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**Global Markets, National Tax Systems, and Domestic Politics: Rebalancing Efficiency and Equity in Open States' Income Taxation**

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**01 / 9**


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## Abstract

Competitive pressure on some capital income tax rates reinforces a generic "quadrilemma" or a four-way tradeoff in domestic income taxation. To maintain competitiveness, governments have to cut some tax rates on capital income down to "international standards." If these cuts lead to a de-alignment of different rates on capital income, domestic allocation becomes more inefficient, all else being equal. Cutting all tax rates on capital income to a uniform low level, while maintaining high and progressive tax rates on labor incomes, avoids this inefficiency, but sacrifices comprehensive income taxation, that is, joint and equal taxation of capital and labor incomes. Finally, reducing all income tax rates to international standards, including top rates on labor income, implies a strong significant reduction in the progressiveness of labor income taxation (and/or significant revenue losses). As a result, governments that aim at all four goals – competitiveness, allocative efficiency, horizontal equity (comprehensive income taxation) and progressivity – and want to maintain a given revenue level cannot avoid seriously compromising one of them. This paper analyzes how this income tax quadrilemma has played out in seven OECD countries: Australia, Denmark, Finland, Germany, New Zealand, Norway, and Sweden. Combining the results of this matched comparison with exploratory data analysis for all OECD countries, the paper discusses the general implications of the quadrilemma for the domestic political economy of tax competition and the future of "domestic compensation" in open states.

## Zusammenfassung

Der Wettbewerbsdruck auf einen Teil der Steuersätze auf Kapitaleinkommen verstärkt ein prinzipielles „Quadrilemma", d.h. einen vierseitigen Zielkonflikt, in der innerstaatlichen Einkommensbesteuerung. Regierungen müssen einige Steuersätze auf Kapitaleinkommen senken, um wettbewerbsfähig zu bleiben. Wenn diese Satzsenkungen zu einer zunehmenden Spreizung zwischen Steuersätzen auf unterschiedliche Kapitaleinkommen führt, verringert sich, *ceteris paribus*, die Allokationseffizienz der innerstaatlichen Kapitaleinkommensbesteuerung. Dies wird vermieden, wenn alle Steuersätze auf Kapitaleinkommen auf ein einheitliches, wettbewerbsfähiges Niveau gesenkt und gleichzeitig höhere und progressive Steuersätze auf Arbeitseinkommen beibehalten werden; jedoch wird damit das Prinzip der synthetischen Einkommensbesteuerung aufgegeben, nach dem alle Arten von Einkommen gemeinsam und gleichmäßig zu besteuern sind. Werden schließlich alle (Spitzen-)Steuersätze der Einkommensteuer auf ein wettbewerbsfähiges Niveau gesenkt, führt dies zu einer Verringerung der (direkten) Progressivität der (Arbeits-)Einkommensbesteuerung – und/oder zu erheblichen Ausfällen bei den Steuereinnahmen. Regierungen können deshalb bei einem gegebenen Steueraufkommen nicht alle vier Ziele – Wettbewerbsfähigkeit, Allokationseffizienz, synthetische Einkommensbesteuerung und direkte Progressivität – in vollem Umfang erreichen. Der Beitrag zeigt, welche Rolle dieses grundlegende Quadrilemma der Einkommensbesteuerung in sieben OECD-Ländern gespielt hat: Australien, Dänemark, Deutschland, Finnland, Norwegen, Neuseeland, Norwegen und Schweden. Auf der Grundlage dieses Fallvergleichs und einer explorativen Datenanalyse für 21 OECD-Länder werden Schlussfolgerungen gezogen für innerstaatliche politische Ökonomie der Einkommensbesteuerung.

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# 1 Introduction

Income taxation has figured prominently in recent debates about the impact of globalization on the autonomy of nation states – both in academia and beyond (see, for example, Berger 2000; Hertz 2001; Wolf 2001). The focus on income taxes is straightforward. On the one hand, they account for a large part of total tax revenues and were explicitly designed to achieve equity objectives. On the other hand, they are subject to the most significant competitive pressures.

The academic literature on the comparative political economy of (income) taxation in open states has been organized around two hypotheses. The *compensation hypothesis* – drawing on the seminal analyses of Cameron (1978) and Katzenstein (1985) – argues that globalization has created powerful incentives for governments to increase welfare effort, as "compensation" for the increased inequalities associated with international market integration. The compensation hypothesis is associated with the view that even high-tax states can maintain or even increase total tax revenues, capital income tax revenues, and progressive income tax schedules. This hypothesis is usually also meant to imply that political parties are still important in shaping fiscal policy – both in government and when in control of oppositional veto points (Boix 1998; Garrett 1998; Hallerberg / Basinger 1998).

According to the *efficiency hypothesis* increasing competitive pressures in goods and services markets, combined with heightened exit threats by mobile firms and investors, have made spending cuts, tax cuts, and "regressive" changes in the tax mix inevitable. This hypothesis also implies a significantly reduced role for political parties in shaping tax policy outcomes (Rodrik 1997; Bretschger / Hettich 2002).

Unfortunately, when it comes to causal inferences, the quantitative literature on the compensation and efficiency hypotheses is largely inconclusive. Virtually all causal claims related to the two hypotheses have both been rejected and defended – depending on operational definitions of variables, data sources, time periods, model specification, and regression techniques (for overviews, see Schulze / Ursprung 1999; Garrett / Mitchell 2001; Swank / Steinmo 2002). Garrett and Mitchell (2001: 176) therefore conclude that "the welfare state-globalization nexus is more nuanced than either simplistic efficiency or compensation theses would suggest", and that "scholars would be well served by comparing the political economy of

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different facets of globalization and of different aspects of welfare state effort, rather than trying to make grandiose generalizations."

This paper tries to contribute to the type of research program envisioned by Garrett and Mitchell in the area of income taxation. I contend that one of the most fundamental problems of the existing literature is the relative lack of interest in specifying, exploring, and testing *causal mechanisms* (cf. Brady 1995; Hall 2000). As noted above, sophisticated regression analyses have tried to estimate *causal effects*. However, these analyses could not avoid working with fairly "vague theories" (Western 1996) and have often been unable to adequately specify important control variables or interaction effects. Similarly, excellent qualitative analyses – which are better suited for exploring causal mechanisms – are available (see, for example, Messere 1998; Steinmo 2000; Hardiman 2001), but these have focused on understanding particular tax reforms in their complex historical political-economic context, rather than on the working of well-defined causal mechanisms across different contexts.

This paper attempts to fill the gaps in the literature by investigating one particular causal pathway of competitive pressures in seven carefully matched countries. My analysis brings in *national income tax systems* as an omitted explanatory variable. More precisely, I focus on how different income tax rates are linked within national tax systems. Different tax rates are economically linked through the arbitrage and tax avoidance behavior of taxpayers; and they are often legally aligned to increase the allocative efficiency and horizontal equity of domestic taxation.

Linkages between income tax rates are important because the strength of competitive pressures varies greatly both within and between the capital and labor income tax base (Ganghof 2000a: 603–608). This characteristic of competitive pressures thus leads to "conflicting imperatives"[1] for policymakers. On the one hand, policymakers have an incentive to differentiate their tax treatment in accordance with competitive pressures in order to maintain competitiveness with respect to mobile tax bases, while preserving high revenues from less sensitive tax bases. On the other hand, strongly differentiated tax rates may reduce the domestic allocative efficiency of capital income taxation, (re-)establish many options for inefficient tax avoidance, and reduce horizontal tax equity.

I will show that in countries where domestic allocative efficiency of capital income taxation has been valued highly, competitive pressures on parts of the capital income tax base have given rise to an *income tax quadrilemma*, that is, a generic tradeoff between four policy goals, one of which has to be sacrificed or at

1 This term is borrowed from Gould (1999).

least seriously compromised. Between the mid-1980s and 2000, New Zealand sacrificed progressivity and heavily reduced the redistributive and revenue-raising capacity of the its tax system; Australia and Denmark reduced domestic allocative efficiency; Sweden, Finland, and Norway abandoned the principle of joint and equal taxation of capital and labor; and Germany – the only "large" country in my sample – sacrificed "competitiveness."

The theoretical and empirical analysis of the generic income tax quadrilemma generates important insights into tax policy adjustment more generally. On the one hand, it provides an understanding of how and in what sense governments have been able in the past to reconcile "efficiency" and "compensation." On the other hand, it highlights the costs and preconditions of this reconciliation. In addition, by specifying a more complex "utility function" of governments, my analysis offers a fresh perspective on the role of political parties and veto institutions in shaping tax policy adjustment. I argue that government ideology and party-controlled veto players have generally been irrelevant for the setting of corporate tax rates, but have had a marked impact on the setting of top personal income tax rates. The effect of government partisanship and veto players is mutually dependent. An increase in the bargaining power of left-wing parties – either in government or as non-governmental veto players – tends to lead to higher top rates on (labor) income, and vice versa. An increase in the power of rightist parties tends to lead to lower rates. In addition, the effect of government partisanship and party-controlled veto players is mediated by other important factors, such as the size of the income tax burden or the type of income tax system.

The paper is set out as follows. Section 2 offers a theoretical analysis of the income tax quadrilemma, based on a stylized description of competitive pressures and domestic income tax systems. Section 3 analyzes how the income tax quadrilemma played out in seven countries. Section 4 discusses the implications of my analysis for the comparative political economy of tax policy adjustment. Section 5 summarizes the argument and outlines additional implications of my analysis.

## 2 Income Taxation in a Global Economy: A Quadrilemma

Consider a simple tax system with three tax bases: two types of capital income, one susceptible to competitive pressures (*M* for "mobile") and one not (*I* for "immobile"), and labor income (*L*). Simplifying somewhat, we can say that *M* consists of corporate profits and interest income, and *I* of most other forms of capital income (Ganghof 2000a: 603–608). For the sake of simplicity, the rest of the discussion equates *M* with the corporate tax base.

I assume, quite realistically, that *L* generates by far the largest share of total income tax revenues. Total revenues from capital income taxation are typically low or even negative. Take the Swedish example: while revenues from labor income taxes (excluding social security contributions and consumption taxes) amounted to 19% of GDP (OECD 1998: 83), total revenues from capital taxation accounted only for 3%, even when property taxes were included. Revenues from personal capital income taxation were negative, mainly due to the deductibility of interest payments (Strand 1999).

I further assume – in line with a weak version of the compensation thesis – that the *level* of income taxation (revenue expressed as a percentage of GDP) has to be kept constant. This assumption is supported by empirical evidence, according to which countervailing pressures on public budgets give governments little room to maneuver (Swank 1998; Ganghof 2000a; Genschel 2001; Swank/Steinmo 2002). In the design of income tax *structure*, a representative government would be concerned with the following three *domestic* policy goals:

**Direct wage tax progressivity.** For reasons of *vertical equity*, governments want high-income taxpayers to pay a higher proportion of their income in tax. More precisely, they want direct or statutory progressivity, that is, statutory tax rates that increase with income.[2] (A flat income tax rate with a large basic allowance is indirectly progressive in the sense that the average tax rates increase with income.) Statutory progressivity at the upper end of the earnings scale implies a "high" top personal income tax (hereafter: PIT) rate. What "high" means depends on the total income tax ratio (revenue as % of GDP): a high income ratio implies a high tax rate for the average worker, which in turn requires a higher top rate in order to attain direct (high-)wage progressivity. To take another example: the German government has recently decided to reduce the top personal income tax rate from 51% to 42% (by 2005). This cut will reduce, but not abolish, direct progressivity in Germany, which has an income tax ratio of around 11%. Cutting the top PIT rate to 42% would, however, abolish direct progressivity in Denmark, which has a ratio of around 30% (Nielsen/Frederiksen/Lassen 1999). In what follows, I nevertheless focus on the top rate on labor income, $t_L$, as a proxy for high-wage progressivity, but put this rate in relation to the income tax ratio.

**Comprehensiveness.** For reasons of *horizontal equity*, governments want to treat capital income and labor income equally. Under directly progressive income tax schedules, equal treatment implies joint treatment. Under joint taxation, the sum

2 Of course, concerns about *efficiency in labor taxation* may lead governments to reduce (top) marginal tax rates, i.e. to flatten the rate schedule. Here, I assume that the level of wage tax progressivity chosen in the status quo ante represents the model government's compromise between equity and efficiency in labor taxation.

of labor and capital income indicates a taxpayer's "ability to pay," that is, the sum determines the taxpayer's average and marginal tax rate. As a corollary, the top marginal rates on capital and labor incomes are also equal. Strictly speaking, comprehensiveness is a matter of degree. The more types of capital income are treated jointly with labor income, the more comprehensive a tax system is. Here, however, I treat comprehensiveness as a matter of principle because it is the principle rather than the real-world practice that tends to become salient in the political process. Thus, comprehensiveness is abolished when no type of capital income is taxed jointly with labor. In terms of our stylized tax system, comprehensiveness is abolished when *both* M and I are taxed with different (top) rates than labor income, that is, $t_M \neq t_L$ and $t_I \neq t_L$.

**Symmetry.** For reasons of *allocative efficiency in capital income taxation*, our representative government would want to align statutory tax rates on different types of capital income. When all types of capital income are subject to the same statutory tax rate, capital income taxation is completely *symmetrical* (Hagen / Sorensen 1998: 41).[3] Symmetry is important because large differences in tax rates are likely to distort economic choices. For example, if equity-financed investments are taxed at lower rates than debt-financed investments, financing decisions will be distorted; and if retained corporate profits are taxed at lower rates than distributed profits (dividends), profits may be locked into a corporation instead of being allocated via the capital market. Symmetry is also important for preventing domestic tax avoidance. For example, when the standard corporate tax (hereafter: CT) rate is much lower than the standard rate on profits of unincorporated businesses, capital owners have an incentive to incorporate, to undertake all kinds of – real and financial – investments through the corporation, and to store the profits in the corporation for as long as possible. In terms of our stylized tax system, which focuses on the CT rate as being susceptible to competitive pressures, symmetry requires that corporate profits are taxed at the same (top) statutory rate as personal capital income, $t_M = t_I$.

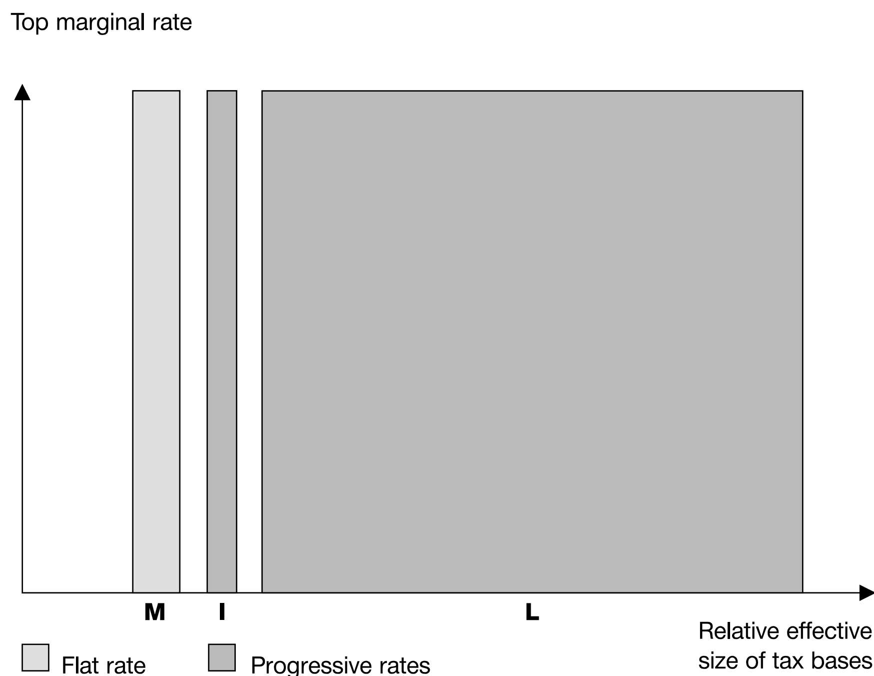
## 2.1 The Closed Economy Case

In a closed economy, governments could combine all three domestic tax policy goals by fully integrating all types of capital incomes into progressive income

3 To what extent symmetry translates into a 'level playing field', or what economists call 'intersectoral neutrality', depends on how 'clean' the tax base is. In fact, much of the political economy literature on capital income taxation has focused on this base-aspect of a level playing field (see, for example, Martin 1991; Swank 1998). Yet symmetry is an equally important prerequisite of a level playing field.

taxation, that is, by putting all types of incomes in a basket and subjecting the sum to a certain tax rate, depending on the taxpayer's overall "ability to pay." Figure 1 depicts this case of a ***comprehensive income tax*** in a simple fashion. Comprehensiveness is indicated by the fact that both labor income and personal capital income are taxed progressively (indicated by the shading of the bars for I and L) and face the same top marginal rate.

Figure 1 Stylized Description of a Comprehensive, Progressive and Symmetric Income Tax

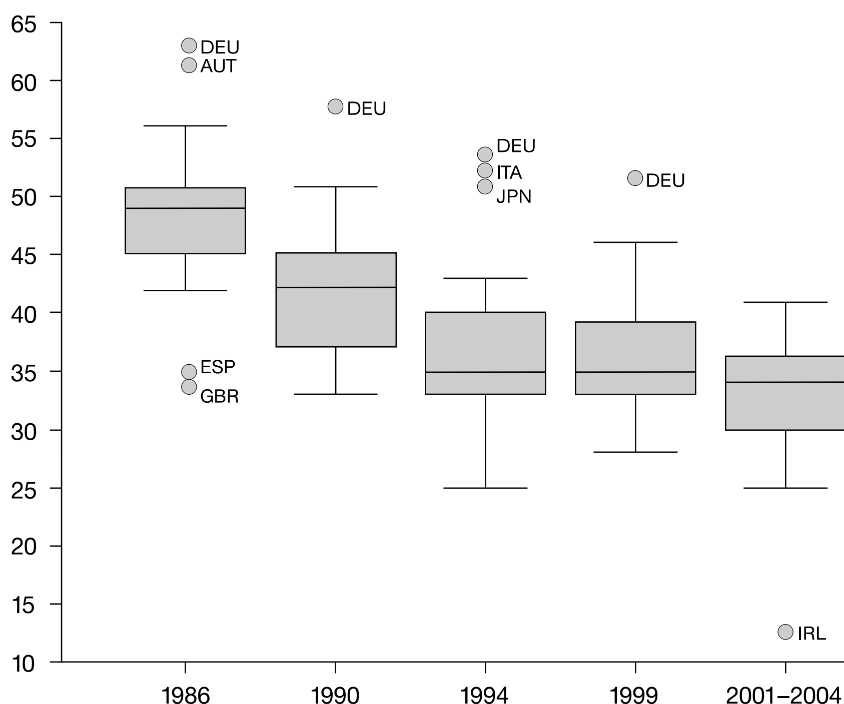



To integrate corporate taxation into progressive income taxation, all profits – both retained and distributed – would ideally be allocated to individual shareholders and taxed on an annual basis. Since this is technically infeasible, the closest approximation to a "full integration" of corporate taxation into progressive income tax is to give the shareholder a credit for the full amount of corporate tax paid on distributed profits (the so-called imputation credit), and to align the CT rate with the top PIT rate. In combination, these two measures abolish the incentive of individuals paying the top rate to store corporate profits in the corporation.[4]

4 This system was first suggested by the Canadian Carter Report (Carter Report 1966: Ch. 19) and is therefore sometimes called the Carter-style imputation system (Head 1997: 80).

In a closed economy, this ideal type of comprehensive income taxation can achieve all three policy goals at once. All incomes are taxed jointly and equally (*comprehensiveness*), income can thus be taxed *progressively* according to a taxpayer's ability to pay, and a *progressive form of symmetry* is established. The tax rates on all kinds of capital income are equal, but dependent upon the taxpayer's ability to pay.

Figure 2 Corporate Tax Rates, 1985–2004




Notes: Corporate tax rates include local taxes on corporate profits.
The last boxplot reflects tax cuts that have already been passed but not yet implemented. N = 21.

## 2.2 The Open Economy Case

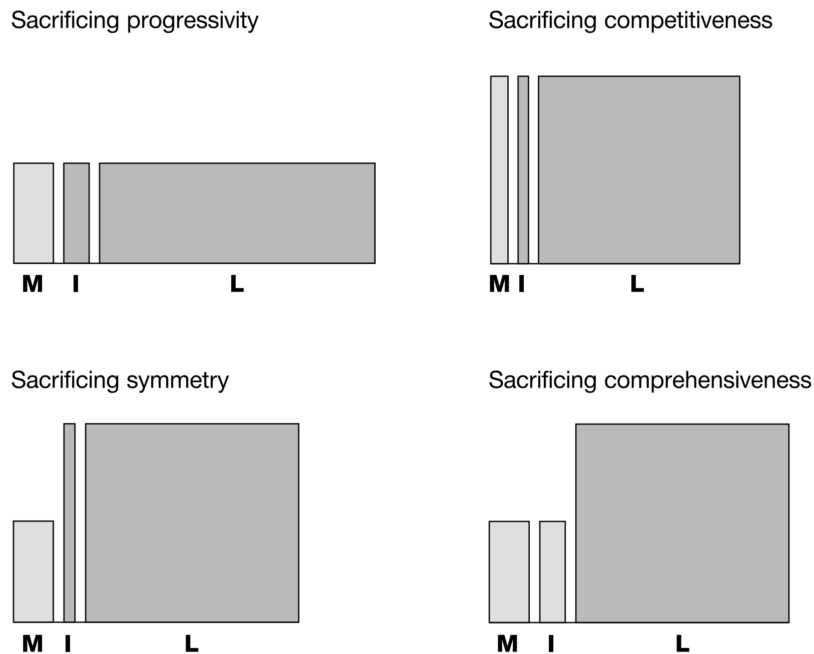
Let us now introduce competitive pressures. As is well known, there have been strong and rising downward pressures on CT rates.[5] To some extent, these pressures concern statutory rates as such, rather than effective tax burdens, because statutory tax rates are crucial for the location of both mobile tax bases and direct investment (Slemrod 1990; Hallerberg / Basinger 1998; Swank 1998; Ganghof 2000a). Figure 2 shows boxplots of the distributions of headline CT rates (includ-

5 As noted above, the quadrilemma argument also applies to competitive pressures on other forms of capital income, most notably individual income from financial assets.

ing sub-national rates) in 21 advanced OECD countries for five time periods. Between the mid-1980s and the early 2000s, the median CT rate fell from around 50% to approx. 35%, and while all countries had rates above 40% in 1986, all countries will have rates at or below 40% by 2004.

When our model government has to include "competitiveness" into its set of goals, it can no longer reach all four goals simultaneously. It has to sacrifice or compromise at least one of the four goals. The basic choices are as follows (see Figure 3):

Figure 3 The Income Tax Quadrilemma




**Sacrificing wage tax progressivity.** One option would be to maintain the joint taxation of capital and labor as well as the rate alignment of top rates, and to reduce *all* (top) rates to a common lower level. This option is quite attractive in that it maintains high standards of horizontal equity and allocative efficiency. The reduction in wage tax progressivity may be negligible if the rate reduction needed to reach competitiveness is not too large, and if the country's income tax ratio is not too large either. Policymakers may then be able to compensate for revenue losses by broadening both the capital and labor income tax base; and to the extent that this base-broadening includes more capital and high labor incomes into the tax base, overall effective progressivity may be maintained or even increased. However, when the "competitive" level of the CT rate is very low and/or when governments raise a lot of income tax revenues, most of which come from wages,

this option may be impracticable. Governments would then have to significantly reduce direct progressivity to bring down the top PIT level to "competitive" levels.[6]

**Sacrificing competitiveness.** The second option would be to simply bear a tax rate on mobile tax bases – here: a CT rate – that is significantly higher than that of other competing countries. However, this option is unlikely to be sustainable in the long run, especially for small countries.

**Sacrificing symmetry.** If competitiveness is perceived as a "must," and if significant wage tax progressivity is to be maintained, tax rates have to differ. The easiest option would be to simply differentiate tax rates according to the elasticity of the tax base – as suggested by optimal tax theory (see, for example, Hettich / Winer 1999: 102–106). Tax rates on the most sensitive types of capital income would then be taxed under very low flat rates, while other types would remain within the ambit of progressive income taxation. This option sacrifices symmetry, however, because different types of capital income are taxed with widely differing rates.

**Sacrificing comprehensiveness.** If our government wanted to maintain "symmetry" while at the same time responding to strong competitive pressures, it would have to abolish comprehensiveness, that is, the joint treatment of capital and labor incomes. The most obvious rate schedule for capital incomes would be a uniform *flat* rate for all capital income, because once capital is taxed separately taxable income does not reflect "ability to pay" anymore. The combination of a uniform flat rate on capital income and a progressive rate schedule for labor incomes is called *Nordic dual income tax* (Sørensen 1994; Cnossen 1999). A uniform and low flat tax rate on all capital income not only establishes symmetry in the simplest way, but also makes it easier to broaden the capital income tax base. A low flat tax rate makes it easier to include certain types of capital income, such as capital gains; and to the extent that there have traditionally been significant revenue losses due to the deductibility of consumer or mortgage interest, these losses will be reduced when interest can no longer be deducted against high marginal tax rates on labor incomes.

In sum, downward pressure on the statutory tax rates on some types of capital income – here: retained corporate profits – lead to a generic trade off between four tax policy goals (Table 1). The income tax quadrilemma implies that it is possible to reconcile one dimension of "efficiency," that is, international efficiency or

6 Recall that I assumed the income tax ratio to stay constant. However, vigorous flattening of income taxation and the shift of the tax burden onto consumption taxes (value-added taxes) or social security contributions are economically very similar. Both of these alternative levies are, in effect, more or less regressive taxes on labor so that the outcome is the same: wage tax progressivity is reduced.

Table 1 Tax Policy Goals Involved in the "Income Tax Quadrilemma"

| Basic economic policy goals | Efficiency | | Equity ("Compensation") | |
|---|---|---|---|---|
| Dimensions of basic policy goals | International efficiency | Domestic allocative efficiency | Horizontal equity | Vertical equity |
| Operational policy goals | Competitiveness | Symmetry | Comprehensiveness | Wage tax progressivity |
| | *"low"* $t_M$ | $t_M = t_I$ | $t_I = t_L$ | *"high"* $t_L$ |

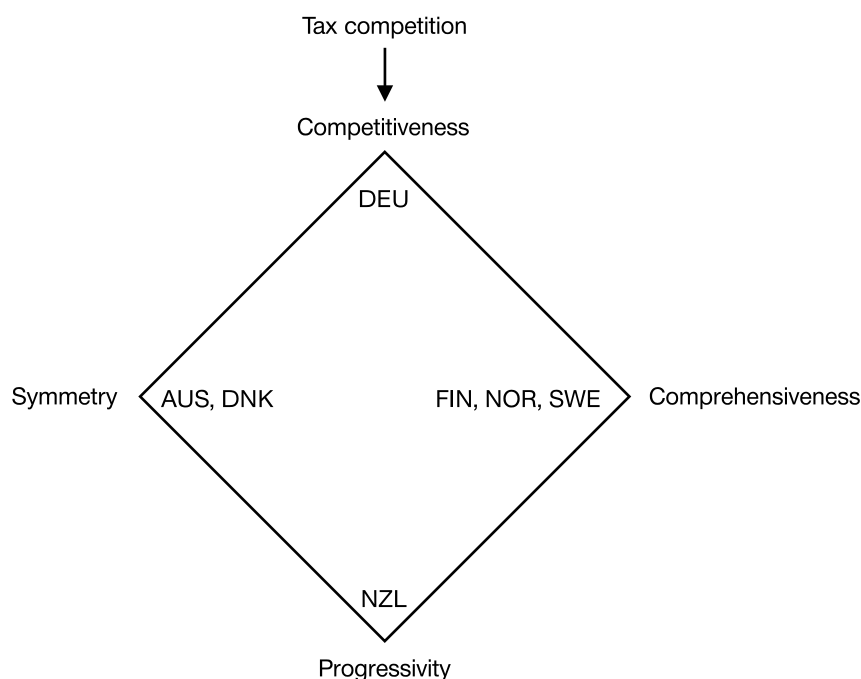
*competitiveness*, with one dimension of domestic equity or domestic compensation, that is, *wage tax progressivity*. However, this reconciliation is predicated on sacrificing either another dimension of efficiency or another dimension of equity. Policymakers have either to make domestic allocation less efficient by allowing for different tax rates on different types of capital income (*sacrificing symmetry*) or to restrict tax progressivity solely to labor income (*sacrificing comprehensiveness*).

## 3 Common Pressures, Divergent Choices: The Income Tax Quadrilemma in the Real World, 1985–2001

The previous section has shown how competitive pressures on some type of capital income can put governments in a quadrilemma situation. Obviously, the quadrilemma exists only to the extent to which countries actually aim at all four tax policy goals. Since not all countries have traditionally aimed at strong forms of symmetry in capital income taxation, I have to control for the country-specific importance of this goal. Therefore, I focus on those countries that did actually *establish* a strong form of symmetry in capital income taxation at some point. More precisely, I focus on the seven OECD countries that aligned the corporate tax rate with the general (top) rate on personal capital income: Australia, Denmark, Finland, Germany, New Zealand, Norway, and Sweden. For these seven countries, I can be sure that symmetry figured prominently in domestic policy debates and that policymakers had to deal with the income tax quadrilemma explicitly.

Figure 4 summarizes which goal the seven countries *predominantly* sacrificed *until 2000*. Not surprisingly, none of the six small countries could afford to compromise competitiveness. All countries quickly moved to very low CT rates after the tax reform wave had started in the mid-1980s. Only Germany maintained an exceptionally high headline CT rate until 2000 (see Figure 2).

Figure 4 Domestic Tax Policy Goal Predominantly Sacrificed, 1987–2000




Germany, Australia and New Zealand had actually established a formally comprehensive, symmetric and progressive income tax that aligned the CT rate with the top PIT rate before tax capital mobility put pressure on the CT rate. The three countries reacted very differently. Germany did almost nothing and maintained very high top tax rates (thus sacrificing competitiveness), New Zealand did the opposite by drastically reducing all rates (sacrificing progressivity), and Australia cut only the CT rate (compromising symmetry).

The Nordic countries aimed at dual income tax (DIT) systems; Denmark already in a (perceived) closed-economy context, the other countries as a response to competitive pressures. Norway, Finland, and, to a lesser extent, Sweden maintained fairly "clean" DIT systems (sacrificing comprehensiveness). By contrast, Danish policymakers refused to accept a large gap between a uniform capital income tax rate and the top rate on labor, re-introducing instead differentiated and quasi-progressive tax rates on capital income.

The following brief case studies explicate the context of national policy choices and focus on the role of partisan politics and political institutions in shaping these choices. Competitive considerations became much more important after the US tax reform in 1986 (cf. Hallerberg/Basinger 1998; Ganghof 1999). In general, therefore, the case analyses start in the mid-1980s. However, for those countries that introduced symmetry after the mid-1980s – Finland, Norway, and Sweden – the analyses focus on the subsequent period.

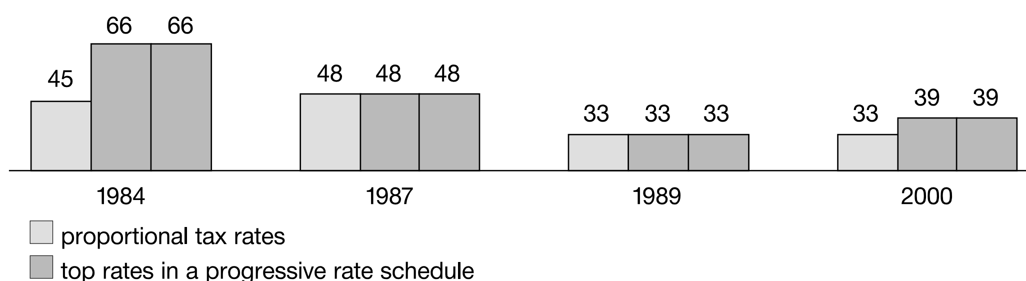
### 3.1 Sacrificing Progressivity: New Zealand

New Zealand's income taxation is striking. New Zealand has the world's third highest (corporate and personal) income tax ratio (20% of GDP in 1998), topped only by Sweden (21%) and Denmark (29%). However, while Sweden and Denmark both have top PIT rates of almost 60%, New Zealand maintained a top PIT rate of 33% all through the 1990s. Only recently, a Labor-led coalition increased it to 39% – still very low from a comparative perspective (see Figure 5).

Of course, raising so much revenue with a top rate of 33% implies that New Zealand's income taxation is not very progressive, neither at the bottom nor at the top (van den Noord/Heady 2001: 19). There is no basic allowance for low-wage workers and the top PIT rate already starts at the income level of an average production worker. In addition, low average and marginal tax rates for high-income earners have made a greater reliance on means-tested welfare benefits both necessary for fiscal reasons and easier politically to defend, and such targeted welfare benefits lead to high marginal tax rates for low-income earners (Quiggin 1998: 84; Boston 1999: 9; Boston/Dalziel/John 1999).

New Zealand's move towards this type of tax-transfer system cannot be understood without bringing competitive pressures on CT rates and the income tax quadrilemma into the analysis. Between 1984–87, a Labor government implemented a tax reform which was still largely unconstrained by competitive pressures (Sandford 1993: 70). The main goal of this reform, strongly advocated by governmental and non-governmental tax experts, was to increase comprehensiveness and symmetry. Personal income tax rates were reduced – the top rate coming down from 66% to 48% –, tax bases were broadened, tax rates aligned, and double taxation of dividends was fully abolished (Treasury 1984). To align tax rates, the CT rate was actually *increased* to 48% (Figure 5).

Figure 5 Income Tax Rates in New Zealand, 1984–2001




Notes: The first rate is the headline rate on corporate income (including sub-national taxes). The second rate is the (top) rate on personal capital income. The third rate is the top rate on labor income.

However, with increasing downward pressures on the CT rate, this system was not viable. Policymakers had to give up one of the domestic policy goals to achieve competitiveness. Given the general economic crisis and the government's strong emphasis on allocative efficiency, the choice was clear: the system had to become less progressive. The Minister of Finance was committed to cut the CT rate to an "internationally competitive level, but not less than the [top] personal rate" (Sandford 1993: 55). Thus, in a second tax reform, 1987–1990, both rates were reduced to 33% (Stephens 1993: 48–49). Initially, the Minister of Finance had planned to move towards an even lower level, 23–24%, by moving towards a real flat tax. However, the Prime Minister rejected this plan because of the distributional consequences and the additional spending cuts needed to make the flat tax possible (Chapman 1992). Yet the additional 33% bracket only modified the flat tax, and there was a remaining element of deficit built into the tax cuts, which made it necessary to raise the value-added tax (called "GST") from 10% to 12.5% in 1989.

The National Party, coming into office in 1990, was happy with the income tax system, so that the basic system remained unchanged until 1999. From 2000, a center-left coalition, led by a remodeled Labor Party, shifted the balance towards less symmetry and more progressivity and income tax revenues. It increased the top PIT rate to 39% – despite the Treasury's remaining strong preference for tax symmetry (Whitehead / Oliver 1999) – in order to fund additional social spending (Figure 5).

## 3.2 Sacrificing Symmetry: Australia and Denmark

### 3.2.1 Australia

Australian tax reform until the mid-1980s was very similar to that in New Zealand (Head 1989; Porter / Trengove 1990; Sandford 1993: ch. 5). In a reform unaffected by competitive considerations, Australia endeavored to establish a strong progressive form of tax symmetry. PIT rates were reduced and the CT rate was increased, aligning the top rates at 49% (see Figure 6). Double taxation of dividends was abolished, and the capital income tax base was broadened, for example by including realized capital gains.

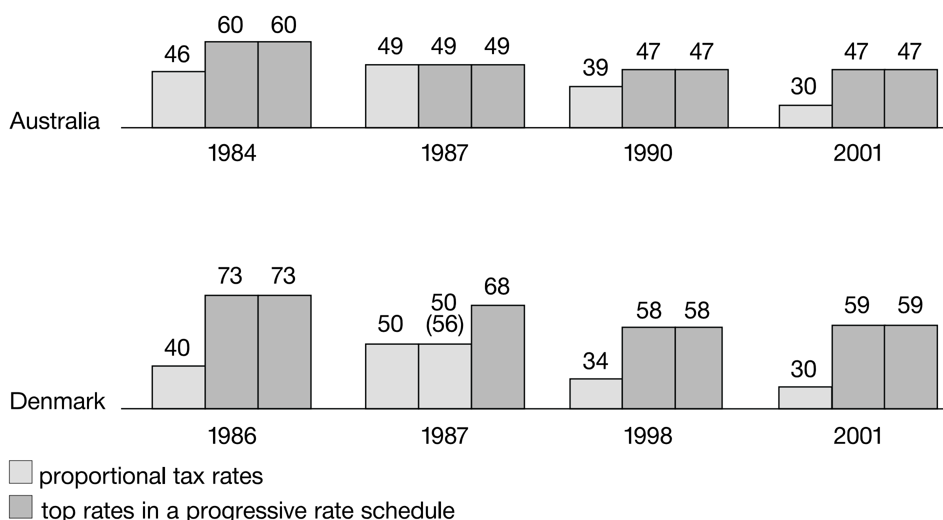
This symmetric tax system only survived the year 1987. Already during the debate on the 1985 reform, policymakers began to be concerned about the high CT rate (Evans 1988: 30–38). To achieve "competitiveness" the CT rate was reduced to 39% in 1988, and 33% in 1993. The Labor government was unwilling, however, to further reduce statutory progressivity in personal income taxation. The price it had to pay was reduced tax symmetry and an increase in corporate tax shelters:

> [T]he wide [tax rate] gap … has served … to reintroduce some of the worst distortions and inequities of the [former] classical system of company tax which dividend imputation was supposed to eliminate. Indeed, there are now serious new problems of tax avoidance with the use of private company structures to shelter the investment portfolios of the wealthy and the labour incomes of self-employed professionals and consultants. (Head / Krever 1997: xxix)

Australian Taxation Office statistics indicate that the number of private companies has increased by 32% since 1991, while employment has grown by only 10% over the same period (ACOSS 1999). Tax avoidance is undoubtedly one main factor behind this growth in private companies, about which both the Treasury and the Australian Taxation Office have repeatedly expressed their concern.

Recently, the National-Coalition government, in office since 1996, made a significant move towards more symmetry and less progressivity. It finally managed to introduce a value-added tax (called GST) at a rate of 10%, which partly financed marked income tax cuts. While the government shied away from reducing the top personal income tax rate, it pushed out the income threshold for the highest bracket from $50,000 to $60,000, so that most taxpayers face a rate of 30%, which *is* aligned with the CT rate. Originally, the government wanted to push out the threshold to $75,000, but Australian Democrats and the Labor Party in the Senate prevented this.

Figure 6 Income Tax Rates in Australia and Denmark, 1984–2001




Notes: The first rate is the headline rate on corporate income (including sub-national taxes). The second rate is the (top) rate on personal capital income. The third rate is the top rate on labor income.

### 3.2.2 Denmark

In 1985, the Danish bourgeois minority government also wanted to move to symmetric capital income taxation. However, given Denmark's large income tax share in GDP (28% in 1985), the government could not aim at a progressive version of tax symmetry. The top personal income tax rate was reduced from 73% in 1986 to 68% in 1987 (Figure 6), and increasing the CT rate to that level was, of course, out of the question.

The government wanted to introduce a dual income tax, with a flat rate of 50% on all capital income (Drejer 1988; Lotz 1993). The DIT had the great advantage of reducing the value of deducting consumer interest, because interest was to be deducted against the flat capital income tax rate rather than the top personal rate. However, the tax reform was based on an agreement with the oppositional Social Democrats and Social Liberals, who did not want to give up progressive taxation of capital income taxation (Sørensen 1994). As a result, an additional 6% was introduced on high capital incomes (Figure 6). Nevertheless, the standard flat rate on capital income was 50% and thus the CT rate was *increased* from 40 to 50%. The double taxation of dividends was to be completely abolished by 1990.

As in Australia, tax symmetry in Denmark did not survive competitive pressures. Given marked cuts in CT rates in other Western countries, the 50% CT rate was felt to "send a negative signal to international investors" (Andersson et al. 1998: 118). The CT rate had to come down, but policymakers were unwilling to reduce the uniform capital income tax rate to "internationally competitive levels." While they had been willing to abolish the *principle* of comprehensive income taxation, they were unwilling to accept too large a gap between the tax rate on capital income and the tax rate on high labor income. The government thus reduced only the CT rate to 34% by 1992.

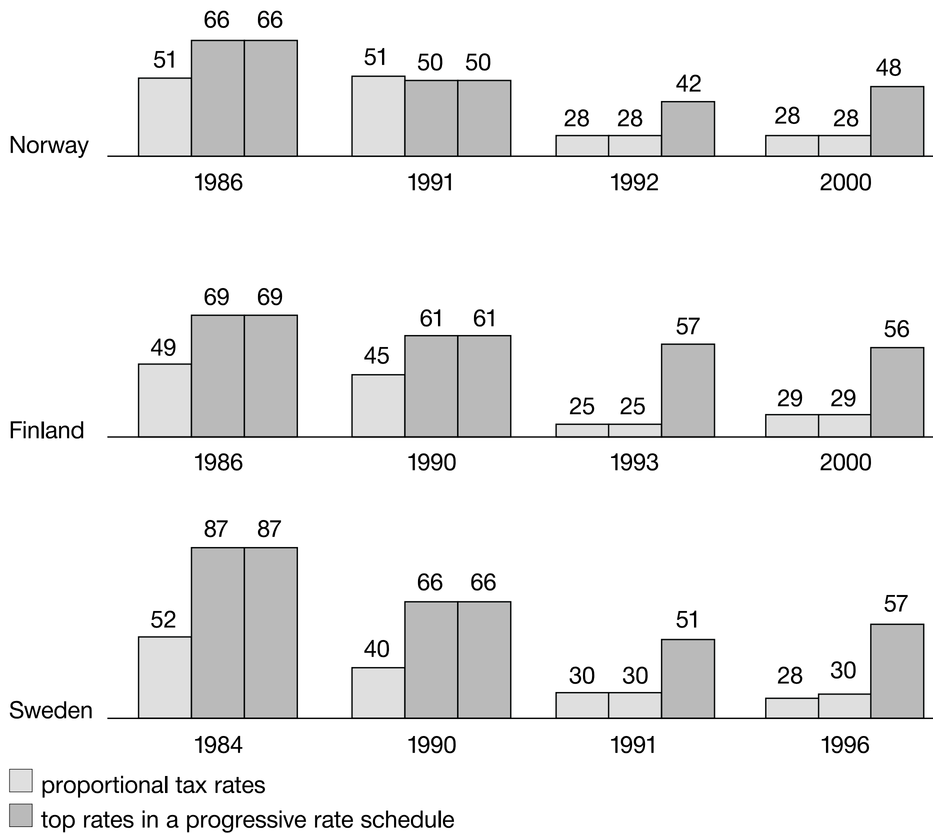
In a tax reform in 1993, a center-left government made a further move (back) to more progressive and differentiated tax rates on different types of capital income (Figure 6). In 2001, the top rate on wages is 59%, while the tax rates on capital income vary from 30% on retained corporate profits to around 60% on high income from shares (Pedersen 1993; Lange / Pedersen / Sorensen 1999: 135–39).

## 3.3 Sacrificing Comprehensiveness: Norway, Finland and Sweden

### 3.3.1 Norway

Before 1992, Norway also had an asymmetric, but, in principle, comprehensive, tax system with high marginal tax rates (Figure 7) (Koren 1993; van den Noord

Figure 7 Income Tax Rates in Norway, Finland, and Sweden, 1984–2001




Notes: The first rate is the headline rate on corporate income (including sub-national taxes). The second rate is the (top) rate on personal capital income. The third rate is the top rate on labor income.

2000). All types of interest were fully deductible against the taxpayer's marginal income tax rate, so that high marginal rates contributed little to income redistribution and much to a net revenue *loss* from capital income taxation.

In 1992, a DIT was introduced (Zimmer 1993): a basic rate flat rate of 28% was levied on income from all sources, including corporate income and all personal capital income, while a two-step additional progressive rate schedule applied to "gross personal income," that is, labor income (Figure 7). Excluding social security contributions, the top rate was around 42% after 1992. Double taxation of corporate profits, whether distributed or retained, was completely abolished.

The reform was enacted in 1991 under a Labor minority government. Yet, after many years of negotiations and committee work, it was passed with almost unanimous agreement in parliament (Fagerberg et al. 1990: 86, n. 38; Gjelsvik 1998: 182).

All parties saw the new tax system as both strengthening Norway's international competitiveness and better serving redistributive goals (van den Noord 2000: 8).

Nevertheless, the decision to give up "comprehensiveness" and accept a large gap between the top rates on labor and capital income was a difficult one, which has been challenged ever since (Zimmer 1993: 152–53; Gjelsvik 1998: 184). Zimmer nicely summarizes how policymakers perceived the quadrilemma:

> The relatively low tax rate on capital is based first of all on considerations of *competitiveness*. If the rate of tax on capital income in Norway were considerably higher than in other countries, then capital would flow to these other countries. … [H]igher taxes on earned income were considered necessary both for fiscal and equity reasons: the revenue was needed, and it was considered politically impossible to introduce a tax reform which gave significantly greater tax advantage to well-off taxpayers than to the less well-off. (Zimmer 1993: 143, italics in original)

The main partisan conflict was thus between progressivity (and revenue-raising), on the one hand, and the size of the tax rate gap, on the other. The left wanted higher tax rates on high labor incomes to finance additional social spending, while the right wanted to keep the tax rate gap as small as possible. As from 2000 the top rate on labor was increased to 47.5% (55.3% including national insurance contributions) as a result of the Labor government's veto power under a very small centrist minority government (Christian People's Party, Center Party, Liberals). After long negotiations, the government eventually agreed to increases in both labor taxes and social spending in order to get its budget through parliament (Narud / Valen 2000: 485).

### 3.3.2 Finland

Finland also had an income tax that was formally comprehensive, but very asymmetric. Top marginal rates were high, but many types of capital income were subject to low flat rates; double taxation of corporate profits was not completely eliminated; and interest deductibility eroded the capital income tax base. In 1988, a coalition of Conservatives, Social Democrats, Swedish People's Party and Rural Party moderately reformed income taxation, partly responding to competitive pressures. Marginal tax rates were reduced in small steps (see Figure 7), the tax was broadened and double taxation of dividends was abolished in favor of symmetry in corporate taxation (Tikka 1989).

The tax reform process continued, however, due to rapid financial market deregulation, a deepening recession, and growing public deficits (OECD 1989: 91; Tikka 1993a; 1993b; Honkapohja / Koskela 1999). A more rightist coalition of Conservatives, Center Party, Swedish People's Party and Christian Party, which had

come into office in 1991, switched to a full-fledged DIT from 1993. A uniform capital income tax rate of 25% was introduced, the capital income tax base was broadened, and the top rate on labor was set at 57%.

The Finnish left-wing opposition did not oppose the switch to a DIT. The only bone of contention was the *level* of the capital income tax rate. Right-wing politicians and economic experts called for a rate even lower than 25%, given tax competition and the previous under-taxation of capital income (see, for example, Koskenkyla 1992). By contrast, Social Democrats wanted a higher rate of 30% (Tikka 1993a: 92). After Social Democrats returned to office in 1995 (together with Conservatives, Greens, Left Wing Alliance and the Swedish People's Party), the rate was increased – to 28% in 1996, and to 29% in 2000.

### 3.3.3 Sweden

Sweden – the case best documented in the political science literature (Steinmo 1993: 179–192; 2000) – is a mixed case from the quadrilemma perspective: while Swedish policymakers were the first to take up the Danish idea of a full-fledged dual income tax, a fully symmetric DIT was not sustained. The DIT system was introduced in 1991. The reform was intended to be revenue-neutral (in the end it was not), the tax base was broadened significantly, a uniform tax capital income tax rate of 30% was introduced and the top rate on labor income fell to 51% (see Figure 7). The classical system of taxing dividends twice was not abolished, but double taxation was mitigated by means of deductions at the level of the corporation (Andersson / Kannianinen / Södersten / Sorensen 1998: 90).

The central features of the DIT were worked out and passed under a Social Democratic minority government between 1989 and 1991 (Salsbäck 1993; Andersson / Mutén 1998: 350). However, the reform was based on a formal agreement with the Liberals, who acted as a real veto player and extracted a number of significant concessions from the Social Democrats (Steinmo 1993: 235, n. 49). Most importantly here, Liberals kept the government from responding to the union demands by increasing the top rate on wages to 55% (Salsbäck 1993: 209).

A bourgeois coalition (Center Party, Christian Democrats, Conservatives, Liberals), coming into office in 1991, respected the main thrust of the Socialists' tax reform, but wanted to make the system both more symmetric and more competitive. From 1994, it completely abolished double taxation of dividends by exempting dividends at the level of the shareholder. In addition, it reduced the tax rate on capital gains from shares to effectively 12.5%, and wanted to reduce the uniform capital income tax to 25%.[7] This time, however, the Social Democrats

7 The move to a 12.5%-rate on capital gains was intended to be a move to more, rather

acted as veto players. In a crisis deal with the government, the 5 percentage point cut in the capital income tax rate was postponed until 1995, and only the CT rate was cut to 28% in 1994.

The reduction in the capital income tax rate never materialized. Social Democrats returned to office at the end of 1994 and shifted the balance again towards less symmetry and higher revenues: the capital income tax rate stayed at 30%, the double taxation of dividends was reintroduced, the tax rate on capital gains from shares was increased once more to 30%, and the top rate on wages was increased to 57% – only the CT rate stayed at 28% (Figure 7). These rate increases allowed Social Democrats to bring public finances in order in the second half of the 1990s (without relying exclusively on expenditure cuts), and to target tax reductions to low and medium incomes in the early 2000s.

### 3.4 Sacrificing Competitiveness: Germany

Germany – the only "larger" country in my sample – essentially sacrificed competitiveness until 2000 by maintaining a very high headline corporate tax rate (Figure 8). While this is partly explained by the larger size of the German economy, the German case is a general "outlier" throughout the 1986–2000 period (Figure 2). Policymakers needed longer than in any other country to cut the CT rate below 40%.

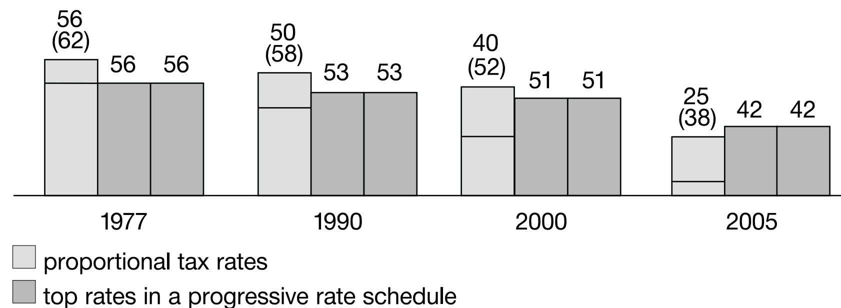
But something else is even more puzzling. When the Red-Green coalition, in government since late 1998, finally managed to cut the headline CT rate to around 38% in 2001, it also decided to cut the top PIT rate to a rate of 42% by 2005 (Figure 8). This cut will lead to a personal income tax reduction of around 1.3% of GDP,[8] and it will also reduce *high-wage* progressivity in Germany.[9] What one could have expected a left-wing government to do instead – analogous to those in other con-

than less, symmetry. Capital gains are, to a significant extent, the result of retained profits which are already taxed at the level of the corporation. The bourgeois coalition thus assumed that about one half of capital gains are due to retained profits and that only the other half, therefore, was to be taxed at the 25% rate (Andersson / Mutén 1998: 337).

8 Germany's tax schedule does not have brackets, but is based on a formula with continuously increasing marginal tax rates. Therefore, cuts in the top PIT rate generally reduce marginal tax rates for lower and medium incomes as well.

9 The 42% top PIT rate will not only be one of the lowest in Europe (see Figure 9); it will also start at higher incomes than in most other EU countries, that is, incomes above 59,000 EURO, compared to 22,000 in Ireland, 36,000 in Denmark, 44,000 Sweden, and 45,000 in the United Kingdom.

Figure 8 Income Tax Rates in Germany, 1986–2005




Notes: The first rate is the headline rate on corporate income (including sub-national taxes). The corporate income tax rate is depicted by the lower bar. The upper bar is the effective (average) local business tax rate. The overall effective tax rate on corporate profits is given in parentheses. Until 2001, unincorporated businesses were also subject to the local trade tax. The second rate is the (top) rate on personal capital income. The third rate is the top rate on labor income.

tinental European countries like the Netherlands and France – was to maintain fairly high rates on high personal income and to focus cuts on the lower end of the earnings scale, where they could have had the biggest impact on service sector employment (cf. Scharpf 2000).

The German pattern of compromising first "competitiveness" and then "progressivity" can easily be explained from within the quadrilemma framework. Germany, like New Zealand and Australia, had operated an ambitious form of comprehensive income tax. Already in 1977, the CT rate was aligned with the top PIT rate at 56%, and double taxation of dividends was completely abolished (Figure 8). The values of comprehensiveness and (progressive) symmetry were thus even more deeply entrenched in German tax policy than in that of the Antipodes.

Germany's rate alignment system was not perfect, however, because Germany operates a local business tax that is not technically an income tax and was therefore not part of the rate alignment (for details, see Ganghof 2000b; Homburg 2001). Nevertheless, the tax burden fell effectively on profits and added to the headline tax rate of corporations – as well as unincorporated businesses for that matter (see Figure 8).

What is crucial for the Germany case is the existence of additional, independent veto players who have made it more difficult to solve the income tax quadrilemma. First, local governments effectively prevented the abolishment of the local business tax, and the German courts, most notably the Federal Constitutional Court, defended the goals of "comprehensiveness" and, in part, "symmetry." In addition, sacrificing symmetry between corporations and unincorporated busi-

nesses could have led to high economic and electoral costs for any government because around 85% of all businesses are unincorporated.

As a result, while the Christian-Liberal coalition wanted to reduce the headline CT rate, it did not dare to allow for a large gap between the CT rate and the top PIT rate at the central government level. Since it could not agree either on far-reaching cuts in the top PIT rate, CT cuts in 1990 were very small, as shown in Figure 8 (Ganghof 2000b: 18). This pattern basically continued until the late 1990s, when the coalition finally agreed to cut both (top) income tax rates at the central level to 39%. However, this proposal was blocked by the Social Democrats in the upper house – not because Social Democrats disliked a lower CT rate but because they disliked a very low PIT rate.

The situation was turned on its head in 2000. Now Social Democrats were in office, together with the Greens, and finally wanted to make Germany's CT rate "competitive." To overcompensate for the local tax, they wanted to cut the CT rate at the federal level to 25%. Of course, cutting the top PIT rate to this level was out of the question. The government therefore made the local tax deductible from the personal income tax for unincorporated businesses. In addition, they wanted to give unincorporated businesses the "option" of being treated as corporations for tax purposes so that the top PIT rate could stay higher, at least at 47%, than the combined federal-local CT rate of around 38%. This time, however, the right-wing opposition in the upper house, especially the FDP, used its veto power to push through a reduced top PIT rate of 42%.

In sum, competitive pressure, in combination with multiple veto positions, forced German governments to compromise all goals except comprehensiveness (Figure 8). Since the local tax could not be reformed or abolished, Germany had to compromise symmetry in order to achieve a lower CT rate. Double taxation of dividends was re-introduced, with the result that retained profits are now often taxed at lower rates the distributed profits. At the same time, the combined federal-local CT rate is essentially still linked to the top PIT rate. It is therefore only a question of time until a new wave of tax cuts in CT rates in Europe will put new pressure on the German top PIT rate. The only way to avoid this would be to switch to some kind of dual income tax, but that option seems to be blocked by the Constitutional Court. Competitive pressures will therefore continue to strongly constrain income taxation in Germany.

# 4 International Efficiency, Domestic Compensation, and the Politics of Tax Policy Adjustment

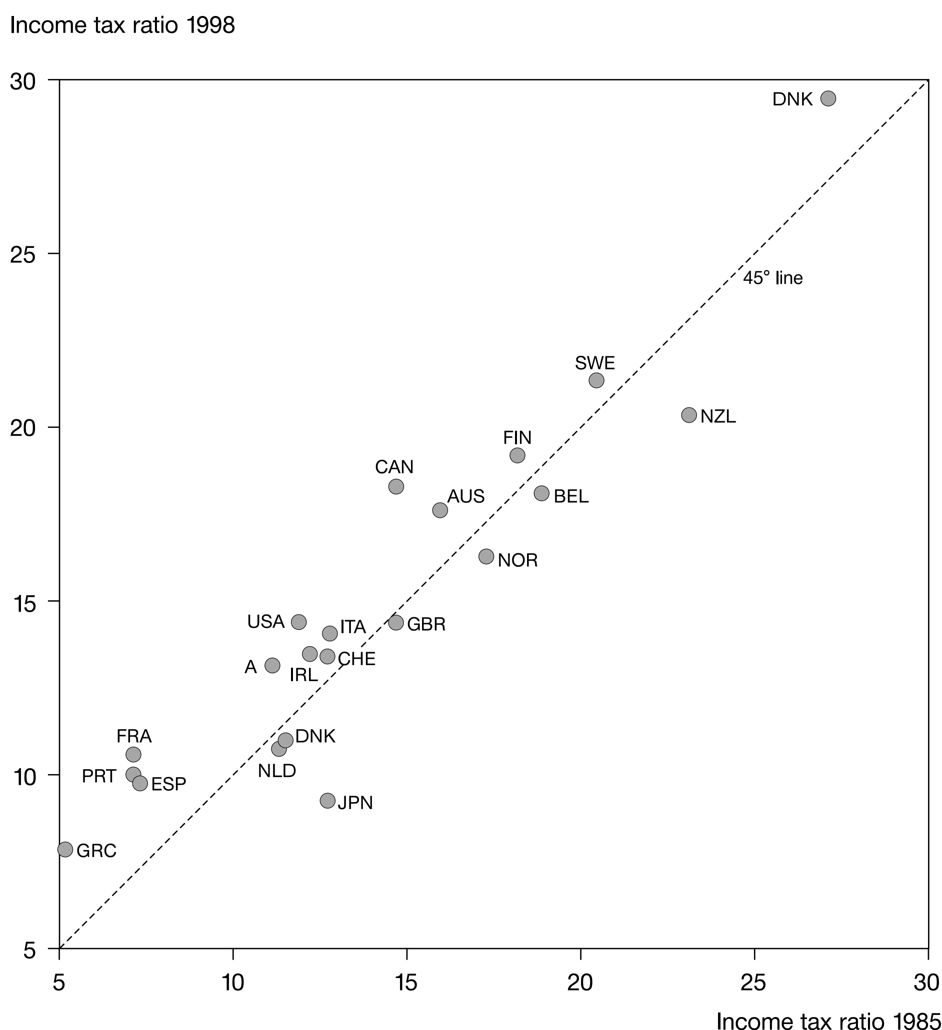
The politics of the income tax quadrilemma in those countries that had aimed at strong forms of domestic tax symmetry – that is, equal tax rates on different types of capital income – offers more general lessons on the political economy of income tax adjustment. After all, no government in the OECD world has been completely ignorant about domestic tax symmetry. It is thus reasonable to assume that most governments' past choices of income tax structure already, in part, reflected the generic income tax quadrilemma. Consider two examples: in Belgium, as in other countries, important voices called for more symmetric and comprehensive income taxation but, given strong competitive pressures and Belgium's small size, policymakers never considered such a policy to be feasible (Spruyt 1990: 165). Similarly, we should not be surprised that the British Labour Party does not aim at higher income taxes on the well-off since Britain has a fairly comprehensive and symmetrical income tax system, where increases in the top PIT rate would hit most types of capital income.[10]

## 4.1 The Continuing Feasibility of "Compensation"

The first lesson of my analysis then concerns the way in which governments have been able to reconcile *competitiveness* (international "efficiency") with *progressive* income taxation and large public sectors (domestic "compensation"). The analysis suggests that tax rate differentiation has been crucial for this reconciliation. Since capital income had been taxed leniently in the past in most countries, and since negative capital incomes (that is, private debt) had been partly subsidized through tax systems, maintaining revenues while cutting tax rates on mobile capital income was not very difficult for most governments. There was a lot of "slack" in the form of low or negatively taxed capital income, so governments shifted the tax burden within the capital income tax base rather than from capital to labor. However, this policy was predicated on tax rate differentiation. Compensating large tax cuts in top rates on *labor incomes* by broadening the tax base is much more difficult and ultimately leads to flat income taxation. Thus, the formula of

10 Tax symmetry was an important goal of the Thatcher government (Leape 1989; 1993). In 1988, the government reduced the top PIT rate to 40% and aligned capital gains tax rates and inheritance tax rates with general personal income tax rates (Boix 1998: 169). While the CT rate, 33% at that time, was not aligned with the top PIT rate, it was aligned with the basic rate of shareholder income (Bond/Chennels/Devereux 1996).

Figure 9 Income Tax Rates Revenues as a Percentage of GDP, 1985–1998




Note: Revenues include both personal and corporate income.

revenue-preserving tax policy adjustment was "differentiated-tax-cuts-cum-base-broadening."

Figure 9 shows that competitive pressures have not generally led to significant revenue losses in the income taxation of OECD countries. Between 1985 and 1998 most countries increased their income tax ratio, regardless of the level of their income tax ratio in 1985.[11] Even Denmark, the country with the world's highest income tax burden, increased income tax revenues. New Zealand is the only exam-

11 This income tax ratio includes corporate tax revenues. Due to differences in firm structures and corporate tax systems, corporate and personal income tax revenues cannot be compared separately across countries.

ple of a country that significantly reduced its (high) income tax ratio in response to competitive pressures on some types of capital income – and this case is easily explained within the quadrilemma framework.[12]

### 4.2 The Costs of "Compensation"

The second lesson of my analysis is that reconciling international efficiency (***competitiveness***) and "domestic compensation" (***wage tax progressivity*** and ***high revenues***) does have costs.[13] Governments have had to sacrifice or compromise either domestic allocative efficiency (***symmetry***) or horizontal equity (***comprehensiveness***). While this is an important insight in its own right, it also helps us to understand why and how competitive pressures have constrained domestic compensation in some countries. Where governments have been unwilling or unable to make the necessary compromises with respect to horizontal equity or domestic allocative efficiency, competitive pressures have reduced revenue-raising and/or progressiveness in income taxation, all else being equal.

New Zealand and Germany are the most obvious examples. However, income taxation in Australia or the United Kingdom may be constrained to a similar extent, because the new – or, rather, more transparent – tradeoffs between horizontal equity, vertical equity, and domestic efficiency may create a bias of the *political discourse* towards income tax cuts, even when the demand for increased social spending is fairly large. For example, in Australia income tax cuts remain high on the agenda and figure prominently in the run-up to the elections in 2001. The right-wing government keeps using the tax gap as an argument for bringing down tax rates on high personal income.[14] This focus on horizontal equity and domestic efficiency may help to explain the puzzling behavior of the Labor Party: even though Australia's total tax ratio is very low and the demand for additional social spending ("compensation") is fairly large, and even though the Labor Party pledged to rollback GST, it does not dare to call for income tax increases on higher incomes.

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12 Japan also reduced its income tax ratio and shifted the tax burden onto social security contributions and consumption taxes. There is little evidence, however, that this shift was related to competitive pressures (Ishi 2001: ch. 6).

13 It is not possible to deal with all types of costs in this paper. There are direct costs associated with a policy of revenue-neutral tax-cut-cum-base-broadening in corporate taxation, because this policy tends to reduce the incentive to re-invest profits in companies already located in a given country (Wallerstein/Przeworki 1995; Ganghof 2000b).

14 The head of the government's consultative committee on tax reform has called for a top PIT rate of 30% to re-establish symmetry and horizontal equity (OECD 2001a: 13).

Even the Nordic countries have not been immune to this kind of discourse (Strand 1999; Tikka 1999; van den Noord 2000; OECD 2001c: 105–108). In Norway, for example, ever since the introduction of the dual income tax, loud voices have called for reducing the tax rate gap between capital and labor and suggested a flat tax of around 30% on all types of income (Gjelsvik 1998: 184), backed up by econometric estimations according to which the effects on income inequality would be small and a majority of households would gain from moving to a flat tax (Aaberge / Colombino / Strøm 2000). Zimmer (1993: 152) aptly summarizes the underlying logic:

> [I]t is difficult to justify the difference in tax rates for capital income and earned income. And … the dual income tax system creates very important and difficult implementation problems. … The most obvious alternative, of course, is to eliminate, or at least significantly reduce, the differences in tax rates… However, in the short term at least, this alternative seems to be impossible for fiscal and political reasons. Of course, the revenue loss could be compensated by increasing the tax rate on general income. This would, however, decrease the international competitiveness of the Norwegian capital income taxation. … Nevertheless, in the longer term, the best way out of the problem seems to be a reduction or outright abolition of the surtax.

### 4.3 The Role of Political Parties and Veto Institutions

Whether or not the income tax quadrilemma will lead to a long-term bias towards flatter income tax schedules and lower revenues, the quadrilemma framework suggests that in the medium run political parties are crucial in shaping income tax structure – both in government and whenever they occupy oppositional veto points (Immergut 1992; Tsebelis 1995). The quadrilemma framework implies distinct hypotheses on *how* political parties and veto players matter.

#### 4.3.1 Corporate Tax Rates

Hallerberg and Basinger (1998: 344–345) suggest that between 1986 and 1990 left-leaning governments were more likely to make deeper cuts in the corporate tax rate than their right-leaning counterparts – either as a political premium to investors who have fears about their future rate of return under left-wing governments or due to a change in attitude towards redistribution within Social Democratic parties. These authors also suggest that countries with only one veto player made much deeper rate cuts than those with two or more veto players, everything else being equal. By contrast, my theoretical analysis suggests that government ideology and the number of party-controlled veto players have been gener-

ally irrelevant for the setting of CT rates.[15] The simple reason is that all parties have had a strong competition-induced incentive to move to low CT rates, and "differentiated-tax-cuts-cum-base-broadening" has allowed them to do so without high costs.

This expectation is clearly borne out by my matched comparison. Among the whole set of advanced OECD countries, the seven countries investigated above should have had by far the biggest problems cutting CT rates because policymakers in these countries did care strongly about tax symmetry. Yet bringing down CT rates was not a big issue in the six small countries. With the exception of Germany, quick and far-reaching tax cuts were made by left and right-wing governments alike, and under any number of veto players, ranging from one in New Zealand (cut from 48% to 33%) to four in Finland (cut from to 49% to 25%). The German case is explained by the country's larger size (see below) and the existence of additional independent veto players – courts and local governments – which made the quadrilemma more difficult to solve.

Leftist parties had, if anything, a slight negative effect on the magnitude of rate cuts – both in government and as oppositional veto players. The Finnish left preferred a 30% instead of 25% rate on capital income in 1992, and achieved an increase in the rate after coming back into office. The Swedish Social Democrats kept the bourgeois minority government from reducing the capital income tax rate from 30% to 25% in 1994 and maintained the higher rate after coming back into office. However, these differences are of minor importance relative to the overall distribution of tax rates (see Figure 2).

The general irrelevance of government ideology and veto players is corroborated by the available quantitative evidence. In Ganghof (1999) I showed this for the period between 1986 and 1994 and for general government tax rates (including sub-national rates). However, the same result holds for central government tax rates and shorter adjustment periods.[16] If there is any systematic difference be-

15 The usual distinction, drawing on Tsebelis (1995), is between partisan and institutional veto players. The former are coalition parties, the latter presidents and second chambers. I find it more useful to distinguish between party-controlled and independent veto players (Ganghof 2001). Party-controlled veto players include coalition parties, second chambers, presidents, and – contrary to Tsebelis – the opposition under minority governments. All of these veto players are also vote-seekers, which has important consequences for their behavior. By contrast, independent veto players such as courts or central banks are generally pure policy-seekers.

16 Hallerberg and Basinger (1998) generally opt for taking the tax cut until 1990 as the response of governments to the 'shock' of the US tax reform in 1986, but include the 1991 cut for Sweden (Hallerberg/Basinger 1998: 328). In addition, their primary data source (OECD 1993: 66) gives an incorrect tax rate for Finland in 1990. The Finnish

Table 2 Headline CT Rates (incl. Sub-national Rates) and State Size (Population)

| | 1986 | 1990 | 1994 | 1999 | 2001–2005 |
|---|---|---|---|---|---|
| Average | | | | | |
| OECD, N = 21 | 48.0 | 41.4 | 37.1 | 35.7 | 33.5 |
| Small states (< 20 mill.), N = 13 | 48.2 | 40.5 | 33.8 | 33.1 | 31.5 |
| Correlation between population (natural logarithm) and CT rate | 0.03 | 0.16 | 0.58 | 0.61 | 0.62 |

tween the CT rates of open economies, it is likely to be due to state size (i.e. size of the population) rather than domestic politics (cf. Sørensen 2000). As shown in Table 2, small states had the same average CT rates as large states in 1986, but reached bigger average cuts by 1994 and maintained lower CT rates afterwards. The correlation coefficient between state population and CT rate jumped to large and statistically significant levels in 1994 and remained there from then on.

### 4.3.2 Personal Income Tax Rates

While parties matter little where corporate taxation is concerned, they matter a lot in regard to personal income taxation – both in government and as non-governmental veto players. However, the quadrilemma framework suggests that the direction and magnitude of partisan influence is much more conditional than is recognized in the existing literature (Hallerberg / Basinger 1998, 1999; Wagschal 1999).

First, in line with the work of Boix (1998) and Garrett (1998), I expect left parties to prefer higher top PIT rates, all else being equal As a corollary, I expect the direction of the effect of veto players on top PIT rates to be conditional on the players' partisan identity. Left-wing veto players tend to increase top PIT rates, right ones tend to decrease it.[17]

Second, I expect top PIT rates to be higher in countries that have removed most sensitive capital incomes from the ambit of progressive income taxation (Ganghof

CT rate (central government) fell from 33% in 1986 to 28% in 1990, 23% in 1991, and 19% in 1992 (Tikka 1989: 108; Messere 1993: 341; Andersson / Kanniainen / Södersten / Sorensen 1998: 121). If the dependent variable is coded consistently for either 1990 or 1991, there is no large or statistically significant effect of either the number of veto players or the ideological orientation of governments on the magnitude of corporate tax cuts. Full regression analysis can be obtained from the author.

17 For the mutual dependence of partisan and institutional effects, see in general Schmidt (1996) and Haggard and McCubbins (2001).

2000a: 618). Where the top PIT rate only applies to labor (dual income tax), maintaining high top PIT rates is easiest, both economically and politically. By contrast, where all capital income except retained corporate profits are taxed under the progressive income tax, maintaining a high top PIT rate is most difficult.

Third, I expect the importance of parties and party-controlled veto players to be conditional on the size of the income tax ratio and the total tax ratio. In a country with a large total tax burden and a high income tax burden (the Nordic states) the top PIT rate has to be very high to achieve high-wage progressivity, regardless of the party in government. By contrast, in countries with relatively high total tax burdens, but a low-to-medium income tax burden (the continental European states), much social spending is financed by social security contributions that are sometimes regressive at the top (due to ceilings). In these countries, I expect right-wing parties to focus solely on wage progressivity in income taxation, thus reducing the top PIT rate in accordance with the income tax ratio. By contrast, I expect left-wing parties to maintain steeper progressivity in order to compensate for the more or less regressive effect of social security contributions.

Obviously, the multiple interaction effects implied by the theoretical analysis are virtually impossible to model in small-N regression analysis – even when additional economic variables are neglected. However, the combination of qualitative evidence and exploratory data analysis clearly corroborates these expectations.

Figure 10 plots the distribution of the top PIT rates of advanced OECD countries against the share of income revenues in GDP, for the years 1984/85 and 2001–2005.[18] I interpret the regression line displayed in Figure 10 as indicating the "conditional average" of top PIT rates, that is, the average of top PIT rates *given a certain level of income tax revenues.* Figure 10 shows that this "conditional average" has dropped sharply, by more than 15 percentage points. Nonetheless, countries are still able to maintain widely different top PIT rates, varying from around 40% to almost 60%. Finally, the variation around the regression line has decreased so that top PIT rates reflect more closely countries' income tax ratios.

The Nordic countries, with their high total and income tax ratios and their highly differentiated income tax systems, have maintained the highest top PIT rates. Norway is somewhat of an outlier due to oil-related revenues. By contrast, while Denmark may technically be an outlier in the overall bivariate distribution, it is not an outlier from a theoretical perspective. Its income tax ratio is exceptional, but, given this ratio, its top PIT rate is "in line" with those in Finland, Sweden, Belgium, France and the Netherlands.

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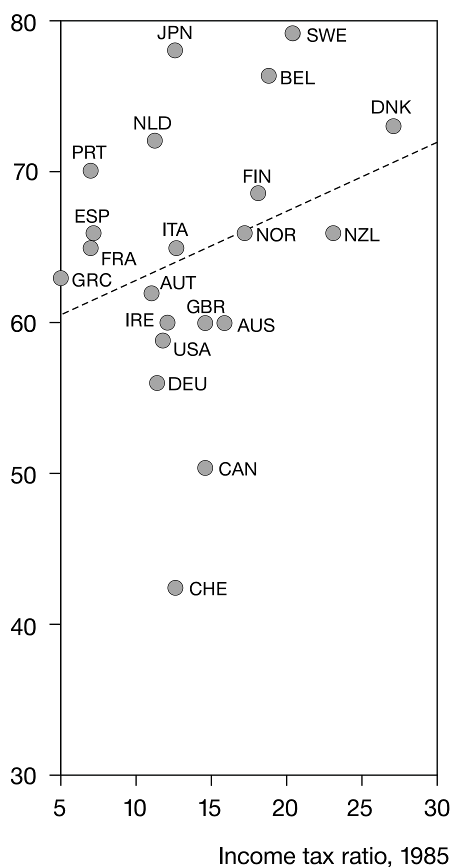
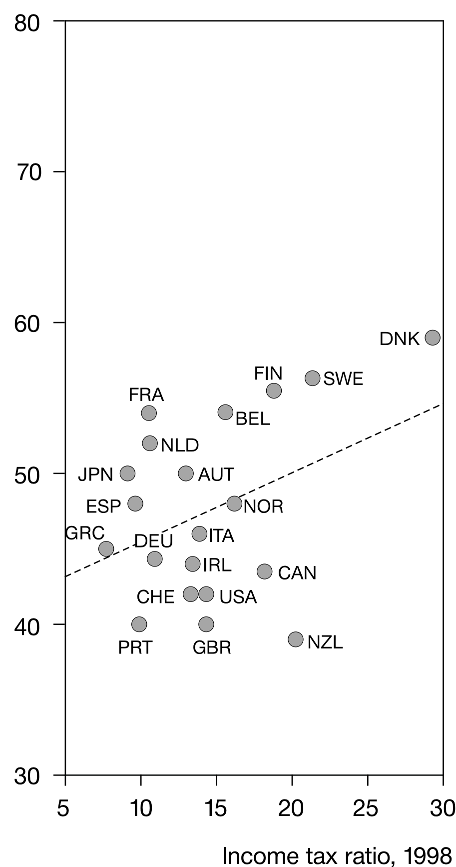
18 Figure 10.b also includes top PIT rates that have already been scheduled by governments, but not yet implemented. The income tax ratio is for the year 1998, the last available year from the OECD Revenue Statistics.

Figure 10a–b Top Personal Income Tax Rates and Income Tax Ratios, 1984–1985 and 2001–2005




As shown in the qualitative analysis, government partisanship and veto players have made a clear difference. In Sweden, the Liberal Party blocked a higher PIT rate in 1991, while Social Democrats increased the top PIT rate on wages after getting back into office in 1994; in Norway, the Labor Party used its veto power during budget negotiations with a small bourgeois minority government to push through a higher top rate on wages effective from 2000. In addition, leftist parties in Denmark and Sweden were also more inclined towards compromising tax symmetry if this allowed them to increase the progressivity of *capital* income taxation and bring in more revenues.

In the liberal Anglo-American countries, top PIT rates – which reflect the recently passed personal tax cuts in the US and Canada – are generally below the conditional average. All of these countries have maintained a general commitment to comprehensive income taxation and formally integrate most types of capital in-

come into progressive income taxation. As a result, in all of these countries – except the US as the only "large" state – competitive pressures may well have constrained the level of the top PIT rate, indirectly via the tax rate gap between the CT rate and the top PIT rate, and more directly via competition for portfolio investment.[19] As demonstrated by recent reforms in Australia and New Zealand, partisan differences have clearly mattered. However, left-wing parties in Australia, Ireland and the UK have not dared to propose increased tax rates for higher incomes.[20] Only in New Zealand did a left-wing government recently bring an extremely low top PIT rate more in line with the other Anglo-American countries.

Finally, the continental European countries, with their relatively large total tax ratios but low-to-average income tax ratios, reveal the expected variation. In France, Belgium and the Netherlands, most types of capital incomes have been removed from the ambit of progressive income taxation, so that above-average PIT rates could be maintained without sacrificing "competitiveness." In France, and especially in the Netherlands, the resulting high-wage progressivity partly compensates for regressive social security contributions (van den Noord/Heady 2001: 19). Government ideology has clearly mattered in these countries. In France, a bourgeois coalition wanted to reduce the top PIT rate from 54% to 52% in 1997 with the intention of reducing it to 47% in 2001. However, the Socialist government elected in 1997 set the top rate at 54% (Blotnicki/Heckly 1998: 127). Similarly, center-left governments in Belgium and the Netherlands maintain above-average top PIT rates even after their recent tax reforms (Cnossen/Bovenberg 2001; OECD 2001b: 55). In Germany, by contrast, a right-wing majority in the upper house – in combination with independent veto players – has forced the government to strongly reduce the top PIT rate by 2005.

In sum, government partisanship and party-controlled veto players have been important in shaping the structure of *personal* income taxation. In general, an increase in the power of left-wing parties – whether in government or as non-governmental veto players – tends to lead to higher top rates on personal (labor) income. An increase in the power of right-wing parties tends to decrease top PIT rates. However, this general tendency is strongly mediated by domestic tax systems (comprehensive vs. dual income taxation), the level of the income tax ratio, and independent veto players.

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19 In Ireland, there have also been strong concerns about the emigration of young people (Hardiman 2001: 834).

20 The British Liberal Democrats do propose an increase of the top PIT rate from 40% to 50%.

## 5 Conclusion

This paper has argued that governments in advanced OECD countries have generally been able to reconcile competitiveness with domestic compensation that is, progressive taxation and large public sectors, because they had never taxed overall capital incomes (including *negative* capital income) highly in the past. Governments had traditionally relied on fairly high tax rates and narrow tax bases, and were thus able to make use of this "slack" in their income tax structure when competitive pressures forced down tax rates on mobile capital income. Tax rate differentiation was a necessary ingredient of this low-cost policy adjustment. Tax rates on mobile capital incomes and tax rates on high labor incomes had to be dealigned. Otherwise, tax cuts on high labor incomes would have led to large revenues losses and / or significantly reduced wage tax progressivity.

This policy of "differentiated-tax-cuts-cum-base-broadening" was thus highly effective in combining "international efficiency" and "domestic compensation," but was also associated with significant costs. Governments had to compromise domestic allocative efficiency in capital income taxation and / or horizontal equity between workers and capitalists. Not surprisingly, therefore, policymakers in some countries, such as New Zealand or Germany, were unwilling or unable to differentiate tax rates; and in these countries very limited competitive pressures did reduce the capacity for domestic compensation, either in the form of less progressive taxation or in the form of reduced income tax revenues. What is important – and contrary to conventional expectations – is that in these countries competition-induced revenue losses appeared mainly in wage taxation, rather than capital income taxation.

The choices policymakers made in the face of the income tax quadrilemma were decisively shaped by the partisan center of gravity of governments and the power of oppositional veto players. Generally speaking, leftist coalition parties and veto players tend to increase top rates on personal income, especially when these only apply to wages. Conversely, rightist coalition parties and veto players tend to reduce top rates. However, the effects of partisan influence and party-controlled veto players are mutually interdependent and strongly mediated by national tax systems, their economic structures, and by independent veto players such as courts.

The constraining effect of tax competition is likely to increase in the future. Tax competition will continue to exert downward pressure on some capital income tax rates, especially corporate tax rates, and governments will find it increasingly difficult to compensate for the resulting revenue losses by broadening the capital income tax base. In addition, explicit and increasing gaps between tax rates on

capital income and tax rates on average and high wages may create a general political dynamic towards cuts in labor taxes. Such a bias is already visible in Anglo-American countries as well as in Germany, but it may constrain revenue-raising in many countries in the long run.

My analysis has consequences for a number of debates in political economy. For example, it has been argued that the tradeoff between earnings inequality and service sector employment – emphasized by Iversen (1999: 174) and Esping-Andersen (1999: 173) among others – could be mitigated by targeting tax reductions on the low-skilled (Scharpf 2000; Kenworthy 2001: 17). My analysis suggests that competitive pressures have constrained such a policy to different degrees, by constraining the revenue-raising potential of capital income taxation, and by enforcing significant tax cuts on medium and high wages.

In addition, my emphasis on the linkages between domestic income tax rates and the overarching importance of the labor tax base for revenue-raising has important consequences for how to evaluate recent tax initiatives of the European Commission. After many failures in European tax co-ordination, the European Commission has committed itself to tougher unilateral action against "harmful tax competition" (cf. Radaelli 1999). While many scholars unequivocally welcome supranational action against special low-tax regimes for companies (see, for example, Ugur 2001), my analysis suggests that this strategy is a double-edged sword. Scrapping preferential tax regimes for very mobile companies is likely to reinforce the movement towards lower CT rates and thus increase downward pressures on other income tax rates as well, including tax rates on high labor incomes. This could make it more, rather than less, difficult to reduce the tax burden of low-skilled labor. In both national and European income tax policy, therefore, national income tax systems do matter.

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