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How Labour Ended Up Taxing Itself: The Political Consequences of a Century of Self-transformation of the German Welfare State

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ABSTRACT

This paper investigates the long-term evolution of the tax system in Germany to explain why the political left has increasingly expanded taxation to its own clientele. The paper contrasts the second half of the 19th with the second half of the 20th century to show that some of the underlying parameters of tax systems have changed over time. In particular these are the existence of a mature welfare state and the significance of real wages as a tax base. Moreover, the paper selectively uses comparisons with the United Kingdom (UK) to show that where these conditions are absent the structure of the tax system is very different and taxes labour much less than in Germany. In this sense the British self-transformation of the welfare state has had very different political consequences than the German.

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How Labour Ended Up Taxing Itself:
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1 INTRODUCTION HOW TO TAX LABOUR - AN OLD QUESTION

When the tax and social security state arose in the 19th century it was a product of a political power struggle (e.g. Esping-Andersen 1990). This struggle could be framed along the lines of capital vs. labour. Progressive (income) taxation was a weapon of the political left to tax the political right. Today, as most economists agree, the overwhelming part of the tax incidence lies on labour (e.g. Nickell/ Layard 1999). How did labour end up taxing itself? What is the political explanation for this process? These are the key questions of this article. Going back to the origins of the welfare state we will see that the answer is, in part, a process that can be labelled the self-transformation of the tax state. This has important consequences for an understanding of the politics of taxation after 1945.

Differences in the funding of welfare states have been debated ever since the very beginning of welfare statism. Bismarck’s decision to organize German social insurance as a contribution-based scheme was observed early on by Lasalle and others as a major attempt to produce social security without socialism (Tennstedt and Winter, 1993). Ironically, the contribution-based revenues of Bismarckian welfare states were not the intellectual offspring of Bismarck himself. To the contrary, Bismarck favoured a tax-financed social security system. In particular, in the first draft of the German ‘Unfallversicherungsgesetz’ (bill for invalidity insurance), Bismarck defended the idea of tax-funded insurance with a vocabulary which strongly reminds us of modern critics of high non-wage labor costs:

> *‘For freedom is nothing but death! If you don't want to reach into your pocket and the treasury, you will not achieve anything. To impose the whole burden on industry, I don't know whether it could stand that. It would hardly work for all industries. For some it may work: for those in which the wage of workers is just a small component of the entire costs of production. [. . . The problem however] exists for those, in which wages amount to 80 or 90 per cent of all costs, and whether those could survive, I don't know.’(own translation of Tennstedt and Winter, 1993, 590)*

Note that current debates on the effects of taxation on employment focus on very similar points: high levels of taxation reduce incentives to work and reduce employers’ willingness to hire. They will hurt particularly vulnerable segments of the population. In highly developed countries these are the low skilled, i.e. the low-wage sector.

Interestingly, the bill designed by Bismarck never passed, but was replaced by a contribution-based proposal finally backed by a conservative- Christian majority in the German parliament. The reason for this outcome had little to do with finding economically optimal ways of financing the welfare state. Rather, political parties in the German parliament feared that a tax-financed scheme would strengthen the role of the central state vis-à-vis the federal states in Germany. Ultimately, the decision on how to finance insurance was a political one (Schmidt, 1998, 24).

In Bismarck’s case, politics overrode economics. The question is whether we see similar effects taking place today, in a time when the claim is often made that politics - and nation states as the prime political actors - recede in the face of international market pressures. Proponents of such a no-politics idea argue that most of the empirically discernible variation in the tax structure is due to inflation, growth or other socioeconomic fundamentals. Hence, diverging national trajectories are driven by automatic fiscal responses. Historical institutionalists enhance this argument. They claim that the important tax policy decisions were made some 100 or more years ago. From then on, the tax system evolved as a consequence of institutional path-dependencies and created political dynamics of its own (Steinmo, 1993).

There are scholars who disagree. Early on Titmuss (1974) claimed that taxation is a fundamental part of the welfare regime which in turn is of political origin. Left versus right positioning still has explanatory power in people’s attitudes on the domain of public spending and taxation (Kitschelt, 1994). If there are deviations from a partisan preference, these are due to the role of political institutions or international competition (Ganghof, 2006). Hence, all in all the left vs. right is still an important description of the underlying differences in tax-policy preferences of governments (Wagschal, 2003). So, who of the two sides is right?

I will investigate the long-term evolution of the tax system in Germany in form of a historical case study. In particular, I will contrast the second half of the 19th with the second half of the 20th century to show that some of the underlying parameters of tax systems have changed over time. In particular these are the existence of a mature welfare state and the significance of real wages as a tax base. In this respect Germany is very useful case since it is one of the pioneers of modern welfare states.[1] Moreover, I will selectively draw comparisons to the United Kingdom (UK) to show in what sense the German case is unique or may be comparable to a larger class of cases.[2] In the remainder of this paper I will first depict the theoretical argument, before I narrate the

1 For a critical discussion of Germany as a historical role model cf. Lindert 2004

2 In my book (Kemmerling 2009 forthcoming) I extend my case study analysis to a cross-country comparison and discuss the related literature in more detail.

evolutions in the late 19th and 20th century respectively. The last section concludes with some more general implications of my findings.

2 The Argument

In this section I want to lay out the main theoretical argument which helps to understand the long-term changes of the German tax system. In a nutshell, there is one crucial difference between 19th century Germany and contemporary OECD countries: Back then costs could not be completely rolled-over to labour, since wages were close to what workers needed in terms of basic nutrition and accommodation. Hence it may well be that the parliament discussed two different forms of taxation on capital rather than on labour. Note that Bismarck himself was not worried about workers; he was worried about ‘the industry’. Today, however, many countries provide substantive levels of public social security and have, above all, comparatively high real wages for most workers. This implies some level of decommodification[3], i.e. wages are considerably higher than the level of subsistence. The economic implication of this is that the incidence of major tax forms such as income, payroll[3] and indirect taxation is largely on wages. It is, perhaps unintentionally, the modern welfare state that is a key reason why most of these taxes today fall on labour, since it has empowered workers to strive for higher wages and higher demands for tax-based social security.

Against this historical background, the previously mentioned ‘no-politics idea’ is clearly not wrong, but somewhat misleading. Path dependencies are at work and have led to a growing tax state. But the underlying logic differs. The conflict of interests in the tax structure is nowadays one within labour, less between labour and capital.

Similarly, the ‘politics-still-matters idea’ is neither false, but has usually played the heterogeneity of workers down (for a similar point cf. Rueda, 2006). The reason is that progressive taxation has only straightforward redistributive effects in a perfect market economy. Only in this case higher progressivity translates into higher redistribution between rich and poor voters, and only here the preferences for progressivity follow a clear left-vs.-right pattern. In labour markets with welfare state arrangements, progressivity also translates into redistribution of employment and income probabilities. Lack of progressivity will strongly harm low-skilled workers, whereas medium-skilled workers are left in an ambivalent situation. If there is competition between medium- and low-skilled workers, the former will have an ambiguous stance on progressivity. The sharper

3 Note that throughout this article I will use payroll taxes and contributions to the social security system synonymously. Strictly speaking that is not entirely correct, since contributions are not taxes, but it is common practice to do so.

the conflict between insiders (medium skilled) versus outsiders (low skilled),[4] and the more political parties and unions represent the former, the more ambivalent will there stance on progressive taxation become.

There are two major causal mechanisms that possibly work together to explain this somewhat counter-intuitive hypothesis. First, tax progression eats up wage increases on the margin. This is particularly bad for unions when they bargain autonomously for waged with employers' associations. Tax policy is therefore similar to income and inflation policies of the 1970s and meets similar ambivalence on the part of trade unions. Second, tax progression at the lower end of the wage scale makes job competition fiercer. Progression makes take-up of work easier for low-wage earners and will put workers with slightly higher wages under pressure. Trade unions that represent the latter more than the former will therefore have an ambivalent stance also as regards activation and workfare policies.[5]

To exemplify these claims I use the historical case of Germany in the 19th and 20th century. 19th century Germany shows that, when there is no meaningful welfare state, the traditional left-vs.-right cleavage goes a long way in explaining the dynamics in the political fate of progressive taxation. 20th century Germany shows that this strong link is seriously weakened once labour taxes itself. I will describe evolutions of the tax structure in Germany after the World War II. We will see that intra-class conflicts arose and emanated in an ambivalent stance of labour parties and trade unions on progressive taxation. This not only holds for the taxation of low-wage workers but also for tax policies targeted at the low-wage sector.

3. REVISITING 19TH CENTURY GERMANY

In the introduction I mentioned Bismarck's worries about a contribution-based scheme of social insurance. Since many scholars treat Wilhelmine Germany as the cradle of the modern welfare state this historical epoch has provoked a large interest (Tennstedt and Winter,1993; Schmidt, 1998). Wilhelmine Germany has also been frequently used as an empirical example for investigating issues of tax competition and economic integration (Hallerberg, 1996). However, the area of overlap has not. Bringing these two perspectives – the evolution of the welfare state and early evidence for tax competition – together we will see in how far trade unions and the German social-democratic Party

4 In Kemmerling (2009 fc.) I discuss in more detail the theoretical foundations of the insider-outsider logic which comes from labour economics but which also has been applied to political science (e.g. Rueda 2006).

5 I have to stress the fact that this is not meant to say that trade unions are bad for redistribution. The only analytically important point in this essay is that long-term changes in the underlying structures drive wedges into the large class of voters usually known as labour.

could shape the tax systems and its progressiveness against severe international and institutional restrictions.

Germany’s Many Tax Systems

Hallerberg (1996)’s study on German tax competition in the second half of the 19th century is an interesting start for my discussion. He argues that the major changes in the tax system before the beginning of World War I were: (1) an upward convergence in tax levels, in his eyes refuting the argument that tax competition automatically leads to downward pressure; (2) less mobile tax bases were only taxed where political institutions allowed this to be done. Hence property was only slightly taxed in Prussia because of the census franchise, whereas it was taxed more heavily in southern German states with liberal constitutions. (3) Labour taxation remained lower than would be expected by a tax competition model. I will tackle these claims to show why and how labour ended up with seemingly low tax rates.

With the end of the Holy Roman Empire in 1806 economic integration proceeded for several decades before political integration caught up with it. Negotiations on economic liberalization between German states started soon after Napoleon’s defeat in 1815. They lead to the formation of a tariff union (Zollunion) in 1834 and culminated in the German empire of 1870. The empire consisted of 25 very heterogeneous states all with different systems of taxation. Across levels there was a system of mixed financing. Indirect taxes were partly pooled at the central level, and mainly consisted of tariffs and specific excise taxes (Henning, 1996, 622). Most direct taxes remained at the state level (Hallerberg, 1996). The Reich mirrored the tax mix of other federal countries at that time, such as Switzerland or the U.S. The tax base with the least mobility, land or property taxes, was an important public revenue source in many German states, and was politically a more salient issue than nowadays. For this reason German states were reluctant to pool these taxes at the central level. In the 1880s, the introduction of a social security system led to the accumulation of specifically earmarked public revenue in the form of social security contributions, but its size was for a long time marginal. On the central level a prototype of an income tax was only introduced in 1913 as a consequence of war finance (Wehler 1995: 1037). This stands in marked contrast to a country such as England, were some form of income taxation was already introduced in the late 18th century as a means to finance the war against Napoleon (O’Brien, 1988).

In a non-democratic regime one has to be careful what kind of political cleavages and interests constitute the polity. The German Empire was a political federation dominated by one player: Prussia. So we have to inspect this player more closely. Historians hold two distinct and somewhat conflicting beliefs about the Prussian state (Steinmetz, 2000). They argue either that it was an autocratic regime with substantial autonomy vis-à-vis the society (Skocpol cited in Steinmetz, 2000, 265) or that it was a state largely controlled by the old feudal ‘Junker’ class of land-owning aristocrats (Taylor, 2004). Hallerberg implicitly uses both notions. He argues that the upward convergence of tax levels was mainly due to the fact that the Prussian government needed higher revenues, while the other states followed the ‘Stackelberg leader’ (Hallerberg, 1996, 349). The fact that property taxes were left mostly untouched was, in his view, due to the political resistance of land-owners, who were privileged in their political representation. According to this reading the endurance of agrarian interests in Germany is part of the German ‘Sonderweg’. This is true in that the German state was autocratic, but it underestimates the role of the business sector and of influential branches such as iron and steel in the German system.

The Role of Business

Hallerberg argues that taxes on capital were higher than the conventional race to the bottom story would suggest. But once you look at the whole ‘package’ taxation, trade policy and public subsidies, it becomes clear that political deals struck between industrialists and agrarians were in the mutual interest of both. The tax structure depended on the level of tariffs imposed on imports. Although higher tariffs were an instrument that clearly favoured agrarians, they were not necessarily harmful for influential German companies (Henning, 1996, 810). Instead, companies shifted higher tariffs forward onto consumers who bore the brunt of protectionism. Industrialists benefited from the subsidies they received for building railways and, after 1900, the German navy (Taylor, 2004, 176). The industrialists maximized the net benefits of this package deal, by agreeing with comparatively high levels of taxation, which were then compensated by these subsidies.

Data on the total level of subsidies toward the business sector is difficult to gather, but some estimates illustrate the idea that taxes net of subsidies and public contracts were much lower. During the 19th and early 20th century the major item in public outlays was public defence, which benefited the German metal and steel industry (Henning, 1996, 1085). In contrast, even at the eve of World War I social expenditure was a mere 3 per cent of the public budget. Moreover, this is only the public budget itself and does not include other forms of subsidies, such as the special royalties granted to railways. It is therefore a plausible assumption that industrialists knew how to flex their political muscle and yielded a net benefit even if this did not show up in lower levels of taxation for them.

In a similar vein, recent historical research emphasizes the fact that industrialists also shaped early social policies very much to their liking (Steinmetz, 2000, 265). Before World War I German social policy was largely a set of ’poor laws’ and the social insurance transfers did not outgrow means-tested benefits during this period. Business also played a strong role in the decision for a contribution-based system of social security. Again one has to be careful not to confound nominal with real incidence of the burden. Ullmann (cited in Lindert, 2004, 174), for instance, argues that big industry was very swift with rolling the burden of contribution onto to consumers, whereas small export-oriented firms largely opposed social insurance. Steinmetz (2000, 301) concludes that the autocratic Prussian state was largely dependent on ‘big’ capital and was not able to act contrary to its interests.

The Role of Labour

This question which can be arised new is as follows: Why was labour not taxed more heavily at that time? This brings us back to an analysis of the economic and political restrictions. Hallerberg largely talks about the mobility of a tax base and concludes that more mobile taxes, such as taxes on companies, were not less taxed than less mobile taxes such as those on property. Labour was not taxed extensively, according to Hallerberg, because the German Empire allowed for freedom of settlement which increased labour mobility. But inter-state mobility was a minor cause for a high elasticity of labour taxes. A more important one was whether the tax base was large enough to be taxable at all. Indeed, absolute tax bases were so small that most 18th century (political) economists such as David Ricardo assumed that the incidence of total taxation fell exclusively on capital. This leaves us with the hypothesis that labour taxation could only become politically salient with the development of the welfare state, and the concomitant growth of a ‘taxable’ tax basis: real wages.

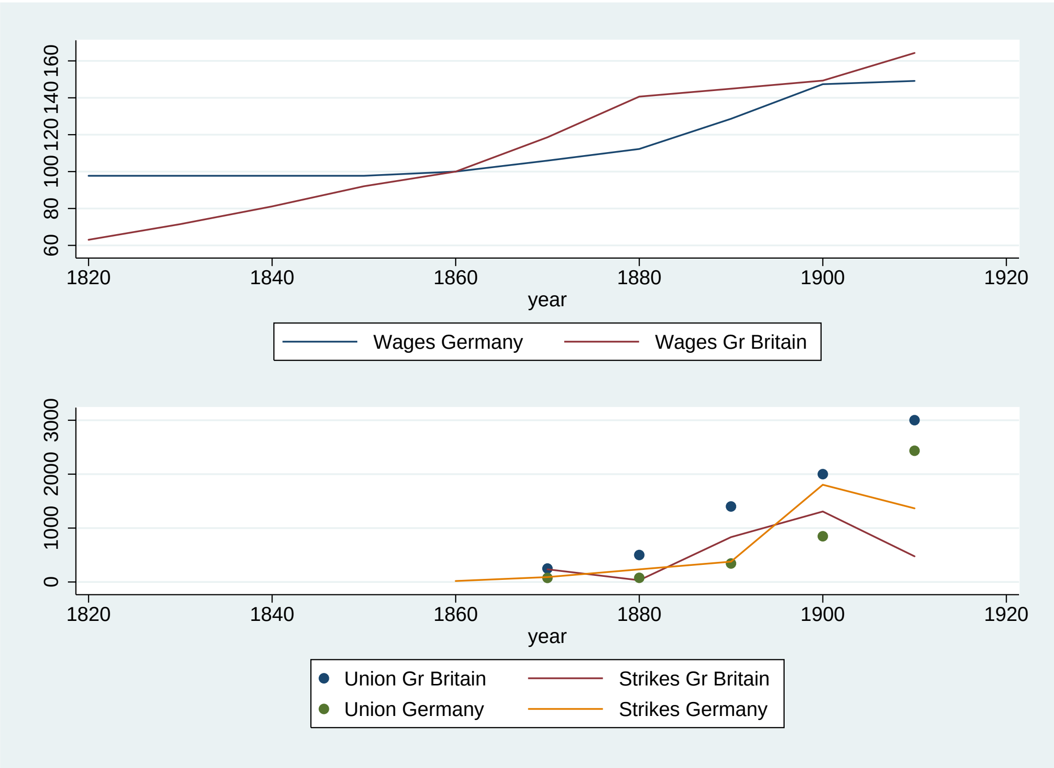
Indeed German pauperism peaked in about 1850 (Henning, 1996, 749) and real income only surpassed its level of 1780 some 90 years later (ibid. p. 1096), around the time when the second German empire was founded. The level of real wages was not very much higher than the reproductive wage, i.e. the wage a worker needed for his basic needs. It was at times even lower, as the numerous famines of the period serve to remind us. It is therefore no wonder that real wages only started to grow substantively in the last quarter of the 19th century. Figure 1 shows some consensus estimates for the evolution of real wages from 1820 to 1920 in Germany and compares them to the real wages in Great Britain.[6] Even in Great Britain, the pioneer of industrial revolution, real wages took off comparatively late, from the 1840s onwards. Analysing wage data of British craftsmen (Clark, 2005) concludes that till the mid of the 19th century still fol-

6 The ‘consensus’ estimates are own calculations on basis of Scholliers and Hannes (1989, 232). They are cumulative growth rates indexed to the year 1860 as 100. Hence it is not possible to compare the levels of real wages in Germany and the UK.

lowed the medieval trend of a Malthusian society in which population growth determines real wages.

Under these circumstances, in the first half of the 19th century taxing wages was not a feasible strategy for any government. What happened thereafter? To answer this question it is important to see that it is the relative elasticity of both sides of the market that counts for the incidence of taxation. In the second half of the 19th century, the balance was tipped more and more in favour of labour supply. There were several reasons for this. The demographic explosion had already reached its high-point in the early 18th century, so that growth rates slowed down when the economic integration process started. Labour supply continued to increase in the middle of the 19th century, but at a slower rate (Henning, 1996, 296). Labour demand, however, increased dramatically after major technical innovations made workers in the manufacturing sector scarce.

Figure 1 German and British Wage and Unions in the 19th Century



More importantly, a factor that worked against the taxation of labour was the organization of labour itself. The lower panel of figure 1 shows the evolution of union membership and the number of strikes in the 19th century, again for Germany and the UK compared.[7] Although both strikes and union membership were subject to business cycles

[7] Strike and membership data stem from Cronin (1984), Boll (1984) and Hohorst, Kocka and Ritter (1975). Union data is in 1000s of union members. Strike data is numbers of strikes per annum. Note that there are breaks in all series, since the original data comes from various sources.

there is a clear upward trend visible in both countries. Until World War I union density approached 25 per cent in Great Britain and 15 per cent in Germany. There is also evidence that in both countries unions replaced strong measures such as strikes with more moderate strategies of negotiation and collective bargaining (Cronin, 1984, 107). A comparison of both panels in figure 1 also shows a roughly similar upward trend in union members and real wages. Needless to say that increases in real wages depended on many more factors than strong unions, but many economic historians would argue that it played an important role at the time.

For a comparison with the 20th century it is important to analyse not only the strength but also the heterogeneity of labour. One way to do so is to look at the composition of trade unions. Again Germany mirrored earlier evolutions in British trade unions (Cronin, 1984, 83). The first workers to get organized were typically higher skilled craftsmen (Ritter, 1963, 110). Until World War I unionism became increasingly a mass phenomenon and the median union member was much more low-skilled than before (Ritter, 1963, 113). Hence, union became more and more encompassing. Neither did they ‘over-represent’ insiders in the labour market, and rent-creating institutions in the sense of Saint-Paul (2000) – for example employment protection legislation – did not yet exist.

From the very beginning German trade unions and the labour movement had political motives (Ritter, 1963, 13). Taxation became an important part of its political programme. In the Communist Manifest Marx (1989 (1848)) himself argued for high tax progression. Similar claims soon pervaded both trade union publications and those of their politically: the Social Democrats. Fearing a socialist revolution, Bismarck used a twin strategy of prohibiting workers’ associations and granting some of their political demands such as social security (Ritter, 1963, 27). This did weaken the course of the labour movement, but only for some time. With the Gotha program of 1875 the Social Democrats explicitly referred to a progressive income tax (Corneo, 2005, 17) and henceforth fought for its introduction.

This pressure was not without consequences: Some smaller German states introduced an income tax already from 1848 on. Prussia introduced a (minor) income tax in 1893, and the German Reichstag passed a law on war finance which already contained important properties of centralized income taxation in 1913. Nevertheless, both the timing and scope of these income taxes show that the political institutions hampered labour interests. Hallerberg (1996) focuses on the role of voting rights: In states like Prussia the upper class had a tight grip on legislation because of a class-based franchise that gave more power to the rich. Here it was particularly difficult to implement progressive tax forms such as income taxation. Also for elections to the Reichstag (national parliament) the voting rules worked against the Social Democrats. The plurality rule and the design of constituencies lead to the fact that Social Democrats received significantly less seats in parliament than votes (Ritter, 1963, 67).

Finally, it is noteworthy that the conservatives as the major opponents of labour were against the introduction of a modern income tax. Bismarck himself dreaded such a tax at either state or federal level for its sheer redistributive potential:"A rational limitation of the principle of progressive taxation is not possible. It will develop further, once legally acknowledged, towards the direction in which lie the ideals of socialism." (quoted in Henning, 1996, 886, own translation). At the time a progressive income tax clearly polarized the electorate between conservative, rich voters and left, poor voters.

Conclusions in the 'half-time break'

Where does this lead our discussion? The general picture is that context factors are important in historical comparisons. Even a non-democratic state needs the support of powerful classes such as the industrialists of turn-of-the-century Germany. In addition, the tax mix could not be shifted to employees, since the tax base of real wages was small and the political resilience of workers grew stronger. This drives home our idea that the welfare state and the wage-bargaining system are influential institutions for the impact that taxes have on the labour market: one needs some degree of 'deco modification' in the parlance of Esping-Andersen (1990) to make labour face the burden of taxation effectively. With no welfare state, no wage-bargaining institutions and low real wages, the only way to tax labour is consumption. This was exactly what happened back then.

Nowadays taxation falls overwhelmingly on labour: income, payroll and consumption taxes. This changes the underlying logic of the political game on tax progression and redistribution. To show this I will leap forward some 50 years and will depict the political situation in Germany after the World War II. We will see that the changing context has also visible implications for the strategic options of the political left. When income taxation was not only about expropriating the rich any more, it was not unambiguously preferred by trade unions and left political parties any longer.

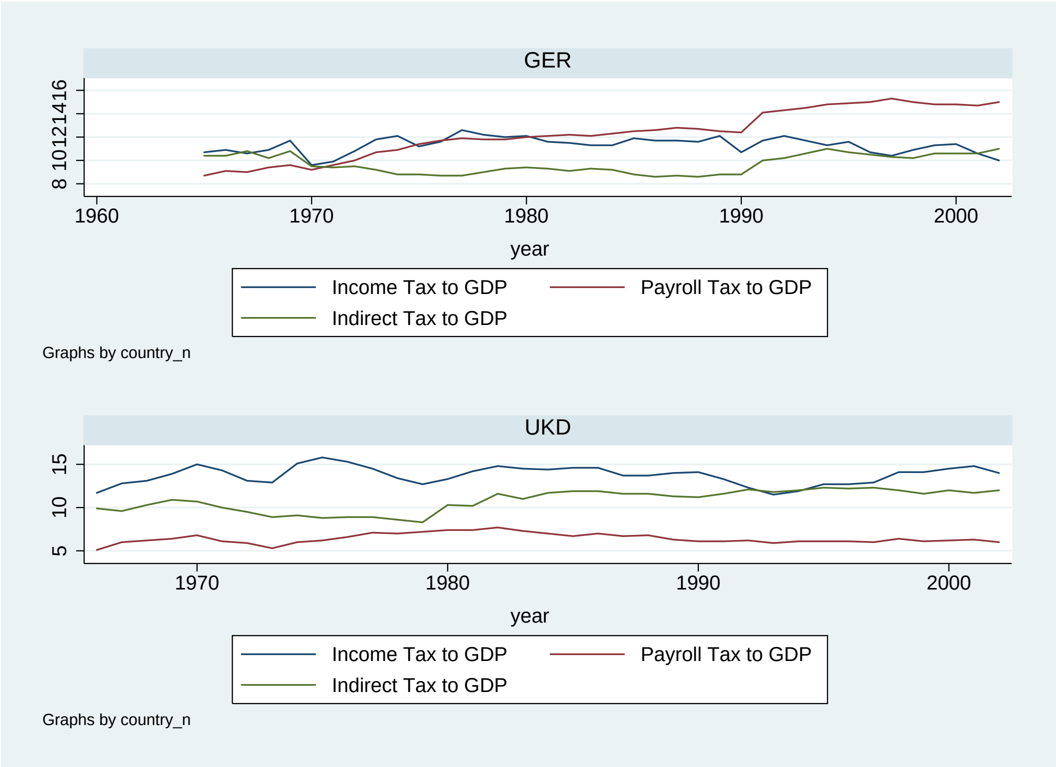
4. Germany after World War II

Let us start with a look at aggregate statistics of tax ratios. Figure 2 shows the evolution of the tax mix in Germany after the Second World War.[8] Income tax ratios peaked in the late 1970s and went on an almost continuous decline thereafter. Economic shocks such as the oil crises and reunification led to noticeable jumps of social security contribu-

[8] Data comes from OECD Revenue Statistics. Payroll taxes include social security contributions.

tions. From the 1980s onwards payroll taxes became the dominant form of public revenues, but indirect taxes in the form of VAT (value-added tax) have caught up in recent years. For comparative reasons I have plotted the tax mix of the UK on the right hand side of the figure. In the UK the income tax ratio hit its all-time high already in the mid 1970s, became briefly more important in the early Thatcher years, and then went back on decline until the mid 1990s. Only from then on income tax revenues have recovered slightly. Indirect tax revenues have increased over the whole period. Only during the labour governments of the late 60s and 70s payroll taxation was of some importance.

Figure 2 Tax Mix of Germany and the UK after World War II



In both countries one sees influences of business cycles (inflation and growth) in the growth of income tax. One can also see long term changes that are due to political reasons that shifted the tax mix away from progression. Of course, a higher proportion of income taxes does not automatically lead to higher levels of progressivity. Yet different measures of tax-based redistribution move broadly in line with ratios in both countries. Using both statutory marginal rates and coefficients of ’residual progression’ Corneo (2005) shows for Germany that from 1958 till the mid 1980s tax progression was on the rise for middle and high incomes, whereas it has decreased from then on. Very low incomes of half the average GDP per capita income have seen a remarkable increase in marginal rates so that the overall progressivity of highest and lowest income brackets has been reduced since the mid 1970s. It is therefore safe to argue that across time the

German tax system has first become more progressive up until the 1970s and since progressivity has been on decline.[9]

The Rise of German Income Taxation until late 1970s

The period from the end of World War II till the late 1970s is the golden age of income taxation in Germany. Not only were income taxes the major tax form, but also they became more and more progressive. This correlates with a strong political representation of unions and left parties. Unions had close ties to major political parties and were directly inserted into the corporatist arrangement of the state. However, sectoral changes were under way that deeply changed the composition and the scope of trade unions in these three decades. With it came the first signs of a roll-back in the progressivity of the tax mix. As mentioned earlier, income taxation was introduced comparatively late.

The Weimar Republic replaced the 27 income taxes on the state level by a national income tax, but payroll taxes were of much greater (political) importance as sources of revenues (Lindert, 2004). Military occupation after 1945, however, gave income taxation a big push since the Allied Forces installed a very progressive scheme with marginal rates as high as 95 per cent.

The first democratically elected government of Konrad Adenauer cut general levels of taxation to stimulate economic activity (Zohlnhöfer, 2006). It was very careful, however, to maintain or even increase tax progression. This was in part the consequence of the ideological closeness to the Catholic Church, but it also had a clear strategic component: Adenauer’s party, the Christian-Democratic Union (CDU), aimed at the centre of the political spectrum and at integrating workers into its electorate. Its political future depended directly on the permissive consensus of trade unions which the CDU tried to lure with tax policies, but also with measures that strengthened the role of trade unions in big companies such as workers’ council and codetermination (Zohlnhöfer, 2006, 8). In consent with the unions the Adenauer government also sowed the seeds for the latter explosion of social security contributions: it linked pension benefits to economic growth and introduced new benefits such as schemes for early retirement (Manow and Seils, 2000).

With the first economic crisis Social Democrats came into office, first as the smaller coalition partner of the CDU in 1966, then as the dominant political force in a social-liberal coalition government from 1969 onwards. The political change also marked a change towards Keynesian economic policy. Fighting the economic crisis eventually made higher revenues necessary. Automatic adjustment kicked in and increased social security contributions enormously (Manow and Seils, 2000). At the same time, the gov-

[9] For further evidence and references cf. Kemmerling (2009 fc., chapter 2).

ernment depended on the wage restraint of trade unions and enhanced efforts to insert unions directly in the so-called “Konzertierte Aktion“ (Scharpf, 1987), a tripartite corporatist arrangement. The result of this process was a high point in union power. In 1969 the Social Democrats won the elections, not least due to support from trade unions. Union density still increased and unions proved their militancy in a number of wildcat strikes in the early 70s even before the oil crisis changed the political tug of war decisively (Schmid, 2006).

The mid 1970s mark a turning point in the representativeness of trade unions. Bargaining coverage was instituted already in the Weimar years, but the German constitution or Basic Law (Art. 9, 3) strengthened unions with the freedom of workers’ associations to bargain for wages autonomously. The rise in union power concealed a qualitative change in union membership. The median union member represented more and more medium-skilled workers, most importantly of big companies. In turn, big companies laid-off more and more low-skilled workers (Carruth and Schnabel, 1990).

This change is also visible in unions and employers’ associations demanding new policies such as the expansion of early retirement schemes notwithstanding the sharp rise in social security contributions these measures provoked. Hence, the political demands started to mirror this shift in composition since early retirement or higher unemployment benefits were predominantly in the interest of the core of the workforce. Moreover, wage negotiations and the expansion of the social wage should act as a whip for employers to increase productivity (Scharpf, 1987). This pattern eventually affected tax policy: if the strategy of social partners is to enhance productivity, it is not reasonable to ‘subsidize’ low-wage worker by tax progression. The issue of tax progressivity became one about taxing the highest income brackets, not one of progressivity all across the income range.

Conservative Retrenchment of Tax Progression in the 1980s

In the late 1970s and early 1980s economic crises led to the demise of the German Social Democrats and to the ushering in of a period of retrenchment. However, the Kohl government’s position on tax and social issues was not so far away from the Social Democrats.[10] Moreover, it crucially depended on some level of consensus with trade unions on issues of labour market and social reforms (Scharpf, 1987). If tax policy changed in this period it must have been because of hard economic restraints or because the Social Democrats and the trade unions were not so firmly aligned behind the idea of tax progression any more.

[10] If anything the Party Manifesto Data of Budge et al. (2001) shows convergence on both the welfare and the economic planning dimension between the 1960s and 1980s.

In 1982 the Kohl government came with the promise of a ‘moral turnaround’ which put the blame for a stagnant economy, comparatively high rates of unemployment and increasing budget deficits on Social Democratic policy making. In the beginning, the government opted for an austerity package that included some cuts in welfare benefits (Scharpf, 1987). In the Budget Reform Act of 1983 the Kohl government increased VAT and social security contributions (Zohlnhöfer, 2006). To counterbalance the regressive impact the government also decreased family allowances for very rich people. Having achieved a mild budget consolidation, the Kohl government went on to reform the tax system in three steps from 1986 to 1990. The revenue effects of this reform were fairly small. Both the top marginal rate and the lowest rate were cut slightly, and basic allowance was mildly increased. In effective terms, the tax reforms benefited mainly the middle class (Ganghof, 2004, 68).

On the expenditure side of the budget the Kohl government was not very successful in cutting benefits. In 1984 it reduced unemployment benefits and unemployment assistance slightly, but at the same time it increased eligibility for earnings-related unemployment benefits to 32 months (Zohlnhöfer, 2001, 665). It also increased spending for active labour market policies so that overall contribution to unemployment insurance had to increase slightly over time to keep the budget of the federal employment agency balanced. More importantly for the long-term evolution of the tax mix were decisions to decrease tensions on the labour market with a reduction in labour supply: sending home foreign workers, early retirement and a tax policy that was oriented to the male breadwinner (Schmid, 2006). All these measures led to automatic shifts of the tax mix towards payroll taxation in times of high unemployment (Manow and Seils, 2000). This became dramatically evident after German reunification. The steep incline in the number of unemployed people and pensioners led to an enormous jump in payroll taxation. Eventually, this made deep cuts in the generosity of welfare benefits necessary, but Social Democrats and trade unions opposed such measures.

In the 1980s the Kohl government did try to restrict union power somewhat, for instance in its regulation of worker councils, but, in general, reforms of labour market institutions took place at the fringes of the labour market and not in its centre (Zohlnhöfer, 2001, 667). For example, the Kohl government increased the possibility of limited contracts, but left general employment protection legislation untouched. Neither could the government directly affect the bargaining power of trade unions which stayed at high levels throughout the decade, although union membership was already on decline.

With reunification the gap briefly widened as trade unions were not very popular in the formerly communist Eastern Germany, but western unions were successful at exporting labour market regulation to Eastern Germany. The unions themselves preferred a wage policy that should lead to a quick levelling of the wage gap by increasing eastern wages to the western standard. The idea was once again to force productivity levels to such levels that growth and consumption would kick in (Sinn and Sinn, 1992). As a result unions’ wage policies enhanced the major slump in employment that was already on its way because of the economic transformation.

The later years of the Kohl government resulted in a continuous struggle against high labour costs. The government had to introduce a new ’solidarity’ surcharge on income taxes, and yet the relative proportion of income taxation went down, since the inflow of unemployed and retired Eastern Germans lead to steep incline of contribution rates. In its last years the Kohl government aimed at a major tax reform, the so-called Petersberger proposal, which, for example, would have cut top marginal income taxes from 53 to 39 per cent. The Social Democrats, who dominated the second chamber in the parliament, refused to accept this proposal.[11] With their veto the most important income tax reform of the Kohl government failed. The only factor that re-established some degree of progression on the lower end of the income scale was an influential ruling of the German Federal Court of Justice. In 1995 it demanded a dramatic increase of the basic allowances in income taxation in order to realign the tax system with the social minimum of the social security system. The government responded with a twofold increase of basic allowances.

To summarize, we see that the conservative government did not implement very far reaching policy reforms against the interest of unions and Social Democrats. If the tax mix shifted towards less progressivity this was due to automatic adjustment against which neither the conservatives nor a heterogeneous and indecisive left fought strongly.

Tax and Labour Market Policy at the Turn of the Century

The last decade is too short and too recent to be fully analysed here. Many policy reforms linked to taxation are still very much in flux, some are already rolled back again. The overall picture is one of a stop-and-go pattern since the Social Democrats swayed between different ideologies with no clear winner visible so far.

In 1998 Gerhard Schröder broke the spell of four consecutive electoral defeats and ushered in a red-green coalition government. The coalition agreement of both parties promised greater social justice. In the area of tax policy it mentioned the rise in the basic allowances and a lower first rate the income tax system. In the beginning the new government undid some of the reforms under taken by its predecessor: for example, it undid Kohl’s last pension reform and increased pension benefits and it tightened em-

[11] There is some debate whether the Social Democrats’ veto was primarily due to substantive differences or electoral motives (Ganghof, 2004;Zohlnhöfer, 2006).

ployment protection after the Kohl government had loosened it somewhat. It also made so-called minor jobs of 630 DM liable to social insurance contributions. These reforms did not last for long, however, since the government soon started to take all of these policy reversals back (Egle and Zohlnhöfer, 2007). More importantly, it designed a reform package that included relatively tough austerity measures with a tax reform that cut statutory rates on corporate and personal income dramatically.

The ironic twist of this tax reform was that it came fairly close to the last reform proposal of the Kohl government which the Social Democrats majority faction of the second chamber had vetoed. From the mid 1990s onward the major political parties perceived tax competition on corporate income to be more and more a serious obstacle to economic growth in Germany (Ganghof, 2004). Since both coalition partners accepted the need for a cut in corporate tax rates, the question remained whether the reform should also include a cut of statutory rates on personal income. Given the complexity of the German income tax systems it was very difficult to find compromises in that respect. Perhaps of even higher importance was the role of the Federal Court of Justice since many politicians' rightfully feared the court would veto a tax reform that generated a large gap between corporate and personal income tax rates and thereby violated 'horizontal' tax equity (Ganghof, 2004). The upshot of this veto position was that the cut corporate tax rate from 52 per cent to 39 per cent had to be accompanied by a similar cut in personal rates gradually from 53 to 42 per cent. Counteractive measures to re-establish progressivity were much weaker. The tax reform contained a cut in the first tax rate from 23 to 15 per cent and an increase in the basic allowance, but all things considered, the reform flattened the German income tax schedule to a degree hitherto unknown.

The tax reform, no matter how inefficient or unfair, was of minor political importance compared to the reforms of labour market and social policies in the so-called Agenda 2010. Reunification had increased the number of unemployed steadily up to 4.5 million or 12 per cent of the labour force in 1997. The government promised to tackle this problem, but did not do much about it in the first years so that voters became increasingly disappointed (Egle and Zohlnhöfer, 2007). A scandal in the Federal Employment Agency[12] provided a window of opportunity to finally engage with the reform of the labour market. The result was a package of several reforms, named after the governments' key broker Peter Hartz and implemented in the years 2003 to 2005. This reform went far beyond a mere reform of placement services and included a serious cut in benefits for long-term unemployed (Kemmerling and Bruttel, 2006). On the revenue

[12] During that scandal it was revealed that the Agency grossly overstated the number of successfully placed unemployed (Kemmerling and Bruttel, 2006).

side the reform implied lower contributions to the unemployment insurance and a shift in the financing of long-term unemployed into general taxation.

The reform package also included some welfare-to-work policies. Until the reform there were only scattered experiments with in-work benefits in some of the federal states and with very low tax incentives. For instance, the so-called Mainzer Modell gave a tax credit to reduce social security contributions and an increase in child benefits to needy low-wage earners with families. These reductions amounted to some two to five per cent of the wage of an average production worker and – compared to other countries such as the UK – very low (OECD, 2005, 142). The “Hartz” reform increased the number of subsidies for the low-wage sector and thereby also reduced the taxation of minor jobs. It cautiously expanded the wage range for which the reduction of social security contributions is applicable, promoted ’micro’ self-employment, and increased incentives of unemployed to combine benefits with small jobs (Kemmerling and Bruttel, 2006).

It is still very much debated whether some of these reforms added to the recent recovery of the German labour market (e.g. Bundestag, 2006). Politically the reform proved to be disastrous, since the population deeply resented the retrenchment part of “Hartz”. Trade unions, the extreme left and non-governmental organizations mobilized against the reform and, in particular, against the subsidies for the low-wage sector, since they feared that the thereby generated jobs would threaten existent jobs. The disruption between the Social Democratic government and the unions led so far that two years after its successful re-election the government resigned and called for new elections which took place in 2005.

All in all, the tax and employment policies of the red-green government were marked by its stop-and-go character: the swing to the left was abruptly halted and the next years saw a moderate degree of deregulation in the labour market and a steep decline of (statutory) tax progression. External economic restrictions in the form of tax competition, and maybe even the European Monetary Union, explain this reversal to some extent, but this explanation is not sufficient. If it is really true that the case for a progressive income tax is more and more difficult to make, left politicians could have still resorted to a functional equivalent: implementing a level of progression in the system of social security contributions (Scharpf, 1995). However, the fiercest opponents of such a strategy came from within labour: traditional Social Democrats and trade unions (Heinze and Streeck, 2003).

For a deeper understanding of these political tensions one has to look at the underlying fissures within the Social Democrats (Egle and Zohlnhöfer, 2007, 9) and their relation to the trade unions. Because of the huge structural changes and the reunification union membership declined steeply in this period. Once Schröder made it obvious that he hold ‘Blairism’ and new Labour in high esteem (Glyn and Wood, 2001) unions became alarmed. Unlike, for instance, in the UK the estrangement of the Social Democrats and the trade unions harmed Schröder more seriously. One reason was that despite its decline in membership German unions were still much more powerful than in the UK. This is due to the institutional entrenchment of trade unionism in the welfare state and the constitution. A second important reason lies in the German electoral system. Unlike in the UK the proportional system always allows for minor but more radical left parties to compete against the Social Democrats. This was already visible in the 1980s when the Greens seized some of the left domain (Kitschelt, 1994), and it became once more obvious after reunification and, in particular, after the Hartz laws when the ex-communist party of Eastern Germany got a grip on the West German electorate. The existence of political alternatives puts the unions in a much stronger position vis-à-vis the Social Democrats than, for instance their British counterparts during the government of Tony Blair. Given the German context a policy that re-introduced progressivity at the lower end of the income scale was blocked by opposing unions. The shift towards labour taxation has also shifted the locus of political conflicts into labour itself.

5. CONCLUSIONS

The empirical evidence corroborates the visible, but ambivalent role of the political left in shaping the tax system. It is clear that political and economic restrictions do play a role, but they do not impede progressivity of the tax system. Left labour power in the form of strong unions is indeed an important means to achieve tax-based redistribution both across countries and in a dynamic perspective. Its actual role, however, depends on the institutional context as the historical comparison has showed.

A look at 19th century Germany corroborates our basic intuition of a nexus between left labour and tax progressivity. Unions and Social Democrats indeed fought for the introduction of progressive income taxation. Compared with today, two contextual factors differed crucially in the 19th century: first, labour markets were virtually free of any institutions that could drive wedges between workers; second, wages as a tax base were only about to develop some significance. Even at the turn of the century, the political power of unions was still comparatively small, whereas its economic power increased rapidly. To become mass organisations unions accepted more and more low-skilled workers and acted in accordance with their interests. The government had to take these interests into account since taxing the payroll of workers was not yet a serious alternative to indirect and income taxation.

The comparison of Germany after World War II shows that the strategic situation of left labour has changed dramatically. Unions and labour parties nowadays act in a field of a highly regulated labour market that sharpens the conflict of interest within the electorate. The shift towards labour taxation has made this conflict even more severe. As is to be expected the declining power of left labour has clearly weakened the case for tax-based redistribution. Since the decline in membership has affected more the fringes of the labour market and especially the low-skilled workers, insiders have even more to loose than before. The political institutions have shaped the behaviour of both unions and political parties. Neither the CDU nor the Social Democrats have ever been able to distance themselves from a trade unionism that became more and more a phenomenon of special rather than general interest politics. The shift against tax progressivity was therefore not due to a conservative revolution, but due to institutional drift in the absence of a strong political signal to strengthen income taxation. This evolution may be contrasted with Swedish experience where strong and encompassing unions have defended the importance of income taxation and tax-based redistribution against the influences of international competition and conservative ideology (Ganghof, 2006). Again, it is the configuration of the welfare state and, especially, the labour market that are the crucial reasons why politicization of the tax mix has arisen and to what effect.

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