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## **High Taxes in Hard Times**

How Denmark Built and Maintained a Huge Income Tax

Steffen Ganghof



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## **Abstract**

Denmark is a welfare state whose *income* tax burden is larger than the *total* tax burden of the United States or Japan. Given recent political science accounts of the links between tax mixes and the welfare state, Denmark seems to be a puzzling anomaly. These accounts see income taxation as inherently problematic and claim that “regressive taxes” (social security contributions and indirect consumption) have been conducive to building and maintaining large tax/welfare states. This article provides a simple explanation of the “Danish puzzle” and challenges the argument about tax mixes. What is problematic about income taxation is capital income taxation, but low income taxes are only one of two ways to keep the capital income tax burden moderate. The other is to differentiate the tax burdens for capital and labor within the income tax. The article also explores the politics of income tax differentiation and suggests that Denmark’s high level of income taxation made it easier to maintain and even increase this level in the 1980s and 1990s.

## **Zusammenfassung**

Die Einkommensteuerlast des Wohlfahrtsstaates Dänemark ist größer als die Gesamtsteuerlast der USA oder Japans. Im Lichte neuerer politikwissenschaftlicher Theorien über den Zusammenhang zwischen Steuermix und Größe des Wohlfahrtsstaates erscheint Dänemark als rätselhafte Anomalie. Die Besteuerung der Einkommen wird als inhärent problematisch angesehen und „regressive Steuern“ (Sozialabgaben und indirekte Konsumsteuern) sollen Wachstum und Widerstandsfähigkeit des Wohlfahrtsstaates begünstigt haben. Dieses Discussion Paper liefert eine einfache Erklärung des dänischen Rätsels und relativiert die Bedeutung des Steuermix: Die Einkommensbesteuerung ist problematisch im Hinblick auf die Besteuerung der Kapitaleinkommen, aber die Senkung der Einkommensteuer ist nur einer von zwei Wegen, die Steuerlast der Kapitaleinkommen zu begrenzen. Der andere Weg besteht in der Differenzierung der Steuerlast für Arbeit und Kapital innerhalb der Einkommensteuer. Das Discussion Paper analysiert die Politik der Einkommensteuerdifferenzierung und argumentiert, dass das hohe Ausgangsniveau der Einkommensteuerlast eine Erhaltung oder gar Erhöhung dieses Niveaus in den 1980er und 1990er Jahren erleichtert hat.

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## 1 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 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: chap. 12). In the 1980s various factors led to a complete reversal of the ideal of progressive income taxation, with tax rates being cut while revenue reliance shifted from income taxes to consumption taxes and social security contributions (Kato 2003: 14). Domestically, there was a “paradigm shift” from equity-oriented to efficiency-oriented income taxation (Swank/Steinmo 2002: 645). Internationally, there was growing downward pressure on both corporate and personal income tax rates (Hallerberg/Basinger 1998). The result was a serious difficulty or even impossibility of increasing income taxes (Beramendi/Rueda 2003: 27; Kato 2003: 22). Hence, “regressive taxes” (general consumption taxes and social security contributions) are conducive to building and maintaining large tax/welfare states (Wilensky 2002; Beramendi/Rueda 2003; Kato 2003).

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 ratio of countries such as Japan and the United States in the same period (OECD 2003a). What is more, the Danish income tax ratio was around one fourth higher in 2002 than in 1975 (see Table 1). To achieve such a revenue level, marginal tax rates also had to stay high. In fact, between 1970 and 2002 the top personal income tax rate fell by only 4 percentage points (to 63%). Whereas Denmark’s corporate rate is roughly in line with the OECD average, an increasing gap has emerged between its top personal rate and the OECD average. 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 even increase it after the mid-1980s?

In this paper I offer a simple explanation: One of the core reasons why high income taxes are seen as problematic is that the taxation of *capital income* gives rise to high economic, political, and administrative costs. Hence, building and maintaining large welfare states is most likely predicated on keeping the tax burden on capital income modest (e.g., Przeworski/Wallerstein 1988; Lindert 2004). Yet *low income taxation* is only one of two ways to keep the tax burden on capital income small. The other is to tax capital income at a lower level and less progressively than labor income within the income tax. Danish policymakers were able to build and maintain a large income tax precisely because they chose the second option: *differentiated income taxation*. In fact, I will show that historically the large Danish income tax was primarily a tax on wages.

My account thus explains why high income taxation posed no major obstacle to the emergence and resilience of a large tax/welfare state and why increasing tax competition did not produce major problems for policymakers: Because the *effective* tax burden on capital income had been low in the past and because tax competition largely concerns *statutory* tax rates on certain types of capital income, the tax reformers of the 1980s and 1990s could lower the latter while even increasing the former.

Differentiated income taxation is not without problems. Large tax-rate gaps between capital and labor taxation can create economic inefficiency, administrative complexity, and voter resentment. However, although these problems are visible in the Danish case and have influenced the politics of tax reform, they have not yet presented a major challenge to high Danish income taxes. This insight is important because income taxes have important advantages over other types of taxes. Most notably, compared to proportional social security contributions and value-added taxes, income taxes go relatively easy on low wages, which can help alleviate the employment problems of low-skilled persons (Scharpf 2000; Kemmerling 2005).

The paper is set out as follows. The next section shows that the growth of Danish income taxation was, in the aggregate, largely the growth of a wage tax. The third section summarizes the major Danish tax reforms of the 1980s and 1990s and explains how they were able to cut statutory tax rates on capital income while increasing tax revenue. In the following section I discuss the main lesson of the Danish experience and put it in comparative perspective. In the fifth section I explore the problems and politics of differentiated income taxation. The final section provides a summary of the main argument.

## **2 Growth and crisis: Danish income taxation 1903–1982**

This section shows that the development of the Danish income tax was largely the reverse of what one would expect from the stylized facts summarized in the introduction. The growth of the Danish income tax was made possible by large but unsystematic tax privileges for the most important types of capital income. This approach undermined the revenue-raising potential of capital income taxation and the progressivity of the income tax.

The Danish personal income tax was instituted (permanently) in 1903, the corporate income tax in 1922 (Kraus 1981: 191). To show that the income tax was characterized by large tax privileges for capital from the start, I focus on what are generally considered the three most important types of capital income (Sørensen 2001: 12): (a) household saving in the equity of owner-occupied housing, (b) pension savings through institutional investors, and (c) retained corporate profits.

**Table 1 Danish taxes as percentage of 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	–7
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 OECD	–	–	9.0	10.4	11.6	12.4	12.7	13.2	12.8	13.4

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.

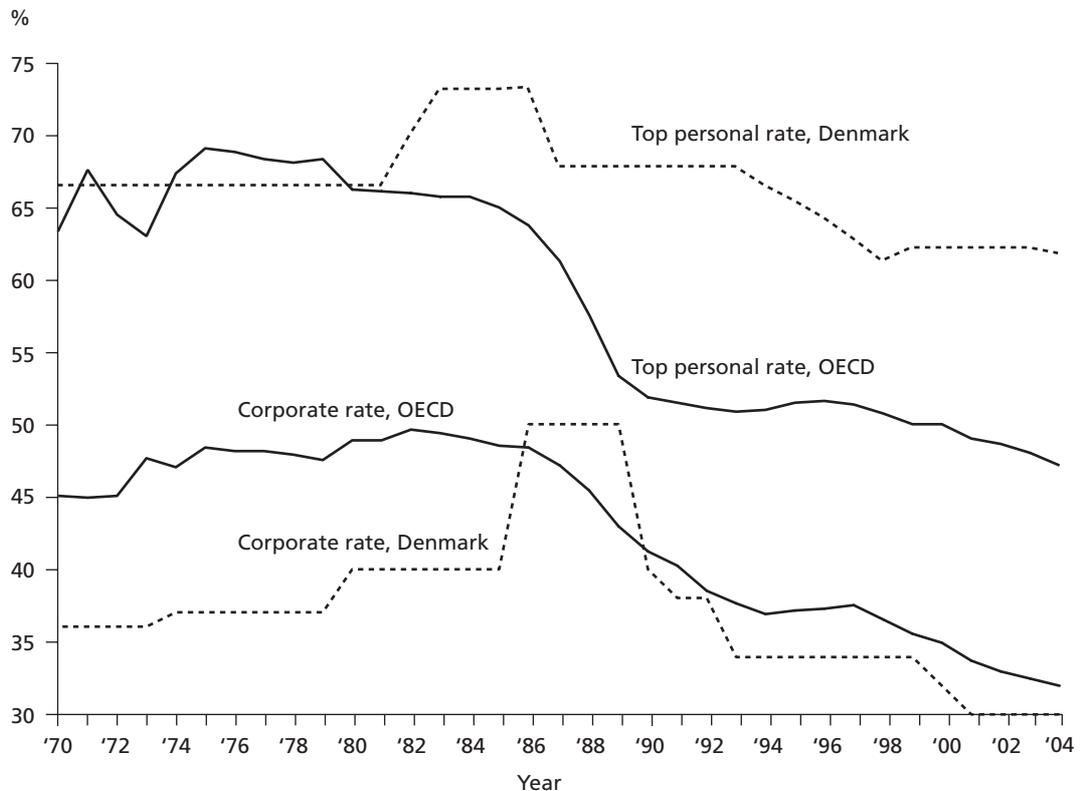
Sources: OECD (2003a). The data for the years 1924 and 1948 come from Flora (1983: 262, 291), data on income taxes of households and self-employed from Eurostat (2004: 146).

First, from the inception of the income tax, *homeowners* benefited greatly from very liberal rules for the deduction of interest payments from taxable income: they could fully deduct mortgage 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. 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 deduction (cf. Lefmann/Larsen 2000: 192–193; Müller 2000).

After World War II, the political Left wanted to reduce this tax privilege but was hindered first by the veto of the Right and later by anticipated electoral costs. Because more and more workers had been acquiring homes, cutting back on tax expenditures for homeowners was politically risky. In 1973, a Social Democratic proposal to reduce tax deductions even provoked a rightist splinter, which developed into the Center Democratic Party and caused heavy electoral losses for the Social Democrats (Esping-Andersen 1985: 186, 265–266). As a result, the return on investment in owner-occupied housing continued to be taxed at lower effective rates than was labor income.

Second, *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, as policymakers wanted taxpayers to save for their retirement. 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 (Vesterø Jensen 1985; Ervik 2000: 172–173). 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, and in 1958 the overall approach to taxing pension savings was codified. In 1961, tax incentives were further extended by introducing individual pension accounts in order to increase savings. In 1972 all contributions to capital lump-sum

**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 (2003b). 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 data base constructed by the author. For details about coding and sources, see Ganghof (forthcoming).

pension saving schemes were regarded as employer contributions, so that taxpayers' own contributions became fully tax deductible as well.

Finally, the *corporate income tax* was never a source of much revenue (see Table 1). By 1965, Danish total taxation had grown to around 30% of GDP, of which 12.4% was due to personal and only 1.4% due to corporate income taxation. What is more, while personal income taxes almost doubled in the following 15 years, reaching 23% in 1980, corporate tax revenues remained unchanged. Like most other OECD countries, Denmark relied heavily on investment incentives in order to mitigate the adverse effects on investment and growth (Andersson et al. 1998). In addition, even statutory corporate tax rates were not particularly high in Denmark. In 1970 the rate was 36%, roughly half the top personal rate and much lower than corporate rates in other OECD countries (see Figure 1).

As a result of these and other tax expenditures for capital income, the growth in Danish income taxation was mainly the growth of wage taxation. Although this development was to a large extent policymakers' deliberate response to the high economic, political, and administrative costs of taxing capital income, the unsystematic nature of tax privileges for capital created an aggregate tax burden for capital which was below what policymakers had intended. Most notably, the combination of liberal interest-deductibility rules and low taxation of pension savings and owner-occupied housing accounts for the fact that taxes on personal capital income have historically tended to imply a substantial *loss* of revenue for Danish governments (Sørensen 1998). Sørensen (1988: 300–301) estimated that in 1986 tax revenue collected from personal capital income was *minus* 1.6% GDP, which was roughly balanced by the revenue from corporate taxation (see Table 1). The aggregate tax burden resulting from the “income” tax was essentially 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 (Nordic Council for Tax Research 1993). First, marginal effective tax rates on different types of savings and investment varied excessively, thus hindering an efficient allocation of capital. Second, the massive subsidization of private debt by means of lenient interest-deductibility rules depressed household savings. Third, the massive tax privileges for capital income also favored tax avoidance schemes and reduced the effective progressivity of the income tax. In response to these problems, Danish policymakers started to reform income tax policy in the early 1980s.

### **3 Reform and further growth: 1982–2003**

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 were in a minority position, too. As we will see, there was broad partisan consensus about the basic pillars of income tax reform. Policymakers agreed that the fiction of joint and equal taxation of capital and labor incomes had to be abandoned in order to make (differentiated) income taxation both more efficient and more equitable.

In the early 1980s, tax privileges for private pensions were reduced, partly as a response to criticism of the labor movement. After the Social Democratic minority government's proposal to abolish the tax exemption of interest income from private pension funds had been blocked by the non-socialist opposition parties in 1982, a similar bill was passed by the Center-Right coalition in 1983 (Nannestad/Green-Pedersen, forthcoming). The bill introduced a “real interest tax” of 40% on pension fund re-

turns above a long-term real yield of 3.5% on the capital stock. Savings from before 1983 were exempted, however, so that the effective tax rate was initially much smaller.

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). Most types of capital income were 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%).<sup>1</sup> The capital income tax base was broadened, so that the 50% rate applied to interest, dividends, imputed rents from owner-occupied housing, imputed returns to capital invested in unincorporated businesses, and certain capital gains. 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.

Tax competition was not yet a concern. In fact, 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 (e.g., Sørensen 1998: 23).

Arguably 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%. This was the result of the futile attempt to tax all capital and wage income jointly. By reducing the capital income tax rate to 50%, the DIT greatly reduced the tax value of interest deductions and thus the tax privileges granted to homeowners. The consequence was less subsidization of private debt and the housing sector, greater effective progressivity, and higher revenue from capital income taxation.

While the DIT model served as a model for subsequent reforms in the other Nordic countries (Ganghof 2005), Danish policymakers started to move away from it (for reasons to be discussed in more detail in the fifth section). In a reform passed in 1993, they established a more differentiated income tax. The reform was passed by a Social Democratic-led majority coalition but based on the proposal of a committee that had been established by the Center-Right government in 1992 (Sørensen 1998). A strong effort was made to again include *positive* capital income into the progressive rate schedule applying to wages. Some capital income was taxed jointly with wages: interest income, the (still underestimated) rental value of owner-occupied housing, and

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1 The reform did not abolish progressive capital income taxation entirely. First, indirect progressivity by means of a basic tax allowance was retained. Second, as a concession to Social Democrats an element of direct progressivity was retained by applying a 6% national surtax to high capital income. This surtax was a “gross tax,” that is, interest payments typically had a tax value of only 50%.

short-term capital gains. By contrast, 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, marginal tax rates on labor were cut, 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 on energy and water use, the other half by new “social security contributions” (OECD 1996: 46).<sup>2</sup>

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 both corporations and unincorporated businesses was reduced to 34%. This was most of all a response to increasing competitive pressure on corporate tax rates (Andersson et al. 1998: 118). There was also no intention to re-increase the tax value of interest deductions (i.e., the tax rate on negative capital income).<sup>3</sup> 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. Finally, pension savings certainly continued to be treated under separate tax rules.

Another major income tax reform passed in 1998 continued along the same reform path. The booming Danish economy provided the government with the chance to further reduce the tax value of interest deductions and thereby dampen consumption. The resulting tax reform, based on an agreement between the Social Democratic-led minority coalition and the left opposition parties, reduced the tax value of interest deductibility to 32% from 2001 onwards (OECD 2000, 86–89). Apart from this, the lowest income tax rate at the central government level was reduced in steps from 8% in 1998 to 5.5% in 2002, a tax allowance for positive capital income taxed at the top marginal tax rate was abolished, and the top personal tax rate was increased from 58 to 59% (see Figure 1). The cut in the bottom income tax rate was partly financed through increases in environmental taxes.

The preferentially taxed types of capital were also subject to reform. The taxation of the rental value of owner-occupied houses was replaced, in the vast majority of cases,

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2 A proportional gross tax on wages was introduced, earmarked to finance labor market policy. The contribution rate for employees increased from 5% in 1994 to 8% in 1997, and an employers’ contribution was introduced in 1997 at a rate of 0.3%, increasing to 0.6% in 1998 (OECD 1994: 42). This gross tax financed almost half of the cuts in personal income taxes. Because these contributions are essentially income taxes, they are included in the computation of marginal income tax rates in Figure 1.

3 It was slightly reduced by the reform, to 46%, but to mitigate the adverse effects on the cost of housing finance, the imputed income from owner occupation was lowered from 2.5 to 2% of the housing value, up to a certain limit.

by a municipal property tax on the “accommodation value of an owner-occupied home.”<sup>4</sup> A flat rate on interest from pension savings of 15% was introduced from 2001. The tax rate on retained business profits was reduced to 30% in 2001, again mainly due to concerns about tax competition.

At the end of 2001, Social Democratic-led governments were replaced by a Liberal-Conservative minority government, but this did not change the government’s basic approach to income tax reform. The income tax reform passed in 2003 and to be implemented from 2004–2007 contains very moderate income tax cuts, rising to 0.75% of GDP in 2007. The comparatively high 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.

The reforms of the 1980s and 1990s resulted in lower statutory tax rates but higher revenue. The capital income tax revenue from the household sector continues to be slightly negative, but the positive revenue from corporations and the self-employed contributes to positive revenue from capital income taxation (see Table 1).<sup>5</sup> For 2002, Eurostat puts the total capital income tax burden at 3.5% of GDP, which is higher than in the past but still only around 12% of total income tax revenue, with earned income accounting for the other 88%. If we take the size of the tax bases into account, the difference is smaller but still pronounced: the average effective income tax rate on capital is put at 16.1%, the corresponding rate for (employed) labor at 39.9%.

#### 4 The Danish experience in theoretical and comparative perspective

The crucial lesson from the Danish case is that real-world “income taxes” can be very different things. Their tax base varies, depending on which types of capital income are taxed and at what rates. A textbook income tax would lead to an equal effective tax burden on capital income and wages, but, as we have seen, a real-world income can be similar to a pure wage tax, that is, it can lead to a zero aggregate tax burden on capital income.

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4 This tax was intended to partly counterbalance the tax value of mortgage deductions – a value that is still high by international comparison (OECD 2000: 86). This partial replacement of income taxation on owner-occupied housing by property taxation was thus not a substantive change of the tax burden, but rather a reaction to voters’ resentment against income taxes on owner-occupied housing.

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

This variability of the income tax base is not sufficiently acknowledged by the literature on the links between tax mixes and the size of the tax/welfare state. Wilensky (2002) and Kato (2003) argue that “regressive taxes” (i.e., social security contributions and indirect consumption taxes) have been conducive to building and maintaining large welfare states. Kato (2003: 197) notes the obvious Danish exception to this argument and explains it 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.” Although this may count as an explanation of why Danish policymakers *wanted* to create and maintain an exceptionally high level of income taxation, it does not answer the question of how they were *able* to do it.

I offer a straightforward answer: The main reason why “regressive taxes” tend to be conducive to building large welfare states is that they go relatively easy on capital income (cf. Przeworski/Wallerstein 1988; Lindert 2004). This point is also emphasized by Wilensky and Kato. Wilensky states that income (and property) taxes, but not consumption and payroll taxes, imply a heavy tax burden on capital and are therefore a “drag on economic growth” (Wilensky 2002: 392). However, the Danish experience shows that low income taxation is only one of two ways to keep the capital income tax burden moderate. The other is a differentiated income tax which taxes wages much more highly than capital income. Similarly, Kato (2003: 199) acknowledges that there are certain theoretical types of direct taxes that go easy on capital income and that these taxes could “thwart” the association between regressive taxation and large welfare states. However, in her view these taxes are “still far from being implemented” (Kato 2003: 199).<sup>6</sup> This is misleading. For while the differentiated income taxes implemented in OECD countries do not resemble any ideal-type tax, the aggregate tax burdens they create are often much closer to pure consumption or wage taxes than to textbook income taxes (see also, e.g., Gordon et al. 2004). The Danish case study has made this very clear.

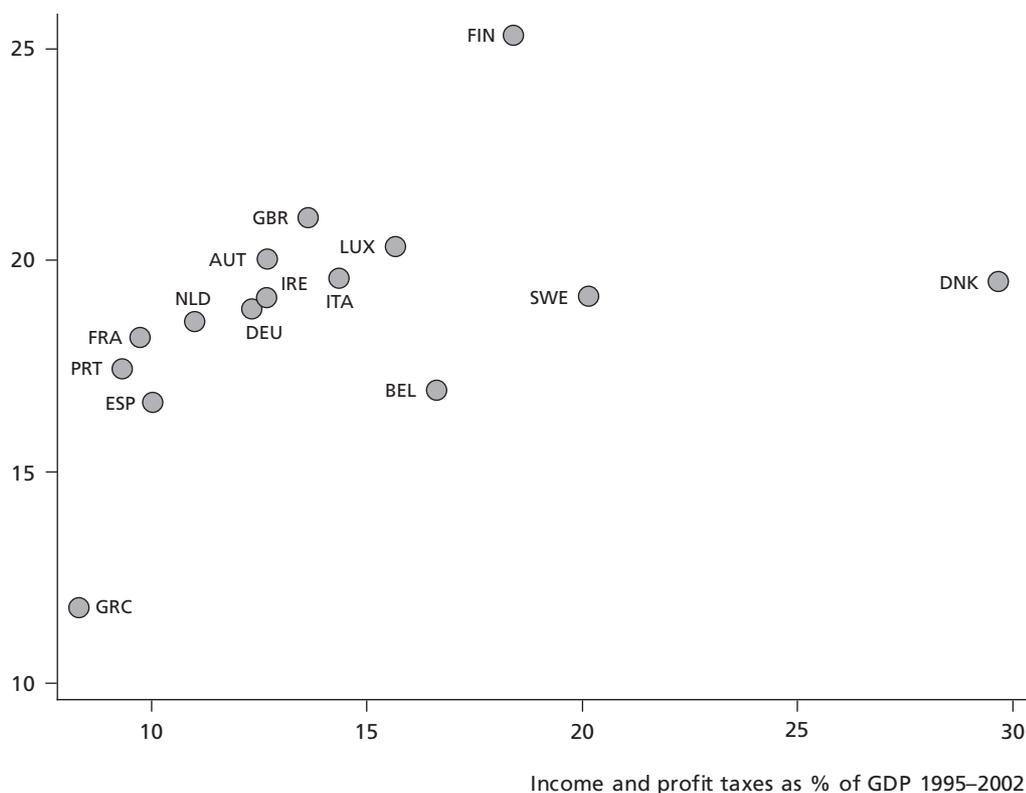
This interpretation suggests that there should be *no* linear relationship between the total income tax burden and the effective tax burden on capital income. To test this expectation, we need a measure that splits personal income tax revenue into its capital and labor components and then expresses the combined revenue of corporate and personal capital income taxation as a percentage of the underlying tax base. Such data are difficult to come by because adequate information on the relative shares of labor and capital income in personal income tax revenue is generally lacking (Carey/Rabsona 2002). Fortunately, Eurostat (2004, in collaboration with the European Commis-

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6 Kato means *direct* consumption taxes that are implemented like income taxes but whose tax base is identical to that of value-added taxes. For a more detailed discussion of the tax base of consumption taxes and their difference to income taxes, see, e.g., Hubbard (1997).

**Figure 2** Income tax ratio and implicit tax rate on capital income, in %

Average effective tax rate on capital income 1995–2002, in %



Notes: Period averages.

Sources: Income Tax Ratio: OECD (2003a); Implicit Tax Rate: Eurostat (2004).

sion) has gathered this information on the basis of national sources. I therefore use Eurostat’s measure of the “implicit tax rate” on capital income, which is available for 15 European Union countries (the EU-15) for the years 1995–2002.

Figure 2 shows that there is indeed no linear relationship between total and capital income taxation. Rather, it suggests a decreasing marginal “effect” of income taxation on capital income taxation. Countries with high income taxes, such as Belgium, Sweden, or Denmark, do not have systematically higher tax burdens on capital income than do countries with low income taxes, such as Spain, France, or Austria. The only exception is Finland, but its high tax burden on capital *income* is balanced by a very low tax burden on *stocks* of capital.<sup>7</sup> Hence, the comparative evidence also suggests

<sup>7</sup> If we look at the relationship between *total* taxation and *total* capital taxation (income and stocks), a picture similar to that in Figure 2 emerges. The main difference is that the outlier with by far the highest capital tax burden is not Finland but France (Eurostat 2004: 294), a

that the relationship between tax mixes and the welfare state is spurious. What seems to matter most is the underlying tax burdens on capital (income) and labor, which are influenced by tax mixes but also by the internal structure of income taxes.

This insight is also important for the social science literature on so-called tax expenditures. This literature has looked at tax relief for certain types of capital income, most notably pension savings and owner-occupied housing, largely as forms of “hidden” welfare provision (Howard 1997; Ervik 2000). The previous discussion highlights the fact that such relief also has a straightforward taxation rationale: Tax expenditures for capital income are one way of keeping the tax burden on capital income moderate. Hence, tax expenditures, like regressive tax mixes, may to a significant extent simply follow from the need to keep the overall tax burden on capital income moderate. This logic is well recognized in the public-choice literature on taxation (e.g., Hettich/Winer 1999: 59), but not always in the political science literature. For instance, Steinmo (1993: 114, emphasis in the original) has argued 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.

Finally, the lessons of the Danish case are also important for the literature on the domestic effects of globalization and tax competition. Arguments about these effects often do not differentiate between different types of capital income or discuss how heavily capital income had been taxed before increasing tax competition. Sophisticated explanations are advanced for why we do not see a “race to the bottom” in the overall tax burdens on capital (Basinger/Hallerberg 2004). Yet once we accept that (a) competitive pressures vary greatly across different types of capital income, that (b) many types of capital income had not been taxed highly in the past, and that (c) competitive pressures tend to be strongest with respect to *statutory* tax rates, a much simpler explanation of the lack of a race to the bottom is available (cf. Ganghof 2000). By differentiating statutory tax rates and broadening the capital income tax base, policymakers could reduce statutory – and, if necessary, also effective – tax rates on the most mobile types of income (mostly capital income), while increasing the tax burden of less mobile types of capital income.

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country with a very low income tax burden and thus a very large share of “regressive taxes” (Kato 2003).

More concretely, Danish policymakers reduced the corporate tax rate from 50 to 30%.<sup>8</sup> Yet they not only recouped revenue by broadening the corporate tax base but also increased the tax burden on economically less sensitive capital income that had been taxed at a low level in the past. The main example is the reduction in tax subsidies to owner-occupied housing. Finally, policymakers differentiated income tax rates in order to insulate wage taxation from corporate tax competition. The top personal income tax rate stayed roughly twice as high as the corporate tax rate in order to avoid major revenue losses and/or a substantial reduction of progressivity. To see the importance of this rate in revenue terms, consider that in 2002 it set in already at around 90% of the earnings level of an average production worker (OECD 2003b). Maintaining a high top rate was possible because direct competitive pressures on personal income tax rates were absent.<sup>9</sup>

## 5 The problems and politics of differentiated income taxation

Of course, differentiated income taxation is not without problems. It has economic costs because tax rate differentials may affect the decisions of economic actors in negative ways. It has administrative costs because tax differentials create incentives for tax avoidance, which have to be countered by administrative means. And it has political costs because voters may resent tax differentiation. This resentment is likely to be deliberately fostered by both left and right opposition parties. Left parties are likely to push for higher capital income taxation, right parties for lower taxation of (high) wages. In this section, I intend to show that these problems also existed in Denmark, but that their effects have so far been rather modest. In addition, I suggest that high income taxation itself as well as Denmark's basic political institutions have been conducive to maintaining a large income tax despite the problems of differentiated income taxation.

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8 One could argue that some of the capital income that is taxed progressively together with wages is also sensitive and could therefore be expected to be taxed under special tax rules as well. However, a closer look shows that this is in fact the case. Hagen, Norrman, and Sorensen (1998: 195) state that Danish portfolio investors have so far "tended to channel the bulk of their foreign portfolio investments via financial intermediaries and institutional investors which are subject to special tax rules ..."

9 Some are based on the assumption of direct pressure on personal income tax rates (e.g., Hallerberg/Basinger 1998). Yet in Denmark and elsewhere sensitive types of personal income are removed from the ambit of progressive income taxation. If unincorporated businesses are a problem, they are subjected to special rules, and the same is true for particularly mobile groups of taxpayers such as foreign expatriates of international companies (Ganghof 2000).

The problems of differentiated income taxation had two main effects. First, *they contributed to the fact that Danish policymakers turned away from the DIT model* – which was invented by them and proved to be extremely successful throughout the OECD world (Ganghof 2005) – and moved toward a more complicated form of differentiated income taxation in the 1990s. The reason: the crucial task in designing a DIT is to find a proportional capital income tax rate that is *low enough* to apply it to all main types of capital income but *high enough* to keep the difference to the top tax rate on labor within acceptable limits. The very high level of income taxation made it difficult to find this rate. Sticking to the DIT model after the 1987 reform would have required a general reduction of the capital income tax rate from 50 to 30%. Corporate tax competition was very important in this respect: The tax rate on retained corporate profits had to fall, and achieving the simplification advantages of the DIT model required an alignment between this rate and the rate for personal capital income (Sørensen 1998: 23). This large a reduction of the uniform capital income tax rate, however, was out of the question.

Three reasons stand out. First, lowering the capital income tax rate uniformly would have increased the gap between the tax rate on capital and the top rate on labor, which would have fuelled tax arbitrage as well as voter resentment about the obvious inequities of the DIT model. Already with the relatively high capital income tax rate of 50%, it “had been difficult to gain popular acceptance of a tax system which taxes large positive income from wealth at a considerably lower marginal rate than income from labour” (Sørensen 1998: 23). A tax rate of 30% would have made this problem much more severe. The second reason is related: In the search for popular acceptance of the tax system, it seemed necessary to again include into the ambit of progressive taxation those types of capital income which were less affected by tax competition and did generate some revenue (see the third section). This revenue was to be used for reduction of the marginal tax rates on wages. Third, given the DIT model, a large cut in the general capital income tax rate would have implied an equally large cut in the tax value of interest deductions. Yet in the early 1990s, such a cut would have been disastrous for the Danish housing market. The 1985 reform had already created severe strains in this market, as the cuts in tax subsidies were capitalized in prices and led to a drop in the value of real estate. A considerable number of homeowners no longer could cover their mortgages with the market value of their real estate and went bankrupt (Nannestad/Green-Pedersen, forthcoming). In short, Denmark’s high income tax burden required even more differentiation of tax burdens than was possible under the DIT model.

The problems of differentiated taxation had a second, related effect: *They made the overall tax system somewhat less progressive than it would probably have been without them.* The reason: to make the re-inclusion of some types of capital income into the progressive income tax possible, marginal tax rates on labor had to fall, especially at the top. The top rate fell from 68 to 59%. As discussed in the third section, this reduction was partly financed by new “social security contributions,” which, in fact, are proportional (gross) income taxes on wages (OECD 2003a: 130).

Both effects – the dilution of the DIT model and downward pressure on the marginal tax rates on high wages – are visible in other countries as well, for example Australia, Germany, Norway, and New Zealand (Ganghof/Eccleston 2004; Ganghof, forthcoming). However, it must be emphasized that the resulting constraint on the progressivity and revenue-raising potential of the Danish income tax has so far been rather moderate. In concluding this section, I shall discuss two factors that have likely contributed to this result. This discussion uses Germany's tax reform experience as a contrastive foil.

First, the *existence* of high income taxation itself has likely been conducive to maintaining high income taxation in the 1980s and 1990s. The reason is as follows. The main contender of differentiated and dual income taxation is a flat income tax (hereafter: Flat Tax). This tax reform model simply extends the uniform proportional capital tax rate of the DIT to labor. It thereby achieves maximum tax simplification. The downside of the Flat Tax is, of course, reduced progressivity (in labor taxation). However, indirect progressivity can be achieved by maintaining a large basic tax allowance. Therefore, the Flat Tax is an extremely attractive model for countries with moderate income tax burdens. If total income revenue amounts to less than, say, 15% of GDP – as it does in most countries shown in Figure 2 – an indirectly progressive Flat Tax with a rate of 20 to 25% could be introduced in a revenue-neutral manner and thus seems very attractive. Right-wing parties and business organizations are likely to embrace this model and denounce the “inequity” of differentiated income taxation, thus stacking the decks in favor of lower and flatter income taxation. In fact, this kind of dynamic is visible in a number of OECD countries, such as Germany (Ganghof, forthcoming), and some East European countries have already adopted the Flat Tax. The EU member state Slovakia, for instance, implemented a flat rate of 19% in 2004.

A similar kind of dynamic is much less likely to arise in Denmark because a *revenue-neutral* switch to a Flat Tax is virtually impossible. With an income tax burden of almost 30%, a real-world Flat Tax with a significant basic allowance would require a tax rate that is nearer to 40% than to 30% (Nielsen/Frederiksen/Lassen 1999; *Broste Report* n.d.). Given tax competition, however, increasing the Danish corporate tax rate is out of the question. To the contrary, it seems to be only a matter of time until it will be further reduced. Because the favorable properties of the Flat Tax also depend to a large extent on the alignment of corporate and personal taxation, revenue-neutral Flat Tax reform lacks credibility. Of course, right-wing parties could combine the Flat Tax with a large-scale shift of the tax burden onto proportional “social security contributions.” Yet any such maneuver is associated with very high political risks. It contradicts what is sometimes called *Canard's tax rule* (Canard 1801): “Old taxes are good taxes.”<sup>10</sup> In short, when income taxes are low to begin with, differentiated or dual

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10 Canard's rule is frequently cited in tax reform debates in Germany. The causal mechanisms cited by Canard, however, are outdated. He believed that the entire tax burden is eventually

income taxation requires special political justification, whereas flat taxes seem like the natural endpoint of tax policy-learning. When income taxes are high to begin with, the opposite is more likely.

The second factor contributing to the resilience of high income taxes in Denmark is political institutions. Denmark is a *truly* majoritarian country in the sense of Mill (1958 [1861]) and Nagel (2000). It combines electoral proportionality (and hence multiparty politics) with legislative majority rule. There are no strong institutional veto rights for minorities. This institutional context can induce parties to adopt accommodating policy stances in order to become part of legislative majority coalitions (McGann 2004). By contrast, if parties have institutionalized veto rights, their incentives to search for pragmatic compromises may be reduced.

A comparison with the German tax reform experience can help to illustrate this point. In Germany there are two powerful veto players in tax policy: the upper house, or Bundesrat, and a very activist Constitutional Court. In combination, these two veto players forced a center-left government of Social Democrats and Greens to pursue substantial cuts in marginal tax rates and a significant net reduction of the income tax burden (Ganghof, forthcoming). The main reason for this requirement was that even a minor gap between the corporate tax rate and the top rate on personal income was seen as a *constitutional* problem. Minimizing the tax-rate gap therefore became one of the paramount goals of tax reform in Germany, vigorously defended by the opposition parties holding power in the Bundesrat. As a result, the top personal rate had to fall from 56% in 1998 to 44% in 2005 in order to allow for a corporate tax rate (including local taxes) of just below 40%. In effect, corporate tax competition spilled over into personal income taxation. If the Danish constitution gave right-wing actors similarly strong veto rights, the requirements of corporate tax competition would have probably also had more far-reaching effects on personal income taxation.

These conclusions are in many ways preliminary. The main purpose of the discussion is to shift attention to the politics of differentiated income taxation. If this type of taxation is one major way to reconcile large tax/welfare states with the structural constraints of open market economies, then the conflict over the size of the welfare state will inevitably lead to a conflict over income tax differentiation. Although the political science literature should avoid exaggerating the problems of differentiated income taxation, it should not avoid studying the politics of it.

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shifted equally onto everyone, so that any change in the tax mix would induce costly adjustment processes without being able to change tax incidence.

## 6 Conclusion

The main argument of this paper can be summarized succinctly: Moderate capital income tax burdens are conducive to building and maintaining large tax/welfare states. The dominant way of keeping these burdens moderate is *low income taxation*. This has led some political scientists to argue that “regressive taxes” (social security contributions and indirect consumption taxes) are conducive to building and maintaining large tax/welfare states. However, this argument fails to see that there is a second way to keep the tax burden on capital income moderate: *differentiated income taxation*. If this is recognized, the very high Danish income tax burden ceases to be an anomaly. Danish policymakers decided to discriminate against wages *within* the income tax rather than shift much of the income tax burden onto social security contributions.

Differentiated income taxation does create economic, administrative, and political problems. However, the Danish case shows that these problems should not be exaggerated. Pragmatic differentiation of tax burdens within the income tax is possible without undermining economic and administrative efficiency and without prohibitive political costs. This insight is important because progressive income taxes have an important advantage over standard forms of social security contributions and value-added taxes: they go easy on low wages and can thus help mitigate the problems of low-wage employment (Scharpf 2000; Kemmerling 2005). In this respect income taxes are instrumental for building efficient and resilient welfare states. Mainly for this reason, it is important to better understand the politics of differentiated income taxation. Although the present paper has contributed insights on the Danish case, more work remains to be done.

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