

THE POLITICAL ECONOMY OF HIGH INCOME TAXATION
Capital taxation, path dependence and political institutions in Denmark

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Abstract: Denmark's income tax burden as percent of GDP is larger than the total tax burden of the United States or Japan and increased further in the post-1980 period. How can this be explained, given increasing tax competition and widespread views that strong reliance on "regressive taxes" was conducive to building and maintaining large tax/welfare states? The explanation offered highlights three factors: First, large income taxes are feasible if the capital tax burden is moderated within the income tax, i.e. if the income tax is first and foremost a wage tax. Second, the effective Danish capital income tax burden that had developed up to the early 1980s was so low that subsequent tax reforms could cut marginal tax rates on mobile types of capital income while increasing tax revenue. Third, the combination of drastic changes in the legal structure of the income tax and stability in aggregate tax policy outcomes was facilitated by the combination of proportional representation and legislative majority rule.

Keywords: tax mixes, tax competition, capital taxation, path dependence, proportional representation, veto players

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INTRODUCTION

Much of the recent literature on the comparative political economy of taxation has converged on the following stylized facts. Corporate and personal income taxes were a crucial part of the welfare state in the 1950s and 1960s, introducing some degree of progressivity into the tax system as a whole. In the 1970s, it became clear that income taxes were politically and economically more difficult to sustain than other taxes (Wilensky, 2002, chaps. 10 and 12). In the 1980s and 1990s various factors led to “the reversal of the ideal of progressive income taxation” (Kato, 2003, p. 14), with tax rates being cut while revenue reliance shifted from income taxes to consumption taxes and payroll taxes (social security contributions). Domestically, there was a “paradigm shift” from equity-oriented to efficiency-oriented income taxation (Swank & Steinmo, 2002, p. 645). Internationally, there was growing downward pressure on income tax rates (Hallerberg & Basinger, 1998). The result was a serious “difficulty” (Kato, 2003, p. 22) of increasing income taxes. Hence, strong reliance on “regressive taxes”, i.e., general consumption taxes and payroll taxes, was conducive to building and maintaining large tax/welfare states (Kato, 2003; Wilensky, 2002).

Against the background of these stylized facts, the Danish case stands out as a puzzling outlier. The Danish income tax ratio (revenue/gross domestic product [GDP]) has long been the world’s highest, averaging around 30% during the last 15 years. This ratio was roughly one third higher than the next-highest ratios in Sweden and New Zealand and significantly higher than the *total* tax ratios of countries such as Japan and the United States in the same period (OECD 2003a).¹ What is more, the Danish income tax ratio was around one fourth *higher* in 2002 than in 1975 (see Table 1) – despite the fact that the income tax was subject to continuous and, in part, drastic legal reforms. To maintain a high revenue level, at least some marginal income tax rates had to stay high. While the corporate tax rate was almost cut in half between 1989 and 2005, from 50 to 28%, the top personal income tax rate still amounts to around 63% (in 2005), which is only 4 percentage points below the

1970-level (see Figure 1). Hence, the Danish case is something of an enigma: Why, given the alleged problems of progressive income taxes, was it possible to build such a large income tax? And how can we account for the combination of drastic legal changes and stability in (increase of) the aggregate income tax burden in the post-1980 period?

[Table 1 about here] [Figure 1 about here]

This article answers both questions and challenges some of the above stylized facts. Two main lines of arguments are advanced, both with an economic and a political component. The first line of argument concerns the alleged superiority of “regressive taxes” with respect to states’ revenue-raising capacity. I argue that much of this superiority results from the fact that these taxes imply moderate capital income taxation but that the same result can be achieved by differentiating the tax burdens on capital and labor *within* the income tax. Low income taxation and differentiated income taxation are to some extent economically equivalent. This argument is complemented by a more political argument about path dependence: Because any major shift of the tax burden from one type of tax to another is associated with significant transaction costs and political risks, and because a large degree of policy adjustment can be achieved within the confines of a given tax mix, tax mixes generally reveal a high degree of stability. As will be explained in more detail, this kind of path dependence has contributed to maintaining a large income tax in Denmark.

The second line of argument concerns the combination of drastic legal changes and the remarkable stability of the underlying income tax burden—a phenomenon that is visible in other OECD countries as well (Swank & Steinmo, 2002). I argue that the specific variants of differentiated income taxation implemented in Denmark and elsewhere were pathological in many ways (Ganghof, 2006). Most notably, they implied *too little* capital income taxation. The tax reforms of the 1980s and 1990s therefore reflected no paradigm shift. Rather, they were efforts to rationalize differentiated income taxation and to adapt it to strong but narrowly confined corporate tax competition. Drastic changes of the *legal* status quo were

thus a precondition for defending the underlying *substantive* status quo (cf. McGann, 2004, p. 68).

This insight is important because it helps us to gain a deeper understanding of the causal importance of political institutions. I argue that the Danish combination of parliamentarism, proportional representation (PR) and legislative majority rule contributed to maintenance of a high income tax burden. While this argument draws on well-known claims about the differential effects of “collective” (partisan) and “competitive” (institutional) veto players in welfare state reform, it differs in two related ways. First, while collective and competitive veto points are often seen as “conceptually and empirically distinct dimensions” (Lijphart, 1999, p. 253), I highlight their *interdependence*. More specifically, the effect of PR on policy change is conditional upon the existence and strength of institutional veto points. Second, while the standard argument is that institutional or “competitive” veto points mitigate “neoliberal” policy change in the retrenchment era (Huber & Stephens, 2001, p. 309; see also Swank, 2002, pp. 48-51), I show that this is not always the case. The reason is precisely that the defense of the *substantive* status quo may require drastic changes of the *legal* status quo. If this is the case, institutional veto points may favor, rather than weaken, the forces of retrenchment. Evidence for these claims is partly provided by contrasting Danish income tax reform to the cases of Germany and New Zealand.

The argument proceeds as follows. The next section situates the Danish case in the comparative literature on the political economy of taxation. Sections 3 and 4 summarize the development and economic characteristics of the Danish income tax in historical and comparative perspective. Section 5 discusses the politics of differentiated income taxation. The final section summarizes the argument and makes suggestions for further research.

THE DANISH ANOMALY IN THEORETICAL PERSPECTIVE

The main goal of this article is what Collier and Mahoney (1996, pp. 71-2) call “complexification based on extreme cases”. I will use the in-depth investigation of what appears to be an outlying case in order to challenge more general theoretical arguments about the political economy of taxation. This section discusses the relevant theoretical issues, starting with the role of tax mixes and moving on to the stylized facts about post-1980 policy change.

TAX MIXES AND TAX STRUCTURE

The Danish case is an anomaly for the kind of tax mix arguments advanced by Wilensky (2002) and Kato (2003). Wilensky (2002, chap. 10) argues that strong reliance on income and property taxes is positively associated with the likelihood and/or degree of “tax-welfare backlash” at the level of *electoral politics*. The rise of Danish Progress Party, leading to the “political earthquake” elections in 1973 (e.g., Miller, 1996, pp. 128-43), is the paradigmatic example. However, Wilensky cannot explain why the political backlash seems to have had no policy effects (Table 1). Wilensky (2002, chap. 12) also advances an argument about tax mixes and the *economic* sustainability of high taxation and spending levels. He claims that income (and property) taxes are a “drag on economic growth” whereas “consumption and payroll taxes are good for the economy in the long run because they foster savings and investments” (2002, p. 392, see also pp. 453, 457, 483). Yet while Denmark’s strong reliance on indirect consumption taxes (16.2% of GDP in 2002) is consistent with this argument, its strong reliance on a huge income tax is not.

Kato’s general argument is that “a revenue shift to regressive taxes makes it politically easier to maintain a large public sector” (2003, p. 51) and hence that “a mature welfare state is closely connected to a larger reliance on regressive taxation” (p. 112). In addition to the lower visibility of (some) regressive taxes and the lower tax burden on capital

induced by them, she also highlights flat tax rates and earmarking for social programs as important advantages (Kato 2003, pp. 7, 14, 52, 106, 199, *passim*). Kato qualifies the general argument with a subsidiary argument about path dependence: only countries that implemented “regressive taxes” (most notably value-added taxes) rather *early*, experienced the positive causal effect of a regressive tax mix on its revenue-raising capacity. After the 1980s, so the argument goes, increased public knowledge and suspicion about this effect prevented the regressive “revenue machines” from displaying their full potential (Kato 2003, pp. 196-7).

Kato acknowledges the Danish exception to her argument but does not analyze this case. She claims that it is explained by the fact that “the country has no revenue items that correspond to social security contributions in other countries and that it finances social security expenditures by a general revenue reliant heavily on income tax” (Kato 2003, p. 197, see also p. 17, n. 17). However, this merely restates the puzzle. It is at best an explanation of why (some) Danish policymakers wanted to maintain an exceptionally high level of income taxation and not how this was feasible.

The economic explanation I offer is simple. I accept two basic premises of Wilensky, Kato and others. First, I do not deny that the economic, political and/or administrative “efficiency” of tax *structure* can have a positive causal effect on the sustainability of high *levels* of taxation—although I believe that the causality can also take the other direction; tax structure and tax level are best considered part of an equilibrium (Hettich & Winer, 1999). Second, I agree that the tax mix is a very important aspect of tax structure. However, I depart from these authors in one way: with respect to the crucial issue of capital taxation, I reject the implicit assumption that strong reliance on regressive types of taxes is the *only* way to keep the capital tax burden moderate. This goal can also be achieved by differentiating the tax burden *within* the income tax, as emphasized, e.g., by Przeworski and Wallerstein (1988). I argue that once we focus on the relative tax burdens on capital and labor, the Danish puzzle

can be solved by demonstrating that the kind of income tax that had developed in Denmark is a highly *differentiated* one that moderates the aggregate tax burden on capital. The more general point is that there is a “very large overlap in base” among income, sales and payroll taxes, which reduces the importance of the tax mix (Boadway, 1999, p. 386).

The explanation offered implies that so-called “tax expenditures” for capital income, most notably for retirement savings and owner-occupied housing, are not only “hidden” forms of welfare provision (Ervik, 2000; Howard, 1997) but also have a straightforward taxation rationale. Large income taxes with privileges for capital are to some extent *substitutes* for a strong reliance on “regressive taxes”. Once this is recognized, we can see the link between arguments about regressive taxes as revenue-machines and similar claims about progressive taxes. For instance, Steinmo (1993, p. 182, emphasis in the original) argues that “postwar economic growth turned progressive taxes ... into enormously lucrative revenue machines. They were so lucrative that tax policymakers could offer special tax expenditures *and* increase tax revenue.” This is true as far as it goes, but the causal arrow most likely also goes in the other direction: *Because* policymakers offered special tax expenditures to capital income, they could build lucrative revenue machines without hurting economic growth (cf. Hettich & Winer, 1999, p. 59). The common characteristic of progressive and regressive “revenue-machines” may well be lenient capital taxation.

Kato (2003) at one point seems to endorse this view. She acknowledges that *in theory* there are types of direct taxes that reduce the level of capital income taxation in a systematic matter and claims that if these taxes were to become “new tax policy”, they “may thwart the existing association” between regressive taxation and large welfare states (p. 199). What she has in mind are direct taxes that are identical to conventional income taxes in terms of visibility, progressivity and lack of earmarking for social programs, but whose tax base is similar to that of European-style value-added taxes. That is, these taxes exempt a significant part of what is conventionally called “capital income” from taxation. However, Kato (2003.

p. 199) incorrectly states that these taxes are “still far from being implemented”. For while it is true that few countries have implemented them *consistently*, many of their elements have long characterized the differentiated income taxes of advanced OECD countries (Aaron, Galper & Pechman, 1988), and the resulting aggregate tax burdens were often indistinguishable from the theoretical taxes considered by Kato (see below). Hence the policy described by Kato is not new and the resulting challenge not counterfactual.

STABILITY AND CHANGE IN INCOME TAX POLICY

The focus on differentiated income taxation is also important for understanding the relationship between two stylized facts about post-1980 policy change in advanced OECD countries: (1) drastic changes in the *legal structure* of income tax systems (tax rates and tax base definition); (2) a remarkable stability in the underlying *levels* of taxation, regardless of whether one looks at total taxation, income taxation or capital taxation (Swank & Steinmo, 2002). The first observation has led to the diagnoses of “paradigm shifts” and “policy reversals” cited in the introduction, the second observation to sophisticated explanations for why economic internationalization has not led to a race to the bottom in capital taxation. For instance, Basinger and Hallerberg (2004) assume that there was significant downward pressure on the entire capital tax base and argue that domestic politics—left governments and ideological differences between veto players—explains why this pressure did not lead to visible patterns of a race-to-the-bottom.

I propose a different perspective (Ganghof, 2000; 2006, chaps 3-4). The tax reforms of the 1980s and 1990s were first and foremost efforts to rationalize the existing approach of differentiated income taxation. The tax reforms did not fundamentally change the weighting of different tax policy goals (efficiency and equity) but tried to better achieve both goals. This seemed possible because the pathological *variants* of income tax differentiation that had developed up to the late 1970s turned out to undermine efficiency, progressivity and revenue-raising alike (Ganghof, 2006). Due to the unsystematic nature of tax privileges for capital,

they turned out to imply “too little” capital income taxation. In fact, capital taxation in some places and periods led to *revenue losses*, so that marginal tax rates on labor income were higher than they would have been if capital had been completely tax exempt. Examples are the U.S. and Scandinavia in the 1980s (Gordon, Kalambokidis & Slemrod, 2004; Sørensen, 1998), including, as we will see, Denmark. The reforms of the 1980s and 1990s responded to these pathologies.

However, policymakers did not abandon the approach of differentiated income taxation altogether. The reason is that significant levels of income taxation continued to be predicated on moderating the tax burden on many types of capital. Moreover, policymakers were forced to adjust the precise *form* of tax burden differentiation to corporate tax competition. Prior to the 1980s, many countries combined fairly high corporate tax rates with investment incentives (Huber & Stephens, 1998; Przeworski & Wallerstein, 1988). Increasing corporate tax competition rendered this policy infeasible and forced countries to cut both corporate tax rates and investment incentives (Ganghof & Eccleston, 2004; Ganghof, 2006). Due to the differentiated approach to income taxation, however, adjustment to tax competition did not have to lead to revenue losses. Even if policymakers were forced to cut statutory—and perhaps even effective—tax rates on some types of capital income, they also had plenty of opportunity to simultaneously increase the tax burden of less sensitive types of capital income that had been taxed very lightly in the past. Due to this possibility of shifting the tax burden *within* the capital income tax base, the competitive pressure on this base *as a whole* was probably much smaller than is assumed by Basinger and Hallerberg (2004).

This does not mean that domestic political institutions do not matter in explaining the stability of aggregate policy outcomes. However, it does suggest a more conditional effect of veto players. For if drastic changes of the *legal* status quo were needed to defend the *substantive* status quo in terms of aggregate tax burdens, veto players may be associated with more, rather than less, substantive policy change. But before we look into this in more detail,

we have to put the economics of the Danish income tax into historical and comparative perspective.

THE DANISH INCOME TAX: 1903-2005

The Danish personal income tax, instituted permanently in 1903 (Kraus, 1981, p. 191), was characterized by large tax privileges for capital from the start. The two most important types of personal capital income are household savings in the equity of owner-occupied housing and pension savings. Homeowners benefited greatly from the full deduction of interest payments. Such a deduction is no “tax expenditure” if the return on the investment in owner-occupied housing is taxed at the same tax rate at which the interest is deductible. But although Denmark also introduced a tax on the rental value of owner-occupied housing in 1903, this tax never balanced the value of the mortgage interest deduction (Lefmann & Larsen, 2000, p. 192-3). Social Democrats were never able to organize majorities in favor of reducing homeowner tax privileges. In 1973, a social democratic proposal to reduce tax deductions even provoked a rightist splinter, which developed into the Centre Democratic Party, based on the defense of homeowner interest (Esping-Andersen, 1985, pp. 183-6, 265-6).

Pension contributions were considered part of taxable income by the laws of 1903, and the law of 1912 explicitly included all forms of voluntary or compulsory contributions. In 1922, however, personal contributions were made deductible up to a ceiling. From then on, and until the early 1980s, the growth of the income tax was accompanied by a growth in tax privileges for pension savings (Ervik, 2000, pp. 172-3). In 1924 employer contributions to pension funds became deductible and fund income tax-exempt; in 1955/56 the ceiling for the deductibility of pension contributions was abolished; in 1961 tax incentives were further extended by introducing individual pension accounts; in 1972 all contributions to capital lump-sum pension saving schemes were regarded as employer contributions, so that taxpayers’ own contributions became fully tax deductible as well.

Hence the two most important types of *personal* capital income were taxed at much lower effective rates than was labor income. The *corporate* income tax, introduced in 1922, was not much of a counterweight (see Table 1). By 1965 the corporate income tax burden had “only” grown to 1.4% of GDP (personal: 12.4%), and while personal income taxes almost doubled in the following 15 years, corporate tax revenues remained unchanged. Like most other OECD countries, and the Nordic countries in particular, Denmark relied heavily on investment incentives in order to mitigate the adverse effects on investment and growth (Huber & Stephens, 1998). But even statutory corporate tax rates were not particularly high in international comparison (Figure 1).

As a result of the various tax expenditures for capital income, the growth in Danish income taxation was mainly the growth of the *taxation of wages* (and transfers). While this development certainly reflected the high economic, political, and administrative costs of taxing capital income (Hettich & Winer, 1999; Lindert, 2004; Przeworski & Wallerstein, 1988), the unsystematic nature of tax privileges for capital created an aggregate tax burden for capital which was below what policymakers had intended (e.g. Lotz, 1993). In fact, due to the combination of liberal interest-deductibility rules with low taxation of pension savings and owner-occupied housing, taxes on personal capital income implied a substantial *loss* of revenue for Danish governments (Sørensen, 1998). Sørensen (1988, pp. 300–1) estimated that in 1986 the revenue loss from personal capital income was 1.6% GDP, which was roughly balanced by the revenue collected from corporate taxation (Table 1). Hence the aggregate tax burden resulting from the “income” tax was similar to that of a pure wage tax.

The unsystematic forms of tax discrimination in favor of capital income—which existed in the other Nordic countries as well—undermined not only the revenue yield of Danish capital income taxation but also its efficiency and equity objectives (Ganghof, 2006, chap. 6; Nordic Council for Tax Research, 1993). In response to these problems, policymakers started to reform income tax policy in the early 1980s. From 1982 to 1993 and

after 2001 tax reform took place under center-right minority coalitions, from 1993 to 2001 under Social Democratic-led coalitions, most of which also had minority status.

In 1983 tax privileges for private pensions were reduced, partly as a response to criticism of the labor movement (Nannestad & Green-Pedersen, Forthcoming). In 1985 broad partisan agreement was reached on a fundamental tax reform to take effect from 1987. A Dual Income Tax (DIT) was introduced, which separated capital and labor taxation (Lotz, 1993). Capital income was generally subjected to a uniform proportional tax rate of 50%, whereas wages continued to be taxed progressively at somewhat reduced marginal rates (the top rate fell from 73 to 68%). The capital income tax base was broadened. Because tax competition was not yet an issue, the corporate tax rate was *raised* from 40 to 50% in order to align it with the tax rate on private capital income. This alignment is crucial in order to achieve the efficiency advantages of uniform and proportional capital income taxation (Sørensen 1998, p. 23). The idea behind the DIT was to make capital income taxation more “market-conforming” (Swank, 1998) without constraining the progressivity and revenue-raising potential of *wage* taxation too much. The most important effect of the reform was to reduce the tax value of interest deductions. In the old system, interest payments (i.e., negative capital income) had been deductible against the top marginal tax rate on wages of up to 73%. By reducing the capital income tax rate to 50%, the implicit tax subsidy for homeowners was reduced so that tax revenue increased.²

In the 1990s policymakers started to move away from the DIT, because they wanted a more fine-grained differentiation of statutory tax rates and effective burdens (Sørensen 1998). An important reason was corporate tax competition, which had heated up after the U.S. tax reform of 1986 (Andersson, Kannianinen, Södersten & Sørensen, 1998, p. 118; Hallerberg & Basinger, 1998). The corporate tax rate fell to 34% (from 1993) and was later cut further to 30% (from 2001) and 28% (from 2005). A *general* cut of the capital income tax rate to this reduced level was out of the question, however. Policymakers feared adverse economic and

electoral effects of a further reduction of tax subsidies for homeowners as well as adverse electoral effects of an increasing tax rate gap between capital and labor taxation (Sørensen 1998, p. 23). As a result, they decided to again include some types of *positive* capital income into the progressive rate schedule applying to wages: interest income, the (still underestimated) rental value of owner-occupied housing, and short-term capital gains. Long-term capital gains and dividends were jointly taxed under a separate two-bracket rate schedule, which—together with the corporate income tax already paid—resulted in marginal tax rates similar to the rate on the other, progressively taxed capital income. To make this re-inclusion of capital income into progressive income taxation possible, cuts in the marginal tax rates on labor were phased in over a five-year period. The top personal rate (ceiling) fell from 68 to 58%. Roughly one half of the cut in marginal rates was financed by the introduction of “green” excise taxes, the other half by new “social security contributions”. Since these are in fact proportional income taxes on gross wages, the de facto top rate on wages fell only to 61.8%.

Despite reduced marginal tax rates, many important types of capital income were considered too “sensitive” to be (re-) included into the progressive income tax: the tax rate on the retained profits of unincorporated businesses was reduced to the corporate rate to achieve neutrality between different legal forms of doing business; owners of shares in a quoted company were fully exempt from capital gains tax after a holding period of three years, provided their total share portfolio did not exceed a certain amount; pension savings continued to be treated under separate tax rules.

In 1998, a booming economy provided the government with the chance to further reduce the tax value of interest deductions and thereby dampen consumption. Based on an agreement between the Social Democratic-led minority coalition and the left opposition parties, the tax value of interest deductibility was reduced to 32% from 2001 onwards (OECD, 2000, pp. 86–89). A flat rate on interest from pension savings of 15% was

introduced (also from 2001) and statutory income tax progressivity was increased slightly, with the top personal tax rate increasing to 62.7% (Figure 1).

In 2003 a Liberal-Conservative minority government passed an income tax reform to be implemented from 2004–2007, which contains rather moderate income tax cuts, rising to 0.75% of GDP in 2007. The top personal income tax rate of around 63% will not be reduced. Instead, the main elements of the tax reform are an increase in the threshold for the medium tax bracket and an earned income tax credit. Hence in 2007 the Danish income tax burden will still be well above the 1985-level (Figure 1).

In sum, the combination of many legal changes and stability in aggregate tax policy outcomes is explained by the fact that the differentiated income tax approach was modernized and adapted rather than abolished. This allowed policymakers to *increase* the tax burden on types of capital income that had been taxed at a low level in the past. While the capital income tax revenue from the household sector continues to be slightly *negative* (see Table 1), Eurostat (2004) puts the total capital income tax burden at 3.5% of GDP (for 2002).³ This makes for an average effective income tax rate on capital of 16.1%, compared to a corresponding rate for (employed) labor of 39.9% (Eurostat, 2004, p. 146). Differentiated income taxation allowed policymakers to respond to strong but narrowly confined tax competition without reducing the revenue-raising potential and/or effective progressivity of the income tax. Wages and less sensitive types of capital income continue to be taxed at rather high marginal tax rates, and there is little indication that the post-1982 reforms have had significant effects on the redistributive potential of the income tax, which had always been rather limited (Kenworthy, 2005).

QUANTITATIVE COMPARISON

The argument advanced so far hinges on the claim that countries with high income taxes moderate the capital tax burden *within* the income tax, so that the importance of the tax

mix is reduced. This section provides comparative evidence for this claim. I start by clarifying two methodological issues. First, the argument about tax mixes is based on the positive statistical association between indicators of (changes in) reliance on general consumption taxes and (changes in) high social security expenditure (Kato 2003, chap. 1). But this association is not surprising, as it largely reflects a causal chain going *from* social spending *to* consumption taxes: high levels of (changes in) spending must sooner or later lead to high levels of (changes in) total taxation, which in turn lead to high levels of (changes in) the major types of taxes, typically including general consumption taxes (cf. Kato 2003, p. 51). Therefore, my goal here is certainly not to question the statistical association, but to present evidence suggesting that a broader definition of tax structure—one that does not focus exclusively on the tax mix—leads to a *better explanation* of it.

Second, in pursuing this goal I will focus on the total tax ratio (revenue as % of GDP) rather than social spending as the dependent variable. The reason is simply that there is no direct causal link between tax mixes and social spending. Tax mixes may at best influence states' *capacity to raise tax revenue*, which may or may not translate into higher welfare spending in a second step. Focusing on the first part of the causal chain leads to a clearer empirical picture, because we do not have to worry about cross-country differences in non-tax revenue, public deficits or budget composition.

[Table 2 about here]

Table 2 shows the strength of the correlations between the total tax ratio and indicators of tax structure. The relevant data is available for 22 OECD countries and the period from 1975-2000, which is divided into three sub-periods (1975-80, 1981-90, 1991-2000).⁴ The first two indicators are general consumption taxes and the sum of payroll and consumption taxes (both as % of GDP). They stand for narrow and broad tax mix arguments, respectively. As expected, the table reveals fairly high correlations. However, based on the arguments of this paper, we can expect that the correlation is strengthened if we amend the

second indicator by taking into account the labor income tax burden *within the income tax*. This is because differentiated income taxes, payroll taxes and general consumption taxes are to some extent *alternative* ways of shifting the tax burden onto wages. The last row of Table 2 supports this argument: the overall average effective tax rate on labor and consumption estimated by Carey and Rabesona (2002) reveals a considerably stronger correlation with the total tax ratio.

[Figure 2 about here]

The main reason for this result is that policymakers can determine the income tax burden on wages and capital independently within relatively broad limits. To show this, we need estimates of the average effective income tax burden on capital. Such estimates are provided by Eurostat (2004) for the 15 old European Union countries (the EU-15) and the years 1995–2002. Figure 2 shows the scatterplot of income tax revenues as % of GDP versus the average effective tax rates on capital income. It superimposes a lowess smooth (locally weighted linear regression smoother), which does not assume a particular functional form.⁵ The figure makes clear that policymakers do indeed determine labor and capital income tax burdens independently, at least beyond a certain level of income taxation. Countries like Belgium, Sweden, or Denmark have high income tax burdens without having particularly high capital income tax burdens; *the extra income tax burden is borne (almost) exclusively by wages*.

The only exception is Finland, but I show elsewhere that the country's high tax burden on capital *income* is balanced by a very low tax burden on *stocks* of capital; once we consider the relationship between the total tax ratio and average effective tax rate on capital (income and stocks), a picture similar to that in Figure 2 emerges but Finland ceases to be an outlier (Ganghof, 2005). In fact, the total capital tax burdens of Finland (31%) and Denmark (30.5%) are only slightly above the EU-15 average of 27.5%, while the country with the largest capital tax burden of 35.5% is France, its strong reliance on “regressive taxes”

notwithstanding (cf. Kato 2003, pp. 94-112). From a broader perspective on tax structure, therefore, France is more puzzling a case than Denmark.

THE POLITICS OF REFORM IN COMPARATIVE PERSPECTIVE

Thus far, the argument has focused on the partial economic equivalence between strong reliance on “regressive taxes” and reliance on a large but differentiated income tax. However, these two options are not politically equivalent because differentiated income taxation makes the “discrimination” of labor incomes that is typical of high-tax countries more visible. In addition, it tends to lead to arbitrage behavior and administrative complexity. As I show for a variety of countries, these political and administrative costs *do* create significant incentives to flatten and/or reduce income taxes (Ganghof, 2006). Yet the previous section has shown that these incentives have had rather moderate effects in Denmark. In this section, I highlight two factors that contributed to this outcome: path dependence and political institutions.

PATH DEPENDENCE

As explained above, Kato (2003) uses the idea of path dependence mainly to limit the temporal and spatial domain of her argument about regressive taxes. However, an older and more general argument about path dependence and tax mixes is relevant here. In 1801, the French economist Canard (1969 [1801]) *prescribed* path dependence by postulating the tax reform principle that “old taxes are good taxes”. He essentially believed that the entire tax burden is shifted equally onto everyone, so that any change in the tax mix would induce costly adjustment processes without being able to change tax incidence. While Canard's incidence assumption is of course outdated, part of the underlying logic still applies: Because there is a large overlap in base among the major taxes (income, sales and payroll), and because major overhauls of the tax mix are likely associated with significant transaction costs and political risks, centrist and pragmatic policymakers have strong incentives to focus on

policy adjustment *within* the confines of a historically developed tax mix. As we have seen, in countries with high income taxes, adjustment partly takes the form of tax privileges for capital. In countries with high payroll taxes (social contributions), in contrast, it partly takes the form of introducing elements of progressive income taxes into the contribution system, e.g. by removing the ceilings above which no contributions have to be paid or by introducing a basic personal allowance, i.e. a zero rate tax bracket (Messere, de Kam & Heady, 2003, p. 21). In either case, the need to change the tax mix is reduced.

Let us specify this general path dependence argument with respect to the post-1980 income tax reforms. These reforms were generally based on the idea of equalizing the tax treatment of different types of income (Swank, 1998). Taken to its logical extreme, this idea leads to a flat income tax, which reduces the marginal tax rate on *all* types of income to the level that is acceptable for the most sensitive types of capital income. Such a tax maximizes equal treatment as well as administrative simplification, and it can maintain some degree of progressivity by way of a basic tax allowance. The political attractiveness of a flat income tax, however, seems to be predicated on whether it can be implemented in a revenue-neutral way and without reducing effective progressivity too much (Ganghof, 2006). As a result, low levels of income taxation tend to make it easier to build a political case for flatter income taxes. This is true despite the fact that the *eventual implementation* of flattening exercises is often combined with net reductions of the tax burden.⁶

It is not surprising, therefore, that the flat tax model has gained political ground in countries with low levels of income taxation: it has increasingly taken center stage in “Bismarckian” welfare states like Germany and has already been implemented in a number of Central and Eastern European countries (Ganghof, Forthcoming). In Denmark, by contrast, the political attractiveness of a flat tax is greatly reduced by the fact that its revenue-neutral implementation is *economically impossible*. With an income tax ratio of almost 30%, a flat tax with a significant basic allowance would require a tax rate that is much greater than the

current corporate tax rate of 28% (Nielsen, Frederiksen & Lassen, 1999, p. 125). Instituting a truly equal treatment of all types of income would thus have to be combined with the complete abolition of progressivity and/or a major shift of the tax burden away from the income tax.

In sum, therefore, the high level of income taxation in Denmark makes the income tax *easier* to defend. When income taxes are low to begin with, differentiated or dual income taxation requires complicated and risky political justification, whereas flat taxes seem like the natural endpoint of policy learning. When income taxes are high to begin with, the opposite is more likely.

POLITICAL INSTITUTIONS

Path dependence cannot be the whole story, however, because not all political parties in Denmark have followed the centrist and pragmatic logic just outlined. There *have been* significant political forces that pushed for a major overhaul of the tax system. The Progress Party under the leadership of Glistrup is an obvious example, as it called for the complete abolition of income taxes (Wilensky 2002, p. 377). Why have such forces not affected tax policy outcomes to a greater extent?

An important part of the answer is political institutions. Denmark's combination of legislative majority rule with proportional representation (PR) and hence multiparty politics worked against drastic income tax cuts by creating a centripetal political dynamic and by limiting the power of right-wing parties (cf. Gerring, Thacker & Moreno, 2005; Iversen & Soskice, 2005; McGann, 2004).⁷ PR was important because even when Denmark's right-wing parties were in government they needed the support of centre parties and/or Social Democrats in order to change the legislative status quo. Legislative majority rule was important because right-wing parties did not have guaranteed veto power that would have allowed them to make urgently needed structural tax reforms conditional upon large-scale tax cuts.

Consider first the importance of PR in the retrenchment era. Even when Denmark was governed by right-leaning governments (1982-93, 2001-), these had minority status and needed the legislative support of at least one of the more centrist parties (traditionally the Center Democrats, Social Liberals or Christian People's Party), which led to more moderate policy change. Often they also needed the support of the oppositional Social Democrats, which allowed the latter to extract important concessions (Ganghof 2006, chap. 6). In the early 2000s it was actually the successor of the Progress Party, the Danish People's Party—which had developed a more centrist profile on economic issues—that used its bargaining power vis-à-vis a Liberal-Conservative minority government to reduce the size of income tax cuts (Bille, 2004, pp. 990-1).⁸

The importance of PR is highlighted by contrasting the Danish case to that of New Zealand, the country with the world's second-largest income tax burden (20.6% of GDP in 2002). In the 1980s, New Zealand's single-member plurality system facilitated the formation of one-party Labor majority government that were "captured" by radical reformers and practiced "neoliberalism by surprise" (Stokes, 2001, pp. 2-3). The top personal income tax rate was cut in half, from 66 to 33%, and some of the tax burden was shifted onto indirect consumption taxes. Only after the switch to PR did the Labour Party return to a center-left stance and, in a minority coalition with a left party, set the top personal rate at 39% (from 2000) in order to increase progressivity and finance new expenditures (Ganghof, 2006, chap. 5).

This argument about the moderating and centripetal effect of inclusive electoral institutions is of course well known in the literature on welfare state reform. Following Lijphart's (1999) distinction between two dimensions of democracy, a number of scholars distinguish between "collective" (partisan) and "competitive" (institutional) veto points/players and argue that they had different effects on welfare state development (Birchfield & Crepaz, 1998; Huber, Ragin & Stephens, 1993; Swank, 2002). My argument

builds on this literature but emphasizes the oft-neglected *interdependence* between partisan and institutional veto points or players. Two arguments about this interdependence are important in the present context.

First, the combination of PR-parliamentarism and legislative majority rule can lead to a centripetal dynamic and induce right-wing and left-wing minority parties to adopt compromising policy stances (McGann, 2004). On the one hand, the so-called “instability” of majority rule can induce (likely) members of the majority coalition to look for broad consensus in order to achieve more stable policy-making over time. On the other hand, (likely) minority parties have an incentive to adopt centrist and compromising policy stances in order not to be excluded from policymaking altogether and to increase the chance of becoming part of a majority coalition in the future. In contrast, if minority parties possess institutional veto power, their incentives to compromise will often be *reduced*.

The second argument is based on a more substantive theory of social policy preferences. Iversen and Soskice (2005) argue that PR generally creates a left-wing bias in coalition-formation and therefore promotes redistribution. This could explain the statistical association between “collective” veto players and redistribution. As the authors note, however, the theoretical logic breaks down for a country like Switzerland because “right parties cannot be excluded from government power” (2005, p. 21, n. 12). It would be more adequate to say that these parties cannot be excluded from *legislative* power, though, because the ultimate source of the right parties’ veto power is not their participation in government, but the existence of strong veto points: the referendum, strong bicameralism and decentralized federalism.⁹ The institutionalization of the country’s permanent, oversized four-party coalition (from 1959) was itself to a large extent a *response* to these veto points (e.g., Kobach, 1993). Hence it is precisely Switzerland’s “competitive” veto points that seem to suppress the redistributive logic that Iversen and Soskice associate with PR and hence with “collective” veto players. In contrast, the prime examples for the redistributive logic that

Iversen and Soskice have in mind are the Scandinavian countries, where PR combines with legislative majority rule.

To see the importance of this combination in Denmark, consider first an example from the expansion period of the income tax and the welfare state: the introduction of the tax-financed, national flat-rate universal pension scheme in 1956, which is widely seen as the most important reform of the entire post-war period (Petersen, 1998, p. 137). Universal pensions had originally been rejected by the Social Democrats and the rightist parties (Liberals and Conservatives) but favored by the centrist Radical Liberals, who controlled the median legislator on the left-right dimension (Damgaard, 2000, p. 234). First the Social Democrats changed their mind. While the reasons for this are complex, one of them clearly was to get the support of the Radical Liberals (Petersen, 1998, p. 140). More importantly, once the Social Democrat minority government and the Radical Liberals had achieved basic agreement on universalist pension reform, a centripetal reform dynamic emerged. The two parties had a narrow majority in parliament (Miller, 1996, p. 56) but aimed at broad partisan agreement in order to secure intertemporal stability of pension reform (Petersen 1998, pp. 149-50). However, they made it very clear that they would use their legislative majority if the Liberals or Conservatives demanded too much (Christensen, 1992, p. 63). Hence these two parties moved towards the government even though both of them favored different reform concepts and a greater reliance on social contributions (payroll taxes). The Conservatives in particular wanted a different direction of policy change: “Tapping new sources of revenue other than progressive taxation through a proportional contribution was the point they pressed” (Baldwin 1990, p. 152; see also Petersen 1998, pp. 140-9). Had they possessed institutional veto power, they would very likely have insisted on this preference for “regressive taxation”, which could have given the development of the Danish tax/welfare state a different direction. Given legislative majority rule, however, they eventually perceived it to be in their interest to achieve marginal improvements rather than to be excluded from

policymaking altogether (Christensen 1992, p. 64; Petersen 1998, p. 141). Hence both parties eventually agreed to the government's reform, which was passed almost unanimously. The main concession granted to the Conservatives, the introduction of an inflation-proof savings scheme, was abolished 15 years later (Baldwin, 1990, p. 152).

Consider next the importance of legislative majority rule for income tax reform after 1982. A standard argument in the welfare state literature is that the causal effect of institutional veto points is reversed in this period because they hinder retrenchment rather than expansion (Huber & Stephens, 2001, p. 309; see also Swank, 2002, pp. 48-51). This is true as far as it goes, but the opposite may be the case if drastic changes of the *legal* status quo are needed to maintain or improve the *substantive* status quo (McGann, 2004, p. 68). As explained in section 3, this was precisely the situation in Danish income taxation: the legal structure of the income tax had to be reformed urgently in order to respond to the above-mentioned pathologies as well as to competitive pressure on certain parts of the capital tax base, especially in corporate taxation. But this means that if the rightist parties (Liberals, Conservatives and the Progress Party) had possessed institutionally guaranteed veto power, they could have made their agreement to structural changes dependent upon significant reduction of the overall income tax burden. Legislative majority rule stacked the decks against such a scenario and contributed to pragmatic policy stances of the political right.

To see that this scenario is by no means far-fetched, contrast the Danish case to that of Germany (for details, see Ganghof 2006, chap. 7). The German case is characterized by a much smaller income tax burden (13 % of GDP in 1985) but two powerful institutional veto points: the upper house (Bundesrat) and a very powerful and activist Constitutional Court. Like their counterparts in Scandinavia, German Social Democrats, which governed together with the Greens from 1998 to 2005, came into office with a strong commitment to structural tax reform, revenue-neutrality and budget consolidation. In addition, there had been increasing debates about shifting the tax burden *away* from very high payroll taxes in order to

increase employment of low-skilled workers (Scharpf, 2001). The last thing one would have expected from the Red-Green government, therefore, was effective cuts in the income tax burden. This was exactly the outcome of tax reforms, however; and Germany's "competitive" veto points were a crucial contributing cause. The reason is that the government desperately needed to improve the *legal structure* of the income tax, most notably by drastically reducing the extremely high corporate tax rate of 57% (1998). Backed by a veto threat of the Constitutional Court, however, the right-leaning opposition in the Bundesrat made such a cut conditional upon across-the-board cuts of *personal* income taxes and a significant net reduction of the income tax burden. The top personal tax rate fell from 56 to 44% (in 2005), and the overall net tax reduction achieved by the government's tax reforms is put at around 3% of GDP, which is roughly equal to the structural budget deficit in 2005. Hence because the left-leaning government urgently needed to change the *legal* status quo on certain salient dimensions, legislative veto points gave right-leaning parties the power to achieve more drastic changes of the underlying *substantive* status quo in income taxation. Had the Danish institutions given rightist parties similarly strong veto rights, the requirements of corporate tax competition would probably also have had more far-reaching effects on personal income taxation.

In sum, then, it is the *combination* of PR and legislative majority rule that has reduced the likelihood of more radical policy changes in Denmark. PR has worked against the kind of "neoliberalism by surprise" visible in New Zealand, while legislative majority rule has worked against the kind of "neoliberalism by default" visible in Germany.

CONCLUSION

This article has offered an explanation for the economic and political viability of extremely high income taxation in Denmark. The two main lines of argument advanced can be generalized and raise questions for further research. First, very high income taxation is

facilitated if the capital income tax burden is moderated within the income tax. That is, differentiated income taxation is, in part, an economic equivalent to strong reliance on “regressive taxes”. Related to this, tax mixes are generally path-dependent because significant policy adjustment can be achieved within the confines of a given tax mix and because major changes of the tax mix tend to be associated with significant transaction costs and political risks. These points have not yet been adequately addressed in quantitative tests of the effects of tax mixes on the development of tax/welfare states. More to the point, greater attention should be given to evaluating the *relative* empirical performance of *different* conceptions of tax structure. While the existing literature in political science has tended to equate “tax structure” with “tax mix”, the Danish case reveals the pitfalls of this equation. For if there is a large overlap in base among the major types of taxes, the underlying tax burdens on capital, labor and consumption may be more important than the mix between institutional types of taxes.

The second line of argument concerns the role of political institutions. In line with much of the literature on welfare state reform, I have emphasized that the effects of proportional representation/multi-party politics (“collective veto points”), on the one hand, and institutional (“competitive”) veto points, on the other, differ systematically. Yet I depart from much of the literature in two ways. First, I conceptualize the two dimensions of veto points as being interdependent rather than independent. The effect of proportional representation on welfare state reforms is itself conditional on the veto power of minorities. Future regression analyses should therefore include tests for an interaction effect between the two veto point-dimensions. Second, institutional veto points do not always mitigate changes in aggregate policy outcomes like tax burdens or social spending. The reason is that drastic changes in the *legal* status quo (policies) may be necessary to defend the underlying *substantive* status quo (outcomes). If this is the case, the guaranteed veto power of minorities may facilitate rather than prevent substantive policy change.

Table 1. Danish Taxes as % GDP

	1924	1948	1965	1970	1975	1980	1985	1990	1995	2002
Total taxes	10.8	20.4	29.9	39.2	40.0	43.9	47.4	47.1	49.4	49.8
Income taxes	4.6	8.9	13.7	20.1	23.6	24.3	27.1	27.6	30.0	29.4
Personal income taxes	–	–	12.4	19.1	22.4	22.9	23.9	24.8	26.7	26.3
Taxes on capital income of households	–	–	–	–	–	–	–	–	–	-.6
Taxes on income from self-employment	–	–	–	–	–	–	–	–	1.3	1.2
Corporation tax	–	–	1.4	1.0	1.2	1.4	2.3	1.5	2.0	2.9
Income taxes	–	–	9.0	10.4	11.6	12.4	12.7	13.2	12.8	13.4
OECD										

Notes: For some entries, 2001 values are given in the last column. The OECD average is unweighted and refers to the “OECD Total” entry in OECD (2003a: 77). Income taxes on the self-employed include social security contributions.

Sources: OECD (2003). The data for the years 1924 and 1948 come from Flora (1983, pp. 262, 291), data on income taxes of households and self-employed from Eurostat (2004, p. 146).

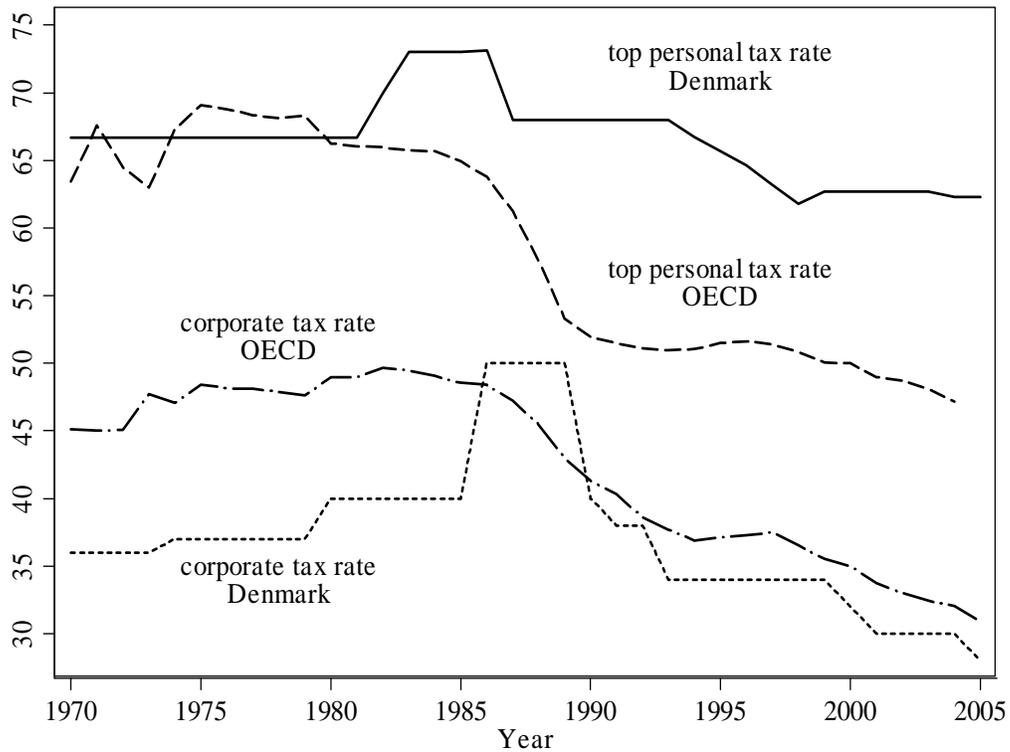
Table 2. Correlates of total tax revenue as % of GDP, 1975-2000

	Period		
	1975-80	1981-90	1991-2000
General Consumption taxes as % of GDP	.79	.77	.75
Regressive taxes as % of GDP	.83	.71	.74
Average effective tax rate on labor and consumption in %	.96	.94	.95
N =	17	22	22

Notes: Sample includes the standard set of “advanced” OECD countries as well as South Korea. For the first period the sample size is reduced due to missing data.

Sources: Carey & Rabesona (2002), OECD (2003).

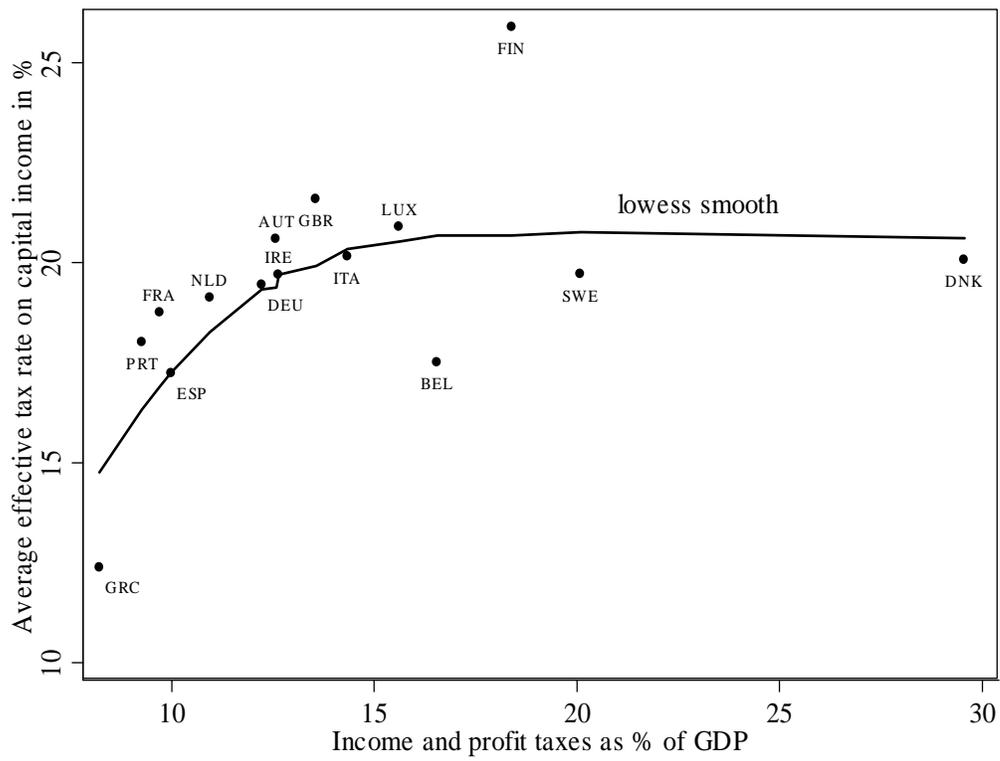
Figure 1. Top marginal tax rates in Denmark and the OECD, in %



Notes: All tax rates include local and state taxes as well as temporary surcharges. The distinction between personal income taxes and social security contributions is based on OECD (2003). The OECD average is unweighted and includes 21 advanced OECD countries. For the 1970s, the variation in the average is partly accounted for by missing observations.

Sources: Tax rate database constructed by the author. For details about coding and sources, see Ganghof (2006).

Figure 2. Income tax ratio and average effective tax rate on capital income, 1995-2002



Notes: Unweighted period averages.

Sources: Eurostat (2004), OECD (2003).

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ENDNOTES

¹ Note however that social transfers are fully taxed in Denmark, so that tax ratios are higher than in countries where transfers are tax-exempt or taxed at low rates.

² As in other Scandinavian countries, however, the DIT reform caused severe strains in the housing market (Ganghof, 2006, chap. 6; Huber & Stephens, 1998).

³ Note that the income of the self-employed also includes wages. Hence, Eurostat's estimate of the capital income tax burden is somewhat exaggerated.

⁴ The 1975-2000 period reflects the data coverage in Carey and Rabesona (2002), who provide the third tax structure indicator.

⁵ The default settings of STATA 8.0 are chosen except that no weighting function is used.

⁶ Revenue-neutrality is difficult to achieve in practice because revenue-neutral tax flattening exercises "typically benefit both the rich and the poor, at the expense of the middle class" (Davies & Hoy, 2002, p. 33). Median voter support may require effective tax cuts.

⁷ Note that there is a kind of minority veto in Denmark. When a bill has been passed by parliament, one-third of the members of parliament may request the submission to a referendum. However, the resulting veto power is generally rather weak, and the rule does not apply to finance and taxation bills (Qvortrup, 2000).

⁸ This observation stands in direct opposition to Wilensky's (2002, p. 378) claim that the mainstream parties in Denmark "adopted some of the Progress Party's agenda".

⁹ Compare Switzerland's four-party coalition to the Finnish "Rainbow Coalition" (1995-2002), which controlled 70% of the seats in parliament and ranged from Post-Communists to Conservatives (Jungar, 2002). Because this coalition emerged in the context of legislative majority rule, the (smaller) coalition parties in Finland were no veto players. This showed in 2002, when the coalition outvoted the Greens and agreed on building a nuclear power plant.