Chapter 7 Taxation Policy

Contemporary governments need money to carry out the wide variety of activities they pursue. Some of that money is raised by the sale of government-provided goods and services. However, in the six countries examined in this book (and in most countries around the world today), the vast majority of government revenues are generated by taxation.

More is at stake here than the generation of revenue. Governments make countless decisions about whom to tax and at what rate to tax them. These decisions can have important implications for other policy areas. Often governments encourage certain activities (and discourage others) through tax incentives. In this way the tax code—in addition to funding government activity—is itself a policy instrument, used in pursuit of goals on a multitude of issues.

Common Policy Problems

In the nineteenth century, government was much smaller than it is today. Because it provided far fewer services to its citizenry, it needed less money. Many countries managed to meet their revenue needs largely by taxing foreigners—in particular by taxing imports and by selling import licenses. In this way, governments minimized the visible tax burden on their citizens (a less visible tax remained in the form of higher prices for consumers of those imported goods).

During the twentieth century, governments began to provide a growing number of services to many people and organizations. All things being equal, most people and most businesses would still prefer to pay little or no money in taxes. Expressed in the language of rational choice theory, actors prefer to free ride on the cooperation of others. People want to receive as many government services and subsidies as possible, but they would prefer that those services be paid for by other people's taxes.

This simple truth provides the backdrop against which governments try to achieve the three fundamental goals of tax policy. First, how can the tax code be constructed to ensure that needed revenues are generated? Second, how can the government generate those revenues while generating the smallest degree of discontent possible? Third, how can the government use the tax code to provide tax incentives to encourage desired behaviors and tax disincentives to discourage other behaviors?

People's distaste for taxes gives individuals and firms an incentive to reduce the total taxes paid regardless of the tax system employed. Tax reduction

efforts can take the form of **tax avoidance** (managing one's money in a way that minimizes tax liability) or outright **tax evasion** (the illegal refusal to pay taxes owed under the law).

In general, people would prefer to pay few or no taxes; however, they can be persuaded to pay taxes for a variety of reasons. For instance, they may pay taxes because they support the services the government provides with the tax revenue. This concept implies that governments have an incentive to fund popular programs out of funds raised explicitly for that purpose. As an example, old-age pensions are normally funded via payroll taxes earmarked for the pension fund. In an effort to increase tax compliance with many disparate programs, governments will sometimes bundle a popular program with several other initiatives paid for out of a given revenue stream.

People also are sometimes willing to pay taxes out of a sense of burden-sharing. If they believe that most (if not all) people are shouldering a fair share of the load, they may be more likely to pay (and less likely to criticize the government for its tax policies). Thus a major policy challenge for governments is to create a tax code that is viewed as equitable.

A second policy challenge results because people are more likely to pay taxes owed when they face a credible possibility of apprehension and punishment for tax evasion. When apprehension of evaders is likely, taxes are easier to collect. Some taxes are easier (or harder) to collect than others. Unfortunately for governments, many of the taxes that are relatively easy to collect are viewed by many as inequitable—thereby conflicting with the goal of equity.

We earlier alluded to a third problem in contemporary tax policy. The tax code is a major avenue of interaction between a government and its citizenry. As a result, the tax code presents an opportunity to pursue goals in other policy areas by providing preferential (or penalizing) tax treatment to encourage (or discourage) certain types of behavior. These provisions are generally referred to as **tax expenditures**—a term that captures how tax incentives spend revenues that otherwise would have been collected. For example, the tax code can be used to promote savings investment, discourage pollution, subsidize health care and education, provide extra tax relief to the impoverished, and so on.

The potential for using the tax code to promote different policy goals is seemingly endless. Nevertheless, the use of tax policy to meet various ends often runs counter to the challenges of tax equity and ease of collection. Too many tax expenditures may create the impression that some people are not paying their fair share—generating calls for a simpler tax code. Additionally, widespread use of tax expenditures may provide an incentive for tax fraud—the evasion of taxes by understating one's tax burden.

How governments manage this complex and conflicting triad of tax challenges (equity, ease of collection, and tax expenditures)—while still meeting the fundamental goals of generating needed revenues without substantial discontent—is central to government success in many areas. Governments

that achieve a working equilibrium in this area can provide a stable economic and political environment. Governments that fail are headed for economic and political trouble.

Major Policy Options

When dealing with the equity issue, policymakers face a difficult series of choices. Sometimes equity is in conflict with other priorities. Moreover, the definition of equity depends on one's perspective. For some, equitable burden-sharing entails the rich paying a larger share of total taxes collected; this is deemed fair because the well-off presumably can pay more in taxes and still live comfortably. When a tax system calls on the wealthy to pay a higher percentage of their income in taxes than the poor, the tax system is said to be **progressive** because it is redistributing money from the rich to the poor. For others, equity implies that all persons and firms pay an equal percentage of their earnings in taxes—regardless of wealth and regardless of the source(s) of income. Such a tax system would be **income-neutral**; it would have no impact on the distribution of income. Finally, if a tax system forces the poor to pay a higher percentage in taxes than the rich, it is said to be **regressive** because it redistributes income from the poor to the wealthy. The progressive and income-neutral notions of equity face difficult technical challenges owing to the multitude of taxes collected. Different sorts of taxes lend themselves better to meeting the dueling concepts of progressivity and income neutrality, respectively.

Tax instruments are usually divided into two major groups. **Direct taxes** are levied as a percentage of income earned by a person or a firm. Personal income tax, corporate income tax, and employee payroll contributions to social security or other government programs (such as health insurance) are examples of direct taxes. Because direct taxes are calculated based on income data, they are a major potential instrument for redistribution. The government can choose to apply increasingly higher tax rates at higher income levels (via the use of **tax brackets**). Alternatively, the government can choose to have income-neutral direct taxes and charge all citizens the same uniform rate; this option is often referred to as the **flat tax**.

Although direct taxes provide the government with a ready means for redistribution via progressive tax brackets, they can be harder to collect than indirect taxes. Because direct taxes are based on income levels, the potential exists for the taxpayer's income to be underestimated by the tax collector, the taxpayer (at times intentionally), or both. During the twentieth century, governments worked hard to improve their information about income levels in order to reduce this problem.

Indirect taxes are not based on the taxpayer's income. Employer payroll taxes (based on earnings of employees) represent a major form of indirect taxation found in virtually every country around the world. Another common

form of indirect tax is the sales tax—a tax charged on the sale of a good or service. In the United States, sales taxes have tended to be charged and collected at the final point of retail sale. In postwar Europe and in many developing countries, governments have increasingly turned to a value-added tax (VAT) charged on every transaction in the production of a good. A special form of sales tax is the **excise tax**—a tax charged on a particular good (for example, tobacco, liquor, or luxury yachts). Property taxes are also deemed to be indirect taxes because they do not take into account income earned but rather are a percentage of the assessed value of a given piece of property, for example, a house, a vacant lot, or an automobile.

Indirect taxes provided the bulk of government revenues in the nineteenth century because they were easier to collect than direct taxes. During the twentieth century, the sales tax was criticized as regressive because the wealthy spend a smaller portion of their income on consumer purchases than the poor. Efforts to address this problem by charging higher tax rates on luxury items have been problematic in industrialized countries because few products are purchased exclusively by the rich. Instead, the wealthy buy pricier, luxury-brand versions of the same products bought by others: cars, alcohol, food, and the like. Furthermore, the excise and property tax rates needed to address the inequities in the basic sales tax are so high that they are difficult to defend politically.

In industrialized countries during the twentieth century, proponents of both the progressive and the income-neutral notions of equity used the generally regressive nature of indirect taxes to argue for the implementation of progressive income taxes. Late-industrializing countries, however, rely heavily on indirect taxes because of the relative ease of collection. To the extent that indirect taxes in a given country's tax system are regressive, impoverished citizens in many poor nations are caught in a vicious cycle. Government programs to aid the poor are often insufficient, and the means used to fund the programs often place a disproportionate burden on the poor.

One might think that a tax system's effect on income distribution in the industrialized world could be readily evaluated. The information on the progressivity of direct taxes is inherent in the tax structure, and one could estimate the amount of money that people spend in sales taxes each year. Nevertheless, gauging the redistributive nature of a tax system is in practice extremely difficult because of the widespread use of tax expenditures. The estimate of sales taxes paid can be hard to calculate because many goods are subject to different sales tax rates (or, occasionally, no tax at all). Governments charge lower sales taxes on products they want to subsidize—sometimes making the good or service tax-exempt. Things can get even more complicated in the realm of direct taxes because governments can provide income tax expenditures to promote or subsidize a variety of activities. Sometimes governments provide **tax credits**, through which the cost of the activity is counted as a credit toward the taxes owed. For example, charitable donations could conceivably generate

Box 7-1 **In Depth: Income Tax Expenditures in the United States**

Tax credits and deductions are used more frequently in the United States than in any other industrialized country. For 2007 the Joint Committee on Taxation of the U.S. Congress tracked a total 136 specific tax expenditures in the individual income tax code and another 102 provisions in the corporate income tax code. These provisions apply to 171 different specific uses of money or categories of beneficiaries. The estimated revenue loss tied to these tax expenditures totaled $1.103 trillion in 2007. By way of perspective, the budget deficit in that fiscal year was $160.7 billion. Total government revenues were $2.729 trillion.

Governments engage in tax expenditures to promote specific activities. The ten largest tax expenditures in 2007 (accounting for nearly two-thirds of all tax expenditures) are as follows (the value in parentheses is the amount of revenue loss estimated for each provision):

- Capital gains exemptions in the individual income tax ($127.1 billion)
- Net exclusion of employee contributions to employer pension plans ($108.6 billion)
- Exclusion of employer contributions to employee medical insurance ($105.7 billion)
- Deductibility of mortgage interest on owner-occupied homes ($73.7 billion)
- Step-up basis of capital gains exemptions at death ($51.9 billion)
- Child tax credit ($45.0 billion)
- Earned income tax credit ($44.7 billion)
- Deductibility of nonbusiness state and local taxes other than those paid on owner-occupied homes ($33.9 billion)
- Deductibility of charitable contributions by individuals ($32.0 billion)
- Exclusion of employee job benefits ($30.0 billion)

a tax credit in an effort to promote giving. Much more often, governments provide **tax deductions**—a reduction in the amount of taxable income. Pursuing further the example of charitable donations, assume that a taxpayer making $50,000 a year donates $1,000 to a charity. If the donation were treated as a tax deduction, the individual's taxable income would be $49,000. If the tax rate were 10 percent, the taxpayer would owe $4,900 in income tax. If the same individual had received a $1,000 tax credit, the income tax bill would be only $4,000. For a look at the major tax expenditures written into the U.S. corporate and individual income tax codes, see Box 7-1.

Once you consider the multitude of tax expenditures written into the tax code, you can begin to appreciate the complexity of evaluating the equity of a

tax system based on the concepts of either progressivity or income-neutrality. Why should governments complicate matters by pursuing policy goals via tax expenditures? Tax expenditures are attractive for a couple of reasons. First, governments can subsidize certain activities without collecting money in taxes and then paying out the subsidies to the relevant individuals. This approach can be an effective means of promoting the activity in question as long as the tax assessment process is not subject to fraud. Second, once the use of tax expenditures becomes widespread, they can have political advantages as well. When tax expenditures clutter the tax code, many citizens and firms have a stake in their retention such that the tax expenditures can be used to build political support for tax policy as a whole. Although all countries have a mix of direct and indirect taxes spiced with tax expenditures, various taxation models have proven to be politically viable in the six countries examined in this book.

Explaining Policy Dynamics

The complexity of the tax code presents a series of issues that can promote demands for change in one or more of its major provisions. Some citizens, interest groups, and public officials are concerned about the overall level of taxation. Others mobilize around particular components of the tax code itself. Under what conditions are governments more likely to reform the tax structure? Although the overall level of taxation is amenable to cross-national statistical analysis, the intricacy of the tax structure has made it difficult to study via quantitative analysis. Instead, research has centered on national and comparative case studies of tax policy. In different situations, cultural, economic, political, and institutional factors can shape the emergence of tax reform on the agenda, the particular reform decisions made, and the nature of implementation concerns.

Cultural Explanations

Some research indicates that deep cultural traditions help to shape the tax structures that governments choose. In particular, significant distrust of government can result in a trend toward tax evasion that prods governments to favor indirect taxes over direct taxes because the former are easier to collect. If tax evasion becomes enshrined in the culture, even if its pervasiveness is exaggerated in national folklore, governments may remain reliant on indirect taxation. When new revenues are needed in this context, governments would be more likely to raise rates on existing indirect taxes (or create new ones) than to expand direct taxation. Italy and France have demonstrated this dynamic more frequently than the other countries examined in this book (Haycraft 1987; Peters 1991).

Other research focuses more directly on public opinion regarding the nature of taxation. As we noted in Chapter 6, a stable majority in most

Table 7-1 A Model of Citizens' Attitudes toward Taxation

		Perceived Fairness of Tax System	
		Fair	*Unfair*
Perceived Justice of Tax System	*Just*	Tax compliance	Tax formalism
	Unjust	Tax protest	Tax revolt

SOURCE: Modified from Confalonieri and Newton (1995: 126).

industrialized societies would prefer to see taxes decrease or, at a minimum, stay at current levels. If and when that desire changes from an idle wish into a firmly stated demand, public opinion can tilt toward strident calls for reform that shape the policymakers' environment. Confalonieri and Newton (1995) present a four-scenario typology of public attitudes toward taxation (Table 7-1).

In this model, public attitudes about a tax system are measured along two dimensions—fairness and justice. Fairness concerns people's willingness to accept as fair the tax structure's general, fundamental principles. Justice involves judgments about whether the tax structure in practice calls on all citizens to pay their share in accordance with the tax system's founding principles. Confalonieri and Newton assert that most of the public opinion data do not support a situation of open revolt against taxation but rather a frequently held perception that wealthy citizens are not paying their just share of taxes. If too many citizens' sense of justice has been violated by their perceptions of the tax system's operation, then the prospects for public mobilization in protest of the existing tax structure increase. Confalonieri and Newton steadfastly hold to a distinction between a **tax protest** generated by perceived injustice and an open **tax revolt** in which many citizens find taxation unjust in its execution and unfair in principle. The latter scenario would involve a much more fundamental challenge to governments' very existence. Grant and Mockabee (2002), in turn, argue that the electoral salience of public attitudes toward taxation increases when voters believe that much of the country is collectively harmed by certain tax policies and decreases when voters find themselves harmed yet do not believe the country as a whole is harmed.

Economic Explanations

Given the impact of economic growth on government revenues, it should come as no surprise that the health of the economy shapes the climate of tax policy making. A growing economy expands revenues, thereby decreasing pressure for reform. In contrast, a recessionary economy contracts revenues while frequently expanding demand for government services. Governments can consider responding by altering the tax code to meet the fiscal challenges of a recession (Swank and Steinmo 2002).

Another economic factor that can build support for reform is sales and investment competition within and across countries. The more open the environment regarding international trade and domestic economic regulation, the more visible tax distinctions that favor some firms or sectors of the economy will become (Hagemann, Jones, and Montador 1988; Winner 2005). Tax rates on investment capital may drop as a result of economic competition in what some observers have termed "a race to the bottom," in which governments make increasingly large concessions to businesses. In turn, taxes designed to fund pensions and unemployment insurance may well rise in an effort to cushion workers from the higher level of economic competition (Adam and Kammas 2007; Katzenstein 1985; Rodrik 1998). These dual logics of reform exemplify the policy pressures posed by globalization. Economic integration in the European Union (EU) has created a variety of reasons to reconsider tax provisions as movement toward a level economic playing field continues within the EU.

Yet, across all industrialized countries, there are limits to the impact of investment competition on tax policy decisions. Basinger and Hallerberg (2004) examined tax reform trends across twenty industrialized countries during the 1980s and 1990s. They found that domestic political dynamics can limit the possibility that tax cuts in one country breed tax reform elsewhere. Where ideological commitments or institutional dynamics make reform more difficult, it is less likely to occur.

Political Explanations

Political parties will almost always play some role in studies of policy making, and tax policy is no exception. Generally speaking, left-leaning parties tend to speak out for a more progressive tax code as an agent of income redistribution, whereas right-leaning parties tend to call for income-neutral taxation and often favor regressive sales taxes over potentially progressive forms of direct taxation. Research has found that changes in partisan control of government can affect the course of tax policy (Basinger and Hallerberg 2004; Castles 1982b; Morrissey and Steinmo 1987; Steinmo 1993).

That said, the role that partisanship can play is contingent on other factors. The effect of partisanship will be greatest when a single party controls the executive and legislative branches of government along the lines of the party government model. Substantial tax reform is more likely when a single party is in control than in a divided government or in a multiparty coalition government. Steinmo (1993) argues that the United Kingdom has seen greater swings in its tax system over the years as the two major parties have alternated in power and have had greater opportunity to realize their visions for reform. Conversely, coalition governments provide the impetus for a more incrementalist approach to tax reform as the coalition partners find it more difficult to work out a shared vision of sweeping tax reform (Rose and Karran 1986).

Interest group politics can also shape the tax system. In more pluralist settings, one should expect to see a greater fight for tax reforms that benefit a particular segment of the population. Conversely, in more corporatist settings, the encompassing nature of the major interest groups should tend to limit calls for tax provisions that benefit a single firm or group of firms. At the same time, existing corporatist commitments to social spending tied to indirect taxation can make reform of those taxes more difficult (Beramendi and Rueda 2007).

Institutional Explanations

Steinmo's work (1993) on the party government model's effects on taxation finds the roots of party government in the electoral and executive-legislative institutions of the three countries whose tax politics he examined—Sweden, the United Kingdom, and the United States. In short, Steinmo believes that party government occurs more frequently in the United Kingdom because of the Westminster model of government, in which a plurality electoral system is combined with a parliamentary executive.

The institutional setting specific to tax policy making can also influence tax decisions. Peters (1991) notes that tax policy making settings can differ in a couple of significant ways. First, the technical nature of tax policy can leave a role for at least three different cultures of expertise: lawyers, economists, and bureaucrats. This approach holds that lawyers are more likely to stress the need for detailed codes, economists are more worried about the incentives associated with taxation changes, and tax bureaucrats are frequently focused on the implementation issues associated with different forms of taxation. This diversity of expert cultures can be a force for incrementalism as the different mindsets make sweeping reform more difficult to deliver in a consensual form.

Second, the division of spending and taxing policy into various executive agencies and legislative committees shapes the context of tax reform. Spending decisions made elsewhere in the government can force the people actively involved in formulating tax policy to create new plans to respond to changed levels of expenditures. The role of government units not charged with forming the tax code is potentially much greater still because legislators, bureaucrats, and lobbyists active in other policy areas may try to place on the institutional agenda specific tax expenditures or particular tax rate changes. Crepaz (2001) finds that the total number of veto points in the political system matters less than their nature: veto points generated by judicial review and by federalism present greater obstacles to tax reform than do veto points presented by interest group dynamics or by executive-legislative relations.

International Policy Making

Few binding international agreements influence the specific tax policy choices individual countries make in an effort to meet the challenges discussed earlier

in this chapter. Countries negotiate a variety of bilateral tax treaties with other countries to determine the tax status of persons and firms spending portions of the year in both countries. These bilateral negotiations have their own challenges that go beyond the scope of this chapter.

The EU's push for a single market has generated an incentive for national governments to harmonize their tax policies with other member countries' tax codes. These pressures, for the most part, have been more informal than formal. In other words, the context of economic integration has had more impact on national tax policies than has EU regulation itself. We examine the pursuit of VAT tax harmonization in greater detail in the EU case study later in this chapter.

A word of caution is in order regarding our treatment of national tax structures. Governments set tax rates, but tax revenues are largely dependent on economic activity. When we discuss tax structure in these six countries and in the European Union, remember that the figures presented can and do change from year to year. When these figures are noticeably out of line with other years, we discuss the difference. In an effort to maintain a similar context across all cases under examination, the discussion of tax structures below is based on national experiences in 2006. Unless otherwise noted, information on tax rates refers to 2008.[1]

United States

Background: Policy Process and Policy History

The tax policy process in the United States is more centralized than is the country's spending policy process, but these formal and informal procedures remain much more pluralist and open-ended than in other countries. Although tax changes can be written into the annual budget, they can also be proposed separately. As a result, policy formulation does not necessarily originate formally in the executive branch (unlike the budget process). As with most other legislation, the president must find legislative members willing to sponsor proposals that could have originated in executive branch discussions among the Office of Management and Budget, the Treasury, the Internal Revenue Service, the President's Council of Economic Advisers, or from many other sources. Alternatively, the tax proposal could originate directly from a legislator.

Although the initiation of formal policy discussions is more decentralized for tax decisions than for spending decisions, the formal review of those ideas in Congress is more centralized. Spending decisions are reviewed by the relevant committees in both chambers, but taxation proposals must be reviewed

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[1]Data on the tax structure in 2006 are taken from Organisation for Economic Co-operation and Development (OECD 2008c). Data on tax rates in 2008 are from OECD (2009d).

in the House of Representatives by the Ways and Means Committee and in the Senate by the Finance Committee. Despite this degree of centralization, interest groups have multiple legislative targets to lobby for particular changes in the tax code because ultimate approval depends on passage in both chambers. The open-ended nature of the tax policy process, and a political philosophy in many sectors that favors tax expenditures over direct transfers, have worked together to produce a lengthy list of tax expenditures for both corporate and individual income taxes (review Box 7-1). The presidential veto is not a useful institutional threat in most cases because tax changes can be attached to legislation that on balance the president supports.

The U.S. tax structure stands out for its reliance on personal income taxes. The United States is the only country among the six examined in this book in which individual income taxes make up well over one-quarter of tax receipts (35.1 percent in 2006). Other direct taxes are also slightly more important in the United States than in other major industrialized countries. The sum of shares represented by employee social security taxes and corporate income taxes in the United States (22.2 percent) exceeded the average for the EU (17.9 percent) by over 20 percent in 2006. The United States relies on sales taxes less than do all of these other countries. In 2006 sales taxes accounted for 17.4 percent of total government tax receipts in the United States. Sales taxes account for less than 4 percent of tax receipts at the federal level, with excise taxes levied on only a few products and no universal sales tax.

The highest marginal rate for corporate income tax is 35 percent. A series of surtaxes force most medium-sized and large firms to pay taxes at close to one-third of taxable income. States and localities are free to establish corporate income taxes. A multitude of systems exist; rates average under 7 percent, and taxable income can be calculated in many different ways. There is no capital gains exemption at the federal level, but capital losses can be used to offset capital gains. The individual income tax code has five tax brackets with marginal rates ranging from 10 to 35 percent. The top rate on individual dividend income is capped at 17 percent. As with corporations, a variety of state and local personal income tax systems exist. Employees pay a basic social security tax of 7.65 percent of the first $102,000 in earnings and 1.45 percent thereafter. Employers pay an equal percentage of payroll taxes plus an additional assessment for unemployment insurance, which varies from state to state.

As noted earlier, the United States has no national sales tax. The federal government levies excise taxes on alcohol, gasoline, luxury automobiles, telephone services, and tobacco. Most state governments and many localities levy a sales tax at the point of sale. These combined state and local tax rates vary across the country from 3 to 11 percent. Similarly, the United States has no national property tax, but states and, especially, localities often rely heavily on property taxes. The sort of property taxed, how the property value is assessed, and the rate of tax charged vary across the country.

The 1986 federal tax reform marked the realization of a central piece of the Reagan administration's agenda: the reduction of tax rates and a simplification of the tax code. A major element of that reform was a change in individual income taxes. The number of tax brackets was reduced from eleven to two, and the top marginal rate was cut from 50 to 28 percent. The top corporate tax rate fell from 48 to 34 percent. Part of the revenue lost was replaced by raising excise tax rates, and another portion was replaced by an increase in the applicability of corporate income taxes. In addition, changes in tax deduction regulations increased many individuals' taxable income.

Upon taking office in 1993, the Clinton administration argued that the 1986 tax cuts had produced higher budget deficits that were hurting the economy by diverting credit markets to finance the deficit. In 1992 the deficit had reached 5 percent of GDP. By a single tie-breaking vote cast by Vice President Al Gore in the Senate, the top tax bracket (with a marginal rate of 28 percent) was raised to a maximum of 39.6 percent. The top corporate rate rose from 34 to 35 percent, and the income cap on Medicare payroll taxes was eliminated: wealthy taxpayers now had to contribute payroll taxes on all income earned. At the same time, personal income tax brackets were indexed for inflation—avoiding the phenomenon of bracket creep, in which inflation pushes people into higher tax brackets without raising their purchasing power. This loss of revenue was justified by the administration on redistributive grounds because it would limit the share of income taxes paid by low- and middle-income taxpayers. These tax changes—combined with sustained economic growth—worked to eliminate deficits as the government produced its first budget surpluses in a generation during the years 1998–2000. During Clinton's second term, tax reform changes centered on incremental changes to the tax code—primarily the expansion of tax expenditures.

Contemporary Dynamics

Amid the new federal budget surplus, the 2000 presidential campaign featured contrasting visions of what improved government finances implied for tax policy. The Democratic Party's candidate, Al Gore, pledged to use the surplus to bolster the financial health of the federal government's two major programs, Social Security pensions and the Medicare program of health insurance for senior citizens. The Republican candidate, George W. Bush, campaigned on a platform of across-the-board cuts in the personal income tax. Business interest groups tended to line up with Republicans calling for tax cuts, whereas labor tended to side with the Democrats.

At the start of George W. Bush's first term as president, the Republican Party held a slim majority in the House of Representatives and faced a 50–50 split in the Senate. When Sen. James Jeffords left the Republican Party in mid-2001, the Republicans faced an uphill battle in the Senate until special elections and the midterm election of November 2002 gave them a small

majority in the Senate that lasted until 2006. To push through the tax cut bill, Bush compromised by agreeing to phase in the cuts over time, by providing new tax expenditures supporting social policy, and, most important, by agreeing to a sunset provision: all major tax reforms enacted would revert to prior law on January 1, 2011. These 2001 tax reforms were the most sweeping since 1986. Tax rates for all personal income tax brackets were lowered by roughly 10 percent. Taxes on dividends and some capital gains were lowered, and the estate tax was phased out over a ten-year period, thus eliminating estate taxes in 2010. On the social policy side, the so-called marriage penalty (in which couples often paid higher taxes filing jointly than they would as single individuals) was eliminated, and the child tax credit was doubled.

Upon passage of the bill, government estimates stated that the 2001 tax changes would initially reduce the size of the budget surplus, but that surpluses would continue throughout Bush's first term. A series of factors made the implementation of these tax cuts more troubling than had been forecast. A weak economy in 2001 and 2002 depressed government revenues. In turn, higher spending commitments to homeland security programs and the U.S. military invasion of Afghanistan in late 2001 pushed the budget into a deficit comprising 3.8 percent of GDP in 2002. President Bush and the congressional leadership in the Republican Party argued that these economic struggles provided a rationale for new tax cuts to try to fuel an economic recovery. Rather than focusing on stimulating consumer spending (which a team of Nobel laureate economists advocated in a public letter in 2003), the 2002 and 2003 tax reforms provided tax subsidies for businesses and a substantial reduction in tax rates on dividends and capital gains. Upon winning reelection in November 2004, President Bush pledged to make the tax cuts of his first term permanent. However, rising budget deficits (growing larger amid the spending associated with the 2003 invasion of Iraq) made it harder for the Bush administration to rally the nearly universal support that his tax bills had received from Republican legislators during his first term. Some fiscal conservatives in the Republican caucus joined Democratic legislators in a refusal to pass new legislation to eliminate the 2011 sunset clause. In addition, in the 2006 midterm elections, voters replaced the slim Republican legislative majorities with Democratic majorities in both houses of Congress. These partisan changes doomed efforts to extend the tax cuts during the last two years of the Bush presidency.

The severe economic downturn of late 2008 in the United States and beyond generated a new discussion of the role of tax policy in the 2008 presidential campaign. Republican candidate John McCain resumed a call for extending all of the temporary tax cuts enacted under the Bush administration. In contrast, Democratic candidate Barack Obama's economic team argued that a stimulus should focus on targeted tax relief for consumers and businesses and on spending programs designed to stimulate job creation. Obama's electoral victory in November 2008—accompanied by

the expansion of Democratic majorities in Congress—made it more likely that his vision would be pursued in 2009.

The battle over tax policy during the Bush administration illustrates the crucial importance of taxation for many politically active citizens and interest groups. In a country in which citizens are generally more skeptical of government expansion than are residents of most industrialized countries, tax cuts can have a visceral political appeal with voters. At the same time, when the enactment of tax cuts threatens government programs that many people support, political parties, interest groups, and individual citizens often rally to protect government revenues needed to pay for those programs. In addition, the dynamics of tax policy also illustrate the extent to which politicians and voters make decisions in a shifting national and global context. In 2001 many people were optimistic that the economic boom of the 1990s could be sustained indefinitely. Rising budget deficits and then a financial crisis have reshaped markedly people's expectations with an eye toward the 2010s.

Japan

Background: Policy Process and Policy History

As with spending policy, tax policy formulation in Japan has centered around the Ministry of Finance. Proposed changes (which can originate from forces outside the ministry as well) are then reviewed by major coalition leaders and the leadership of affected interest groups. Often the relative power of the prime minister in this process is determined by his or her prior experience (or lack thereof) in the Ministry of Finance.

Historically, the Diet's role in tax policy has been limited because agreements were typically arrived at among major Liberal Democratic Party (LDP) factions before bills were presented in the legislature. In the contemporary period, however, multiparty coalitions formed by unstable parties have been the rule of the day. As a result, the process of securing passage of tax reforms announced by the government is no longer a foregone conclusion.

Japan's tax structure is different from most other industrialized countries' systems in two notable respects. First, Japan relies less on sales taxes, which account for only 19.4 percent of tax receipts. Second, corporate income taxes are much more important. In 2006 corporate income taxes accounted for 15.5 percent of all taxes—more than 72 percent larger than the average share found in the other five countries examined in this book. The portions of the tax structure represented by personal income tax (18.3 percent) and by social security (32.6 percent) are more in line with other countries' tax systems.

The basic corporate income tax rate is 30 percent; smaller businesses pay a lower rate (22 percent) on the first eight million yen of taxable income. A local corporate income tax code also exists, with an average rate of 11.56 percent. Localities also levy a corporate inhabitant tax of roughly 5 to 6 percent on the income of businesses headquartered in their jurisdictions.

The personal income tax code has six brackets ranging from 5 to 40 percent. Local income taxes vary and provide a variety of deductions and exemptions. With the exception of accident compensation insurance, social security taxes are borne equally by employers and employees. Rates vary somewhat depending mainly on occupation. Most employees pay roughly 12.2 percent of earnings. Most employers pay a little under 13 percent of payroll.

As we noted earlier, sales taxes are much less important in Japan than in the other industrialized countries. Traditionally, Japan had no general sales tax but rather a series of excise taxes. In the late 1980s, after several failed attempts by prior governments, the Takeshita government finally managed to gets its LDP legislative majority to replace the excise taxes with a 3 percent consumption tax (in large part because opposition parties had expressed uniform disapproval of the measure). After considerable debate, the VAT was ultimately raised to 5 percent in a 1996 reform, effective April 1, 1997; it has remained there ever since. Property taxes on buildings and on land are levied at several different rates.

Japan was the one major economy that did not encounter rising budget deficits in the late 1980s or early 1990s. In fact, Japan ran surpluses from 1987 through 1992. When economic growth slowed to 1.0 percent in 1992 and then to 0.3 percent the next year, pressure mounted on the Japanese government to consider a fiscal stimulus. From 1993 through 1996, several unstable coalition governments—the first governments not led by the LDP in nearly forty years—were divided regarding how to place Japan's economy on a stronger footing. The coalition governments pursued temporary tax relief and spending programs in 1994 and 1995. However, the Ministry of Finance (dominated by officials with long-standing ties to the LDP and with a historical commitment to deficit control) worried that an excessive stimulus would lead to a growing budget deficit. In 1996, partly to please the Ministry of Finance, the Murayama government passed a permanent increase in the consumption tax from 3 to 5 percent, effective April 1997. The consumption tax hike, along with continuing domestic financial crises and a burgeoning regional economic crisis, led to renewed economic stagnation that culminated in a recession in 1998, during which the GDP shrank by 2.5 percent.

Contemporary Dynamics

Japan's deepening economic problems produced varied tax cut proposals from all major political parties and interest groups in the late 1990s. As the recession emerged in mid-1998, veteran LDP leader Keizo Obuchi became prime minister of a smaller, three-party coalition government in which the LDP was the largest partner. He promised a major stimulus package along with structural reforms designed to modernize the Japanese economy. In turn, the bad outcomes associated with the 1997 sales tax hike muted opposition from more fiscally conservative members of the LDP as well as from

officials the Ministry of Finance. The Obuchi government also cultivated the support of business groups supportive of his call for sweeping tax reform.

Obuchi's predecessor, Ryutaro Hashimoto, had been roundly criticized for backing away from his initial commitment to sweeping tax reform. Obuchi, in contrast, vigorously pursued new tax legislation upon taking office in June 1998 following Hashimoto's resignation. In his opening address to the 1999 legislative session, Obuchi made a commitment to permanent reductions in personal and corporate income tax central to the political agenda. He worked with other cabinet members to try to convince LDP legislators that the LDP risked electoral defeat if it failed to heed the call for tax reform. In turn, Obuchi's smaller coalition partners had already committed themselves to tax cuts. By February the government had already gained lower house approval, and a series of tax cuts were enacted for implementation in 1999. The top marginal rate for personal income tax was slashed from 50 to 37 percent; the lower tax brackets retained their existing rates in an effort to avoid further alienation of fiscal conservatives. The overall corporate income tax rate was cut from 46 percent down to 41 percent. These and other policy reforms proved popular with voters initially as the LDP regained a majority in the 1999 legislative elections.

The implementation of the 1999 tax reform produced uneven results. The economy did not immediately pull out of its decade-long slump. When Obuchi suffered a stroke, his successor Yoshiro Mori proved unpopular, which led to the selection of Junichiro Koizumi as prime minister in 2001. Koizumi presented himself as an outspoken advocate of bold economic reforms. As we saw in Chapter 6, his central initiative focused on the privatization of the financial network controlled by the Japanese postal system. His dedication to that privatization project limited his willingness and his ability to pursue his pledge to decrease further corporate tax rates and inheritance taxes. Instead, slightly improved economic conditions during 2003–2006 increased pressure on Koizumi to reduce Japan's large budget deficit. In the end, the major tax reforms of the Koizumi government were revenue-seeking in nature. He reduced tax expenditures; raised the top marginal rate for personal income tax in 2006 (from 37 to 40 percent); and raised social security payroll taxes on employers and, especially, on employees.

Koizumi's personal popularity bolstered his ability to pursue tax increases that other politicians might have avoided. By late 2008, however, the political agenda for tax policy in Japan had shifted yet again. His two immediate successors—Shinzo Abe and Yasuo Fukuda—each lasted less than one year in office prior to resigning in the face of a discordant legislature and declining public approval ratings. This political turbulence, combined with an economic downturn in 2008, put tax reform back on the systemic agenda when Taro Aso became prime minister in September 2008.

The Japanese experience demonstrates a couple of the principles discussed in Chapters 2 and 3. First, large governing coalitions make it harder to craft

a coherent policy. Whereas Obuchi and Koizumi enjoyed several legislative successes as prime ministers, most chief executives in Japan have struggled to remain popular with voters and with legislators from the mid-1990s forward. In the eyes of many observers, the weakness of the Japanese government has negatively influenced tax policy making by producing "stop-go" policy changes in which tax cuts alternate too abruptly with tax hikes and vice versa. Second, visible failures of the governing party or coalition are often grist for the policy formulation mill of the opposition parties. As soon as the LDP became identified with the failings blamed on the consumption tax increase, other political parties swept in with different plans to reduce the tax burden on individuals. The Obuchi government was sly enough to adapt to these shifting political winds and make tax cuts part of the LDP's agenda.

Germany

Background: Policy Process and Policy History

As with spending policy, tax policy in Germany involves the chancellor consulting with all relevant members of the cabinet in forming a proposal before presenting it to the entire cabinet for approval. Historically, coalition governments in Germany have often split the Economic and Finance Ministries among the coalition partners. As a result, both coalition partners have tended to play a major role in tax policy decisions by heading the two major ministries involved. Ultimately any coalition disagreements are arbitrated by the chancellor, the economic and finance ministers, and senior figures in the governing coalition. Leaders of the major business and labor confederations are usually included in the policy formulation process—although formal, mandatory consultation has not taken place for three decades.

In the German tax structure, the largest share of tax revenues comes from social security taxes (36.3 percent). Sales tax accounted for another 29 percent of tax revenues, and personal income taxes comprised 23 percent of revenues in 2006. Corporate income taxes made up a little less than 5 percent of total tax revenues.

The basic federal corporate income tax rate is 15 percent, but subnational governments levy additional corporate taxes averaging nearly 15 percent nationwide. Individual income tax rates range from 15 to 45 percent; the precise rate for each individual is calculated using a sliding-scale formula (rather than via the fixed income brackets used in most countries' tax codes). Both corporate and personal income taxes have been subject to a so-called solidarity surcharge of 5.5 percent of taxes owed (beginning January 1, 1998) to help pay for the costs associated with national reunification. This surcharge raises the highest corporate rate to 30.2 percent and the top individual rate to 47.5 percent. Employee social security taxes are levied at 20.4 percent on the first 43.200 euros earned and then at 11.6 percent on the next 19,800 euros earned. Employers pay social security taxes at the slightly lower rate of 19.5 percent on

the first 43,200 euros paid in salaries and then at the same 11.6 percent rate paid by employees on wages up to a maximum of 62,000 euros. As elsewhere in Europe, the main sales tax is a VAT. The standard VAT rate from 1998 through 2006 was 16 percent; a major tax reform raised that rate to 19 percent from 2007 forward. Food, plants, books, and a few other items are taxed at 7 percent. Several transactions are exempt from the VAT including banking, insurance, and financial services; property transactions; education; health care services; cultural activities; and some nonprofit activities.

In the late 1980s tax reform under the center-right Helmut Kohl government focused on rate reduction and simplification. The basic corporate rate was cut from 56 to 50 percent. The number of personal income tax brackets was reduced slightly from eleven to ten; the top marginal rate fell by 3 percentage points, and the lowest rate was raised from 21.4 to 22.1 percent. Amid the steady growth of 1983 to 1989, a small reduction in some tax rates presented no revenue problems.

As we noted in Chapter 6, reunification generated substantial fiscal pressures in Germany. Its budget deficit grew precisely when the course of monetary unification called for small budget deficits. A difficult challenge resulted in the early 1990s as two potentially conflicting imperatives reached the institutional agenda: a need to generate more revenues emerged simultaneously with a desire to avoid a significant tax increase (because it might further deepen the recession). The watchwords for the late 1980s had been tax simplification and tax reduction. Now, very quickly, revenue enhancement was added to the agenda. The Kohl government responded with a series of revenue-seeking measures—an increase in the VAT rate, the reduction of some tax expenditures, and the creation of a "solidarity surcharge" designed to produce revenues targeted for economic recovery in eastern Germany. In response to criticism from business groups and from their coalition partners in the Free Democratic Party, the Christian Democrats also backed a reduction in corporate income taxes.

Contemporary Dynamics

The 1998 election campaign was a battle of contrasting styles and proposals despite the presence of two major candidates who each labeled himself as a pragmatist. Helmut Kohl, who had served as chancellor since 1982, presented himself as a steady hand amid the challenges of national reunification and European integration. Gerhard Schröder, the new Social Democratic leader, called for an eclectic mixture of tax cuts and well-managed social programs. The center-left coalition of Social Democrats and Greens pledged to protect ordinary Germans' living standards better than the Kohl government. Business groups generally backed Kohl's coalition, whereas labor groups supported Schröder's coalition. In the end, the center-left gained a majority and the Schröder cabinet took power in October 1998.

Vigorous debate ensued within Schröder's governing coalition of the Social Democrats and Greens. Many members of both parties called for tax increases on the wealthy to fund a swift increase in social spending. The first tax reform initiative created a new "ecological tax" on fuel consumption that was designed to pursue two objectives simultaneously. It would encourage energy conservation while also generating a new source of government revenues for social programs. Schröder ultimately backed a modest increase in social spending and a major tax cut package. The 1999 tax reform phased in a series of across-the-board personal income and corporate tax reductions that would take full effect in 2002. The top marginal rate for personal income tax declined from 53 to 48.5 percent while the bottom marginal rate fell from 25.9 to 19.9 percent. The top marginal rate for the federal corporate income tax was slashed from 40 to 25 percent. In addition the government reduced both employer and employee payroll tax rates by 0.4 percentage points; this payroll tax relief was funded via the revenue generated by the new energy tax.

Upon passage and implementation of these heterodox measures, Schröder emphasized that they were emblematic of his "third way" approach to economic policy. The leader of the more progressive wing of the Social Democrats, Oskar Lafontaine, resigned from his cabinet post; Lafontaine had argued that wealthy citizens and businesses did not need substantial tax relief. Most of these policy changes were decidedly easy to implement because they involved no new tax instruments. However, the brand-new energy tax required the creation of a new set of administrative practices and also faced a series of legal challenges as opponents tried to block its implementation in the courts. Debate over the new measure filtered back into the legislative cycle as Greens pushed for higher energy taxes, especially on coal, whereas the initial law had focused primarily on motor fuels. Faced with stagnant economic growth and high deficits following reelection in 2002, the Schröder government turned its attention to revenue-seeking via the reduction and elimination of several tax expenditures.

Persistent economic stagnation culminated in a divided 2005 general election. The creation of the Left Party pulled some voters away from the Social Democrats, yet the Christian Democrats also lost ground. As a result, neither the SDP-Green coalition nor the CDU-CSU coalition with the Free Democrats had enough seats to form a legislative majority. Complicated negotiations ensued regarding the formation a new government. Ultimately, the Social Democrats decided that they would rather form a "grand coalition" with the other major party, the Christian Democrats, than risk a volatile coalition with the new Left Party. This heterogeneous marriage of convenience between the major center-left and center-right parties produced a multitude of often contradictory tax reform proposals. In its first three years in office, the Angela Merkel government introduced several changes favored by Christian Democrats. A visible cut in the federal corporate tax rate from 25 to 15 percent was financed by raising the VAT rate from 16 to 19 percent. At the

same time, Social Democrats supported other tax measures such as an increase in the top income tax rate from 42 to 45 percent, the reduction of some tax expenditures for large businesses, a small reduction in payroll taxes, and the creation of some new tax expenditures for working families.

In addition to demonstrating the clear role of international factors in framing contemporary tax policy, the German experience illustrates the power of a perceived emergency as a political tool that can overcome opposition to tax increases. The dual challenges of reunification and European monetary integration enabled the Kohl and Schröder governments to implement tax increases of much greater size than those pursued in other European countries. Once those emergencies faded, however, tax reduction bubbled back up onto the systemic and institutional agendas. More recent events in Germany under the Merkel government demonstrate the challenges of designing tax policies to suit the preferences of an ideologically diverse governing coalition. It will be interesting to see how German voters evaluate the performance of these two major parties in tax policy when Germany returns to the polls in September 2009.

France

Background: Policy Process and Policy History

As with spending policy, the Finance Ministry is central to tax policy in France. Once budget parameters are set using estimates from the Finance Ministry, the finance minister formulates recommendations for tax changes associated with the coming budget. If changes affect sectors of the economy that correspond to other ministries, those ministries are brought into consultations before the prime minister makes a decision to present the changes as part of the budget bill or as a separate measure. The decision to move ahead with the proposal can also be shaped by consultations with relevant interest groups or senior parliamentary leaders, particularly if the government believes the reforms could be controversial. After the public announcement, the Finance Ministry leads the effort to secure passage in the legislature.

In the French tax structure, roughly one-third of tax receipts are generated by social security contributions (34.2 percent in 2006). Income taxes are less important in France than in other industrialized countries. Individual income taxes accounted for 17.3 percent of revenues, and corporate income taxes represented 6.2 percent. Direct taxes constituted only one-third of tax receipts, compared to over 43 percent in the average industrialized country. Sales taxes accounted for an additional 25.3 percent of revenues.

The individual income tax code has four brackets with progressive rates ranging from 5.5 to 40.0 percent. Because of a relatively high income threshold, roughly half of French households pay little or no income taxes. Residents are assessed an additional generalized social contribution of 7.5 percent of earnings (raised in 1997 from 3.4 percent). The corporate income tax rate is 34.43 percent. Social security rates vary slightly by occupation.

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Most employees pay around 20 percent, whereas employers pay approximately 40 percent of payroll. The basic sales tax is a VAT with a standard rate of 19.6 percent. A lower rate of 5.5 percent is levied on most food products, books, water, and a few other items. On entities with over 90 percent of their production exempt from the VAT, France levies a special payroll tax of between 4.25 and 13 percent.

Like many industrialized countries, France simplified its income tax structure and lowered income tax rates during the 1980s and 1990s. Many of these changes came under the so-called cohabitation center-right governments serving alongside center-left French president François Mitterrand. The corporate tax rate fell from 45 to 42 percent under the first cohabitation government led by Jacques Chirac in the late 1980s. To replace some of the revenues lost in these measures, the government began to levy an income tax surcharge of 1.2 percent of earnings—the generalized social contribution (GSC). After a large center-right electoral victory in 1993, Edouard Balladur's government lowered the corporate rate to 33.33 percent and slashed the number of brackets in the individual income tax from thirteen to seven. It doubled the GSC rate to recoup some of the lost revenues. After Chirac won the presidency in 1995, many analysts predicted a prolonged period of center-right dominance. However, the deficit-cutting economic program of the new cabinet led by Alain Juppe faced a firestorm of criticism from all sides. Conservatives opposed the tax increase proposals, whereas progressives launched strikes and street protests against proposed spending cuts. The Juppe government raised the VAT rate from 18.6 to 20.6 percent and increased the corporate tax rate to 36 percent.

In the wake of the turmoil, in the 1997 legislative elections the center-left bloc led by Lionel Jospin won control and a new cohabitation government emerged. The Jospin government used the need to meet the Maastricht deficit target by the end of 1997 as a justification for quick action on the fiscal front. To maintain the support of organized labor, the government reduced the sales tax rate by one percentage point to 19.6 percent; the top personal income tax rate rose to 54 percent; and the corporate tax rate paid by large companies increased from 36 to 41.6 percent. In the name of burden-sharing and in pursuit of the Maastricht target, the GSC rate was increased from 3.4 to 7.5 percent.

Contemporary Dynamics

In 2002 the political winds in France shifted yet again. Jospin's failure to qualify for the presidential runoff in the April elections set into motion a rising tide of support for the center-right forces led by Chirac, who won overwhelmingly in May. His center-right coalition campaigned successfully for an end to divided government in the June legislative elections. Jean-Pierre Raffarin's government enjoyed a large legislative majority.

The new center-right government proposed a series of decreases in personal and corporate income tax rates. These measures were backed by business

groups. However, the tax cuts were linked by opponents to the Raffarin government's call for major public-sector reforms in retirement pensions and health care. These proposals, as had been the case during the Juppe government, produced a new wave of protests and strikes from center-left political parties and labor unions.

Amid the opposition protests, the center-right coalition limited the scope of the tax cuts that it pursued in practice. The top personal income tax rate fell from 49.6 to 48.1 percent. Similarly, corporate tax rates fell from 35.4 to 34.4 percent. To deal with chronic financing difficulties in pension policies, payroll rates roses slightly (by roughly 0.3 percentage points) for both employees and employers.

The reforms pursued by the Raffarin government faced few technical implementation obstacles. Instead, their implementation generated a new cycle of policy evaluation. Conservatives argued that France had not done enough to reduce taxes on wealthy individuals and firms. Progressives countered that the Raffarin government had deepened the process of shifting the tax burden from the wealthy to the poor. In the 2007 elections, the new leader of the Gaullist movement, Nicolas Sarkozy, campaigned vigorously for deeper tax cuts. When he won the presidency and his coalition retained control of the legislature, Sarkozy worked quickly in the first weeks of his presidency to back Prime Minister François Fillon's proposals for tax reductions. The top rate for personal income taxes fell from 48.1 to 40 percent, and a sweeping reform of the inheritance tax reduced its impact to less than 5 percent of the population.

France's experience demonstrates the potential power of international constraints (and commitments) on domestic policymakers. Although tax increases tend to be divisive, the push to join the euro zone eventually built support for various tax measures to lower the deficit in order to meet the target, once the deadline loomed larger. In the decade following the 1997 Maastricht deadline, the dynamics of domestic politics played a greater role. The emergence of a large center-right legislative majority paved the way for major tax cuts once that majority was reaffirmed in the 2007 presidential and legislative elections. A question now looms on the horizon for policymakers and political analysts: what will be the impact in the 2012 electoral cycle of over 18 billion dollars in annual tax cuts focused largely on affluent citizens?

United Kingdom

Background: Policy Process and Policy History

The tax policy formulation process is much more centralized in the United Kingdom than in most other countries. The prime minister and the finance minister (known as the chancellor of the exchequer) work together to discuss potential reforms proposed from within the Finance Ministry. Those reforms are then discussed with relevant ministers and senior officials at other

ministries. The prime minister is the arbiter of any disputes. Tax reforms are usually worked into the draft budget. Once the budget is announced, the government is typically confident that it will pass in Parliament. As discussed in Chapter 6, the Blair government introduced in late 1997 the practice of an annual Green Budget speech in which the Finance Ministry provides a broad outline of possible tax reform initiatives and the economic concerns that motivate them. Some observers have noted that this procedural innovation is a response to Margaret Thatcher's problems with the poll tax initiative (discussed later in this section).

The British tax structure relies more heavily on sales taxes than do the tax structures of the other industrialized countries we examine here. Throughout the early twenty-first century sales taxes have accounted for over 30 percent of tax receipts. In 2006 social security taxes were just 18.2 percent of taxes received, largely because health care is funded out of other revenues and not via an earmarked payroll tax. Shares from individual income taxes (28.6 percent) and corporate income taxes (9.3 percent) are similar to those found in the other countries.

The basic corporate income tax rate is 28 percent. Small firms with incomes below $2.6 million receive tax relief. There are no subnational or local income taxes. The two individual income tax brackets are set at 20 and 40 percent. Employee social security taxes are set at 11 percent on roughly the first $1,500 earned each week and at a 1 percent rate for all earnings above that threshold. Employer payroll taxes are set at 12.8 percent of all earnings; employer social security contributions have no upper limit.

The central sales tax is a basic VAT of 17.5 percent on most goods and services. An economic stimulus package enacted in late 2008 lowered the VAT rate to 15 percent until January 1, 2010. A lower tax rate of 5 percent is levied on fuel and power for domestic use. Food, books and publications, and passenger transportation are exempt from the VAT, as are many services commonly exempted elsewhere (banking, insurance, and finance; education; health care; and some nonprofit activities). Insurance premiums are subject to a special tax of 2.5 percent. Taxes on residential and business real property are the main source of local government revenues.

The Thatcher government came to power in 1979 on a Conservative platform of smaller government and, in turn, lower taxes. Although some tax reduction took place during the government's first two terms, a persistent budget deficit and pressure on the national currency in foreign exchange markets made it difficult to pursue major tax reform. In the late 1980s, fresh after leading her party to an unprecedented third consecutive electoral victory in 1987, Thatcher set into motion a series of substantial tax changes placed at the top of the institutional agenda. The House of Commons ratified substantial reforms at both levels of government. At the national level, a simplification of the individual income tax code reduced the number of brackets from six to three, and the top rate was lowered dramatically from 60 to 40 percent. The

basic corporate income tax rate decreased slightly from 35 to 33 percent. In turn, the government looked to recoup lost revenue in these direct taxes by raising the basic VAT rate from 15 to 17.5 percent.

At the local level, however, the shift from property taxes to a single poll tax charged to all residents produced a firestorm of opposition once it was fully implemented in 1990. A wave of public demonstrations ensued that included the worst riot in London in recent history. Some citizens openly refused to pay the poll tax in protest. When public opinion polls showed that Conservatives were in danger of being trounced in the next national elections, Thatcher faced a leadership challenge within her own party. After failing to win a clear majority of support within her own party's bloc in the legislature, Thatcher resigned as prime minister. Her successor, John Major, quickly replaced the controversial poll tax with a modified property tax system and used this reform as a central element of his subsequently successful 1992 election campaign.

Contemporary Dynamics

In 1997 the Labour Party pursued its first parliamentary majority in nearly two decades. Tony Blair had spent the 1990s arguing that the Labour Party would find a "third way" in economic policy. With regard to tax policy, his electoral campaign promised not to return to the level of income tax rates observed in the 1970s. Instead, he promised to reforms the priorities and the implementation of government programs. Conservatives countered that Blair would ignore his campaign promises by raising income taxes on all Britons. In the end, the Labour Party won a massive majority in the House of Commons.

Amid the euphoria of a sizable electoral triumph, policy formulation proceeded confidently within the executive branch. The minimalist tax reform agenda called for tax cuts for lower-income taxpayers and for small businesses. In addition, the government proposed to eliminate some tax expenditures that reduced taxes owed by businesses and individual taxpayers. Finally, the government proposed to simplify employer payroll taxes by moving from a five-bracket system to a single rate that would raise the level of employer contributions by an average of 3 percentage points. Although some of the more progressive members of the Labour Party called for tax rate increases on wealthy Britons, the Blair leadership team held firm to its campaign promises. The absence of tax hike proposals helped to block potential protests from business confederations and opposition parties.

The House of Commons approved a dramatic reduction in the tax rate for the lowest tax bracket; the rate fell from 20 to 10 percent. In turn, the corporate tax rate for small businesses was reduced from 24 to 19 percent and the top corporate rate decreased from 33 to 31 percent. Although the corporate tax rates fell and the top marginal rate on individuals remained the same, the simplification of the corporate and personal tax code actually increased the taxes owed by some businesses and by many wealthy individuals. The employer payroll tax reform created a single rate of 12.2 percent.

Implementation of the initial Blair tax reforms went smoothly amid a growing economy. The Blair government's unity surprised its opponents who had expected the Labour Party to fail to live up to its pledge not to increase income tax rates. The political and economic results of the initial tax reforms strengthened Blair's pledge not to raise income taxes in his successful reelection campaigns in 2002 and 2005.

Although tax policy decisions did not pose the problems for Tony Blair that the poll tax reform did for Margaret Thatcher, the Blair government's decision to participate in the U.S. invasion and occupation of Iraq proved increasingly unpopular over time. The troop commitment also placed new fiscal pressures on the government. When the 2005 election produced a visibly smaller Labour majority, Blair resigned as prime minister in 2007 and his chancellor of the exchequer, Gordon Brown, became the new leader of the British government. Faced with rising fiscal pressures and a stagnating economy, the Brown government reversed the signature income tax reform of the first Blair government: it raised the tax rate for the lowest income bracket from 10 percent back to the 20 percent rate levied by the Major government. In an effort to produce a stimulus for consumer spending, the Brown government also authorized a temporary reduction in the VAT from 17.5 to 15 percent; the tax reduction is scheduled to expire at the start of 2010.

The perceived successes of the Blair government in tax policy speak to the manner in which party discipline is aided by the Westminster model of executive-legislative relations. Blair used his authority and popularity as prime minister to resist requests from his own core base of legislators and supporters to increase income tax rates on wealthy individuals and large businesses. In turn, the government's early political successes reinforced Blair's leadership in the years that followed.

At the same time, the poll tax affair and its subsequent ramifications for the Thatcher government serve as a cautionary tale about the double-edged sword of executive power in the Westminster model. On the one hand, with a sizable majority and the varied resources of the prime minister's post, Thatcher was correct in assuming that she could drive through the poll tax despite criticisms of the plan both within and outside the governing party. On the other hand, the executive's ability to enact with relative ease the poll tax reform left it blindsided by a level of public opposition that was difficult to forecast given the limited public debate over the initiative prior to implementation.

Italy

Background: Policy Process and Policy History

The Italian fiscal process has differed from most industrialized countries' by formally separating tax legislation from spending legislation. Any changes to the tax code have to be written outside of the budget bill. As with spending policy, the Treasury has taken the lead role in formulating tax reforms.

Nevertheless, the greater size of governing coalitions and the weaker party discipline of the participants have made it difficult to negotiate major tax reforms through the legislature. As a result, tax policy has tended to follow the same incrementalist dynamic present in spending policy.

In the Italian tax structure, social security payroll taxes, personal income taxes, and sales taxes each account for just over 25 percent of tax receipts. Employers pay the lion's share of social security taxes—nearly 80 percent. Corporate income tax rates were lowered significantly in 1998 and now constitute 6.8 percent of total revenues.

Since 2008 the corporate income tax rate in Italy has been 27.5 percent. In addition, businesses pay a regional tax of 4.5 percent (which can be raised to a maximum of 5.5 percent at the discretion of the regional government). The individual income tax code has five brackets with rates ranging from 23 to 43 percent. Like corporations, individuals also pay an additional regional tax that ranges from 0.9 to 1.4 percent of income; some local governments levy an additional surcharge up to a maximum rate of 0.5 percent. Social security payroll tax rates are among the highest in the world. Most of the responsibility for social security taxes falls on employers, who pay at a rate of 32.1 percent on the first 88,669 euros earned. Most employees pay around 10 percent of earnings up to the same income threshold of 88,669 euros. The self-employed pay, on average, around 5 percent of earnings.

The basic VAT rate is 20 percent. Several goods and services are charged lower rates ranging from 4 to 10 percent. Property taxes of less than 1 percent are levied by local governments. Excise taxes are charged on several items including furs and luxury automobiles. Effective in 1998 a new regional VAT of 4.5 to 5.5 percent replaced the local income tax and the social security payroll tax. This major change increased Italy's reliance on indirect taxes in its quest to reduce tax evasion.

Throughout the 1980s and 1990s Italy had the highest budget deficit among the six countries examined in this book. During the 1980s the deficit was consistently greater than 10 percent of GDP. Following the lead of many other countries, Italy simplified the individual income tax code in the late 1980s by reducing the number of brackets from nine to seven, dropping the top rate from 62 to 51 percent. Although Romano Prodi's government committed itself to the Maastricht guidelines related to European monetary unification upon taking office in 1995, the center-left coalition government was under tremendous stress. In addition to the problems associated with getting multiple coalition partners to agree on a reform proposal, the situation was complicated by the large fluctuations in the Italian party system during that decade. Reductions in the top rates for individual and corporate income taxes were compensated for by a broadening of the tax base achieved by the elimination and reduction of several tax exemptions. As in Germany and France, a temporary surtax, the Eurotax, was enacted in 1997 with an eye toward the Maastricht target. The government also created a regional VAT (varying from

4.5 to 5.5 percent) that would pay for health care and some other social services previously funded by payroll taxes; this particular reform combined efforts to reduce tax rates on employers with efforts to reduce tax evasion associated with social security contributions. As noted in Chapter 6, this program enabled Italy to meet the deficit target at the last minute. However, the fight over continued budgetary austerity in 1998 culminated in the ouster of the Prodi government via a failed vote of confidence in which the government's budget bill failed to pass by a single vote. The subsequent government led by Massimo D'Alema reduced the top marginal rate for personal income taxes from 51 to 46.5 percent and increased the rate for the lowest tax bracket from 10 to 18 percent.

Contemporary Dynamics

The 2001 elections in Italy were a hard-fought affair. Communications magnate Silvio Berlusconi boldly promised voters that a center-right triumph would lead simultaneously to a major public works program and a series of tax cuts. The center-left coalition countered that it would do a better job of protecting the interests of all Italians. Berlusconi won the election with a tighter-knit coalition and a larger legislative majority than he had enjoyed during his short-lived government following the 1994 elections. In particular, his Forza Italia party controlled a greater share of the seats and he no longer needed the support of the Northern League to preserve his legislative majority.

The 2001 electoral triumph, however, had unclear implications for tax policy. Berlusconi had committed to tax cuts, but he had also promised to cut the unemployment rate in half via an ambitious public works campaign. Furthermore, the Stability and Growth Pact (SGP) committed his government to hold deficits to 3 percent of GDP, which placed his two signature economic agenda items in conflict. With a budget deficit right at the maximum level in 2001 and 2002, his government's latitude was limited. Business groups pressured for tax cuts, but many businesses also welcomed government expansion during the recession in place. Labor groups and center-left parties strongly criticized any discussion of funding tax cuts for the affluent by raising taxes on lower-income families.

At the decision-making phase, the government relied on its legislative majority and reminded all skeptical legislators that party discipline was needed to avoid another short-lived government. Tax reforms took place in the direction indicated by Berlusconi, but (to try to hold budget deficits near the SGP limit) the government postponed the major tax cuts until the latter part of his term. This strategy tried to maximize the visibility of the tax cuts for the 2006 election campaign while attempting to delay any expansion of the deficit until after the campaign was over. The top corporate tax rate declined gradually from 36 percent in 2002 to 34 percent in 2004.

To compensate for lost revenues, the lowest income tax bracket's marginal rate was increased from 18 to 23 percent in 2003. The top marginal rate for personal income tax declined from 45 to 43 percent in 2005, and employer payroll taxes decreased by one percentage point in the election year of 2006.

Implementation of Berlusconi's tax reforms pleased some of his most ardent supporters but also met with stiff opposition from center-left political parties and their labor union allies. Rather than reducing taxation on all Italians, the Berlusconi tax reforms raised taxes on lower-income Italians and lowered them only for businesses and affluent taxpayers. The center-left opposition, led once again by Romano Prodi in the 2006 elections, attempted to rally voters around a pledge to protect the interests of ordinary Italians. Berlusconi countered by trying to cultivate voters' skepticism regarding the ability and willingness of the center-left coalition to use government resources effectively.

Winning by a razor-thin electoral margin, the center-left's nine-party coalition formed a new government in the wake of the 2006 elections. However, with almost no margin for error in the Senate, the Prodi government found it difficult to formulate and pursue policies. It narrowly gained approval of its fiscal year 2008 budget proposal in October 2007 by retaining centrist coalition members' support via a provision that lowered the corporate tax rate from 33 to 27.5 percent. In January 2008 the Prodi government won a vote-of-confidence measure in the lower house but lost in the Senate when one of its Christian Democratic allies removed its support from the government. In the subsequent April 2008 general election, Berlusconi's coalition regained control of the legislature. As of this writing, it remains unclear what that will mean for tax policy, but the trend toward lowering taxes on the wealthy seems likely to continue.

The dynamics of Italian politics in the early twenty-first century provide a tale of two different coalition blocs. The center-left coalition involved more political parties and a considerable ideological diversity that made policy making more difficult. By contrast, the Berlusconi coalition during the same period relied on fewer parties, enjoyed greater ideological agreement about the priorities of tax policy, and had the benefit of a larger legislative majority. The center-left bloc's vulnerability made it face several difficult votes of confidence, whereas the Berlusconi coalition, perhaps chastened by the rapid collapse of his first government in 1996, demonstrated the political and policy-making advantages of a more disciplined governing coalition.

European Union

Background: Policy Process and Policy History

The European Union conducts two forms of tax policy. First, it pursues tax policies designed to finance its own activities. The EU itself has no power to create and levy taxes; instead, it must work through the member states. As noted in Chapter 6, the EU budget's total expenditures comprise just

1 percent of the union's overall GDP. Accordingly, revenue pressures are smaller on the EU system than they are in the member governments themselves. Second, the EU designs tax policies in an attempt to guide and frame the nature of taxation in the member states. In both policy areas, proposals are drafted by the Commission and then voted on by the European Parliament and the Council of Ministers.

Observers of the United Nations can always find news stories about the many member states that are behind on their scheduled national contributions to that international organization's shared budget. From its founding in 1957 until 1970, the European Community (EC) faced the same problem: the EC depended on the collection of pledged revenues from each member state rather than on a particular set of tax instruments. In April 1970 the Luxembourg Agreement profoundly changed the tax profile of the EC. It called for three sets of tax revenues to be earmarked directly into the EC budget: customs duties on imports coming from outside the EC, special levies on agricultural imports, and a percentage of the VAT collected in each member state (not to exceed 1 percent). Fiscal pressures amid the stagflation of the late 1970s and early 1980s led to reform in this formula at the Fontainebleau summit, where the maximum rate for the EC portion of the VAT was raised to 1.4 percent. In 1992, in response to a changed fiscal picture for both member states and the EU, the maximum VAT rate was returned to 1 percent in 1999.

The decision to dedicate so-called own resources to the EU achieved its stated purpose. We do not open the newspaper to read a listing of the back contributions owed the EU from its member states every fiscal year. The dedication of certain resources also has a small but visible influence on the taxation options available to EU member states. First, no member state can use import tariffs as part of its domestic revenue mix; all such revenues go straight into the EU budget. Second, the decision to earmark a percentage of the VAT collected by member states quietly deepened the trend in these countries toward the adoption of this form of taxation—as opposed to a sales tax at the point of sale or other options. The use of the VAT instrument avoids the possibility that sales taxes across the member states could visibly inflate the price of a good via a cascading, multiplier effect. When sales taxes are charged at the point of sale, there is a possibility that sales taxes could be charged on the full value of a manufacturer's materiel inputs at the start of the production process, and then taxes could be charged on the full value of the good again at the end of the production process. The VAT mechanism avoids this cascade effect by levying taxes only on the value added at each step of the production and distribution process.

Contemporary Dynamics

With the finances of the EU on a reasonably solid footing, contemporary EU tax policy in the era of heightened integration has focused on the

coordination of member states' tax policies. Although the goal of a single European market implies the pursuit of comparable tax policies among the member states, policymakers have always faced the challenge of national sovereignty. The governments in the member states view tax policy as a crucial policy area over which they are unwilling to cede much of their authority.

The mandate for tax harmonization forms part of the EC Treaty. Article 90 prohibits any tax discrimination that would create an unfair national advantage at the expense of other member states. In turn, Article 93 expressly calls for the harmonization of indirect taxes. Not surprisingly, policy formulation within the EC has focused largely on harmonizing indirect taxes because there is no explicit mandate to regulate other taxes unless they constitute a form of illegal tax discrimination.

With the VAT earmarked as a community-wide endeavor since 1970, political momentum made it easiest to focus the EC's special claim as a VAT stakeholder. The European Commission and many large businesses favored the vigorous pursuit of VAT harmonization. By reducing the variation in taxation across member states, paperwork associated with the VAT's implementation could be reduced and the costs of doing business would vary less across national boundaries. In contrast, member state governments of all political stripes were extremely reluctant to embrace a universalization of VAT procedures. They wanted to retain some meaningful control over which goods and services could be taxed, over the rate of taxation, and over where and when items would be taxed.

After seven long years of debate, in 1977 the Council of Ministers endorsed a common policy that established minimum and maximum levels of all member states' VAT rates. The new policy also defined the precise mix of goods and services over which the VAT could be levied in any and all member states. However, a desire for policy autonomy limited the impact of the community-wide directive in two important senses. First, most countries (as illustrated in the national case studies in this book) permit some important goods and services to be taxed at a lower rate. As a result, the 1977 VAT harmonization directive expressly acknowledged the right of member countries to charge a lower VAT rate (as low as 5 percent) as long as it did not pose a form of illegal discrimination against other member states' economies. Further, the harmonization process permits member states to apply for exceptions via which they can charge even lower VAT rates than the community-wide norm would otherwise permit. In short, the official band of permissible VAT rates was born full of exceptions. Second, despite the recommendations of the European Commission, the member states proved unwilling to permit tax collection to be shifted to the member state of origin (where the finished good or service was produced). Instead, the member governments chose to retain the existing system of collecting the final stage of the VAT in the member state where the item is destined to be purchased. The member state governments did not want to sort out the political trade-offs implicit in shifting where taxes

would be collected because the majority of the VAT revenues go directly to the member state that ultimately collects the tax.

The implementation of the VAT harmonization directive and the pursuit of the 1987 Single Market Act each bred pressures to place the harmonization of indirect taxation back on the EU's institutional agenda. The procedures permitting exceptions to the official VAT rate band permitted a diverse landscape of taxation rules to exist in the face of the harmonization initiative. This forced the EU to process a number of requests for exceptions—beyond the considerable variation permitted by the ability of countries to levy rates as low as 5 percent on goods and services without special permission. In addition, as intracommunity trade expanded, businesses complained about the logistics of needing to request VAT refunds from the country of origin so that they could avoid double taxation when VAT rates were levied in the destination country.

In response to these issues, bureaucrats at the European Commission again served as official advocates for a deepening of tax harmonization. By 1993 their efforts produced an agreement to harmonize indirect excise taxes on tobacco products, alcohol, and mineral spirits as well as a tweaking of the VAT harmonization. The new 1993 directive permitted EU residents to carry VAT-dutiable goods across member-state borders without facing customs and taxation procedures; only businesses were left subject to the need to process VAT refund requests. However, the member states (via the Council of Ministers) again left considerable discretionary "wiggle room" within the VAT harmonization policy. A lower rate band and the possibility of requesting exceptions were retained as features. VAT taxes also continued to be levied in the destination country, necessitating the use of various refund mechanisms for goods and services crossing national borders. Business pressure persisted and, in 2006, the EU approved the levying of the VAT only in the country of origin for certain services that travel across national boundaries upon delivery. Although the European Commission continues to call for greater harmonization of VAT rates, no real progress has been made on that front.

The dynamics of the four-decade-long pursuit of harmonized VAT rates—and of tax policy more broadly—illustrate the role of institutional and economic factors in EU policy making. First and foremost, the willingness and ability of member-state governments to protect their sovereignty on matters of importance remain considerable. Although the staff of the European Commission is charged with viewing the EU as a single entity, the national governments see the EU as just one of several arenas in which they pursue their interests. Second, in spite of political opposition in the Council of Ministers, the economic pressures associated with European integration (and with economic globalization more broadly) helped to create tax harmonization well beyond the level dictated by the EU. For example, there is no EU directive regulating the band of permissible corporate and personal income tax rates, but all six of these economies have moved toward more similar rates on corporate and personal income taxes during the 1990s and 2000s.

Cross-national Trends

A cross-national summary of tax structures in these six countries highlights the greater reliance on indirect taxes in the continental European countries. This distinction was deepened by tax reforms pursued in the push toward monetary unification in the 1990s—most notably by the creation of a new regional VAT in Italy that replaced local income taxes and national payroll taxes for social security. All six countries pursued a simplification of their income tax structures and a reduction in rates for the highest bracket in line with the supply-sider argument, yet the desired policy outcome of higher economic growth rates did not materialize in most countries. Consideration of the dynamics of tax reform in the 1990s and 2000s leads us to focus on the role of economic and political factors as central to contemporary tax policy making.

Policy Outputs

The tax challenge is lowest in Japan and the United States, where taxes represent less than 28 percent of GDP. Conversely, France and Italy gather about 43 percent of GDP in taxes. How do these countries collect taxes?

Several trends and exceptions are visible in Table 7-2. Three of the six countries generate around one-quarter of tax revenues via personal income taxes. The United States generates over one-third of its revenues in this way, whereas in France and Japan personal income taxes account for less than one-fifth of each country's revenues.

Corporate income taxes are a more important source of revenue in Japan than in the other five countries. Corporate income taxes account for over 15 percent of revenues—double the average share for the other five countries. Corporate income taxes are least important in France, Germany, and Italy.

Dependence on payroll taxes (including employee and employer social security contributions) varies even more widely. In the United Kingdom, payroll taxes account for less than one-fifth of revenues. In the United States and Italy, they make up roughly one-quarter of tax receipts. Japan (32.6 percent), France (34.2 percent), and Germany (36.6 percent) are noticeably more reliant on payroll taxes. Table 7-2 also details how payroll tax obligations are divided between employers and employees. In all six countries, employers pay over half of payroll taxes. On average, employers pay 61 percent of the total. At the low end of the spectrum, Japanese employers pay around 51 percent of payroll taxes; at the high end, Italian employers carry a comparatively heavier load (80 percent).

Sales taxes in France, Germany, and Italy account for roughly one-quarter of tax receipts. Sales taxes are most important in the United Kingdom, where they make up over 30 percent of tax revenues. They are noticeably less important components of the tax structure in Japan (19.4 percent) and the United States (17.4 percent). Remember from the case studies that the United States

Table 7-2 Tax Structures as a Percentage of Tax Receipts, 1996 and 2006

Country	Personal Income Tax	Corporate Income Tax	Employee Social Security	Employer Social Security	Sales Taxes	Other Taxes	Total Taxes per GDP
France 1996	14.1%	3.8%	13.0%	26.6%	27.3%	15.2%	*45.7%*
France 2006	17.3	6.2	9.2	25.0	25.3	16.9	*44.1*
Germany 1996	24.7	3.8	17.6	20.5	27.9	5.5	*38.1*
Germany 2006	23.3	4.9	17.4	19.2	29.0	6.1	*34.8*
Italy 1996	25.1	9.2	6.8	23.7	25.9	9.3	*43.2*
Italy 2006	25.5	6.8	5.5	21.4	26.4	14.4	*41.0*
Japan 1996	20.2	16.4	14.2	18.6	15.4	15.2	*28.4*
Japan 2006	18.3	15.5	15.9	16.7	19.4	14.1	*27.4*
United Kingdom 1996	25.9	10.5	7.2	9.6	35.2	11.6	*36.0*
United Kingdom 2006	28.6	9.3	7.8	10.4	30.3	13.1	*36.5*
United States 1996	37.6	9.6	10.6	12.9	17.2	12.2	*28.5*
United States 2006	35.1	11.4	10.8	12.6	17.4	12.7	*27.3*
Average 1966	*24.6*	*8.9*	*11.6*	*18.7*	*24.8*	*11.5*	*36.7*
Average 2006	*24.7*	*9.0*	*11.1*	*17.6*	*24.6*	*12.9*	*35.2*
EU Average 1996	*26.0*	*7.5*	*10.1*	*16.3*	*31.2*	*8.8*	*42.4*
EU Average 2006	*24.7*	*8.6*	*9.3*	*16.3*	*30.3*	*10.7*	*39.7*
OECD Average 1996	*26.8*	*8.2*	*7.8*	*14.5*	*32.5*	*10.2*	*37.7*
OECD Average 2006	*24.6*	*10.3*	*8.4*	*14.5*	*31.9*	*9.0*	*36.2*

SOURCE: For 1996, Organisation for Economic Co-operation and Development (OECD 1999); for 2006, OECD (2008d).

is the only one of these countries with no comprehensive national sales tax; most sales taxes are collected at the state and local levels.

What drives some of these differences in tax structure? A major force behind smaller payroll taxes in the United Kingdom is the decision to fund government health care programs out of general revenues. This decision is somewhat of a double-edged sword. On the one hand, by funding out of general revenues a basic government program that is popular with many citizens, the government can try to increase popular support for the tax system as a whole. On the other hand, such an approach makes these programs potentially more vulnerable to a generalized tax protest. If health care were funded in the United Kingdom out of an earmarked tax, it might be easier to maintain support for that particular tax instrument, even in the face of major pressures to cut (or maintain) tax rates.

Income taxes have been least important in France because of the government's suspicion that tax avoidance and evasion are relatively common. In response, French governments have responded over the decades by relying much more heavily on payroll and sales taxes, which are easier to implement. Property taxes have also been an important substitute.

Policy Outcomes

A crucial outcome for tax policymakers is public acceptance of the tax structure. Since the early 1980s, protests calling for tax simplification emerged in all of these countries. These pressures have helped to increase commonalities

Table 7-3 Personal Income Tax at the National Level, 1985, 1994, and 2008

	Top Rate			Lowest Positive Rate			Number of Brackets			Tax Unit in
Country	*1985*	*1994*	*2008*	*1985*	*1994*	*2008*	*1985*	*1994*	*2008*	2008
France	65%	56.8%	40%	5%	12%	5.5%	13	6	4	Family
Germany[a]	56	53	45	22	19	15	—	—	—	Optional
Italy	62	51	43	18	10	23	15	7	5	Individual
Japan	70	50	40	10	10	5	9	3	6	Individual
United Kingdom	60	40	40	30	20	20	6	3	2	Individual
United States	50	39.6	35	11	15	10	14	5	5	Optional
Average	*60.5%*	*48.4%*	*40.5%*	*16%*	*14.3%*	*13.1%*	*11.4*	*5*	*4.4*	

SOURCE: Organisation for Economic Co-operation and Development (2009d).

[a]The German system includes a sliding-scale formula and not formal brackets. — = not applicable.

across the countries' tax systems. For instance, the major trend in tax reform during the 1990s was the simplification of the personal income tax code and a decrease in the top marginal rate (Table 7-3). During the early twenty-first century, this trend continued and these six countries' top marginal rates converged considerably. In the mid-1990s, the three countries with a tradition of smaller government (Japan, the United Kingdom, and the United States) were the only countries with a top rate of 50 percent or less. By 2008, as this trend of falling income tax rates deepened and spread, the average top marginal rate fell to 40.5 percent. Thus between 1985 and 2008 the top marginal rate across these countries fell by one-fifth or more; the average rate reduction was a cut of one-third.

Lowering of upper marginal rates was expected to increase revenues by stimulating additional economic activity. The added growth would generate new revenue streams to compensate for the tax rate cuts. In most of these countries, however, economic growth slowed during the 1990s and the early twenty-first century in comparison with prior decades. Slower growth stymied the hopes of providing politically popular rate cuts without increasing budgetary pressures. The supply-sider argument reviewed in Chapter 6 has yet to realize its promised goal in practice.

In response, governments often resorted to increases in payroll taxes and sales taxes earmarked for popular government programs (combined with restrained spending) in an effort to reduce the deficit. Italy and the United Kingdom took the further step of increasing income taxes for the lowest tax bracket during the early twenty-first century. Tax cuts tended to exceed tax increases such that real revenue growth trailed economic growth during the same time period in these six countries. Given the commitment to deficit reduction, this situation motivates governments to try to promote economic growth without raising tax rates or spending significantly. The global economic downturn in 2008 will pose a serious challenge to the continuation of this trend in fiscal policy.

Understanding Policy Reform

If the 1980s were characterized as the decade of tax protest, tax simplification, and tax reduction, the 1990s and the 2000s might be considered a period of quiet revenue-seeking. Center-left and center-right governments alike tried to lower their highest personal and corporate income tax rates while also increasing revenues in other ways. These hunts for revenue expansion were motivated largely by the desire to reduce (or, in Japan's case, to control) the budget deficit. As we saw in Chapter 6, most of the motivation for deficit reduction stemmed from international financial markets and from the monetary unification agreement in continental Europe. To understand the nuances of how governments went about revenue enhancement, we need to consider additional factors.

Prevailing short-term economic conditions clearly played a role in most of these countries. Slow economic growth in all but the United States forced taxation rate increases onto the institutional agenda as a path toward deficit reduction because political considerations made wholesale spending cuts undesirable. Stronger economic growth enabled the United States to zero out its deficit briefly in the 1990s with only one specific tax increase—the jump in the top rate enacted in 1993 at the beginning of the Clinton administration. By the end of the decade, continued economic growth and the budget surplus put tax rate reduction back on the U.S. agenda.

In the other countries, slow growth created pressure for tax rate increases, but the public remained unsurprisingly skeptical. In the case studies, we saw three major strategies used to pursue revenue enhancement in the absence of strong economic growth—increases in indirect taxes, increases in the bottom rate of taxation for individuals and corporations, and the creation of a surcharge income tax. In the three countries pushing to meet the Maastricht fiscal target by 1997, governments tried to blunt opposition by using the proposed benefits of monetary unification as a rationale for tax increases. To reduce further the vibrancy of opposition, governments often placed sunset clauses on tax increases. This sunset clause approach was used differently by the Bush administration to cement legislative support for his tax cut measures in the United States during the early twenty-first century.

We also observed how political unity within the government provides a force for policy stability, whereas divisions within governing coalitions and visible swings in election outcomes make it difficult for governments to steer a coherent course. In particular, multiparty coalitions and major voting swings made policymakers' jobs more difficult in the 1990s in France, Italy, and Japan. Although these three governments used approaches seen in all six countries, we observed situations in which French, Italian, and Japanese governments had to reverse recent decisions in tax policy. The creation of larger, more sustained center-right majorities in France and Italy in the early

twenty-first century buoyed the leaders of those governments, whereas the fragmented Japanese political system continued to struggle to find a successful electoral and policy formula. After the 2005 elections in Germany, the "grand coalition" government headed by Angela Merkel also found it difficult to formulate and pursue coherent tax policies in the face of the ideological diversity within the cabinet. Ideological unity, however, is no panacea for sustained electoral success. Both the Thatcher government in the United Kingdom and the Bush administration in the United States implemented bold policy reforms that bred vibrant opposition and a subsequent change in their political fortunes. Unity makes policy making easier, but it does not necessarily ensure the decisions taken will please a majority of the citizenry.

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