BOOK REVIEW


reviewed by Jonathan Barry Forman†

Once we get over the current global economic crisis, most developed nations will need to raise significant revenues to pay for their recent economic stimulus packages as well as for their ongoing social welfare systems. Achim Kemmerling’s book will provide policymakers with some important insights about which taxes to increase and what the consequences are for labor markets. Kemmerling observes that developed nations today all operate as substantive welfare states, and he argues that “the real question in contemporary welfare states is not whether, but how welfare is financed” (p. 1). He shows that, nowadays, most of the burden of taxation falls on labor rather than capital, and he explains how the structure of taxation in contemporary welfare states affects labor markets in general, and the low-wage sector in particular.

More specifically, Kemmerling notes that contemporary welfare states are financed largely by three taxes that primarily burden labor income: income taxes, payroll taxes, and indirect (consumption) taxes.1 Income taxes typically have large exemptions and progressive tax rates. On the other hand, payroll taxes tend to be regressive as they typically have no exemptions and flat rates up to an earnings cap. Consumption taxes tend to be regressive or, at best, proportional as they typically have flat rates and a broad base (one that includes elderly retirees as well as workers). Kemmerling’s book explores how the relative mix of these three taxes

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1. Through most of the nineteenth century, labor earned subsistence wages, and, therefore, most of the burden of taxation fell on capital. As real wages have increased since that time, capital was able to shift most of the burden of taxation onto labor. Consequently, most of the revenue needed to finance contemporary welfare states now comes from three taxes that primarily burden labor income: income taxes, payroll taxes, and consumption taxes.
affects labor markets.\(^2\) In his view, “the discussion has shifted from whether to how to tax labor” (p. 120), and his book is largely an empirical study in political economy.

Kemmerling uses empirical and historical methods to compare the structure of taxation in various contemporary welfare states in the Organization for Economic Co-operation and Development (OECD). He focuses on how the interests of political parties, labor unions, and voters impact the mix of taxation in these countries. In particular, he sees a growing cleavage between low-skilled and medium-skilled workers. Both want to avoid high tax rates that, in effect, reduce their wages. Low-skilled workers prefer a large social welfare system paid for with progressive (income) taxes. On the other hand, higher-skilled workers prefer a smaller social welfare system financed by flat-rate payroll or consumption taxes.

At the outset, Chapter 2 compares the income, payroll, and consumption tax mixes in the OECD countries. Kemmerling uses OECD data to develop aggregate tax-to-GDP ratios for each type of tax. Not surprisingly, the overall tax-to-GDP ratios in these countries have risen considerably in the last forty years.\(^3\) At the same time, “payroll and indirect taxes have outpaced income taxation in most countries” (p. 16). More specifically, payroll taxes nearly doubled from 1965 to 2002, and consumption taxes increased by more than 20% from the 1980s to the 1990s (pp. 18–19). All in all, there has been “a remarkable shift away from income taxation” in recent years (p. 23).\(^4\)

On the other hand, “countries differ in how far they use income taxes as a source of financing the welfare state” (p. 120), with some countries relying on the income tax as their most important source of revenue and other countries relying on payroll taxes or consumption taxes. Broadly speaking, the Scandinavian welfare states have a high overall tax rate and high rates of income taxation. “Bismarckian” continental European welfare states have high levels of payroll taxation (social security contributions). Anglo-Saxon (“Beveridge”) welfare states also rely heavily on income taxes to pay for social welfare benefits; these states also typically provide tax subsidies for targeted employees (e.g., the U.S. earned income tax credit). For Eastern Europe, consumption taxes seem to be an important source of revenue. All in all, each country’s mix of taxes is “highly

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\(^2\) Of note, Kemmerling ignores other sources of income such as property or inheritances, does not deal with the intricacies of corporate taxation, and treats payroll taxes as pure taxes even though these often “buy” social security and other benefits (pp. 13–14).

\(^3\) There has also been a broad convergence in the level of social spending among these countries (p. 13).

\(^4\) Kemmerling notes that international competition may be responsible for some of the recent trend away from progressive income taxation and toward consumption taxes (p. 117).
Chapter 3 provides a valuable review of the economics of taxing labor. All taxes distort decisions about labor force participation and work effort. In particular, “high levels of taxation reduce incentives to work and reduce employers’ willingness to hire” (p. 2). Labor market institutions such as labor unions and minimum wages also influence labor market participation and work effort.

According to optimal tax theories, “the broader the tax base, the better the outcome in terms of welfare for all” (p. 35). High tax rates discourage work and are likely to reduce employment and raise unemployment, and the low-wage sector is particularly sensitive to taxation. Generally speaking, low-skilled workers do best under income taxes that—because of large exemptions—they do not have to pay. A broad-based, low-rate general consumption tax would be next best for the low-wage sector, while payroll taxes would have the worst impact on the low-wage sector. All in all, there is “a trade-off between regressivity and incentives to work” (p. 122), and shifting away from payroll taxes and consumption taxes toward income taxes should enhance employment and reduce unemployment, or so the argument goes. In a series of regressions, Kemmerling finds evidence that payroll and indirect taxes have much more visible and detrimental effects on employment and unemployment than income taxes, especially in the low-wage sector.

In Chapter 4, Kemmerling explores the relationship between political economy and tax structure. His central intuition is that while trade unions and left-of-center political parties generally favor more progressive tax systems, cleavages between low-skilled workers and higher-skilled workers have weakened the labor alliance for redistributive taxation. Because taxes for social welfare now come largely from the taxation of labor incomes, unions and left-of-center parties are no longer automatic supporters of progressive income taxes. Medium-skilled trade union members are just not all that interested in paying higher taxes to provide benefits for low-skilled, nonunion and unemployed “outsiders.” Instead, medium-skilled union members will prefer the relatively lower tax burden that comes from using payroll and consumption taxes to finance social welfare.

In Chapter 5, Kemmerling uses regressions to evaluate the relationship between the mix of taxes and various characteristics of trade unions and governments. In particular, his trade union measures try to get at that inherent conflict between medium-skilled, trade union “insiders” and low-

5. Indeed, a powerful case can be made for subsidizing low-wage labor through mechanisms like the U.S. earned income tax credit or the U.K. working family tax credit. See, e.g., JONATHAN BARRY FORMAN, MAKING AMERICA WORK 165–67, 177–82 (2006).
skilled “outsiders.” To gauge union strength in each country, Kemmerling develops a measure of union density—that is, the percentage of the workforce that is unionized. To gauge union representativeness of low-wage workers, he develops a measure of bargaining coverage—the extent to which the union-bargained wage becomes the industry wage.

As he expected, his regressions show that union strength and breadth of coverage both have an impact on the mix of taxes. On the one hand, union strength has a positive impact on progressivity. On the other hand, bargaining coverage has a negative impact on progressivity. In short, “[h]igher membership fosters the case for more (progressive) taxation, higher coverage indicates the contrary” (p. 87). These findings are in keeping with Kemmerling’s view that there is a cleavage between low-skilled and medium-skilled workers that has undermined trade union and left-of-center party support for progressivity.

Also in Chapter 5, Kemmerling uses two historical case studies to bolster his conclusions about the increasing ambivalence of trade unions (and left-of-center parties) toward progressive income taxation. One case study traces the long-term trends in the German tax structure from the nineteenth century on, and the other compares the evolution of the tax structures of the United Kingdom and Germany since World War II.

Finally, Chapter 6 summarizes the author’s main findings and offers some policy options. Kemmerling’s major finding is that contemporary welfare states have shifted their mix of taxes away from progressive income taxes. The sheer magnitude of the revenues needed for modern welfare states have also pushed them toward payroll and consumption taxation.

Kemmerling’s real contribution comes from his focus of the political conflicts that have arisen among employees and from his analysis as to why trade unions and left-of-center parties have become a lot less supportive of progressive (income) taxation. His research suggests that “in countries where unions are strong and include a large and representative part of the low-wage sector, unions will take interests of low-wage workers into consideration” and will favor a tax mix with relatively more progressive income taxes (p. 121). On the other hand, “in countries where there is a huge gap between bargaining coverage and union density, tax progressivity is markedly lower” (p. 122).

6. More precisely, union density is positively associated with higher proportions of income taxes (p. 87).
7. More precisely, higher bargaining coverage is negatively associated with income taxes (p. 87).
8. Kemmerling also found that GDP growth and inflation lead to a higher proportion of income tax relative to payroll and consumption taxes. In addition, he found that countries with higher inequality tend to have more income taxation. Finally, he found evidence that suggests that income taxes are less harmful to unemployment than other taxes: a 1% rise in the ratio of income to other taxes leads to a 0.1% decrease in the unemployment rate (p. 96).
All in all, a high tax burden and high marginal tax rates make a real difference in labor force participation, especially in the low-wage sector. Kemmerling explains that “it is not the tax burden, but the tax (and transfer) structure that affects the performance of a labor market” (p. 120). In that regard, payroll and indirect taxes “matter more for aggregate employment and unemployment than income taxes,” and “[t]he effect seems to be concentrated in the low-wage sector” (p 121).

Looking to the future, Kemmerling suggests that we need “to combine goals of public policy such as redistribution and a good performance of labor markets” (p. 120). “A ‘neoliberal’ option is to lower the overall tax burden together with a reduction in social benefits” (p. 124), as Reagan did in the United States and Thatcher did in the United Kingdom. “A different option is to strengthen the ties between contributions and benefits so as to reduce the tax component of social security contributions” (p. 124). In the end, however, Kemmerling favors shifting the tax mix toward income taxation and tax progression, but he sees tough challenges in forming the broad political coalitions that would be needed for this or any other political strategy. As the welfare states slowly recover from the recent global economic crisis, it will be interesting to see just what political coalitions develop and just what tax mixes result.