Regressive Taxation and the Welfare State

PATH DEPENDENCE AND
POLICY DIFFUSION

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Argument

PATH DEPENDENCY AND THE DIFFUSION OF A REGRESSIVE TAX

Economic stagnation and subsequent shortage of government revenue brought the welfare state under intensive censure in the 1980s. The welfare expenditures,[1] which had expanded smoothly during the postwar high-growth period, became a primary target of retrenchment. Despite this overall trend, however, a cross-national comparison of the welfare state defies a simplistic generalization. The golden-age expansion reinforced a demarcation between high-spending and low-spending countries, and moreover, since the 1980s, high-spending countries have proved much more immune to welfare retrenchment than low-spending countries have. As a result, neither rapid expansion during the early postwar period nor subsequent chronic budget deficits have caused a convergence of spending levels among welfare states (Figure 1.1). Tackling this puzzle head on, this study sheds new light on the funding base of the welfare state. Available financial sources serve to restore the public confidence in the welfare state that was severely challenged in the 1980s, whereas financial scarcity makes welfare state backlash inevitable. The divergent funding capacity of the welfare state is path-dependent upon the institutionalization of regressive taxes. The institutionalization of revenue raising from

[1] Generally, welfare spending or expenditure is used to mean a broader category than social security spending or expenditure and, thus, often includes the cost of health and sometimes education. Social security expenditure is usually related directly to social security programs. Such a distinction is, however, conventional. One may calculate either social security or welfare expenditures based on certain criteria, but there is no uniform definition of "expenditures" that are agreed upon and well applied across countries. Because the relative size of the welfare state across countries does not change significantly as a result of the definitions of welfare or social security expenditure, here these terms are used interchangeably. The quantitative analysis presented later uses a specifically defined "social security expenditure."

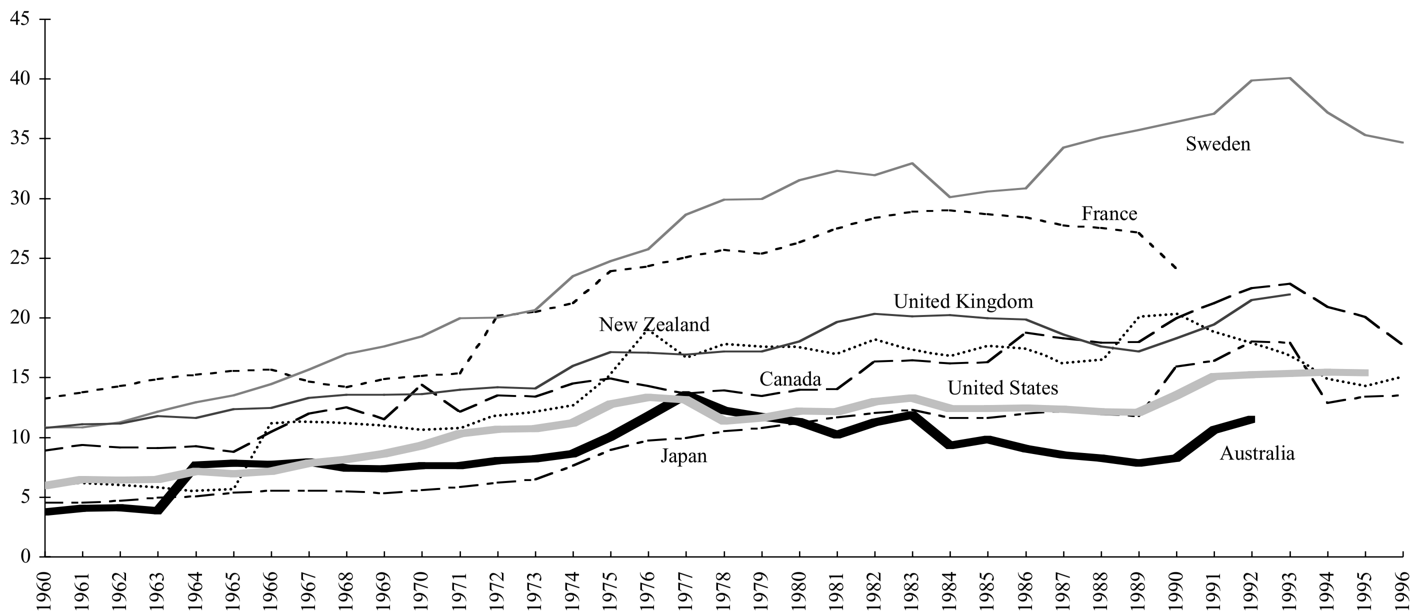

Figure 1.1. Total social security expenditure as percentage of GDP. See a definition of SSEXPT in Appendix. *Source:* ILO.

regressive taxes during a high-growth period has enabled the government to secure financial sources during times of low growth. In contrast, a government's attempt to institutionalize a regressive tax system during low growth is thwarted by public suspicion that a new burden would be exhausted to solve deficits without any welfare compensation. Tax politics ultimately explains the diversification of high-spending and low-spending countries.

How a welfare state is financed has attracted little attention aside from a small number of works on public finance (Steinmo 1993; Peters 1991) and those on the history of taxation that consider this contemporary problem (Webber and Wildavsky 1986; Levi 1988). A relative indifference to the funding base and the exclusive concern with taxation as a means for redistribution is closely related. More specifically, if one regards taxation as another measure for redistribution, one exclusive focus is a progressive income tax that applies discriminatory tax rates to redistribute income. The importance of the funding capacity of the welfare state is overshadowed by an overwhelming concern for redistribution through welfare programs and taxation. On the other hand, when one considers taxation important for financing the welfare state, the revenue-raising capacity of a regressive tax attracts new attention: a regressive tax, owing to its flat rate imposed on a uniform tax base, is more consistent with the financial needs of the government.

The Funding Base of the Welfare State and a Progressive Tax: A Cross-National Variation

The two oil shocks in the 1970s triggered the end of high growth. Economic consideration has since worked as a restraint on the welfare state, and the funding capacity of a government has come to influence welfare retrenchment. Increasing the visibility of the tax burden and avoiding easy revenue enhancements are more effective for welfare retrenchment in the long run than cutting benefits and welfare expenditures under deficit-ridden finance.[2]

[2] This point parallels that of Pierson (1994), who conceptually distinguishes two forms of welfare retrenchment based on a comparison between the United States and the United Kingdom in the 1980s. The "systemic retrenchment" that alters "the context for future spending decisions" is increasingly important for long-term change compared with "programmatic retrenchment," that is, cutting expenditures and lowering the level of provision in welfare programs.

The funding base of the welfare state, however, is hard to explore because of the complicated financial relationship between general revenue and expenditure. For example, a part of the loss of tax revenue can be attributed to tax exemptions and special tax measures (tax expenditures) that are considered another form of benefits if implemented for welfare purposes.[3] Alternatively, a financial flow from the social security system into the general tax revenue through taxes on social security benefits is now increasingly imposed or planned to be introduced in more industrial democracies. The social security budget surplus may also be used to contribute to decreasing the apparent deficits in the public sector and thus lowering the pressure on the government to increase taxes in general and/or cut public expenditures.[4] Similar to the current financial intricacy, historically, several contingencies and complicated interactions simultaneously caused the development of the welfare state and the construction of the tax state.[5]

Welfare state development went hand in hand with the development of the tax state owing to the increasing financial needs of the government for redistribution. Despite a recurrent debate about which principle is superior for redistribution,[6] the welfare state with higher income equality has tended to adopt universalism instead of targeting. This increases the importance of the government's funding capacity. Targeting, if it successfully selects beneficiaries based on income level (i.e., means-testing), achieves equality with less expenditure, whereas a universal principle inevitably requires high tax revenue for financing universal provision to all, based on criteria such as age, sickness, and disability regardless of income level (Table 1.1).[7] There is a "paradox of redistribution": "[t]he more we target

[3] On this problem, see Howard (1997). I will discuss this problem thoroughly in Chapter 4 in the section on the United States' case.

[4] A surplus within the social security system funded by contributions is included as a surplus in the government sector when the deficit is measured by the saving-investment gap of the general government in national account statistics.

[5] For example, during the interwar period of the Great Depression, policy makers recognized the failure of laissez-faire (Tanzi and Schuknecht 1995, 5), and big government was introduced at the same time as the surge of government-sponsored programs, including social security (Kelly and Ashford 1986). The postwar development of the welfare state was facilitated by the legacy of the state's capacity to raise revenue for urgent military expenditures during the two world wars (Peacock, Wiseman, and Veverka 1967; Klausen 1998).

[6] For example, see Skocpol (1991), Greenstein (1991), Rosenberry (1982), and Korpi (1980). Sen (1995) and Atkinson (1993) argue that, in reality, identifying beneficiaries and then implementing means-testing programs effectively are not easy.

[7] Of course, the distinction between universalism and targeting in practice is not as simple as discussed here. First, many countries combine the two different ideals in different ways

Table 1.1. *Universalism and targeting compared*

Principle	Coverage	Benefit
Universalism	Universal	Earnings-related or flat-rate
Targeting (means-tested)	Earnings-related	Flat-rate or earnings-related

benefits at the poor only and the more concerned we are with creating equality via equal public transfers to all, the less likely we are to reduce poverty and inequality" (Korpi and Palme 1998, 26). Among eleven countries compared by Korpi and Palme (1998), the Scandinavian countries plus France and Germany have larger expenditures with less targeting, and their level of income equality is higher than in the United States, Canada, Australia, and Switzerland, which have smaller expenditures with more targeting. This tendency qualifies the emphasis on the "qualitative" aspect of welfare provision at the expense of "quantitative" analysis focused on expenditures. As the critics of quantitative analysis argue, direct spending is not an exclusive means for redistribution, and more spending is not to be equated with more income equality in analyzing the effects of welfare programs. But, if more total spending tends to coexist with more income equality among the existing welfare states, one needs to examine how it has been financed. This also redirects attention to the role of taxation as a financing, in addition to redistributive, measure for the welfare state.

Progressive income taxation and a large social security program were an indisputable part of the welfare state in the 1950s and 1960s. During this process, the conventional view emerged wherein the contemporary welfare state was said to have expanded to raise revenue from progressive income taxation promoted by left-party governments. This view has implicitly and explicitly influenced the comparative perspective of the welfare state. For example, Esping-Andersen's (1990) "three-world"

and to different degrees. Second, in some countries, such as Sweden, many social insurance programs are occupation-based and tied to employment. Thus, a universal welfare state is the result of effective employment policy, that is, universal employment. Also, under the occupation-based system, the extension of universal coverage accompanies a new entitlement for those disadvantaged under the existing system that is more like targeting. Baldwin (1990, 113) distinguishes this as "vertical" rather than "horizontal" universalism.

classification – social democratic, conservative, and liberal welfare states[8] – focuses on the extent of labor's "decommodification"[9] – the states' protection of labor from market rule. The concept of decommodification relies on the experience of the Scandinavian social democratic welfare state, where the historic compromise between labor and capital first attempted to achieve distributive equality by introducing both social security programs and progressive taxation. In a "four-worlds" classification by Castles and Mitchell (1993, 103), tax progressivity and size of welfare expenditure are expected to be associated with the strength of the labor movement and government partisanship, respectively (Table 1.2),[10] and nonright hegemony, conservative, and liberal welfare states correspond roughly to the "three-world" characterization.[11] Direct attention to tax and welfare explains a new fourth category (the radical welfare state) of Australia, New Zealand, and the United Kingdom, which the "three-world" classification does not explain well,[12] but France, Canada, Austria, and Finland

[8] More specifically, the classifications are (1) social democratic welfare states, such as Denmark, Finland, the Netherlands, Norway, and Sweden, based on the principle of universalism with the highest scores in decommodification; (2) conservative welfare states, such as Austria, Belgium, France, Germany, and Italy, with a nonuniversalist, status-based, provision, exemplified by a generous pension scheme for state officials (etatism) or a larger number of occupationally distinct pension schemes (corporatism); and (3) liberal welfare states, including Australia, Canada, Japan, Switzerland, and the United States, inclined toward means-tested poor relief expenditures and strong private pensions or health insurance systems. For classification, see Table 3.3 in Esping-Andersen (1990, 74).

[9] A minimal definition of decommodification is that "citizens can freely, and without potential loss of job, income, or general welfare, opt out of work when they themselves consider it necessary" (Esping-Andersen 1990, 23). Empirically, it is measured by the quality of welfare provided through old-age pensions and sickness and unemployment cash benefits.

[10] As indicated in Table 1.2, the progressivity of a tax system is expected to be higher with a strong labor movement (high union density) and a welfare expenditure whose relative size is increased by nonright party governments. The progressivity of a tax system is measured by income and profit taxes as a percentage of GDP, and welfare expenditure is measured by household transfers as a percentage of GDP.

[11] Esping-Andersen's social democratic welfare state has a different label, nonright hegemony, here. To confirm the correspondence of the two classifications, compare the countries classified in footnote 8 with those in Table 1.2.

[12] Australia is classified as a liberal state, and New Zealand and the United Kingdom do not elicit specific characteristics in Esping-Andersen's classification. For example, Australia and the United Kingdom have low post-(income-)tax Gini coefficients of inequality, which are comparable to those of the social democratic welfare states of Sweden and Norway. New Zealand 's post-(income-)tax Gini coefficient of inequality is much higher than those of the United Kingdom and Australia; in the three-worlds model by Esping-Andersen (1990), New Zealand is considered to have a low degree of decommodification, but in terms of social stratification, it appears as a medium socialist regime.

Table 1.2. *Political configurations and worlds of welfare*

		Nonright incumbency (household transfers as a percentage of GDP)			
		Low		*High*	
Trade union density (income and profits taxes as percentage of GDP)	*Low*	*Canada* (Radical) *France* (Conservative) Ireland Japan Switzerland US	**Liberal**	(West) Germany Italy Netherlands	**Conservative**
	High	Australia New Zealand UK	**Radical**	*Austria* (Conservative) Belgium Denmark *Finland* (Radical) Norway Sweden	**Nonright hegemony**

Sources: Constructed from Tables 3.3 and 3.7 from Castles and Mitchell (1993).
Notes: The classifications by financial terms are added in parentheses if they are different from the ones by political terms. For clarification, the names of the countries that are inconsistently classified are written in italics.

(in italics in Table 1.2) are inconsistently classified between the political and financial characteristics.

Wilensky's (1976) study is an exception to the existing emphasis on the progressive tax and leftist support for a welfare state and focuses rather on the contrast between "visible" and "invisible" taxes. Austria, Sweden, Belgium, the Netherlands, France, and West Germany achieved and were likely to maintain a high level of welfare provision owing not to a domestic corporatist arrangement but rather to the use of a less visible taxation such as indirect taxes on consumption. Conversely, Denmark, Finland, the United States, the United Kingdom, Switzerland, Canada, and Australia did not and were not expected to cope with the public intolerance of the tax burden caused by the extensive use of visible taxes on personal income, property (paid by households), net wealth, gifts, and inheritance. Although tentative and preliminary, Wilensky's analysis implies a close link between the welfare state and regressive taxation whose representative form is a general consumption tax, that is, an invisible tax. In contrast, a visible progressive income tax that is best for redistribution may not be an effective measure or a politically feasible solution for raising revenue. More important, as Wilensky predicted in the mid-1970s, except for a couple of cases, such as Denmark and Finland, the countries with invisible taxes have had a higher tax level and more universal welfare provision than the countries with visible taxes. In politics, when the gap between expected expenditure and necessary revenue is common knowledge, the weak revenue-raising power of the government more effectively constrains welfare expenditures. For the last decades of low growth, the diffusion of regressive (invisible) taxes has thus consolidated this diversification.

Cross-National Variation in Tax Revenue Structures

Between 1965 and 1980, the level of total tax revenue (as a percentage share of gross domestic product, GDP) and the composition of the tax revenue structure among eighteen Organisation for Economic Co-operation and Development (OECD) countries were different, although all countries increased their tax levels (Figure 1.2*a*,*b*). There were shifts in degree in a few countries relative to other countries; that is, some Scandinavian countries became higher-tax countries, and the United Kingdom reached a medium level. Each country's tax revenue structure and its relative size of total tax revenue were preserved; thus, the overall tendency was maintained in 1995 and 2000 (Figure 1.2*c*,*d*): high-tax countries have continued to increase their level with no sign of convergence with low-tax countries. A difference in relative composition of tax revenue that was already observed in the 1980s has thus only become explicit among countries.

The cross-national variation that emerged is more clearly summarized in Table 1.3, which cross-tabulates four clusters by Peters (1991) and six cases by Messere (1993). Peters's[13] "Anglo-American cluster" countries with a higher reliance on property, corporate, and personal income tax are in sharp contrast to the "Latin cluster" countries that rely heavily on indirect taxation including employers' social security contributions and general consumption taxes, such as the value-added tax, customs duties, and excises. "Broad-based taxation" is characterized by an almost equal use of all taxes that is close to the OECD average level of taxation. The "Scandinavian cluster" has a

[13] Peters (1991, 58–66) distinguishes four clusters by a cluster analysis explaining the variations in taxation among the twenty-two OECD members countries. Three countries – Iceland, Turkey, and Yugoslavia – are excluded for lack of data. Thus, in addition to the eighteen OECD countries analyzed here, Peters's analysis includes Greece, Luxembourg, Spain, and Portugal. He uses a composite measure of the percentage share in total revenue of eleven different taxes: personal income tax, corporate income tax, social security contributions, sales and value-added taxes, customs, excise and real estate taxes, and wealth, estate, and gift taxations.

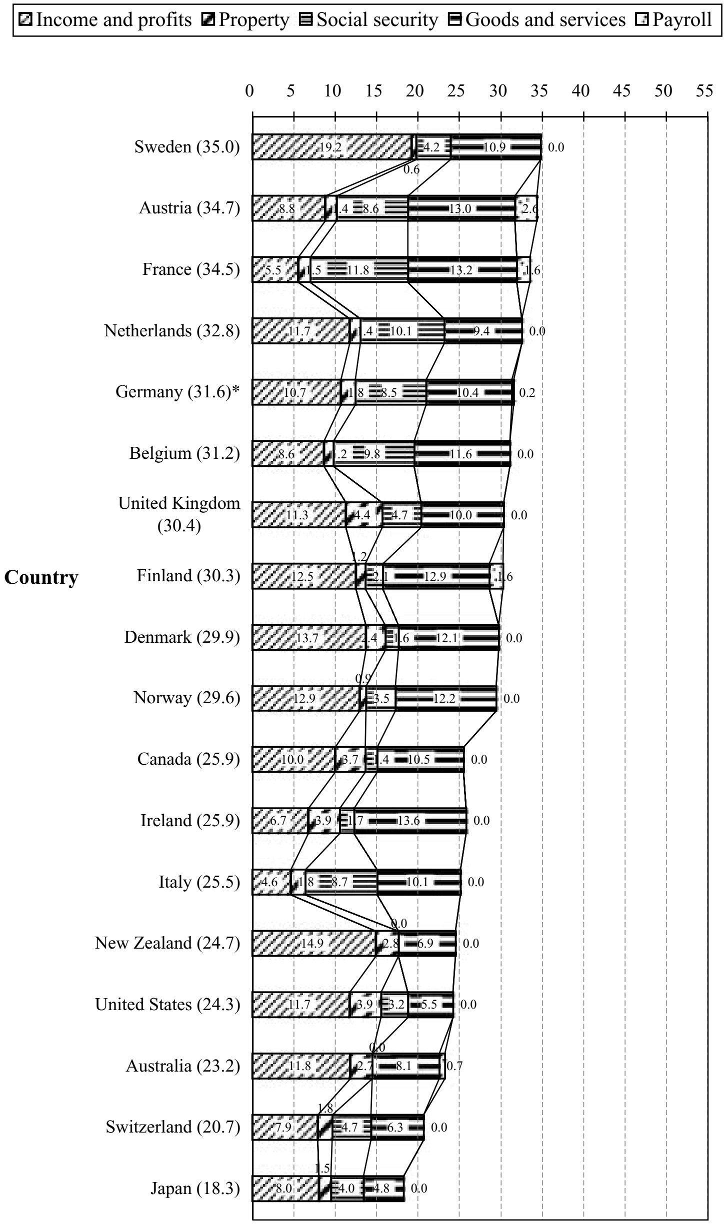

Figure 1.2*a*. Total tax revenue as percentage of GDP among eighteen OECD countries in 1965. Each tax revenue (as percentage of GDP) is shown on a bar. *Data for West Germany. *Source:* OECD 1997b.

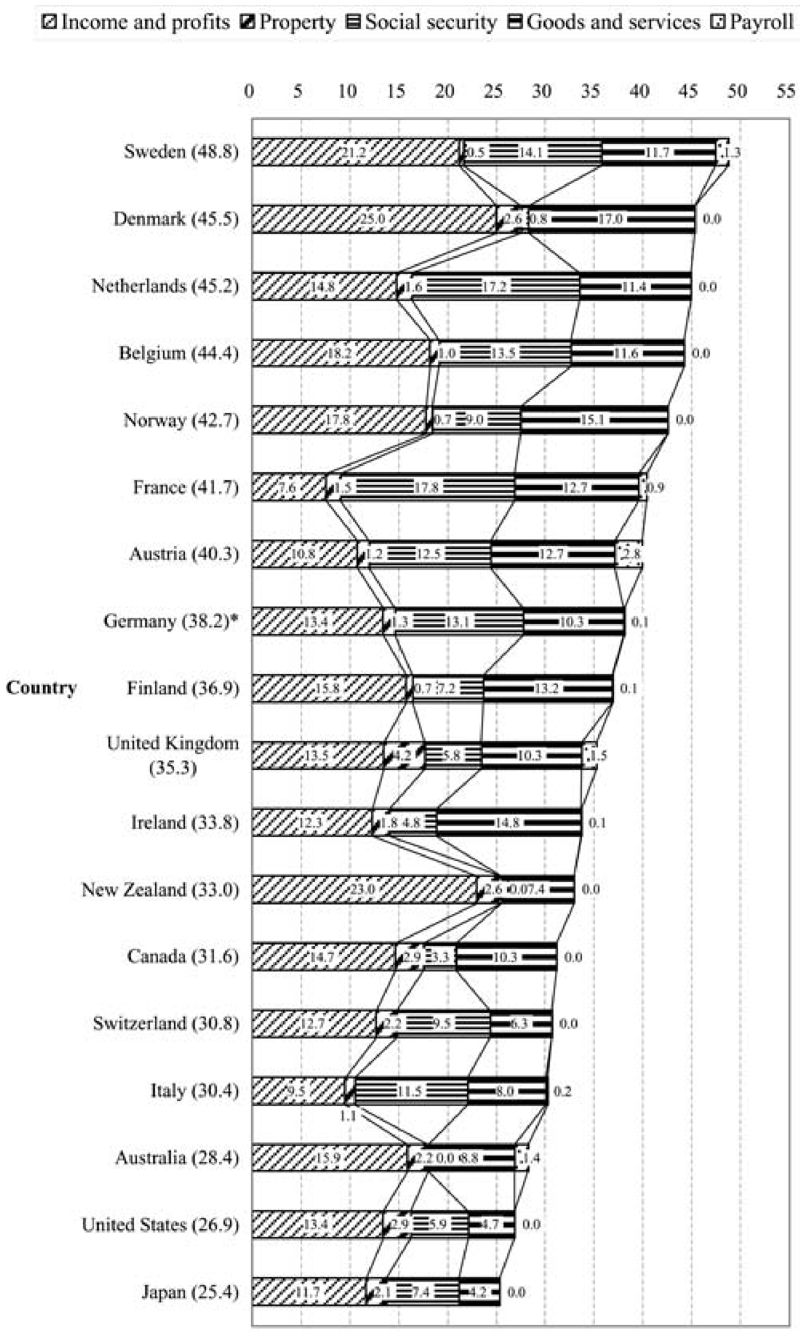

Figure 1.2*b*. Total tax revenue as percentage of GDP among eighteen OECD countries in 1980. Each tax revenue (as percentage of GDP) is shown on a bar. *Data for West Germany. *Source:* OECD 1997b.

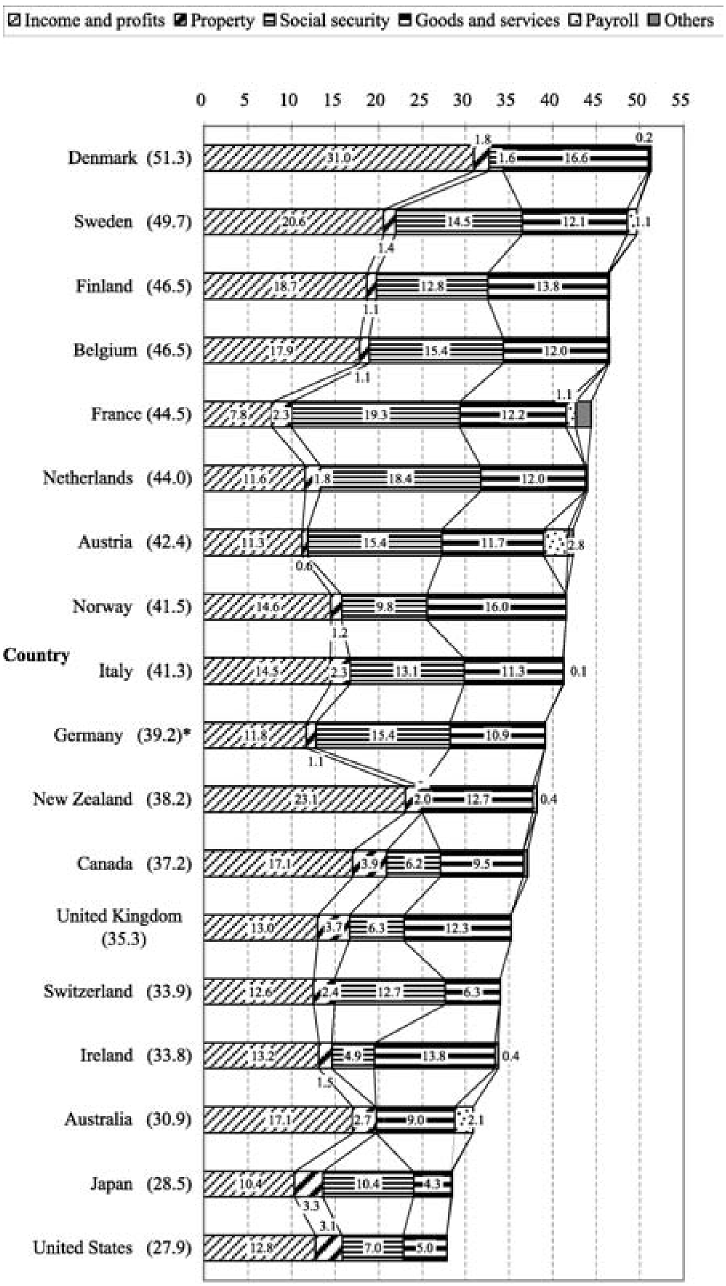

Figure 1.2*c*. Total tax revenue as percentage of GDP among eighteen OECD countries in 1995. Each tax revenue (as percentage of GDP) is shown on a bar. *Data for Unified Germany. *Source:* OECD 1997b.

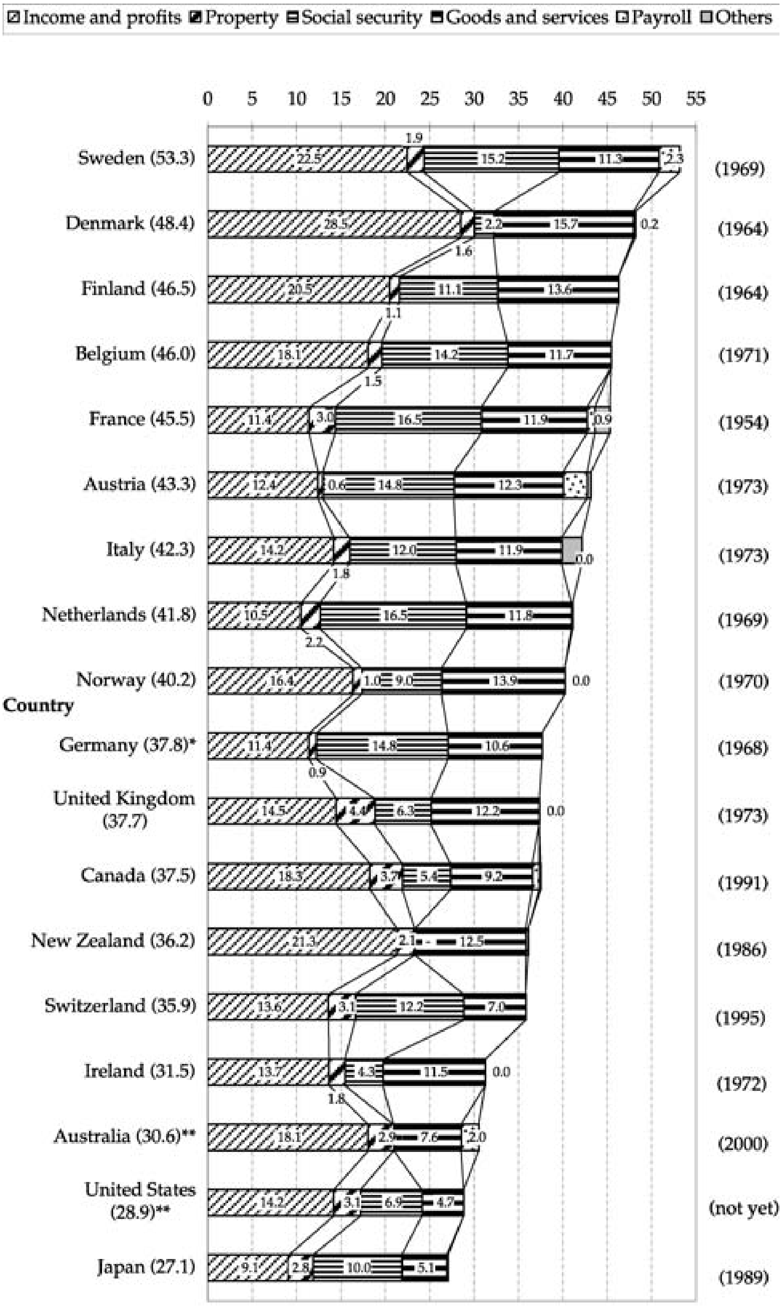

Figure 1.2*d*. Total tax revenue as percentage of GDP among eighteen OECD countries in 2000. Each tax revenue (as percentage of GDP) is shown on a bar. The year in parentheses is the year when the VAT was introduced. *Data for Unified Germany. **Tax revenue in 1999. *Source:* OECD 2001a.

Funding Base

Table 1.3. *Classification of tax revenue structure of OECD countries*

K.C. Messere's Classification \ B. Guy Peters's Classification	Anglo-American Democracies and Their Friends	Scandinavian Countries	Broad-Based Taxation	Latin Cluster
Five non-European OECD countries plus Switzerland	U.S.A., Canada, Australia, Japan, New Zealand, and Switzerland			
Five southern European countries			Spain	France, Greece,[a] Italy, Portugal[a]
Five OECD countries with the highest total tax ratios		Denmark, Norway, Sweden	Belgium, Netherlands	
Two disparate European countries			Germany[b]	Ireland
A special case	United Kingdom			
Not classified		Finland	Austria, Luxembourg[a]	

[a]Not included in the quantitative analysis of this study.
[b]Referred to as "West Germany" in Peters; "unified Germany" in Messere.
Sources: Peters (1991, 60 - 66); Messere (1993, 95 - 102).

high tax levy – a higher reliance on personal income tax (combined with a lower reliance on corporate tax), a higher reliance on employers' (instead of employees') social security contributions, and the extensive use of a general consumption tax. As shown in Table 1.3, there are marginal differences between Peters and Messere: Messere strictly classifies slightly divergent cases such as the United Kingdom, Finland, and Germany but combines five high-tax countries, which Peters distinguishes by focusing on tax revenue composition.

Cross-national variation is, however, unexpected from the postwar history of tax policies among industrial democracies. First, the ideal of a comprehensive income taxation caused the diffusion and extensive use of a progressive tax during the early postwar period. This was the first major example of an academic idea that caused periodic shifts in tax policies in the same direction simultaneously across countries. Second, the worldwide tax reform trend in the 1980s thwarted this postwar ideal of progressive income taxation. Various problems with the progressive income tax became apparent after the 1970s, and the subsequent global policy shift reformulated the existing tax system. If the national tax revenue structure was diversified between 1965 and 1980 and the existing variation was only reinforced between 1980 and 2000, neither the ideal of a progressive income tax nor the reversal of that ideal in the 1980s led to the diffusion of similar tax revenue structures across countries.

To tackle this puzzle, the background and consequences of the global reform in the 1980s are clarified in terms of the reversal of the ideal of progressive income taxation.[14]

1. High inflation in the advanced democracies in the 1970s had pushed up nominal incomes, which had pushed many taxpayers (with substantially lower incomes) into higher tax brackets in a progressive tax system not indexed for inflation. Implementing special tax treatments and exemptions eroded the tax base and complicated the system. In addition, the governments could not efficiently raise revenue from income taxation that was sensitive to the global depression and stagflation after the mid-1970s. To cope with the increasing complexities and inefficiencies, since the 1980s, personal income tax rates, especially the top rates, have been reduced along with a compression of the number of brackets and a broadening of the base by repealing reliefs and exemptions in many countries (see Table 1.4).
2. A high corporate tax rate is likely to cause capital flight during the globalization of economic activities. This not only is harmful for a nation's economic competitiveness but also obstructs a government's attempt to secure revenue. Thus, a rate reduction and a broadening of the tax base were also advanced in corporate taxes.
3. The shift of revenue reliance from income to consumption is the last prominent feature of global reform because governments attempted to finance personal and corporate income tax cuts partly or fully by increasing other taxes. Aside from the exception of the "revenue neutral" reform during the U.S. Reagan administration, other countries tended to finance income tax cuts by shifting revenue reliance to a tax on consumption, especially the value-added tax (VAT) (Sandford 1993a, 14). This resulted in increasing revenue reliance on regressive levies – a flat-rate tax on consumption and social security contributions. Social security contributions[15] began

[14] For more detailed changes in the 1980s, see Pechman (1988), Boskin and McLure (1990), and Sandford (1993a; 1993b).

[15] Social security contributions earmarked for social security expenditures are technically distinguished from taxes but are classified as a part of the total tax revenue in statistics by OECD. This study follows the system of classification that is consistent with the argument

Table 1.4. *Variations in rate schedules of central government income tax, 1986 and 1990*

	Number of Brackets[a]		Top Rates		First Positive Rates	
	1986	1990	1986	1990	1986	1990
Australia	5*	4*	57	47	24	21
Austria	10	5	62	50	21	10
Belgium	12*	7*	72	55	24	25
Canada	10	3	34	29	6	17
Denmark	3	3	45	40	20	22
Finland	11	6*	51	43	6	9
France	12*	12*	65	57	5	5
Germany[b]			56	53	22	19
Ireland	3	3	58	53	35	30
Italy	9	7	62	50	12	10
Japan	15	5	70	50	10.5	10
Netherlands	9	3	72	60	16	13
New Zealand	6	2	57	33	17.5	24
Norway	8*	2*	40	20	3	10
Spain	34	16	66	56	8	25
Sweden[c]	10*	1*	50	20	4	20
Switzerland	6	6*	13	13	1	1
United Kingdom	6	2	60	40	29	25
United States	14	2	50	28	11	15

Notes: Where countries have substantial state and local government income taxes, the central government rate schedules will not reflect the full range of rates of tax on income of these countries.

[a]Excluding zero rate as a bracket. Those with a zero-rate bracket marked with (*).

[b]Number of brackets excluded because the tax schedule is based on a formula and does not have brackets.

[c]Refers to 1991.

Source: OECD 1993.

almost simultaneously with the increase in personal income taxation in the early decade and have continued to maintain their level until recently.

The shift summarized here is observed when revenue composition as a proportion of the total tax revenue is *averaged across eighteen OECD countries* over the last three decades (Figure 1.3). The unweighted average of

here. The regressivity of social security contributions could be alleviated by allowing exemptions or reductions for low-income earners, but their levies by a flat rate is principally regressive.

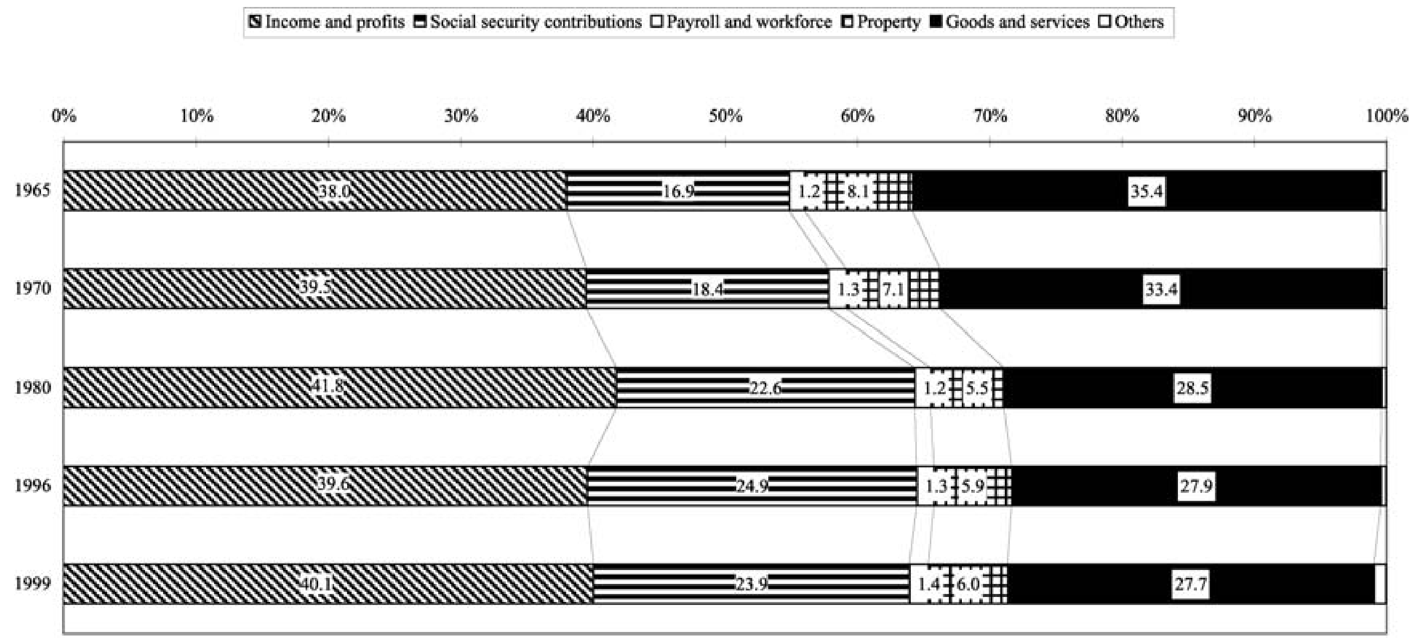

Figure 1.3. Changes in major revenue sources as percentage of total tax receipts averaged across eighteen OECD countries.
Source: OECD 2001a.