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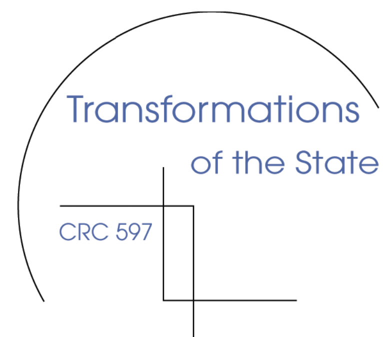

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Partisanship and Taxation: An Exploratory Study of Crisis Responses

Hanna Lierse

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Partisanship and Taxation: An exploratory study of crisis responses

ABSTRACT

With the outbreak of the financial crisis in 2008, European governments extensively intervened to avert a severe economic recession. Taxation is a crucial instrument to achieve such economic objectives, but it also represents a redistributive tool in democratic societies. Generally, left-wing parties are more supportive of progressive taxes and redistribution than right-wing governments. As a crisis response, one could assume that European governments, especially social-democrats, reinforced a redistributive stance to compensate for the substantial amounts of public money used to bail-out financial institutions. Yet, the internationalisation of capital markets has made it difficult to levy high income taxes as it might cause capital flights, less investments and growth. Based on the tax reforms introduced between 2008 and 2010, the paper explores how European governments mitigated the fiscal stress from the crisis. The findings show that fiscal pressures significantly restrained the policy choices available to governments.

Keywords: Crisis, fiscal stress, economic growth, tax policy, political parties, European Union.

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Partisanship and Taxation: An exploratory study of crisis responses*

1. European tax politics during the crisis

With the outbreak of the global financial and economic crisis in 2008 banks were socialised, growth rates declined and unemployment rose. As a consequence, average public debt in the European Union (EU) rocketed from 59 per cent in 2007 to 80 per cent of Gross Domestic Product (GDP) in 2010. Rising fiscal stress and a negative economic outlook, above all, in particularly indebted countries such as Greece and Latvia, placed increased pressure on European governments to adjust their economies. On the one hand, they need to consolidate public finances and avert a further slowing down of the economy. On the other hand, a substantial amount of public tax money was used to bail-out financial institutes and thus triggered the demand for redistribution. The aim of the paper is to understand if social-democratic and conservative governments have opted for different policy measures. Have they been able to mitigate the fiscal pressure stemming from the crisis?

The paper is of exploratory nature aiming to shed light on the tax policy strategies adopted by European governments. An assessment of the entire economic policy responses is too broad to allow a focused comparison. Moreover, as existing studies primarily address the expenditure side, above all social policy responses (Heise and Lierse 2011, Watt 2011, Starke et al. 2011) this article concentrates on the revenue side, that is, on the tax adjustments. It explores and compares the tax measures adopted by European governments since the outbreak of the crisis.

In 2009 most EU countries offered tax reliefs to stimulate the economy, reversing this trend in 2010 by raising taxes due to an increased pressure to consolidate. For instance, after the introduction of some tax benefits in 2009, the Greek government increased the VAT rate by 4 points, hiked the top personal income tax rate by 5 points and imposed an extra levy on large profitable corporations (EU Tax Trends 2010). Yet, the amounts of adjustments and the kind of tax responses are diverse in the EU. While Greece imposed a one-off extra levy on companies and Hungary raised the corporate income tax, other governments such as the Netherlands offered tax reliefs to companies through special depreciation and exemption rules.

There are two main sources that can account for the variation in tax policy-making: political and economic factors. With regard to the former, one assumes that leftist par-

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ties react differently than right-wing parties as social-democrats tend to favour a more interventionist and redistributive role of the government (Garrett and Mitchell 2001). Accordingly, one would argue that the socialist Greek government opted for extra charges on corporate and high incomes whereas the conservative government in the Netherland implemented more investment-driven tax measures. In turn, a more functionalist approach would focus on differences in macroeconomic performance such as the interest rate on bonds or the deficits, which requires different kinds of intervention. According to this strand, the Dutch government had room to reduce taxes and to stimulate the economy whereas the Greek government was forced to address its unsustainable debt levels, thus mainly raising extra charges.

The next part addresses such theories to explain variations in state activity and tax intervention, in particular. The third part addresses methodological aspects and describes the data employed whereas the fourth part discusses the empirical evidence. Based on a period of three years from 2008 to 2010 the tax measures of the member states are first, analysed from a more quantitative perspective (EU Tax Trends 2010). Different than previous research, the dependent variable is not the tax ratio as a percentage of GDP or the tax rate. By contrast, the focus is on the policies themselves, the amount and the direction of tax adjustments. The advantage of this approach is that it also entails information on base changes and can therefore render more comprehensive insights into governments’ crisis responses. Second, the tax measures are compared from a more qualitative perspective to better understand the content of the reforms. The overall evidence indicates that high fiscal stress severely restrict governments’ capacities to shape political intervention. In fact, there is little proof that social-democratic governments adopt a more redistributive and interventionist approach to taxation than conservatives.

2. EXPLAINING VARIATION IN STATE ACTIVITY

There are only a few studies that directly deal with tax differences among countries (Garrett and Mitchell 2001, Swank and Steinmo 2002, Genschel and Schwarz 2011). Yet, in general, the comparative public policy literature differentiates between two main approaches that explore variations in state intervention in the economy (for an overview see Starke 2006, Castels and Obinger 2007): those that highlight the effect of party politics and domestic institutions on policy outcomes and those that regard functional imperatives as the main drivers of change. The following section discusses each strand taking into consideration the special circumstance of the crisis.

2.1. Party politics and taxation

The most popular approach that highlights the importance of political parties for economic outcomes is the Power Resource Theory (PRT) (Esping-Anderson and Korpi 1984, Stephens 1979, Huber and Stephens 2001, Bradley et al. 2003). It is based on the assumption that different forms and intensities of class organisation affect public policy outcomes. Of importance is the left-right composition of governments as they represent the interests of different social groups. Lower income groups and labour are regarded as favouring a large and active state that regulates the market. In contrast, capital owners and high income groups are thought to reject strong economic interventionism and redistribution. The idea is that left- and right-wing parties, once they are in power, implement those policies that serve the interests of the respective electorate (Cusack 1997).

The original idea was brought forward by Hibbs (1977) who studied whether particular macroeconomic outcomes are linked to left- and right-wing governments. His main argument is that the economic interests of lower income groups are better served by a low unemployment-high inflation oriented policy, whereas a more high unemployment-low inflation stance is preferred by upper income groups. By comparing the policies adopted by twelve states Hibbs confirmed his assumption showing that a high unemployment-low inflation pattern is dominant in states that are regularly governed by centre and rightist cabinets. He therefore concludes that governments tend to pursue macroeconomic policies consistent with the interests of their main target groups.

More recent studies concur with Hibbs in that domestic politics have an influence on how governments react to market pressures (Garrett 1998, Garrett and Mitchell 2001, Timmons 2010). Garrett’s (1998) findings show that even though taxes generally became less progressive in the 1980s, the greatest change occurred in countries with strong right-wing parties whereas left-wing power is positively correlated with higher effective corporate tax rates. Hence, his analysis shows that government composition affects the policy choices adopted with left governments opting for more progressive and redistributive tax measures. Also Bradley et al.’s study (2003) confirms that leftist governments positively affect income redistribution.

These findings suggest that left-wing governments favour more redistribution through higher proportions of public revenue and through a more progressive setup of taxes. Quinn and Shapiro (1991) classify the left-wing approach as consumption-oriented whereas right-wing governments favour an investment-driven approach. Accordingly, social-democratic governments minimise the burden on low and medium incomes as these tend to have a higher marginal propensity to consume. In turn, conservative and liberal governments seek to reduce the tax burden on capital and governments in the hope that high profits are used for future investments. Hence, social-

democratic parties are more likely to shift the tax burden from labour to more capital intensive factors and vice versa for right-wing governments.

Although literature tends to highlight the kind of taxes that are preferred by different governments, their divergent preferences may also affect the overall number of tax changes and the direction of change. Social-democratic governments are often depicted as favouring a more interventionist role of the state. This may translate into a more active policy stance and higher number of changes to stimulate the economic activity through tax reliefs in times of recessions and higher taxes in times of stability and prosperity. By contrast, right-wing governments tend to regard the economy as a more self-regulating entity, which needs less intervention. Hence, we may observe less tax adjustments in countries that are governed by a party classified as right-wing (see section 3). In sum, one can expect that the composition of governments has two potential effects on the tax crisis adjustment strategy. First, on the overall amount of tax changes and second, on the kind of tax, that is, whether the focus is on capital or labour intensive factors. Table 1 provides an overview of the effects.

2.2. Functionalist theories

Functionalist scholars regard policy changes as a response to particular socio-economic challenges (Genschel 2004, Garrett and Mitchell 2001, Swank and Steinmo 2002). These approaches tend to focus on dependences from global economic integration such as trade openness and capital liberalisation, which have caused tax competition among states. Tax competition was initially thought to have two effects (for an overview see Genschel and Schwarz 2011): first, it was thought to lead to lower tax revenues and second, it was to bring about a shift in the tax burden from capital and corporate taxes to labour and consumption taxes.

The convergence hypothesis captures the notion that tax competition causes a shift of the tax burden (Garrett and Mitchell 2001, Genschel 2004, Scharpf 1991). More explicitly, the hypothesis postulates that the exit option of capital has changed the power balance between markets and politics leaving little choice for governments but to provide market-friendly policies (Scharpf 1991, Garrett and Lange 1991). As a result, progressive tax systems are uncompetitive in a global economy and tax policies will convergence around neoliberal ideas. Hence, the functional strand suggested that socio-economic pressures will shift the tax burden from capital to labour, which would end up in less progressive instruments of taxation (Rodrik 1997).

But to what extent has tax competition caused the convergence of national tax systems (Genschel 2002, Swank 2006)? Empirical evidence is inconclusive: often the effects are small and dependent on the specification of the model (Starke 2006, Swank 2002, Plümper et al. 2009). There are a variety of reasons that account for why the ob-

servable effect is the smaller than anticipated. First, economic integration also puts downward pressure on labour taxes as governments need to secure employment (Swank and Steinmo 2002). If labour is comparatively expensive, then (labour-intensive) investments will be shifted to other regions. In fact, international tax competition is least pronounced in the field of indirect taxes (Rixen 2008), which are also considered as less growth-deterrent (OECD 2010). A shift of the tax burden from direct to indirect taxes is therefore most likely.

Second, governments have budget rigidities with fixed long-term costs and are therefore restricted in lowering taxes. During the course of the recent crisis, European member states have faced particularly strong fiscal pressure. Deficits drastically rose, as governments bailed-out financial institutions, implemented economic stimulus packages and public spending rose due to the recession. While a deficit as such is little damaging, government bond rates rocketed for some member states with particularly gloomy economic outlooks. For them, loans from the capital market became extremely expensive placing pressure on the member states to act and to reduce their long-term debt to regain access to cheap international finance. In such circumstances, governments' priority switches to reducing the deficit and they increasingly turn to domestic taxpayers where they impose extra levies to discharge their payment obligations.

Although the crisis represents a general upsurge of fiscal stress, some member states were hit particularly hard. To account for differences in fiscal stress, I focus on the long-term interest rate on government bonds (see also section 3). For example, Greece paid an interest rate of more than 15 per cent in May 2011 and also Lithuania was charged about 14.5 and Latvia 13 per cent throughout most of 2009 for ten year maturity bonds (Eurostat 2011). According to the functionalist approach, we can assume, in terms the overall number of tax adjustments, that governments with high fiscal stress also implement more changes as they face a greater need to adjust the economies to newly emerging challenges in general. Moreover, they have more pressure to consolidate and are therefore more likely to adopt tax increases. Yet, they are likely to circumvent increases in the field of direct taxes, above all corporate taxes, as they face international competition.

Table 1 summarises the arguments of both strands of literature and their possible impact on governments' tax adjustments strategies. In general, there are three dimensions of policy changes that can be affected: the number of tax adjustments, the direction (tax cut vs. increase) and the distribution between different kinds of taxes. While government composition is likely to only affect two dimensions, from the functionalist strand we can expect an impact along all three aspects.

Table 1: Possible effects of political and economic factors on the tax adjustment strategies

Three dimensions of tax adjustment strategies:	**Left- vs. Right-wing governments**	**Functionalist pressures (fiscal stress, tax competition)**
The number of tax adjustments.	The left is more interventionist and therefore opts for more changes than right-wing governments that regard the economy as more self-regulating.	The more fiscal stress, the more changes to align the economy to newly emerging challenges.
The direction of adjustment (tax increase vs. cut).	—	The more fiscal stress, the more do governments implement tax increases to fulfil their fiscal obligations.
The distribution between different kinds of taxes.	The Left attempts to redistribute from capital to labour whereas the Right attempts to reduce the tax burden on capital and corporations.	As international tax competition is less pronounced in the field of indirect taxes, tax increases are most likely to take place in this field.

3. Data and Methodology

The analysis is based on a unique dataset that captures the tax reforms implemented by the European member states between 2008 and 2010 (EU Tax Trends 2011). One may argue that the data for this period does not suffice to assess government's crisis reaction; after all, the crisis erupted in 2008 and hence, one needs data from previous years to evaluate if a policy change occurred. Although it is true that the crisis started in 2008, policy reactions take some time. In fact, in 2008, we only observe two tax changes whereas the policy adjustments drastically increase to 82 and 71 in following two years (Table 2). In other words, 2008 serves as a reference year. Moreover, the crisis did not hit all the member states to the same extent, so that between-country variations also serve to validate the argument.

As highlighted at the outset of the paper, the dependent variable differs significantly from most analyses, which focus on the tax revenue or the tax rate. The revenue is particularly prone to erratic conclusions about governmental decisions as changes can be due to multiple reasons such as macroeconomic fluctuations, which are not linked to actual policy adjustments. Although tax rates better reflect policy decisions, they discard changes in the tax base and therefore do not provide an all-embracing picture of governments' responses. This analysis therefore explores the number and the directions of adjustments, increase versus cuts, of different taxes such as the corporate and the personal income tax, consumption taxes and social security contributions.

The following examples better illustrates the advantage of the data employed. A number of member states directly reduced the corporate tax rate such as the Greek, the

Slovenian and Swedish government. Yet, various governments also opted for other forms of tax reliefs through accelerated depreciation and tax incentives such as the Dutch and the Austrian governments (European Tax Trends 2010). If we analysed the tax rate, we would not be able to account for such effects whereas the dataset developed in this paper takes these changes into consideration and therefore provides a more comprehensive account of the policy reactions. Yet, there are also some disadvantages; the main one is that the data does not include information about the budgetary impact of the reforms. A tax change, no matter how high the fiscal effect, counts the same. In other words, whether a government lowers the corporate tax rate by 1 or 5 per cent is not reflected in the data. To compensate for this shortage, I include an analysis at the end of the next section that better illustrates the kind of changes and the amounts of changes implemented during the crisis.

It is possible to distinguish between different aspects of policy changes (see also Table 1). The analysis captures these dimensions and first, assesses how many reforms governments have implemented and second, whether they opted for tax cuts or increases. In a third step, the analysis takes into consideration which kind of taxes have been adjusted and in which direction. In other words, the interest is not only if governments mainly opted for tax cuts or increases as a crisis response but also which taxes have been subject to increases and decreases, respectively.

To better understand reasons for such policy changes, the theoretical analysis highlighted political and economic factors that are likely to determine tax outcomes. To account for party differences, I constructed a left-right indicator based on the cabinet seats of each government. If green and social-democratic parties, as defined by the Party Manifesto Group (Volkens et al. 2011), occupy the majority of cabinet seats, then the government is coded as “left”. By contrast, if liberal, conservative or Christian-democratic parties are in power, then it is coded as “right”.

To assess the impact of fiscal stress on governments’ reactions, I tested a variety of factors. Often the deficit and debt rates are applied to test for the effect of fiscal stress (Mitchell and Garrett 2001). Yet, these variables only capture part of the picture. For instance, Hungary had an average deficit of 4.1 per cent of GDP between 2008 and 2010, France of 5.9 and Poland of 6.3 per cent. Nonetheless, the Hungarian government had to pay the highest price to obtain money from the financial markets with an average interest rate of 8.2 per cent in contrast to France Poland and France with 6 and 3.7 percent, respectively. The bond rates account for other important factors such as the growth rates and expectations about future economic developments. To illustrate the effect of bonds on governments’ policy reactions, I distinguish between three main categories: first, those cases that are below the EU-27 average of 5.1 per cent between 2008 and

2010, second, those above this average and third, those that are even above the average of the second category (>7 per cent)[1].

To explore how governments reacted to the fiscal pressures emanating from the crisis and if left-and right-wing governments have opted for different policies, the research proceeds in two steps. First, I conduct a more quantitative examination by assessing governments' reactions based on the political and economic variables just outlined. I complement the descriptive statistics of the policy changes with a statistical significance test: as the dependent variable is a count measure, a test for the Poisson distribution can best capture if the group variations are significant. The test is however, only conducted for the total amount of changes and the direction of change (total increases and/or decreases). The statistical test for each sub-field such as the VAT or the CIT is not appropriate due to a lack of sufficient cases. The quantitative approach is then complemented with a more qualitative analysis to better understand the content and the direction of the reforms.

4. TAX RESPONSES TO THE CRISIS: EMPIRICAL EVIDENCE

In the preceding section guiding indicators were identified to explain and compare tax crisis responses between countries. Both government composition and fiscal stress serve as a point of references for the empirical analysis. It is not the goal to systematically test these theories but rather to use them as focal points to scrutinise the empirical data. Such an exploratory approach is particularly suitable as no systematic study exists about how governments respond under high fiscal pressures. In a first step, I compare the different tax policy responses based on a more quantitative approach. Second, I discuss the content of the reforms in more detail and show what kind of tax reliefs and increases have been implemented.

Although the policy data shows the number and direction of adjustments, it lacks more detailed information about reforms. For instance, the fact that Denmark cut the personal income tax does not provide any information about who benefits from this change. Did the government offer a family relief package, tax credits to the lower income classes or reduce the top income tax rate? Thus, in a second step, the analysis involves a more detailed account of the tax reforms with the aim to better understand the actual policy responses.

[1] Many studies also control for capital market openness when comparing tax policies. The idea is that countries, which are particularly liberalised, are more subject to tax competition. However, this study is only based on cases from the European Union, where free capital movement is one of the four main freedoms. It therefore seems pointless to distinguish between different degrees of capital openness.

4.1. The role of party politics and government composition

The aim of this section is to understand if a particular crisis response on the revenue side is linked to the government composition. In 2010 nineteen member states were dominated by a conservative and eight by a social-democratic cabinet. Of both ideological positions, about 40 per cent focus on tax increases and 60 per cent plan to mainly

Table 2: Overview of tax measures by country

Country	Year	Gov. Comp.	Total Tax Changes			Growth	Deficit	Interest
		1=right 0=left	Total	Decrease	Increase	% of GDP	% of GDP	10Year Bond
BE	2008-10	1	5	4	1	0.13	-3.77	3.93
BG	2008-10	0/1	8	5	3	0.30	-2.07	6.06
CZ	2008-10	1	5	3	2	0.23	-4.43	4.45
DK	2008-10	1	6	4	2	-1.40	-0.73	3.60
D	2008-10	1	5	5	0	-0.03	-2.07	3.31
EE	2008-10	1	5	0	5	-5.30	-1.47	7.37
IE	2008-10	1	6	2	4	-4.03	-18.00	5.17
EL	2008-10	1/0	7	1	6	-1.83	-11.90	6.35
ES	2008-10	0	6	3	3	-0.97	-8.17	3.59
FR	2008-10	1	4	3	1	-0.43	-5.93	3.67
IT	2008-10	1	7	6	1	-1.73	-4.23	4.34
CY	2008-10	0	5	3	2	0.97	-3.47	4.60
LV	2008-10	1	6	1	5	-7.50	-7.20	9.70
LT	2008-10	1	9	4	5	-3.50	-6.63	8.39
LU	2008-10	1	2	2	0	0.43	0.13	4.00
HU	2008-10	0	12	6	6	-1.83	-11.90	6.35
MT	2008-10	1	1	1	0	1.87	-3.93	4.85
NL	2008-10	1	5	5	0	-1.83	-11.90	3.64
AT	2008-10	0	4	4	0	0.10	-3.20	3.85
PT	2008-10	0	5	3	2	-0.40	-7.57	4.71
RO	2008-10	1/0	8	6	2	-0.37	-6.87	8.24
PO	2008-10	1	5	4	1	3.53	-6.30	6
SI	2008-10	1/0	7	5	2	-1.07	-4.47	4.43
SK	2008-10	0/1	6	5	1	1.67	-6.00	4.28
FI	2008-10	1	8	5	3	-1.40	0.30	4.20
SE	2008-10	1	5	5	0	-0.13	0.50	3.34
UK	2008-10	0/1	3	2	1	-1.23	-8.93	3.74
EU-27	2008	0=8, 1=19	2	2	0	1.39	-2.10	5.08
EU-27	2009	0=10, 1=17	82	56	26	-5.65	-6.52	5.60
EU-27	2010	0=8, 1=19	71	39	32	1.62	-6.27	4.66
EU-27	2008-10	0=26, 1=55	155	97	58	-0.88	-4.96	5.11

Source: own research based on Eurostat (2011), European Tax Trends (2009, 2010), Volkens et al. (2011), and the European Election Database (2011).

consolidate through expenditure cuts. The focus on the expenditure side is not surprising as it is commonly proposed to have more long-lasting consolidation effects than tax increases (EU Public Finances 2010). However, they tend to significantly affect lower income groups who rely relatively more on public and social spending. In turn, tax increases can be designed to specifically target wealthy groups and capital owners.

In 2008 very few tax adjustments took place compared to the following two years, which is due to the fact that the crisis erupted at end of 2008 and political responses are time-lagged (Table 2). The years 2009 and 2010 show a considerable increase in economic adjustments independent of the cabinet composition. While left-wing governments conducted about 8.2, conservative cabinets implemented 7 average changes between 2008 and 2010. The same is true as regards the average increases and decreases, which do not significantly differ. Also the statistical analysis does not confirm that parties opted for different approaches as regards the amount of overall changes and the direction of change (Table 3).

Table 3: Number and Direction of Tax Changes

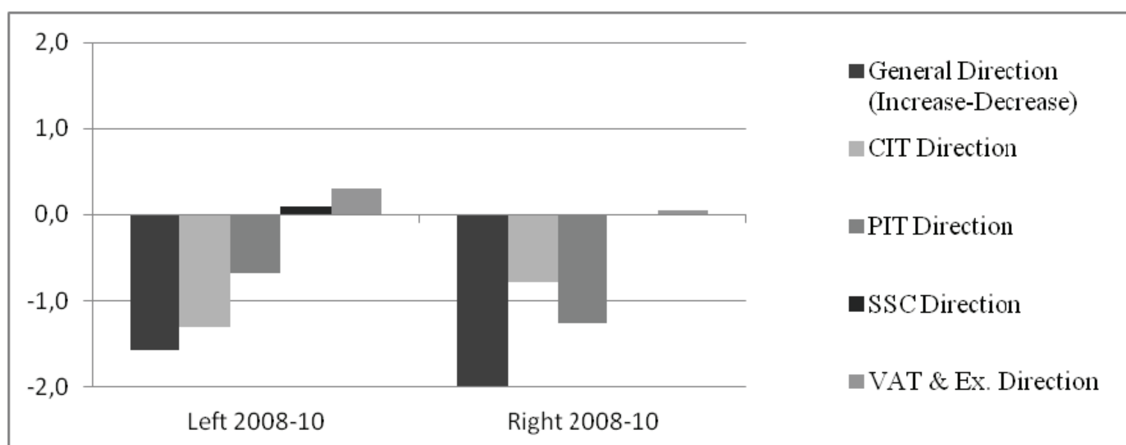
	Total Changes	**Total Increase**	**Total Decreases**
Right-wing government	-0.248 (0.165)	-0.430 (0.269)	-0.182 (0.212)
Interest rates on bonds (10 year maturity)	**0.104*** (0.030)	**0.227*** (0.039)	-0.017 (0.050)
Observations	81	81	81

Standard errors in parentheses, *p<0.01, constant not reported

Figure 1 goes beyond the level of intervention and evaluates the tax adjustments in terms of the direction of change: the data indicate that both, left- and right-wing governments reacted with more tax decreases than increases even though social-democrats opted for less decreases in total. Although one may argue that this shows that leftist parties support a more active and interventionist approach than rightist parties, the difference seems trivial. The data rather highlights that social-democratic and conservative governments both, actively reacted to the crisis: they opted for a mixed strategy between fiscal consolidation and stimulating economic growth.

The evidence further indicates that the tax approaches are similar between social-democratic and conservative governments with some differences as regards direct taxes. Figure 1 shows that both government setups shifted the burden from direct to indirect taxes. On average, consumption taxes and social security contributions (SSC) were increased while corporate (CIT) and personal income taxes (PIT) were adjusted downwards. This pattern is the same irrespective of the cabinet composition. Yet, there are two interesting differences as regards direct tax changes.

Figure 1: Direction of tax changes according to government composition*



Source: own research based on Eurostat (2011), European Tax Trends (2009, 2010), Volkens et al. (2011), and the European Election Database (2011).

Note: * The direction of change is calculated by increase-decrease; hence, a negative number indicates an overall tax decrease whereas a positive one indicates an increase.

First, social-democratic governments adjusted the PIT more upwards than the conservative ones. This *may* suggest that left-wing governments took a more redistributive approach than right-wing governments. While an increase in indirect taxes is regressive, an increase in direct taxes can at least potentially have progressive effects. However, to assess if this is the case, it is necessary to conduct a more qualitative investigation of the measures adopted and to evaluate which social groups are mostly affected by the personal income tax measures. This is done in section 4.

Second, social-democratic governments decreased corporate taxes more than their counterparts. This does not imply that they directly lowered the corporate tax rate but it could involve measures to stimulate incentives for innovation, R&D and accelerated depreciation, which are mostly base changes. Nonetheless, the finding that labour parties decreased corporate taxes more than right-wing governments is inconsistent with the hypothesis that labour parties redistribute from labour to capital. The evidence rather shows that the tax strategies adopted by left- and right-wing governments differ only marginally from a quantitative perspective.

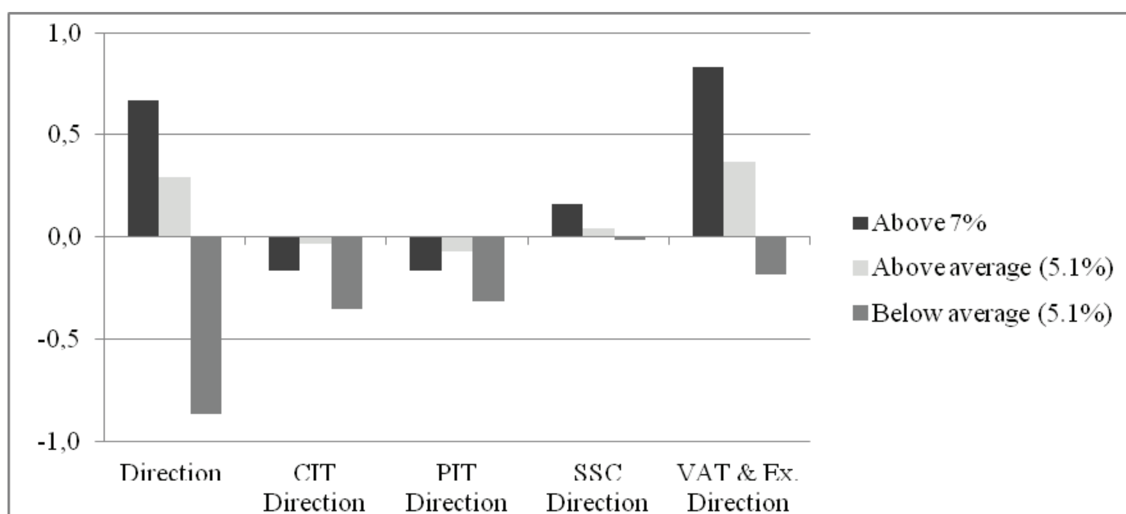
4.2. Functional pressure during the crisis

This section identifies whether socio-economic pressures better shed light on the tax measures adopted by the EU member states. The pressures stemming from declining growth rates, rising public debt levels and increasing interest rates on government bonds was intense during the crisis. Some countries such as Greece and Portugal have faced particularly strong pressures whereas others such as Germany comparatively little. Hence, it is likely that different degrees of socio-economic pressure cause different pol-

icy responses. Those countries that are highly indebted cannot adopt a long-term growth strategy based on lowering certain taxes and are therefore more likely to increase taxes than those with low debt burdens (section 2.2).

Figure 2 summarises the number of tax adjustments according to the interest rate on ten year maturity bonds of the EU member states. The data illustrate that the level of stress is linked to the number of tax changes. They show that governments with high interest rates on bonds opted for more tax adjustments and for more increases than those with lower ones. For instances, the above 7.0 per cent group implemented on average, 3.33 changes over three years whereas the below average group only adopted 1.61 measures. In other words, the higher the bond rates the higher the pressure to adjust particularly, based on tax increases. It demonstrates that states with high fiscal stress have less room to lower their taxes and therefore need to adopt a more consolidation-oriented as opposed to a growth-oriented strategy. This finding is confirmed by a statistical analysis, according to which the impact of bond rates on the overall number of changes and the amount of tax increases is significant (Table 3).

Figure 2: Direction of tax changes according to interest rates on ten year government bonds*



Source: own research based on Eurostat (2011) and European Tax Trends (2010)

Notes: * The direction of change is calculated by increase-decrease; hence, a negative number indicates an overall tax decrease whereas a positive one indicates an increase; ** Please note that the category above average also accounts for the members of the above 7 percent group (see section 3).

Countries with bond rates above EU-average adjust taxes more upwards than those with less fiscal pressure. This tendency is representative for each tax category. Nonetheless, Figure 2 shows crucial difference between direct and indirect taxes. As regards direct taxes, CIT and PIT, all governments rather lowered than increased them. By contrast, SSC and consumption taxes were only lowered in countries with fiscal room whereas

governments under high pressure increased them. This finding shows that these countries also struggle not to lose out in the international competition for investments and businesses, keeping direct taxes low.

Based on a more quantitative approach the crisis reactions are well elucidated by functionalist challenges (Sawnk and Steinmo 2002, Genschel 2002, Plümper et al. 2009). State activity and adjustment processes increase with bond rates. Moreover, the results also support that tax competition is highest in the fields of corporate and personal income taxes as high rates may lead to a capital flight into low-tax regions or to comparatively costly employment. Hence, governments for the most part rely on consumption tax increases.

4.3. Main tax trends and reforms since the crisis

The previous section demonstrated that on average, there are little differences concerning the tax strategies between social-democratic and conservative governments. However, some variation exists as left governing parties increased personal income taxes and reduced the corporate tax burden more than the conservatives. To understand what kind of reforms they implemented and to evaluate whether qualitative differences exist, it is crucial to better examine the contents of their reforms. The following section therefore discusses the main characteristics of the reforms illustrating them with example.

Between 2008 and 2010, the majority of tax adjustments took place in the area of direct taxes. For instance, most member states implemented personal income tax changes with only three exceptions, the Czech Republic, Cyprus and Malta (Table 2). Most personal income tax (PIT) reforms involve some form of tax relief and often benefit various groups simultaneously such as families, low and high income earners regardless of the government composition. For example, Denmark’s centre-right government reduced the lowest tax rate from 5.26 to 3.76 per cent whilst cutting the top income tax rate from 63 to 56 per cent. Certainly, one may argue that this reform is a greater gain for the upper class, yet, also the social-democratic government of Austria reduced the tax burden in such a way as to benefit the lower and middle-upper classes at the same time and the leftist Hungarian governing party even abolished a four per cent solidarity charge for high incomes. Hence, tax reliefs were implemented on a broader level irrespective of the dominant ideological position of the government.

With regard to PIT increases both, left- and right-wing governments have raised taxes primarily, starting in 2010 when the policy focus shifted from providing growth incentives to consolidating public finances. For instance, the Greek and the British governments raised the top personal income tax rate in 2010 and others such as Spain, France, Italy, Luxembourg, Portugal and Finland followed suit in 2011 (EU Crisis Tax Trends 2011). However, this does not mean that a general trend towards more progres-

sive tax systems is underway. Particularly in some Eastern European countries the top rates were drastically lowered: for example, Lithuania cut the PIT rate to 15 per cent, the Hungarian government reduced it from 40 to 16 per cent in 2011 and Poland from 40 to 32 points (European Tax Trends 2010, EU Crisis Tax Trends 2011).

The picture that emerges from the reforms undertaken in the field of personal income taxes is mixed. It does not reflect a clear direction of either a move towards more progressive or regressive income tax systems, especially not consistent with a particular social-democratic or conservative approach. By contrast, it reflects the current diversity of the income tax systems in Europe, which involve highly progressive and flat tax systems.

With reference to corporate income taxes, the picture is more coherent as the changes generally involve a reduction of the burden. However, also in this area, social-democratic and conservative governments do not pursue distinctive tax approaches, on the whole. A number of left- and right-wing governments directly reduced the tax rate such as the Greek, the Slovenian and Swedish or they allowed for accelerated depreciation and tax incentives for R&D as the Dutch and Austrian governments (European Tax Trends 2010). An exception is the Hungarian and the Lithuanian government, which increased the tax rate. For instance, Lithuania raised the rate from 15 to 20 and Hungary from 16 to 19 per cent. Yet, in Lithuania this was a one-off payment in 2009 and in Hungary it was accompanied by abolishing other charges for corporations with high incomes. The same is the case in Greece, where an extra charge on large profitable companies is accompanied by a gradual reduction of tax rate. In other words, most corporate tax reforms alleviate the burden on companies and the nature of relief, a direct cut or an incentive, does not directly depend on a left- or right-wing governing party.

While the corporate tax adjustments are generally downward, there is a clear upward trend in the field of consumption tax rates. The relatively high number of VAT cuts as listed stems from lower rates in certain sub-fields such as food, restaurants and hotels, construction and renovations but they are not due to a general rate reduction. Only a couple of countries reduced the standard VAT rate, namely Ireland (-0.5) and the UK (-2.5). By contrast, on EU-27 average the VAT rate rose by 2.5 percentage points in only three years from 2009 to 2011 (EU Crisis Tax Trends 2011). The highest increases were implemented in Hungary and Romania (+5), in Greece (+4) and in Latvia (+3). Similar as VAT rates, excise taxes were for the most part increased, particularly those on energy products, tobacco and alcohol. Overall, consumption tax rates were drastically raised as a response to the crisis, both under social-democratic and conservative governments.

The qualitative evidence confirms the result of the previous section that leftist parties have not responded with more progressive or redistributive tax approaches than right-wing governments per se. By contrast, we observe that a general shift from direct to

indirect taxes has taken place in the EU. This development is consistent with recent proposals for a growth-oriented tax approach (OECD 2010). The OECD advocates a ranking order of taxes, according to which corporate taxes are most harmful for economic growth, followed by the personal income tax and then by consumption taxes: “*A growth-oriented tax reform would therefore shift part of the tax burden from income to consumption (...)”* (OECD 2010:10). The tax responses that we observe during the crisis period clearly follow this framework. While there are significant country differences, the general reform trend is in line with an investment-driven approach (section 2).

5. Conclusion: Fiscal stress and the lack of political choice

How have European governments mitigated the fiscal pressures stemming from the global crisis? At the outset of the paper two main forces were identified that are likely to affect economic outcomes: political parties and functionalist pressures. The power resource theory suggests that labour parties favour a more progressive and consumption-driven strategy than right-wing governments that by contrast, support a more investment-driven approach (section 2.1). Previous studies that account for the relationship between government composition and taxation show that government composition can significantly affect tax outcomes (Timmons 2010, Garrett and Mitchell 2001). However, the findings of this study do not confirm these results but show that the crisis responses were mainly structured by functionalist pressures.

The political orientation of European governments on the whole, does not correspond to a party-specific tax adjustment strategy. On the contrary, both left- and right-wing governments actively intervened in the economy: while in 2008 very few tax changes took place, the number of adjustments drastically increased in the following two years, irrespective of the government composition. Initially, they mainly intervened based on tax cuts to stimulate economic activity in 2009 while the focused shifted to a more consolidation-oriented approach in the following year. Likewise, there is no evidence that socio-democratic parties have adopted a more progressive or redistributive policy stance. In fact, left-wing governments adopted more corporate tax cuts than conservatives, which is not consistent with the hypotheses that labour parties redistribute from labour to capital.

Also the more qualitative investigation of the reforms did not detect party-specific differences as regards the form of tax policies and the way in which the burden is distributed among different societal groups. In the field of personal income taxes the finding is mixed: a number of countries changed lower *and* higher level tax brackets, while others mainly raised or lowered the top income tax. Some Eastern European countries even changed to a flat tax system substantially reducing the burden for high income earners. Hence, there is no clear indication whether income taxes have become more or

less progressive during the course of the crisis. The evidence in the field of corporate and consumption taxes is more homogenous. While the former have a clear downward trend, the standard VAT rates have mostly been adjusted upwards suggesting that a shift from direct to indirect taxes has taken place.

The results do not necessarily prove but they certainly suggest that the tax burden has been shifted from direct to indirect taxes in the EU. This finding is consistent with the growth-driven approach advocated by the OECD (2010) and reflects the attempt to safeguard investments and economic growth. Yet, it appears that most governments do not compensate such a policy stance with redistributive measures in the field of personal income taxes. Certainly, it is possible that redistributive policies were implemented on the expenditure side by increasing social security benefits or other transfers. However, such transfers are mainly designed to protect people external to the employment market whereas taxes can be spread out among different income groups.

So, do political parties no longer matter in contemporary democracies? It is crucial to stress that the evidence does not contradict previous studies, which found differences in tax outcomes between social-democratic and conservative governments. Instead the analysis shows that we ought to evaluate how national actors respond to external pressures and under which conditions their room for independent strategies diminishes or increases respectively. The financial and economic crisis is a situation of particularly high fiscal stress, in which governments lack the capacity to act and in turn, functionalist pressures drastically shape the tax outcomes. High fiscal stress, expressed in interest rates on bonds, does not only determine the amount of tax changes but also the degree to which governments need to rely on tax increases as loans from the international capital markets become too expensive. Yet, tax increases are most likely to be implemented in the field of indirect taxes, where international competition is less pronounced. In other words, governments responded to fiscal stress and international competition, and much less so according to party-specific ideals.

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