each; a married couple with one earner would have received a married man's allowance attributable to the one earner and which was somewhat less in amount than two personal allowances; finally, a two-earner married couple would have received a married man's allowance and a single person's allowance, the value of which would have been between the value of two and three personal allowances.[10] The total level of tax allowances available to a non-married, two-earner couple is clearly proportional to that available to a single person and we will not investigate this case further. However, given that married couples would have made a large proportion of the tax base,[11] it is important to analyse the position that is relevant to them. We will examine the case of the single-earner married couple because the tax allowance for a two-earner married couple is simply a linear combination of the positions of a single earner married couple and a single person.

After independent taxation of men and women was introduced, the situation changed somewhat. The main effect of the new system from 1990 until 1994 was to make the married man's tax allowance available to a greater number of people.[12] From 1994, the rate at which the renamed married couple's allowance could be claimed was progressively reduced until it was abolished in 2000.

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10 The then relatively unusual situation of an unmarried couple with one earner would have been entitled only to one single person's allowance.

11 Only 22 per cent of households were made up of single persons, the majority over state pension age, in 1981. See: file:///C:/Documents%20and%20Settings/pmb/My%20Documents/Downloads/ST40_Ch02_tcm77-137071.pdf

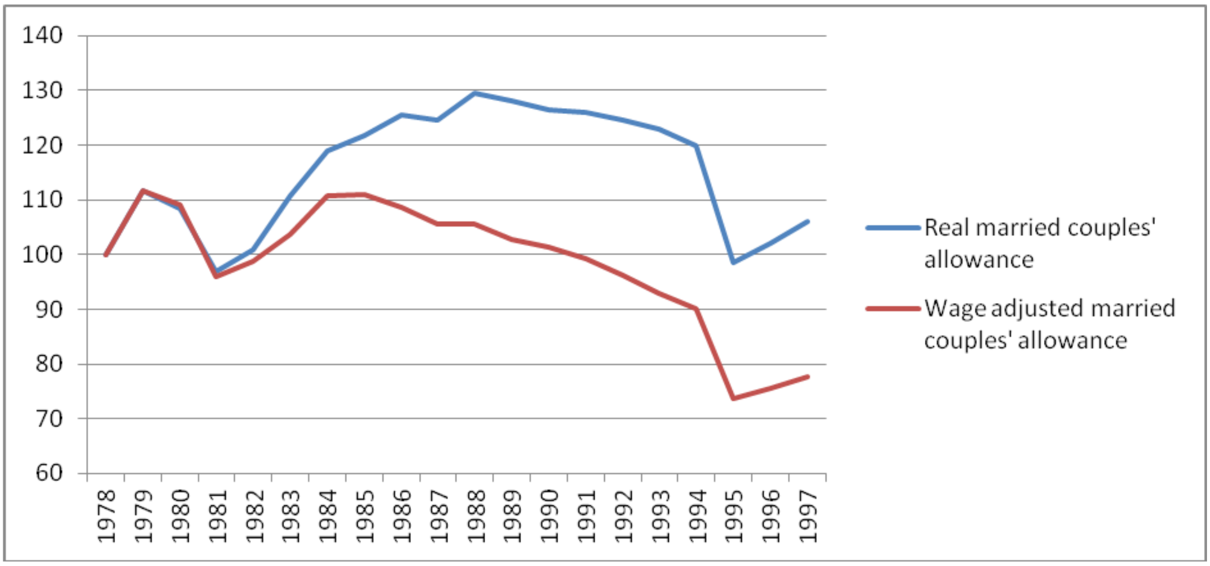
12 The 'married man's allowance' was renamed the 'married couples' allowance' but also given to non-married couples in certain circumstances. The married man's/married couples' allowance will be described as the 'married couples' allowance' henceforth.

In the analysis below, we look at the real value of the married couples allowance relative to both prices and earnings. There can be little dispute about the interpretation of these figures until 1994. From 1994-1997 inclusive, the married couples allowance was still available, but not at the claimant's highest marginal rate of tax. In the first of those four years, the married couple's allowance was restricted to the 20 per cent tax rate (which was below the standard rate of income tax but was a special tax rate within the income tax system); in the remaining three years it became, in effect, a 15 per cent tax credit (15 per cent did not relate to any tax rate in the UK income tax system at that time). From 1995, we have made an adjustment to the real value of the personal allowance facing single-earner couples to reflect the restricting of the allowance below the 20 per cent rate of income tax. However, the figures from 1995 (or perhaps 1994) might be regarded as less meaningful than the figures for earlier years as this adjustment is somewhat arbitrary.[13]

Until independent taxation in 1990, both the price-adjusted and earnings-adjusted married couple's allowance show a very similar pattern to the personal allowance. This is not surprising given that the objectives of the allowances were the same in both cases though the different allowances applied to different groups of people. There was no particular declared policy regarding changing the relative position of married couples versus single people and so one would expect the allowances to reflect similar considerations.

13 Specifically, a reduction in the amount of the married couple's allowance equivalent to the financial loss due to its restriction has been calculated and the level of the married couple's allowance after this adjustment is shown. If anything, this under-estimates the effect of restricting the allowance because the calculations assume that the individual is not paying tax at the higher rate.

Figure 3 Value of tax allowance for single-earner couples in real terms and earnings adjusted terms (1978=100)



After 1990, the married couple's allowance fell in real terms and fell quite dramatically in earnings-adjusted terms. It is easy to ignore the married couples' allowance in the analysis of fiscal policy in this period because it is the personal tax allowance that receives most attention. However, the vast majority of households would have had their tax-free income reduced by the married couple's allowance and, as this allowance was allowed to fall relative to both prices and wages, the real level of income at which people started to pay tax would fall. By allowing the amount of tax-free income households were allowed to receive to fall relative to earnings and reducing marginal rates of tax, the benefits of tax reductions were being focused on narrower – relatively richer – rather than wider groups.

Thus it is clear that, when it came to raising the amount of income people could earn before they started to pay tax, the Conservative governments were not tax cutting governments. However, these Conservative governments did cut tax rates radically, thus reducing tax bills disproportionately for the better off. In 1979, the standard rate of income tax was 33%.[14] The rate was then reduced to 30% in 1979 and remained at that level until 1986 when it was reduced to 29%. Over the following two years, the standard rate of income tax was then reduced to 25%. Then, between 1995 and 1997, the standard rate was reduced to 23% (see Pope and Roantree, 2014).

6 Higher-rate tax from 1979 to 1997

14 There was also a special rate of 25% which was abolished by the Conservative government.

Not only were reductions in taxation implemented in a non-neutral way during this period, even cuts in marginal tax rates between 1979 and 1997 were not broadly spread across the earning population. There were much more substantial cuts in the higher rates of tax than in the basic rate of tax. It is also the case that tax cuts on higher earners were delivered using cuts in the rates of tax rather than increases in tax thresholds.

In the 1979 budget, the Chancellor of the Exchequer Geoffrey Howe referred both to the problem of high tax rates and to the problem of a low starting rate of earnings for higher tax rates:

> The upper rates no longer affect only those on very high incomes. They apply – and Labour Members may find this surprising – not only to senior executives and middle managers in industry but increasingly to skilled workers, as well as to professional people and the proprietors of small businesses. These are the people upon whom so many of our hopes for initiative, greater enterprise and national prosperity must depend. It is universally recognised, or almost universally recognised, that the present top rate of 83[15] per cent on earned income is an absurdity...Such rates bring in very little revenue. But they kill incentive and are patently unjust...The top rate on earned income will be cut from the present 83 per cent to 60 per cent. This now top rate will apply to taxable income over £25,000. At the other end of the higher rate scale, the present threshold of £8,000 – and many skilled workers cross that threshold – is too low. I propose raising it to £10,000.[16]

In the 1979 budget, therefore, a justification was made for both lower tax rates and higher thresholds at the upper end of the earning scale. Geoffrey Howe also suggested the 1979 budget should be a turning point rather than an isolated occasion for cutting tax and that he would return to the issue of cutting tax rates. However, neither Howe nor his successors returned to the issue of raising tax thresholds. As with the basic rate of tax, the higher rates were reduced dramatically. Following the large reduction in marginal rates in 1979, the remaining higher rates of income tax were collapsed into one higher rate of 40% in 1988. Furthermore, the investment income surcharge of 15%, which was paid on income from capital, was removed in 1984-1985[17]. Thus, in effect, a series of marginal tax rates from 98% (83% plus 15%) to 40% were collapsed into one rate of 40% (see Pope and Roantree, 2014).

So, what happened to thresholds? Here we look at the amount of income on which people pay the basic rate of tax so as not to double count the impact of a rise in the personal allowance which will

15 In fact, there was a surcharge on income from investments of 15 per cent, thus making the top marginal tax rate 98 per cent. This was also abolished in 1984 and so the reduction in marginal tax rates for many people would have been higher than we imply in this paper.
16 Available from: http://www.margaretthatcher.org/document/109497 (accessed 7th April, 2014).
17 It is more likely that this surcharge would have been paid by those on very high earnings.

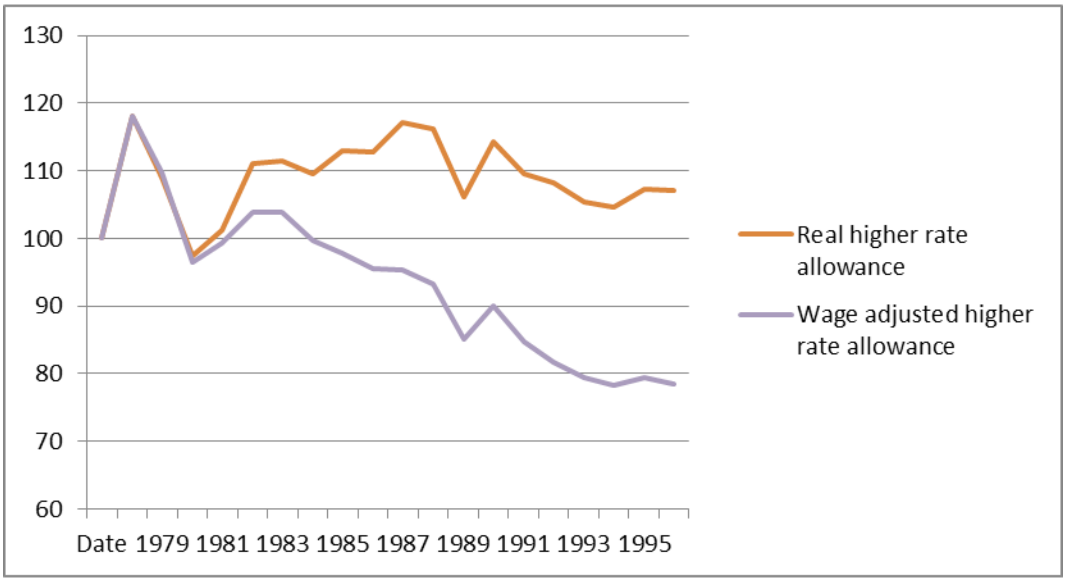
also push up the level of earnings at which the higher rates are paid.[18] As set out above, for the majority of taxpayers, taxes can be reduced either by raising the personal allowance or by reducing rates. If rates are reduced, then the benefit rises with income until the first higher-rate threshold is reached. For higher-rate taxpayers, taxes can also be reduced by raising the higher rate threshold or by reducing the higher rates. If the top higher rate is reduced (if there is more than one rate), the benefit rises with income without limit whereas, if the lowest higher-rate threshold is increased, the benefit to all higher rate taxpayers whose earnings are above the new threshold is the same[19].

Figure 4 below shows the amount of income on which the basic rate of income tax would be paid. Relative to earnings, the lowest higher-rate threshold (which was also the only higher-rate threshold from 1988) fell by over 21 per cent during the period from 1979 to 1997. After the initial increase in 1979, it fell by 34 per cent. Indeed, there was barely a single year in which the level of the higher-rate tax threshold increased relative to earnings after 1979. Furthermore, the higher-rate tax threshold rose by only 7 per cent in real terms (relative to prices) over the full period and actually fell by nearly 10 per cent between 1980 and 1997. The increase in the higher-rate tax thresholds in 1979 was not a turning point, it was a one-off. This was despite the existence of statutory price indexation.

There were significant cuts in tax rates over this period. When taxes were cut, the greatest gains were concentrated within a subset of the population. As it happens, too, more and more people were gradually drawn into the higher-rate tax net without any explicit increase in their rates. There is a tendency for people not to notice when taxes are increased in this way (by not increasing allowances in line with earnings) because those paying the extra tax are simply forgoing part of a pay increase to the Treasury rather than actually experiencing lower take-home pay. Their pay may be cut in real terms as a result of the hidden tax increase but would still rise in nominal terms. This would seem to be an interesting example of the fiscal illusion in which the real cost of public expenditure to individual taxpayers is hidden.[20]

Figure 4: Value of Higher Rate Tax Allowance

18 We call this the "higher-rate threshold" though technically it is the top of the 'basic rate band'.
19 Ignoring the relatively small number whose earnings will be between the old and the new threshold.
20 On the fiscal illusion, see Buchanan (1967, Chapter 10).



7 The impact of different tax cutting policies

We have shown that between 1979 and 1997 the UK governments of Margaret Thatcher and John Major introduced a series of tax reforms that were accompanied by a clear ideological commitment to the reduction of public expenditure and the creation of a free enterprise economy. Apart from an initial increase in the personal allowance, which was an important pre-election commitment, these Conservative governments continually forewent opportunities to reduce the tax burden in a neutral way by raising the level of incomes at which different tax rates applied so that the benefits would be evenly spread across taxpayers. Instead these governments chose to reduce the tax burden by lowering marginal rates and removing higher rates of income tax so that the direct benefits were narrowly focused on a relatively small subset of the population at the top end of the income distribution.

One consequence of these reforms was that the tax system became less progressive and hence the tax burden became 'flatter'. While arguments that very high rates of marginal taxation were inherently unfair were made by government actors during this period, the principal argument made in the context of fiscal policy was that public expenditure and the tax burden should be lowered, not that the distribution of the tax burden should be made flatter. Importantly, arguments for a flat tax and for reduced public expenditure are distinct – indeed, contemporary arguments for a UK flat tax have focused on the rate at which the flat tax must be set to replicate current tax receipts (for example: Teather 2005).

It is also the case that the revenue implications of some of the tax rate reductions in this period would have been relatively small given the dynamic effects of reducing very high tax rates. Though this group is not directly comparable with those paying higher rates of tax, an indication of possible dynamic effects is given by the fact that the proportion of income tax paid by the richest ten per cent of tax payers increased from 35 per cent to 42 per cent over the period of the Thatcher government (see Adam *et al* 2010, p. 15). In retrospect it is certainly possible to argue that it may have been thought that reducing higher rates of tax was justified if the overall tax take from higher earners was simultaneously increasing, given the increase in higher incomes after 1988. However, it should be noted that the Treasury models are static and do not allow for such dynamic effects on incentives from reductions in marginal tax rates. It is also worth noting that a rise in the levels of income at which people start paying higher rates of tax does, of course, represent a cut in marginal rates for some individuals. In his 1988 budget speech, the Chancellor of the Exchequer did mention the problem of high marginal rates in the context of international mobility as well as the potential for lower marginal rates to raise more revenue.[21] Whilst this argument might well have influenced this particular budget decision, it does not explain the general tenor of policy between 1979 and 1997 given the wide range of arguments put forward by the government for reducing taxes. Furthermore, whilst this argument would have helped to explain why *additional* cuts in marginal rates might have taken place that could have been almost self-financing it does not explain why, in general, tax thresholds fell relative to earnings thus, in effect, leading to increases in taxes for many workers. A government committed to reducing overall government expenditure should be expected to at least keep allowances constant relative to earnings whilst cutting marginal rates unless there is a good reason not to do the former.

It is surely particularly salient that the tax policies of this period were targeted at the traditional constituency of the Conservative Party among the highest earners. Figure 1 showed how the alternative policies of an increase in the personal allowance of 8 per cent and a fall in the basic rate of tax by one penny would have affected people on different levels of earnings to a different extent if implemented fully in 1990-91. It is not possible to track how the different trends in tax allowances and tax rates during 1979-1997 affected different voters because the necessary longitudinal data do not exist, but some general points can be made. To take the removal of higher rates of tax in 1988, for example, the benefit from abolishing the 60 per cent tax band rises with income. If, instead, the higher rate tax threshold had been increased at equivalent fiscal cost, a relatively small gain would have been spread around a larger number of taxpayers. Given the skewed nature of the distribution of income, the impact of targeting tax reductions on a small number of people is magnified.

8 The coalition that benefitted from reform

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21 See: http://www.margaretthatcher.org/document/111449

The question that now arises is what link exists between those who benefited from the governments' tax policies and the governments of this period. There is clear evidence that the political support of the Conservative Party at this time, in terms of its voters, party members and donor base, was concentrated among those who benefited from the approach to tax cutting taken by the government. We believe this reflected the need to build a political coalition that supported its public expenditure policies and part of this process was to enact the policies in a way that 'rewarded' the members of this supporting coalition.

In the era of 'class-based voting' in Britain, roughly between 1945 and 1970, the UK electorate voted broadly according to social class, with manual workers tending to vote Labour and the professional, middle classes tending to vote Conservative (Heath *et al* 1985). In that sense, the Conservative government's tax policies spoke to their traditional electoral base. That may be particularly important, because in the two elections held in 1974 that traditional support had begun to fracture, resulting in the emergence of a genuine third party and the return of a majority Labour government in October 1974 (Anderson and Heath 2002). Electorally, the Conservative Party had reasons to want to shore up its traditional electoral base among the professional middle classes from 1979 onwards.

Anderson and Heath's (2002) multivariate analysis of data from the British Election Studies shows that Conservative support among social classes A-C1 rose dramatically from the October 1974 election to the April 1979 election and this increased support was maintained until the election of Tony Blair in 1997. Interestingly, Conservative support throughout this period was highest among the self-employed (80% of whom voted Conservative in 1979), who may be expected to have gained significantly at the margin from the tax policies and will exclude high earning public sector employees who we would expect to have reservations about the tax-cutting agenda. To give a specific illustrative example of the extent of Conservative support among high earners, at the 1987 General Election exit polling showed that the Conservatives enjoyed a 41 per cent lead over the Labour Party among social classes AB (largely high earners), whereas Labour enjoyed a 15 per cent lead over the Conservatives among social classes DE (largely low paid workers) (Waller 1994).

Information about the donor base of the Conservative Party at this time is hard to come by because the requirements on political parties to declare donations were limited and the Conservative Party did not disclose donations where possible. Public companies were required to declare political donations, but donations could be made via an intermediary: for example an organisation named British United Industrialists channelled money from companies and individuals to the Conservative Party during this period, or money could be given in the form of a loan that could be later written-off (Fisher 1994).

Nevertheless, research into the Conservative Party finances from this period, often undertaken by political opponents of the party, does allow some conclusions to be drawn. First, in a system without state funding of political parties, the Conservative Party was (and is) entirely reliant on corporate and individual donations for its income. The Conservative Party declared donations of £7m for 1992-3 to a House of Commons Select Committee (Fisher 1994, pp. 61-2). Second, although there is evidence that a small number of individuals and firms gave relatively large sums, the Conservative Party donor base during this period was in fact very broad – Fisher (1994, p. 63) reports that the mean corporate donation in 1991/2 was a modest £16,085. It seems clear that the Conservative Party at this time was not funded by very large donations from a small number of super-rich individuals, but received financial support from a fairly broad coalition likely to have directly benefitted from the tax policies of the time. That coalition would have included well-off individuals, but also corporations. It is likely that most corporations will have supported the party because directors will have believed that a Conservative government was in shareholders' interests. However, before the Cadbury Code on corporation governance published in 1992, a decision by a company to donate to the party may well have been instigated by the chairman, whose individual powers were that much greater than following the corporate governance reviews of the 1990s. There is little doubt that company chairman would have gained substantially from the approach to tax cutting by the Conservative government. A particularly good example of this is the case of Polly Peck. Asil Nadir was both chairman and chief executive and even today it is unclear whether the donations given to the Conservative Party, instigated by Nadir, were Polly Peck or Nadir money. It is, nevertheless, very clear that Nadir motivated the decisions. Indeed, it was precisely this case that led to the change in corporate governance practice after the Cadbury review (see also Fisher 1994).

Information about Conservative Party members is just as elusive as that for donors. The Conservative Party did not exist as a corporate entity at that time and was a movement of independent associations who affiliated to an umbrella body (the National Union of Conservative and Unionist Associations). No central records of membership were kept and local records were rudimentary. The most comprehensive research about the nature of Conservative Party activists was undertaken by Whiteley *et al* (1994) and related to the year 1992. There is some explicit data on the incomes of party members and we can infer that the average incomes of those in work will have been relatively high given that one quarter of party members surveyed were aged between 56 and 65 and over 50 per cent attended either grammar school or private schools (28 per cent and 23 per cent respectively). Specifically, 57 per cent of members had a household income greater than £15,000 per annum. The average household income at that time was just over £14,000.[22] Around 60 per cent of

22 Office for National Statistics, *Economic and Labour Market Review*, Volume 2, Number 12 and own calculations.

the population earn below average household income because incomes are highly skewed; however, around 60 per cent of party members earned *above* average household income, despite the large number of pensioners amongst party members. Whiteley *et al* (1994, Table 5.2) also suggest that those on higher incomes are slightly more active than those on lower incomes. The views of Conservative Party members on income tax cuts are also very clear. Sixty three per cent of members believed that income tax should be cut (Whiteley *et al* 1994, p. 272). There was no indication as to how members wanted income tax to be cut, but 82 per cent of members believed that high income tax rates made people less willing to work hard (Whiteley *et al* 1994, p. 254). This perhaps provides an indication that cutting rates rather than raising thresholds should be the target for tax cuts. It is worth noting that these views were expressed after a long period of cutting tax rates (not when tax rates were at their highest) and at the depth of a recession when tax cuts might not be expected to be uppermost in the minds of members.

Taken together, evidence of the electoral support, membership and donor base of the Conservative Party during this period reveals a party with broad based electoral support, membership and donors. The Conservative governments of Thatcher and Major were not governments that represented the super-rich or the patrician aristocracy, but rather represented people who were likely to directly and noticeably benefit from changes to the marginal rates of taxation made by the government. The strong support among the self-employed may also be indicative of support for a distributional rebalancing away from the public sector workforce towards the private sector.

The suggestion that the tax policies introduced by the Conservative governments of 1979-1997 benefited particular groups of voters who were its supporters, members and donors, does not alter the fact that the policies introduced were consistent with classical economics, or that important ideological and economic arguments were also made for lowering the tax burden. It does, however, highlight the fact that (1) in a democratic polity any political change requires the mobilisation of a political coalition and the creation and maintenance of that coalition will likely require the distribution (or the promise of distribution) of benefits by the government and (2) public policy should be understood in the context of the *continual* battle for distributional advantage implied by the democratic state that has the power to tax and thereby determine the distribution of benefits and burdens within society – even if the tax policies introduced during this period might be seen as a defensive responsive to what were deemed previously exploitative policies. Indeed, the analysis here is consistent with accounts of majority cycling – the cyclical creation of new majority coalitions motivated by a desire to use the political process for distributional gain (for example: Brennan and Buchanan 1985, Chapter 8).

9 Conclusion

The empirical evidence presented here supports the proposition that rent seeking is a cyclical process in which in both the upward and downward phases distributional concerns remain salient. In this case reductions in government spending and lower income tax were justified to the electorate in terms of creating a free enterprise economy that would generate future economic prosperity, but the policy was implemented in a way that disproportionately benefited particular groups of individuals who constituted the government's core political support.

As Buchanan (1999) cautioned, it is necessary to analyse politics without romance; the battle for distributional advantage never leaves the political arena because, in politics, there are always gains to be made at the expense of others. In the particular situation that existed in the UK in 1979, the gains from rent seeking by further raising tax rates were limited – or non-existent – given the very high marginal tax rates that existed at the time: effectively up to 98 per cent. This did not mean that there was an end to interest-based politics. Rather, the interests that could benefit from reductions in tax rates had much to gain, were influential in the governing party, and, arguably, could make gains at relatively little cost given the potential dynamic benefits of cuts in marginal rates of tax. The Conservative administrations of Margaret Thatcher and John Major saw a confluence of those interests and free market ideas that moved public policy towards a period of rent destruction and drove forward the long-run rent seeking cycle. This conclusion is interesting because it is in line with more recent work in relation to the repeal of the Corn Laws where a confluence of interests and ideas has also been found.

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