Emerging Trends in the Political Economy of Taxation

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Abstract

This essay briefly summarizes recent work and suggests future directions in the study of taxation. We analyze the determinants of total tax revenue, tax structure, tax administration, and the relationship between taxation and spending. In the section on total tax revenue, we look at the effects of democracy, debates a possible ceiling on total revenue, and whether less developed and Asian countries will catch up with revenue extraction in the developed west. The section on tax structure suggests that the era of progressive taxation may be ending and that taxes intended to serve social purposes, such as sin taxes and carbon taxes, are on the rise. Our discussion of tax administration focuses on the determinants of taxpayer compliance and whether less developed countries are developing centralized bureaucratic administrations. We conclude by looking at the relationship between taxation and spending, first exploring the increase in deficit spending and second looking at attempts by both sub-state and supra-state political units to get more control of taxation relative to national states.

INTRODUCTION

In this essay, we attempt to summarize a few emerging trends and suggest future directions for work on taxation. There are two recently published reviews of the literature on taxation in sociology and political science (Kiser & Karceski, 2017; Martin & Prasad, 2014), so it is not necessary for us to do that here. Our focus is on the future of work in this area, not on the past or even the present. Our interest is more prescriptive than descriptive—we are interested less in what trends are emerging (although we will discuss these to some extent) than on outlining the main topics that we think should be the focus of future research.

The essay will be organized around the three major facets of taxation: determinants of total tax revenue (total revenue/gross domestic product (GDP)), tax structure (who and what is taxed), and tax administration (including taxpayer compliance). Within each of these sections, we will separate developed

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and less developed states, because tax policies work very differently in these two contexts. We will attempt to address these issues with a wide geographic scope, but in an essay this short our coverage will fall short of representing all states and all regions.

EXPLAINING TAX REVENUE

The ability of states to extract revenue has varied substantially over time and across societies (Kiser & Karceski, 2017). This section will focus on a few main trends in the contemporary world and ongoing debates about their causes: (i) What is the relationship between democratic institutions and tax revenue? (ii) Have levels of tax revenue in the developed world reached a ceiling? and (iii) Will tax revenues in Asia, Latin America, and Africa increase to match those in the developed West?

DEMOCRACY AND TAX REVENUE

Research on the connection between democratic institutions and tax revenues remains inconclusive, but a few insights can be drawn from this body of research (Kiser & Karceski, 2017). In contemporary states, most taxes are paid into a general fund that is used to cover a wide variety of expenses, making the contract linking tax payments to state services much more difficult to monitor. In this context, democratic institutions facilitate the making and enforcing of fiscal contracts, but democracy alone does not ensure effective institutions. In fact, the relationship between democracy and tax revenue in contemporary states is still unclear. Studies of the direct association between democracy and tax revenues/GDP find mixed results. Some of this can be explained by variation in democratic institutions: electoral systems, veto players, party power, party stability, corporatism, and election participation rates (Kiser & Karceski, 2017), but there is still much to be studied. Because samples and measures vary across studies it is difficult to compare the findings—additional research would be very useful. The direction that future work on democracy and tax revenue should go should include further disaggregation of democracy into its institutional components.

HAVE TAX REVENUES IN THE DEVELOPED WORLD HIT A CEILING?

There are signs that tax revenue/GDP in developed democracies may be hitting a ceiling. Tax revenue/GDP in Organisation for Economic Co-operation and Development (OECD) countries increased 6.7% between 1980 and 1990, 6.7% between 1990 and 2000, but declined 4.3% between 2000 and 2010

(OECD, 2016). The highest revenue to GDP ratio was 49.5% in Sweden in 1987, only Denmark and France are currently above 45%, and very few countries are currently at or near their highs (OECD, 2016). Is this a temporary downturn, or is the period of increasing tax revenues ending? Several factors suggest the latter. The first is increasing labor mobility. The relationship between population homogeneity and high taxation is well known (Eger 2009). The highest levels of taxation are found in the (until quite recently) homogeneous Scandinavian social democracies, whereas the heterogeneous population of the US has often been seen as one cause of its lower taxation and smaller welfare state (Alesina & Glaeser, 2004). Increasing labor mobility caused by globalization has made many more societies racially, ethnically, and religiously heterogeneous, including Scandinavian social democracies. Because people are more likely to pay taxes for other in-group members than for members of other groups (Lieberman, 2003), increasing heterogeneity leads to increasing opposition to high taxes to fund large welfare states (Eger, 2009). The difficulty of maintaining a strong welfare state and an open immigration policy simultaneously—called the *progressive's dilemma* (Kulin, Eger, & Hjerm, 2016) may well end the era of increasing taxation. Further research on this topic is not only important to academics but will also have significant implications for ongoing policy debates.

Will LDC Tax Revenues Catch up with the Developed West?

Modernization theory and its many variants have had a rocky intellectual history, going from wide acceptance to universal dismissal, and now settling somewhere in between. There are two interesting questions about taxation that are relevant to the ongoing debates about its utility. One of the central tenets of modernization theory is that less developed states will evolve to look more similar to contemporary developed states. So should we expect tax revenues in less developed states to increase over time until they eventually catch up to those in developed states? Since 1990, the average tax revenue share of GDP for low and middle income countries (as defined by the World Bank) remained between 10.5% and a little over 13% with no indication of a trend (The World Bank, 2018), while the average in the OECD has been between 31.9% and 34% (OECD, 2016).

Tax increases in less developed states are likely to increase if GDP per capita increases, following Wagner's Law (the tendency for taxation and spending to increase with GDP per capita). Another limit on increasing tax revenues in less developed countries (LDCs) has weak administrative systems that have made it difficult to collect revenue (Kiser & Sacks, 2011). It will be interesting to see if economic growth and administrative capacity increase in LDCs, and, if they do, if tax revenues increase as a result.

Will Tax Revenue in Asia Increase to Match the West?

A related question is whether Asian states will ever match the tax revenues collected in Europe. Tax revenues/GDP are lower among both developed and less developed states in Asia than their counterparts at similar levels of development (Tanzi & Zee, 2000, p. 303), leading to a debate about whether Asian states are violating Wagner's Law (Chang, 2002). The jury is still out, but the fact that tax policy is focused primarily on growth coupled with a low demand for welfare spending could well result in a lower ceiling on tax revenue in Asia than in Europe. The main factor determining the level of tax increase in the future is probably the demand for spending on welfare. The demand for welfare spending could increase if the provision of welfare by families and firms (such as lifetime employment policies in some economic sectors in Japan) continues to decrease, and this would lead to an increase in tax revenues in Asian states.

EXPLAINING TAX STRUCTURE

What and who states tax is a central issue in the study of taxation, and there are many interesting directions for future research in this area. This section will focus on two of them: (i) Is the long period of increasingly progressive taxation ending? and (ii) Are taxes oriented to addressing social problems rather than just raising revenue increasing?

Is the Era of Progressive Taxation Ending?

There are increasing signs that the era of progressive taxation is ending. Highly progressive income taxes began around World War I (WWI) and peaked in the middle to late twentieth century, with average top marginal rates in the developed world over 60% until the 1980s, but they have recently dipped to under 40% (Scheve & Stasavage, 2016). This is occurring in spite of increasing inequality,[1] as Scheve and Stasavage (2016) show that inequality alone does not prompt more progressive taxation. Progressivity has also declined in the last couple of decades in Japan (Steinmo, 2010, pp. 135–138), suggesting that this may be a global and not just western trend.

The trend toward declining progressivity is caused by several factors. First, progressivity causes increasing administrative problems in the globalized economy. Because of the increasing ease of moving and hiding money, the rich have opportunities to avoid and evade taxes by moving assets across national borders in ways that working-class taxpayers cannot, so countries

1. Piketty (2014) suggested that the decreasing top marginal tax rates actually contribute to growth in inequality.

relying more on taxing the rich will get less net tax revenue (Prasad, 2012, p. 170). Tax fraud and illegal cross-border capital flows are by far the most common and largest of all illegal transactions (Schneider, 2013, p. 699). Second, highly progressive tax systems promote and reinforce adversarial class relations which result in lower revenue (Prasad, 2006), so states interested in increasing their tax revenue will be forced to use more regressive taxes. Third, and part of this adversarial fiscal culture, Martin (2013) has shown that policy proposals to increase progressivity are sometimes met by resistance from the rich and that these "rich people's movements" can be successful in blocking progressivity. Finally, Scheve and Stasavage (2016) note that the causal mechanism responsible for the initial rise of progressivity, mass conscription for war, is unlikely to occur again in the era of drone warfare. Is the decline of progressive taxation likely to continue? This should be a major focus of research going forward.

Is Taxation for Social Purposes Increasing?

In general, taxes are collected for the purpose of raising revenue, but a subset of tax policies has another distinct motivation. Taxes such as sugar taxes or carbon taxes can be used to internalize negative externalities (often called *Pigovian taxes*), and help correct present preference biases, self-control problems, and imperfect information, all which likely lead to undesirable levels of "bad" consumption (Brownell & Frieden, 2009; O'Donoghue & Rabin, 2003).

Empirical work on two well-established sin taxes, alcohol, and tobacco, suggests this strategy is effective at reducing consumption, and might also lead to positive social outcomes, especially in measures of health (Chaloupka, Straif, & Leon, 2011; Wagenaar, Tobler, & Komro, 2010). While these sin taxes are quite common, a more recent trend is taxing unhealthy food, notably sugary beverages. Since 2010, taxes on sugary products have emerged around the world in the form of national- and city-level policies—such as France, Hungary, Mexico, and Norway, as well as several US cities including Berkeley and Philadelphia. Additional countries are now planning to implement similar policies, including UAE and the Philippines. Like the policies applied to alcohol and tobacco, these new taxes should reduce consumption as soft drinks and juices are price elastic (Andreyeva, Long, & Brownell, 2010). One study already finds support for the effectiveness of the Berkeley tax (Falbe *et al.*, 2016), but we do not know what conditions lead to these adoptions and what can explain variations in design in these nascent policies—these are important topics for future research.

Environmental taxes place additional costs on environmental degradation by making certain activities more expensive and incentivize shifting to cleaner alternatives (Baranzini, Goldemberg, & Speck, 2000). The most substantial environmental taxes are carbon taxes. Carbon taxes primarily apply to fuels and energy, priced proportional to carbon content. The first carbon taxes were adopted in Finland, the Netherlands, Norway, Sweden, and Denmark, and similar policies have continued to spring up around Europe and the rest of world. Many of these policies have been introduced as part of Environmental Tax Reforms, which include concurrent reductions in other taxes such as those on labor or capital, making policies net revenue neutral (Bosquet, 2000). Most existing carbon taxes include exemptions and rebates for industry, agriculture, and transit (Ekins & Speck, 1999). While this can make the policies more politically feasible (Harrison, 2010), it is likely they also inhibit their carbon-reducing potential (Ciocirlan & Yandle, 2003). There is much debate over whether the policies are having an impact (Nadel, 2016), and few studies have looked at the determinants of adoption and policy design.

COLLECTING TAXES: TAX ADMINISTRATION AND TAX EVASION

Even in the best modern bureaucratic administrative systems, tax evasion is still a significant problem. For example, the "tax gap" (the percentage of total tax obligations that are not paid) for the US income tax is about 14%, and over half of the income of businesses is unreported (Slemrod, 2007, pp. 28, 45). Between 1965 and 2010, tax evasion was by far the largest economic crime in the US, averaging 5% of GDP (the total for all other crimes is 2%) (Schneider, 2013).

In the developed world, the ubiquity of centralized bureaucratic administration has decreased the utility of models like agency theory that focus on organizational structure and incentives. There is very little variation on those dimensions (the only notable exception is that some states are more prone to clientelistic recruitment of agents instead of hiring on merit, and this does have important consequences). In order to explain variations in the tax gap in the developed world, we need to look more closely at the determinants of voluntary and quasi-voluntary compliance by taxpayers (Frey & Torgler, 2007; Levi, 1988; Lieberman, 2003).

Studies of tax compliance in modern states consistently show that rational choice deterrence models based on the odds of getting caught and the severity of punishment explain some of the variation (Slemrod, 2007, p. 43) but predict far more tax evasion than actually occurs (Alm & Torgler, 2006). This strongly suggests that voluntary and/or quasi-voluntary compliance has important effects. For example, will people be more willing to pay taxes if the state provides adequate public goods in exchange and if they think other taxpayers are paying their fair share (Levi, 1988)? Do increasing political divisions affect tax payments? Are people more likely to pay if their favored party is in power and less likely when the opposition rules? To what extent do general values of good citizenship affect propensities to pay (Robbins and Kiser, 2018)? Further research on these topics is necessary to explore the micro foundations of tax compliance beyond rationality and deterrence.

Will Tax Administration in LDCs Develop like the Centralized Bureaucracies of the Developed West?

Problems with administration in less developed states are well known, and Pepinsky, Pierskalla, and Sacks (2017) provide a detailed summary, so we raise only one issue here. Tax administration has become so bad in some contemporary less developed states that they have partially privatized their tax administration (this paragraph draws on Kiser & Baker, 1994 and Kiser & Sacks, 2011). Although this is not a return to premodern tax farming (agents are only partial residual claimants and are more highly regulated), it is a move away from standard bureaucratic administration. African states illustrate this process. The centralized bureaucracies African states inherited from colonial powers devolved into corrupt neopatrimonial bureaucracies riddled by patronage relations that produced little revenue. This failure of centralized bureaucratic administration (predictable in the context of poor communications, transportation and information processing in much of Africa) has led many African states to partially privatize administrative systems (these are usually called *Semi-Autonomous Revenue Authorities*). Because of the short duration of experiments with partial privatization, it is very difficult to judge the success of these reforms. However, it seems clear that they have produced some improvement in efficiency, while also creating new problems, such as over-taxation (Kiser and Baker (1994) for a discussion of partially privatized tax administration in Asian states).

THE RELATIONSHIP BETWEEN TAXATION AND SPENDING

Tax revenue sets general, long-term constraints on spending, working via what we call "rubber band" causation—spending can be stretched beyond revenue, but only so far and only for so long, until it is pulled back, in one way or another. We should be attempting to explain variations in the elasticity of the rubber band throughout history—how tightly (and by what mechanisms) is state spending tethered to total revenue? In other words, what determines the amount and duration of deficit spending?

Deficit spending has become ubiquitous in states in the developed world, as predicted decades ago by (O'Connor, 1978). However, the Marxist argument

(O'Connor, 1978) makes about the causes of deficits is both too vague (he points to features of the structure of advanced capitalism but does not specify clear causal propositions) and lacks microfoundations. Work on deficits in the future should certainly pay attention to features of economic structure, but should also look at factors affecting the discount rates of rulers (Levi, 1988), and in democratic states the discount rates of voters (since personal debt is also increasing).

There are also interesting consequences of the accumulation of debt due to persistent budget deficits. Perhaps the most important is its effect on state legitimacy. Taxpayers generally view taxes as payments made in exchange for public goods, thus they roughly compare the amount they pay to what they get back, and judge the legitimacy of their state in part by whether or not they are getting a fair deal for their money (Levi, 1988). From this perspective, states that have a large debt/GDP ratio will also have consistent legitimacy deficits. For example, if they have to use 10–15% of tax revenue to pay interest on their debt, taxpayers will be getting 10–15% less in public goods than they paid in taxes. This will delegitimize states and fuel the rise of anti-state and anti-tax parties and social movements based on arguments that the state is ineffective and inefficient. We are already seeing this process develop, and as long as deficits continue to pile up state debt it is likely to continue.

MOVING BEYOND A FOCUS ON STATES

Thus far, we have assumed that states are the proper unit of analysis for the study of taxation. We will now move beyond that assumption and consider factors at other levels of analysis. We first look at the dynamics of taxation in nested political systems, both with the rise of supra-states (taking the EU as an example) and the rise of sub-state independence movements (using Catalonia as an example). The section concludes with an exploration of regional similarities in tax systems and processes that cut across multiple independent political units, using the high levels of tax evasion in two large regions (postcommunist central Europe and southern Europe) as examples.

NESTED POLITICAL SYSTEMS

The rise of political units encompassing multiple states but allowing member states to retain sovereignty (e.g., the EU) raises interesting issues for tax policy. The EU is currently a minimal state with very low levels of taxation. Its tax revenue is slightly less than 1% of EU GDP, and it comes from a combination of taxes on trade in and out of the EU, a small percentage of value-added tax (VAT) taxes collected in EU member states, and contributions from member states based on their gross national income (GNI) (European Commission, 2014). Although there is currently no trend toward EU revenue increasing, greater demands on it to provide public goods for all member states could easily drive up revenue in the future. If that begins to happen, will it place downward pressure on taxation in member states?

At the same time that supra-state political units are rising, so too are sub-state regions seeking more autonomy and sometimes even independence, and this too has important implications for tax policy. Catalonia is one example of this process. One of the most commonly cited reasons for the Catalan independence movement is that the region gives more to the central government in taxes than it gets back in state spending. Although estimates of the extent of this "fiscal imbalance" vary (Mount, 2015; Terol, 2017), scholars agree that Catalonia is, in fact, paying more than it is getting back. The interesting question is whether debates about fiscal imbalances will become an emerging trend in the politics of taxation. It is often true that richer regions of countries (like Catalonia) will have negative fiscal balances with the central state and that poorer regions will have positive fiscal balances. For example, in the United States, states like California, New York, New Jersey, and Delaware have negative fiscal balances whereas Mississippi, Alabama, and North and South Dakota have positive fiscal balances. Will this soon become a major axis of conflict in US politics?

Explaining Regional Variations

As we noted earlier, explaining increases in tax evasion should be a focus in future research. One interesting question concerns clusters of states with high rates of tax evasion. Tax evasion is particularly high in two separate regions on Europe, each encompassing multiple independent states. These regional variations force us to think beyond the internal dynamics of nation-states in seeking explanations.

Post-communist countries were faced with "an acute crisis of state capacity" after the transition (Ganev, 2005, p. 427) as a result of an "incapable tax administration" (Easter, 2002, p. 621). One of the main problems was hiring on the basis of clientelism rather than merit, increasing the expense and decreasing the effectiveness of administration (Grzymala-Busse, 2007, pp. 5–6). Differences in levels of corruption in postcommunist states were mainly a function of party competition—when sufficient competition existed, parties had incentives to create more effective administration (Grzymala-Busse, 2007, pp. 10–12). However, in addition to these institutional effects, fiscal culture is also important. The long period of imposed state socialism dramatically decreased the legitimacy of Eastern European states, and led to development of habits of noncompliance that persisted after the transition. Moreover, the knowledge that many other citizens were not paying their taxes undermined quasi-voluntary compliance further, leading to a vicious circle of decreasing compliance (Kiser & Levi, 2015). Future research should address the relationship between institutional and cultural causes of high tax evasion in post-communist states.

The debates about high tax evasion in Southern Europe (Italy, Spain, Portugal, and Greece) are in most respects similar. The Italian case is illustrative (this paragraph draws on Ginsborg, 2006). The tax evasion rate in Italy is around 18–19%—roughly three times as much as most OECD countries. The problem is especially severe in both the VAT and income taxes. The main groups evading taxes in Italy are small businesses and people involved in the informal economy. One of the main causes is institutional clientelistic recruitment of officials. In addition to that, Italian political culture views corruption of all types (including tax evasion) as both pervasive and morally neutral, such that people not engaging in corrupt practices are viewed not as moral but as suckers. The pervasiveness of this political culture makes tax collection extremely difficult, as taxpayers pay little or no moral/reputation cost for evasion (but see Zhang, Andrighetto, Ottone, Panzano, & Steinmo, 2015 for some interesting experimental findings that do not support this cultural explanation). Again, the most interesting questions for future research are about the complex interactions between political institutions and culture.

CONCLUSION

The political economy of taxation is fertile ground for future research. There are many interesting questions yet to be answered about the determinants of total tax revenue, tax structure, and tax administration and compliance. By highlighting a few of these questions, we hope to encourage research that will address them, and raise some new ones as well.

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