1. Introduction

Freedom from taxation bred laziness and lack of ingenuity, declared the Comte' de Maurepas, 18th century president of the French Navy Board in a letter to the governor of Canada. (Weaver, 1914: 746)

But not only would the right to assistance breed laziness among the working classes, so too would it 'extinguish in the upper classes the sweetest and most fruitful virtue, charity, a good which, transferred into State taxes'. Louis-René Villermé, French eighteenth chronicler of the British poor laws (Smith, 2000: 1010–11)

Do excessive welfare states cause crises in labour markets, or do crises in labour markets cause growing welfare states? This 'hen-and-egg' question haunts both academic and political debates alike. In academia apologists of the free-market would confront those who uphold the insurance and equity character of the welfare state. Ideologically extreme politicians see in the welfare state either a social 'hammock' which lures workers into idleness or a bulwark against capitalist attacks of workers' real wages. In the turmoil of these battles it is sometimes forgotten that both the welfare state and the labour market depend on each other. In this book I want to follow this idea in a specific domain of the welfare state: labour taxation. In particular, I will argue that the real question in contemporary welfare states is not whether, but how welfare is financed. How does the structure of taxation affect (low-wage) workers, and why does politics in different countries lead to different tax structures? Both questions depend on each other and are, in fact, no recent phenomena.

HOW TO TAX LABOUR – AN OLD QUESTION?

Differences in the funding of welfare states have been debated ever since the very beginning of welfare statism. Bismarck's decision to organize German social insurance as a contribution-based scheme was observed early on by Lasalle and others as a major attempt to produce social security without socialism (Tennstedt and Winter, 1993). Ironically, the contribution-based revenues of Bismarckian welfare states were not the intellectual offspring of Bismarck himself. On the contrary, Bismarck favoured a tax-financed social

security system. In particular, in the first draft of the German ‘Unfallversicherungsgesetz’ (bill for invalidity insurance), Bismarck defended the idea of tax-funded insurance with a vocabulary which strongly reminds us of modern critics of high non-wage labour costs:

Aber umsonst ist der Tod! Wenn Sie nicht in die Tasche greifen wollen und in die Staatskasse, dann werden Sie nichts fertig bekommen. Die ganze Sache der Industrie aufzubürden -, das weiss ich nicht, ob sie das ertragen kann. Schwerlich geht es bei allen Industrien. Bei einigen ginge es allerdings; es sind das diejenigen Industriezweige, bei welchen der Arbeitslohn nur ein minimaler Betrag der Gesamtproduktionskosten ist. [. . . Das Problem aber] steckt in denen, wo der Arbeitslohn bis zu 80 und 90 Prozent der Kosten beträgt, und ob die dabei bestehen können, weiss ich nicht. (Tennstedt and Winter, 1993: 590)¹

Current debates on the effects of taxation on employment focus on very similar points. In the eyes of the OECD and the EU the gist of this debate is the following (Kok, 2003; OECD, 1995): high levels of taxation reduce incentives to work and reduce employers’ willingness to hire. In interaction with other labour market institutions they will hurt particularly vulnerable segments of the population. In highly developed countries these are the low skilled, that is the low-wage sector.² As the tax structure shapes the tax burden of the low skilled, this argument prompts the question of design: Which parts and aspects of the tax system hurt (low-wage) workers more than others? We see that the current debate about the detrimental effects of some form of welfare state funding over others was already anticipated more than a hundred years ago. The particularities may be different, the fear of bad economic consequences is the same.

Interestingly, the bill designed by Bismarck never passed, but was replaced by a contribution-based proposal finally backed by a conservative-Christian majority in the German parliament. The reason for this outcome had little to do with finding economically optimal ways of financing the welfare state. Rather, political parties in the German parliament feared that a tax-financed scheme would strengthen the role of the central state *vis-à-vis* the federal states in Germany. Ultimately, the decision on how to finance insurance was a political one (Schmidt, 1998: 24). And, although Bismarck’s master plan was to introduce an insurance system, its very specific nature – which made it so prominent a role model for other welfare states – was largely due to federalism and the parliamentary system and not due to Bismarck himself.

In Bismarck’s case, politics overrode economics. The question is whether we see similar effects taking place today, in a time when the claim is often made that politics – and nation states as the prime political actors – recede in the face of international market pressures. Proponents of such a

no-politics idea argue that most of the empirically discernible variation in the tax structure is due to inflation, growth or other socioeconomic fundamentals. Hence, diverging national trajectories are driven by automatic fiscal responses (Volkerink *et al.*, 2002). Historical institutionalists enhance this argument. They claim that the important tax policy decisions were made some 100 or more years ago. From then on, the tax system evolved as a consequence of institutional path-dependencies and created political dynamics of its own (Alber, 1982; Steinmo, 1993; Pierson, 1996).

There are scholars who disagree. Early on Titmus (1974) claimed that taxation is a fundamental part of the welfare regime which in turn is of political origin. Left versus right positioning still has explanatory power in people's attitudes on public spending versus taxation (Kitschelt, 1994; Rehm, 2005). Governments follow this logic, once we control for changes in the economic and strategic environment (Beramendi and Rueda, 2007; Kato, 2003). If there are deviations from a partisan preference, these are due to the role of veto points such as Supreme Courts or Federalism (Ganghof, 2006; Hettich and Winer, 1999). Hence, all in all the left versus right is still an important description of the underlying differences in tax-policy preferences of governments (Wagschal, 2003). So, who of the two sides is right?

THE ARGUMENT

There is one crucial difference between nineteenth-century Germany and contemporary OECD countries. Back then costs could not be completely rolled-over to labour, since wages were close to what workers needed in terms of basic nutrition and accommodation. Hence it may well be that the parliament discussed two different forms of taxation on capital rather than on labour. Note that Bismarck himself was not worried about workers, he was worried about 'the industry'. Today, however, many countries provide substantive levels of public social security and have, above all, comparatively high real wages for most workers. This implies some level of decommodification,³ that is wages are considerably higher than the level of subsistence. The economic implication of this is that incidence of major tax forms such as income, payroll and indirect taxation is largely on labour (see Chapter 3). For this reason I focus exclusively on taxing labour, for it is, perhaps unintentionally, the modern welfare state that is a key reason why most of these taxes today fall on labour. With the long-term shift towards taxing labour came complaints that labour taxation is excessive and causes disequilibria in the labour market.

Against this historical background, the no-politics idea is clearly not

wrong, but somewhat misleading. Path dependencies are at work and have led to a growing welfare state. But the underlying logic differs. The conflict of interests in the tax structure is nowadays one within labour, less between labour and capital. This does not mean that tax competition on mobile capital income, globalization or the conflict between the very rich and the poor has become meaningless. But it is not the only conflict, maybe not even the decisive one, if you focus on tax structure as opposed to tax levels. Rather, there is a conflict between low-skilled and medium-skilled workers on employment and income generation. To illuminate this potential conflict, I will not analyse the employment effects of general redistribution, that is I will not engage with the old question of an optimal level of the public sector. Rather I am interested in the implications of different mixes of taxation and its consequences for the tax structure in terms of progressivity, holding the level of taxation constant. Why do countries choose different forms of labour taxation, and why do they change their strategies across time?

The politics-still-matters idea is neither false, but has usually played the heterogeneity of workers down (for a similar point see Rueda, 2005, 2006). Interests of low-wage workers and medium-wage workers do not necessarily coincide. Both segments will at times be in conflict with each other on the optimal design of tax structure, and in particular on progressivity. The reason is that tax progressivity has only straightforward redistributive effects in a perfect market economy. Only in this case higher progressivity translates into higher redistribution between rich and poor voters, and only here the preferences for progressivity follow a clear left-versus-right pattern. In labour markets with some degree of regulation, progressivity also translates into redistribution of employment and income probabilities. Lack of progressivity will strongly harm low-skilled workers, whereas medium-skilled workers are left in an ambivalent situation. If there is competition between medium- and low-skilled workers, the former will have an ambiguous stance on progressivity.

For such a line of thought, I must presume that progressivity and tax structure will have some impact on employment, albeit this impact is weak and differs from country to country. Figure 1.1 shows evidence for this. Let us assume for the time being that the ratio of income taxes to payroll and indirect taxes is a good measure for the progressivity of a tax system. Later on I will deal with this operationalization in more detail (Chapter 2), but for now we will simply assume it. Let us further assume, as is frequently done (for example Scharpf, 2000; Kemmerling, 2003), that the low-wage sector is concentrated in categories 6 and 9 of the International Standard Industrial Classification system (ISIC) which contains service sector workers. Then Figure 1.1 tells us that there is indeed a negative

Figure 1.1 Tax progressivity and service employment

relationship: the less progressivity in the form of indirect taxation, the lower the employment in this sector.

My argument is that – to some degree – anticipated consequences and origins of progressivity are mutually dependent. Hence, the impact of progressivity on employment in regulated labour markets will also shape preferences of left parties and their major ally: trade unions. In particular, I will show that the sharper the conflict between insiders (medium skilled) versus outsiders (low skilled), and the less representative unions for low-skilled workers, the lower the degree of tax progression will be. There are two major causal mechanisms that possibly work together to explain this somewhat counter-intuitive hypothesis. First, tax progression eats up wage increases on the margin. This is particularly bad for unions when they bargain autonomously for wages with employers' associations. Tax policy is therefore similar to income and inflation policies of the 1970s and meets similar ambivalence on the part of trade unions. Second, tax progression at the lower end of the wage scale makes job competition fiercer. Progression makes take-up of work easier for low-wage earners and will put workers with slightly higher wages under pressure. Trade unions that represent the latter more than the former will therefore have an ambivalent stance also as regards activation and workfare policies.

Figure 1.2 shows a stylized empirical proof of our hypothesis. The panel

dominate income taxes. The US and Denmark have a higher proportion of income taxes and similar levels of surplus coverage. The reasons differ: the US has low membership rates, but bargaining coverage is equally low. For Denmark both stay on intermediate to high levels. There are the two remarkable outliers of antipodean welfare states. I will deal with these later on, but here it suffices to say that this probably a consequence of mismeasurement rather than an outlier for my argument.

If there is indeed such an endogeneity between tax progressivity and employment theoretical and empirical approaches become difficult. My explanation needs to be parsimonious, but parsimoniousness depends on questionable theoretical and empirical assumptions. Throughout this book I will deal with these major assumptions, but to better understand them and the deductions that follow thereof, I have to clarify the underlying theoretical and empirical methodology.

METHODOLOGY AND PREVIEW

The book follows the basic mode of inquiry of political economy (for example Alt *et al.*, 1999; Hinich and Munger, 1997). I assume that policies are the result of political actors that make decisions, and the institutional rules that determine whose decisions are of importance. I will largely focus on the link between governments on the one hand and parties, interest groups and voters on the other. More decisively, I will assume certain cleavages within the electorate, especially the one between low- and higher-skilled workers. This is a common assumption in political economic approaches (Saint-Paul, 2000; Rueda, 2005). It is important to note however, that these cleavages are not necessarily entirely exogenous. To the contrary, they are part of the larger policy space in which political competition takes place and which transforms differences of voters into political conflicts (see Chapter 2).

It is also important to understand the difference between basic and final or induced policy preferences of actors (Geddes, 2003; Satz and Ferejohn, 1994). The latter are the result of an interaction between basic policy preferences and the costs or constraints of certain policies in specific situations. In particular, ever since the Communist Manifesto the basic preference of left parties is undoubtedly more redistribution and more tax progression. Yet, if tax progression entails some costs such as increasing wage competition on the lower end of the wage scale, left parties will think twice about the ‘optimality’ of tax progression. This form of induced preferences has to be distinguished from an underlying deeper change of basic preferences. It is certainly the case that countries

differ in underlying normative and cultural aspects of taxation (Svallfors, 1997) and that these have an impact on tax compliance. However, the economic and political consequences are not at all straightforward and would unnecessarily complicate my analysis in which I focus on the costs of different tax forms.

The most important form of costs for my purposes are the labour market implications of different tax structures. Tax policies have a redistributive impact on labour markets, and in regulated labour markets this implies not only wages but also employment probabilities. Such effects will be anticipated by actors, albeit with a considerable degree of uncertainty. The anticipation is the ultimate reason for a potential of endogeneity in the relationship between origins and consequences of taxing the low wage sector. Again this may not seem very realistic since perception varies. Even economists do not always agree on the effects of tax policies (see Chapter 3). Nevertheless, for my purposes it suffices to say that certain tax policies have the potential to increase or decrease (low-wage) employment. After all, the expected outcome of a reform is all that political actors care about.

The empirical strategy follows a mixed methods design. Given the methodological problems cross-country regressions entail (Kittel and Winner, 2005), I use qualitative evidence to cross-validate my quantitative findings. In particular, I will use three forms of evidence for both origins and consequences of taxing low-wage sectors. First, I will use pooled regressions for some 20 OECD countries and the last 25 to 30 years. These regressions will show some of the employment consequences and some of the political origins of taxing the low-wage sector. Second, I use a historical long-term comparison – nineteenth-century Germany – to back my argument about the long-term shift from capital to labour taxation and its consequences for the induced political preferences of unions and left parties. Third, I will return to the twentieth century and compare Germany and the UK after the Second World War in more detail. The contemporary comparison of two countries allows me to test my argument on the full range of policies designed to enhance low-wage jobs. These not only include tax policies, but also labour market policies. The prime example of the latter is the use of tax-subsidies for low-wage workers.

The order of this book loosely follows the logic of backward induction. If it is true that political actors anticipate the economic consequences of tax policies, I have to start with the latter, before I speak about the former. In particular, I will begin Chapter 2 with a brief depiction of my dependent political variable. I will compare different means of measuring taxation. I will show cross-temporal and cross-country variation in the three major forms of taxation: income, payroll and indirect taxes. Finally, I will explain

their relationship to progressivity as opposed to two other structural features of tax system: their insurance component, and the breadth of their tax base.

In Chapter 3 I will deal with the economic consequences of different forms of taxation. I will first survey the theoretical insights of the scholarly literature, showing that: (a) employment effects of labour taxation depend on the underlying configuration of the labour market, and (b) there is no trade-off between tax progressivity and employment in certain labour markets. I will test the latter hypothesis in a set of regressions and find that indeed some (mainly regressive) forms of taxation hurt employment more than others (mainly progressive).

In Chapter 4 I develop my argument about the political origins of tax structure and, in particular, tax progressivity in more detail. First, I will survey the literature for alternative claims about the evolution of tax progressivity. Next, I will show that key actors – voters, unions, and parties – behave no longer in a traditional left-versus-right manner, if tensions in the labour market are high. The final policy preferences for or against progressivity differs between low-wage and medium-wage employees.

In Chapter 5 I will use my three types of empirical evidence to substantiate my claims. Pooled regressions show that whereas union density has, as expected, a positive impact on progressivity, surplus coverage of union has a negative. These findings remain stable if I control for tax competition and other theoretical explanations. They also remain stable, if I control for endogeneity between unemployment and tax progressivity. The historical comparison shows that there is some truth in the claim of a shift in the underlying cleavage structure of tax policies. In the second German empire, tax progressivity unambiguously rose with the combined strength of trade unions and left parties. The cross-country comparison of Germany and the UK after the Second World War highlights a shift in the preferences of unions and left parties. In particular I will first argue that in both countries tax progressivity got under stress, once unionism surpassed its peak and became less representative for the labour force. Next I will argue that whereas the British Labour party has recently started to re-balance progressivity, the German Social Democrats are still trapped in a stop-and-go policy in that respect.

In Chapter 6 I will summarize my major findings, before I will evaluate them from a normative point of view. It is obvious that there is no clear (Pareto-efficient) political winning strategy in reforming the tax incentives to work. Neither is there a one-size-fits all approach. However, there are clearly discernable political choices, and for a reformist left Labour party high employment and tax-based redistribution are not incompatible in an era of globalization.

NOTES

1. 'For freedom is nothing but death! If you don't want to reach into your pocket and the treasury, you will not achieve anything. To impose the whole burden on industry, I don't know whether it could stand that. It would hardly work for all industries. For some it may work: for those in which the wage of workers is just a small component of the entire costs of production. [. . . The problem however] exists for those, in which wages amount to 80 or 90 per cent of all costs, and whether those could survive, I don't know.' (own translation)
2. Though clearly not equivalent I will use both terms 'low skilled' and 'low wage' interchangeably.
3. Esping-Andersen (1990: 37) defines 'decommodification' as a 'readiness to enable individuals and families to uphold a socially acceptable standard of living independent of market participation'.
4. I use 30-year averages for all country observations. Hence the figure shows long-term correlations between the three variables.