ABSTRACT

During the twenty-first century, why have some welfare state governments shifted their tax system towards a greater dependence upon consumption taxes, while other governments have chosen to move away from this dependence? This paper addresses that question by examining the contemporary politics of taxation in Canada and Germany. It analyzes what causes a government to choose employ specific tax policy instruments. This paper contends that, if a government is insecure and in need of enlarging its support base, it will largely ignore fiscal policies that predominantly focus on improving aggregate economic conditions in favour of policies which provide fiscal benefits to necessary constituencies, unless both dire economic conditions and adequate blame avoidance opportunities exists. While Canada chose to shift its tax burden away from consumption taxes because these necessary conditions did not exist, Germany chose to shift its tax burden towards consumption taxes because these conditions did exist.
# TABLE OF CONTENTS

Abstract........................................................................................................................... ii

Table of Contents.......................................................................................................... iii

List of Tables.................................................................................................................. iv

Acknowledgements....................................................................................................... v

1. Introduction.................................................................................................................. 1

2. Alternative Explanations............................................................................................. 5

3. A Theory of Competing Macroeconomic and Distributive Electoral Incentives........ 13

4. Empirical Analysis....................................................................................................... 23
   4.1. Canada.................................................................................................................... 23
   4.2. Germany............................................................................................................... 30

5. Conclusion.................................................................................................................... 39

References...................................................................................................................... 42
LIST OF TABLES

Table 3.1  Favoured Policy Instruments for Macroeconomic and Distributive Logics............19
ACKNOWLEDGEMENTS

I thank Dr. Alan Jacobs for his constant encouragement, and his consistent efforts in teaching me to pose questions from alternate perspectives. His efforts were responsible for maintaining my enthusiasm throughout this thesis, and consistently increasing my academic curiosity.

Thanks also to Dr. Yves Tiberghien for serving as my supervisor during the thesis’s final stages, and Dr. Gerald Baier for serving as my defence examiner. Without their assistance, it would not have been possible to complete my thesis on time.

Special thanks are owed to my parents, whom have always believed in me and my ability to accomplish anything that I desire.
1. INTRODUCTION

"Governments need money. Modern governments need lots of money. How they get this money and whom they take it from are two of the most difficult political issues faced in any modern political economy" (Steinmo, 1993, p.1). It may appear obvious that fiscal conditions would determine a government's decision whether to increase or decrease tax levels. For example, if a country suffers from deficits, typical economic sense dictates that a government would respond with increased taxes and reduced spending. Even this decision though, is heavily influenced by the electoral rewards and penalties associated with these policy actions. It can often be politically beneficial to utilize policy inaction, or even to decrease tax rates in order to reap short-term political benefits, while leaving longer-term deficit consequences for future administrations. Throughout this paper, 'electoral' incentives will refer to the effect of a specific policy on a party's re-election potential, particularly because of how the policy may increase the party's voter-support base. This definition will be the case except when specifically referring to 'electoral systems.'

A government's choice to increase taxes is not easy. Neither is the decision about which segment of society should bear the brunt of these fiscal demands. This is epitomized by the old Hungarian folk saying "don't tax you, don't tax me, tax that fellow behind the tree" (Gillespie, 1991, 1). Although a government's decision to decrease taxes may be comparatively more popular, even this is not trouble-free. A government may still be punished for the perception that they have rewarded certain societal groups disproportionately greater than others.

This thesis focuses on the taxation politics of two countries that have chosen divergent tax policy trajectories during the twenty-first century: Canada and Germany. For purposes of clarity, the 2006 Canadian and German federal budgets will be used as the focus of this case study. This is an apt choice, not only because both are similar from a temporal perspective, but
also because both are first budgets for new governments. While Germany shifted its tax burden towards greater consumption tax reliance, Canada shifted its tax system away from VAT dependence, and consequently towards less-efficient tax burdens. For purposes of simplicity and clarity, this paper will often refer to both the Canadian Goods and Services Tax, and German Value-Added Tax interchangeably as ‘VAT.’ For the purposes of this paper, ‘VAT’ will refer to a tax on spending that is recoverable by the payer at each level of production, except by the final consumer, essentially taxing only the final consumption value of goods and services. It is also recoverable by the final payer upon export, or when the payer is entitled to a specific exemption (Stout, 1969: 1-2).

While details of these tax shifts will be further elaborated within the empirical analysis section, their importance must still be put in perspective. For example, Canada’s 2006 GST reduction, from 7% to 6%, was estimated to have reduced revenues by an average of $5 billion annually (Poschmann, 2006, p.3). This single percentage point change amounts to a reduction of roughly 2.4% of total federal government revenues (OECD, 2007, p.238), and greatly outweighs the aggregate revenue impact of all other budgetary choices within the 2006 budget combined.

Meanwhile, Germany increased its VAT rate from 16% to 19%, amounting to the most drastic single increase since the initial implementation of the VAT. The 2007 implementation of this change resulted in an estimated €20 billion revenue increase, and consequently a dramatic 8.5% increase in total federal government revenues (OECD, 2007, p.243). Like in Canada, Germany’s VAT shift outweighed the total revenue importance of all other budgetary changes.

While both Canada and Germany have shown significant dependent variable difference, as evidenced by simultaneous tax changes in each country, it is puzzling that many of the traditional influences on welfare state policy change cannot provide persuasive explanations for these differences. Both cases concerned federal, parliamentary welfare states, each with a
newly-elected conservative government. Each country also faced escalating competitive perils associated with an era of globalization. In addition, neither policy choice was preferred by the electorate as a whole. Yet, even though both Germany and Canada shared so many common attributes and policy influences, their tax policies shifted towards dramatically different paths.

The choice to shift tax dependence towards consumption taxes, or away from them, is intricately linked to its consequences. Any tax shift will affect, not only which individuals will bear the changing tax burden, but also what the consequences will be for overall economic efficiency. A greater VAT dependence, while increasing overall tax efficiency, will also make the tax system more regressive, therefore shifting the tax burden towards lower-income individuals. On the other hand, lessened VAT dependence will diminish overall economic efficiency, but also make the tax system more progressive, therefore shifting the tax burden towards higher-income groups. Each choice includes a trade-off of consequences to be borne by the government.

This thesis seeks to explain this variation: why did the Canadian government decide to shift tax system dependence away from its value-added tax, while the German government decided to increase it? More specifically, why did Canadian politicians choose to expend their growing surplus by decreasing consumption taxes, rather than dramatically decreasing alternate tax rates, increasing spending, or focusing on more swiftly reducing the national debt? Conversely, why did their German equivalents decide to combat their swelling deficit, not with immediate spending reductions, increased income taxes, or increased social security taxes, but primarily with a VAT increase?

This thesis seeks to explain why governments choose to alter specific taxes at a particular moment in time, and in particular, what determines whether a government will choose tax

---

1 While the conservative CDU/CSU party received the greatest proportion of votes, instead of ruling as a minority government, the party established a 'grand coalition' with the opposition leftist SPD party. Therefore, they are not a true conservative government, but instead a conservative-led coalition government. Throughout this paper, the terms 'CDU/CSU government' and 'grand coalition government' will be used interchangeably.
policies with macroeconomic or distributive benefits. Macroeconomic logic involves a government making policy changes with the intent of benefiting the aggregate economy. Since this is done in order to achieve electoral benefits, it attempts to achieve economic benefits for voters, but only benefits that can be achieved with limited electoral consequences. Distributive logic involves a government making policy changes with the intent of targeting benefits toward favoured constituencies with whom they want electoral support, while attempting to keep costs away from these same constituencies. This is done as a fundamental aspect of its strategic electoral positioning.

This thesis contends that, if a government is insecure, it will prioritize distributive policies, instead of macroeconomic policies, because they provide greater re-election potential, unless both dire economic conditions and adequate blame avoidance opportunities exists. As with most policy decisions, there are frequently underlying conflicts between macroeconomic and distributive priorities. It will argue that these re-election incentives determine the outcome of this trade-off. The Canadian government chose to shift tax burdens away from consumption taxes because adhering to distributive logic provided greater re-election prospects than following macroeconomic logic. The German government chose to shift tax burdens towards consumption taxes because adhering to macroeconomic logic provided greater re-election prospects than following distributive logic.

This thesis begins by showing why existing explanations appear insufficient for explaining contemporary tax changes in Germany and Canada. The next section presents the theoretical argument, followed by a test against the cases. The final segment concludes by reflecting on this comparison, and contemplates the argument’s broader implications among other welfare states.
2. ALTERNATIVE EXPLANATIONS

While there is already a substantial literature on the politics of taxation, much of this theoretical material appears insufficient in explaining twenty-first century forces that are occurring in these welfare state economies. This section will focus on six of the key potential reasons for these policy outcomes, and why each is insufficient for explaining this phenomenon: economic efficiency, public opinion, government ideology, trade exposure, electoral systems, and corporatism.

It may appear unremarkable that Germany chose to shift greater emphasis towards consumption taxation, because VAT is a more efficient tool for solving fiscal crises. After all, if Germany’s government wanted to come even close to balancing their budget in the short-term, their tremendous deficit would likely demand the most efficient and high-yield revenue tool: VAT. Scholars, such as Peter Lindert (2004), believe that consumption taxation is a more efficient method than other forms of taxation, since universalism cuts administrative costs. VAT also envelops a broad tax base which is unmatched by any other existing tax. This broad tax base amplifies its revenue-earning capabilities. A government needing to raise large revenues within a short-term period would require the most efficient policy tool available. Doing otherwise would threaten to further deepen the country’s economic crisis.

While increasing VAT during a serious deficit may appear a prudent and efficient solution, due to political trade-offs, governments do not always choose the most efficient policy solution. Further, even if efficiency was the reasoning behind Germany’s increase, it does not explain why Canada would concurrently decrease its dependence on consumption taxation: the most efficient method of maintaining a welfare state economy within a world of integrated globalization. If efficiency were solely responsible, Canada would have been expected to
maintain its efficient GST, while devoting its excess fiscal capacity towards decreasing less
efficient taxes or increasing spending.

If efficiency is not responsible, perhaps the particular ideological beliefs of the governing
party determined their respective policy choices. All policy decisions in welfare states are likely
to be determined, to some extent, by the personal ideals of the government in power. In this case
though, it appears an unlikely explanation because, in both cases, conservative governments
were responsible for the budgetary policy choices. Though fiscal conditions may explain why a
German government decided to increase their country’s overall tax burden, while a Canadian
government shifted their tax burden in the opposite direction, it does not resolve their choices
among specific policy instruments. If ideological preferences were solely responsible, it would
likely be observed that both conservative governments would shift their overall reliance towards
regressive taxation: an outcome which did not occur.

It is possible that the differences between what ‘right-of-centre’ represent in each country
may explain these discrepancies. For example, a ‘right-of-centre’ political party in the United
States likely has more extreme conservative ideals than an analogous party in Canada. Even if
an observer allows for these disparities in definition, it is impossible to ignore that, in Canada,
the political party which originally introduced the GST essentially spawned the party responsible
for the subsequent lowering of the GST rate just fifteen years later. In other words, the recent
choice of the government to focus fiscal capacity on a GST decrease must not be due to an
inherent ideological opposition to consumption taxes on the part of the Canadian Conservative
Party. If this was true, the a fundamentally similar conservative party would not have also
chosen to introduce the GST fifteen years earlier. Instead, they would have chosen an alternate
policy instrument to achieve their fiscal ambitions. Obviously political party and ideologies do
not indicate a clear common cause of policy choice.
Even though political values do not appear to directly influence tax policy choices, it is possible that the values and opinions of the electorate influence the outcome. The demands of the electorate can often play a significant role in decision-making, due to the importance of maintaining public support for future election campaigns. Perhaps that is why both governments became elected, since the Canadian Conservative Party vowed to lower GST rates if elected, and the German CDU/CSU pledged to increase the VAT if also elected. The evidence does not sustain this assumption though. In both cases, public opinion was decisively opposed to using consumption taxes as the primary policy tool. In Germany, there was significant public opposition to the prospect of a VAT increase, while in Canada there was surprisingly little public support for a GST decrease.

In Canada, though it seems logical that most voters would support a tax cut of any kind, polls revealed that voters favoured a reduction in income tax over a reduction in the GST by a substantial twenty-point margin (Galloway, 2005). When Harper first announced his pledge to reduce the GST, though 67% of voters said they liked the tax cut, 69% of respondents said the prospect of a GST cut would have little or no impact on the way they would vote. Even the slim minority of voters who were most responsive to the prospect of a GST cut were already likely Conservative voters, thus not likely to be swayed by the policy decision (Ha, 2005).

As preposterous as it may seem that the electorate would elect a government based upon raising taxes, it appears to be a definite possibility in the case of Germany. In part, this is because the CDU/CSU’s main rival, the Social Democrats, campaigned on a platform of increasing Germany’s income tax (“Japan,” 2006). When voters are given a choice between an increase of tax A, or an increase of tax B, public opinion becomes a much more plausible cause. While it is unlikely that the public would ever support a tax increase, it is more conceivable that they would support it as an alternative to an increase of a less popular tax.
Although German voters elected Chancellor Merkel’s CDU/CSU coalition because they believed reforms were desperately necessary in an economy where the deficit had exceeded the 3% EU maximum, support was definitely not overwhelming. Merkel’s coalition was unable to achieve the landslide victory that was originally so widely expected by pundits, partly because of a lack of public support for VAT increases, among other reasons (Langenbacher, 2006). Support for Merkel after she announced her election platform dipped so dramatically that she was forced to enter a ‘grand coalition’ with her rival SPD party once elected. One of the proposals that received the most hostile public reaction was Merkel’s suggestion to raise the VAT rate, which at that time was proposed as only a 2% increase (“Germany politics,” 2005). This blatantly hostile public reaction, and the resultant drastic decrease in party support, suggests that positive public opinion was not responsible for Germany’s VAT increase.

It would be reasonable to assume that these cases may be explained by the forces of globalization. After all, the initial introduction of value-added taxes in each country was, at least partially, prompted by pressure from burgeoning free trade agreements. This occurred in Canada with the introduction of NAFTA (Eccleston, 2007, p.109), and in Germany due to revised EEC regulations (Schirm, 1969, p.32). Both countries tolerated inefficient sales taxes, which were generally opposed by the business community, for at least fifty years before these trade agreements acted as policy catalysts, thereby creating the political momentum to overcome this policy stagnation.

If a country’s economy is significantly dependent on maintaining the international competitiveness of their exports, theorists would predict a shift in tax burdens away from policies which diminish this competitiveness. “[T]he realities of globalization have ultimately shaped what policy elites now believe can be done and what ought to be done” (Steinmo, 2003, p.228). This typically means that these countries will avoid increasing taxes on mobile factors, such as corporations, capital, and to a more limited degree, income. Since considerable sources
of revenue are still mandatory in order to fund expensive welfare state programs, these
governments tend to increase dependence on consumption taxes (Kato, 2003). Therefore, the
recent differences in tax policy choices could be explained if Germany has considerably greater
trade dependence than Canada, and consequently is more likely to increase its reliance on VAT
relative to other taxes.

On first glance, Germany appears to fulfill this prediction, since at least part of its VAT
increase was intended to permit a taxation reduction on mobile capital. A third of the revenue
raised by the VAT increase was earmarked to help reduce unemployment benefit premiums paid
by workers and employers ("Japan," 2006). Along with deficit reduction, a reduction in social
security taxes was one of the goals that Chancellor Merkel explicitly professed before the VAT
increase.

While the argument for this theory may appear to be valid when analyzing Germany, a
similar contention cannot be claimed for Canada. In fact, considering that Canada has
dramatically deepened its international trade links in the years prior to the rate change,
globalization theorists would have difficulty explaining why its government shifted reliance
away from consumption taxes. Trade openness, as measured by exports and imports as
percentages of GDP (Swank & Steinmo, 2002, p.647), is potentially a useful tool in representing
a state's overall dependency on maintaining the international competitiveness of its domestically
produced goods (Garrett, 2005). A country with rapidly escalating trade openness can also be
expected to possess a growing aversion towards taxes which hinder competitiveness. Canada's
exposure, as measured by their total exports and imports as a percentage of GDP, increased from
53.05% in 2001 to 61.44% in 2006 (OECD, 2008a; OECD, 2008b).

During this time, Canada has also increased their exposure to forces of globalization by
signing free trade agreements with Costa Rica, Peru, and the European Free Trade Association,
which includes Iceland, Liechtenstein, Norway, and Switzerland. They have also entered into
negotiations with four Central American countries, South Korea, Singapore, Jordan, and even a proposed Free Trade of the Americas treaty, which would include all 34 democratic countries in the Americas. Obviously Canada has greatly increased its trade dependence during the twenty-first century. Considering this, it appears unlikely that globalization could have been responsible for the Canadian government’s decision to devote the vast proportion of its excess fiscal resources towards a consumption tax decrease, as opposed to alternate tax reductions.

Perhaps the reason these explanatory variables do not appear to exert their predicted influence is because their effects are being distorted by institutional differences. For example, electoral system disparities have been blamed by Sven Steinmo for changing the context in which governments and other societal groups define their policy preferences. He notes that electoral structures “set the stage for development of particular decision-making institutions” (Steinmo, 1989, p.503).

Therefore, a government elected under a proportional representation system may perceive consumption taxation to be a more useful policy tool than a similar government in similar circumstances, but instead under a single-member plurality system. This perception originates due to PR-systems having a greater likelihood of creating minority and coalition governments. As compared to a majority government, minority or coalition governments require greater compromise with other political parties in order to enact taxation changes (Lijphart, 1994; Tsebelis, 1995). A minority or coalition government that is required to often compromise with other parties may be more likely to utilize specific tax changes, such as VAT, as a negotiation concession (Steinmo, 1989).

While their electoral systems are not identical, the relevant differences between Canada’s plurality and Germany’s mixed electoral system (Blais & Massicotte, 2002, p.46-47) have been muted due to parallel outcomes of those electoral systems. Both countries elected a party that possessed only a minority of seats, within a multi-party legislature: the relevant characteristics
supposedly created by PR-based electoral systems. It is these derivative characteristics which are supposedly responsible for changing the context of policy decisions, not the underlying electoral system. Since these derivative conditions are the same among both cases, any electoral system difference is irrelevant.

Finally, even though differences in electoral systems appear not to be responsible for altering the context for these tax changes, differences in levels of corporatism within each country is a viable possibility. While Germany maintains a medium to strong level of corporatism, the level of corporatism in Canada is considered weak (Siaroff, 1999, p.184). Harold Wilensky believes that corporatism supports a trajectory towards low tax visibility, such as consumption taxes (Wilensky, 2002, p.237). Just as with electoral systems, a country’s level of corporatism is relevant because it affects how much compromise a government must pursue, and how many policy trade-offs a government is willing to accept in order to achieve policy change.

Accordingly, a country with high levels of corporatism should be observed to have correspondingly elevated levels of compromise between the government and other societal groups, such as labour and business (Wilensky, 2002, p.85-86). These high levels of compromise typically result in increased dependence on consumption taxes, despite the governing party’s ideology. This is because concessions to labour groups often involve increased social spending, which requires a substantial tax base that only value-added taxes can provide without politically undesirable consequences. Alternative tax mechanisms for fulfilling these spending concessions involve dramatically increasing politically painful visible taxes such as income tax, or significantly increasing social security deductions, which may severely hinder economic growth (Wilensky, 2002, p.236). Also, since low-income and middle-income earners typically benefit disproportionately from this increased social spending, the government may justify a regressive tax such as VAT through a user-pay perspective.
On first inspection, corporatism appears to be a plausible cause of each country’s tax shifting. The high levels of corporatism in Germany likely established incentives for increasing VAT rates, as opposed to other taxes, while a lessened need for the Canadian government to achieve consensus with societal groups provided the government greater flexibility to decrease GST rates. While policy outcomes for each case appear to correlate with those predicted in corporatist states, the corresponding intermediary mechanisms are absent.

In Germany, it is not clear that explicit concessions were provided to labour groups, or at the very least concessions in excess of what would be expected in a non-corporatist country. The VAT increase occurred simultaneously with a freeze on virtually all social spending. In July 2006, the ‘grand coalition’ announced that it would increase health insurance funding by 0.5% the following year, following by a funding freeze. Far from gaining consensus, this issue generated opposition from the trade unions, employer associations, and the opposition parties in the Bundestag (“Germany: coalition,” 2006). Furthermore, the disdain by labour and business interests toward government spending decisions clearly shows a lack of any successful corporatist negotiations within the 2006 budget. Although collaboration with leftist parties was achieved, there is no evidence of similar successful collaborations among the interests required to show corporatism’s responsibility for Germany’s VAT increase.
3. A THEORY OF COMPETING MACROECONOMIC AND DISTRIBUTIVE ELECTORAL INCENTIVES

As mentioned in the introduction, a government may not always respond to poor fiscal circumstances with an increased tax load. While this is true, this thesis will assert that when fiscal conditions are significant and chronic, policy actions become relatively predictable. Significant refers to an unsustainable debt load, such as an annual deficit of three percent of GDP or greater. Chronic refers to a sustained condition throughout numerous years, where the situation displays no semblance of tangible improvement.

This implies that significant and chronic deficits will generally result in increased tax rates and decreased government spending, while significant and chronic surpluses will generally result in decreased tax rates and increased government spending. Though these fiscal conditions determine the direction of tax changes, they do not establish which specific tax or spending instruments will be utilized. Therefore, Canada’s surplus can reasonably be expected to result in a tax cut, while Germany’s deficit will result in tax increases. However, in order to determine why both Canada and Germany chose to focus the predominant emphasis of their tax shifting on consumption tax rates, the overall politics of taxation must first be assessed.

There are two principal reasons why governments may prefer consumption taxes over other kinds of taxation, or vice-versa: macroeconomic effects and distributive effects. Any tax shifting will result in both effects, and its resultant electoral consequences. As described in the introduction, a government’s tax choice involves a trade-off between achieving each of these effects. It is therefore necessary to determine the particular context where a government will favour achieving a particular effect. This can be determined by discovering which situation will provide the greatest electoral benefit for a government pursuing a particular logic.
This paper only claims to be theoretically valid when occurring in a specific domain: welfare states with significant, chronic structural deficits or surpluses. The reason for this is because deficits can originate for numerous reasons, such as currency crises, oil shortages, terrorist events, and even cyclical recessions. While these events may create temporary fiscal hardships and serious deficits, they cannot be considered a chronic structural condition.

Similarly, non-structural surpluses could be a result of booming commodity markets or other temporary situations. These circumstances often dictate different policy choices than would structural conditions, which instead indicate to politicians that current tax rates will never be capable of sufficiently funding existing social programs, regardless of current market conditions.

For example, a government using macroeconomic logic during a temporary deficit may feel compelled to do nothing, and instead wait for the problem to resolve itself. On the other hand, governments whom choose to utilize macroeconomic logic, but face permanent deficits, would be more inclined to raise taxes as their preferred policy tool.

Before it can be determined which conditions are necessary for a particular logic to be chosen by a government, it must first be established which policy tool will be utilized once a government has chosen to follow a particular logic. First, ideology is important because it can further inflate the odds that a government will chose a specific tax as their policy tool. For example, whenever possible, fiscally conservative governments, in response to surpluses, tend to prefer decreasing taxes as an alternative to increasing, and during a deficit, prefer decreasing spending as an alternative to increasing taxes (Steinmo, 1993; Pierson, 1994, p.131).

This paper will begin by describing the policy choices of a government determined to follow macroeconomic logic. Macroeconomic logic in a globalized world favours heavier reliance on consumption taxes. In the case of a chronic deficit, macroeconomic logic, as elaborated in the previous section, would result in the government focusing their tax increase on consumption taxes. In the case of a chronic surplus, macroeconomic logic would result in the
government maintaining consumption tax levels, and instead decreasing taxes which are more vulnerable to globalization and international competition, such as corporate taxes, social security deductions, or even income taxes. For either scenario, the economic importance of this logic is especially salient in the minds of conservative parties, who tend to believe that a less progressive universal consumption tax, such as VAT, is economically preferable to existing progressive taxes (Lindert, 2005, p.305).

From a purely economic perspective, deficit reduction tools other than VAT provide minimal prospects for comparable macroeconomic benefits. Increasing taxes on less-mobile factors, especially when already enduring poor economic conditions, may further exacerbate economic problems. If a government decided to eliminate chronic deficits by relying exclusively on progressive tax increases such as income, corporate, or capital taxes, the sudden marginal rate increases which would be necessary on these more narrow tax bases would damage the country’s international competitiveness and harm productivity, thus threatening to further deepen the country’s fiscal crisis.

It is important to understand why pursuing macroeconomic logic while maximizing net electoral benefits favours increasing relative consumption tax dependence. Whether VAT is increased, or maintained at a constant level while alternate modes of taxation are decreased, a comparative increase in VAT dependence is still the result. As described in the introduction, VAT is the most efficient revenue-raising tax. “Policy makers with strong spending commitments have no choice but to strongly rely on regressive taxes” (Ganghof, 2006, p.371). This is because regressive taxes provide the largest tax base, and therefore the greatest potential to raise considerable revenues with the least per capita impact on individual voters. By maintaining diffuse costs, it is easier to achieve economic goals while not also drastically increasing electoral consequences.
Similarly, a government pursuing macroeconomic logic has little potential for relying predominantly on spending reductions in order to eliminate deficit conditions due to the resultant electoral consequences, regardless of purely economic benefits. The drastic retrenchment necessary to achieve notable deficit reduction in a single electoral mandate would effectively cripple a welfare state’s programs, resulting in electoral suicide for the ruling government. Even blame avoidance techniques would be of minimal benefit for a government that chooses to eliminate a deficit predominately with short-term retrenchment. When governments do initiate cuts, they are usually time-delayed, so the government can avoid blame (Weaver, 1986, p.379). “Governments interested in curtailing social programs may enact policies that cut spending immediately; they may also enact changes to be phased in over time, the full effects of which may not be felt for many years” (Pierson, 1994, p.14). Since they are phased in over a long-term period, these cuts have little prospect to impact a deficit within the short-term or even medium-term, while the political consequences associated with short-term cuts would nullify any electoral benefits associated with adhering to macroeconomic logic.

As was mentioned, only regressive taxation has the potential to deliver meaningful short-term relief from serious deficits. The main regressive alternative to consumption taxes are social security deductions. The consequence of these deductions is that they promote unemployment by “[increasing] the price of labour and thereby [reducing] demand for it,” as well as inducing an employee to reduce their working hours or exit the workforce completely (Cusack & Beramendi, 2006, p.66). This is capable of reducing income tax revenues, hindering deficit reduction efforts. Due to the diminished demand for labour, it can also further slow overall economic growth in the midst of an economic crisis. In addition, due to the effects of globalization, governments possess weak leverage to impose losses on business, so increasing corporate, capital, or social insurance taxes is unlikely (Pal & Weaver, 2003, p.21). Therefore, consumption taxes are a better economic tool than social security taxes.
As with deficit-ridden countries, VAT macroeconomic logic also applies towards countries with a surplus. Taxes on mobile capital, such as those listed above which are vulnerable to the influences of globalization, should have priority when determining tax reductions in surplus countries as well. An analogous argument may even be made for reducing progressive taxes instead of VAT, since the lost revenue cost of a single percent VAT reduction could provide a comparatively large income tax marginal rate decrease, due to differences in tax base size. Not only would this provide a larger marginal benefit for individual voters, but this more substantial rate reduction should encourage employment, thus propelling economic growth. Macroeconomic logic clearly indicates a consumption tax preference.

As opposed to macroeconomic logic, distributive logic dictates that a government will make tax policy decisions in an effort maximize electoral support from a specific constituency. In the case of a chronic deficit, it predicts the government will avoid the blame by choosing, not necessarily the most economically efficient tax for deficit-reduction, but rather tax increases which inflict the least electoral punishment, especially in regards to their favoured constituency. In the case of a chronic surplus, this logic predicts the government will choose to decrease taxes for specific segments of society in an effort to 'buy their vote' in the next election. This may mean reducing taxes for a portion of the electorate that would not otherwise vote for the governing party. It could also suggest the government will lower taxes for a societal group whose support for the governing party is tenuous.

Minority governments, or even members of a coalition government hoping for their party to win a stand-alone majority in the following election, will be most likely to use distributive logic in an appeal for the median voter, rather than using policy to reward their base constituency. This is because, in order to achieve that status, majority governments are typically required to become more broadly-appealing. Therefore, a minority conservative government will appeal to the median voter either by making the tax system more progressive, or by
increasing spending for low and middle-income voters. This indicates conservative
governments, in an appeal for the median voter, will avoid a reliance on regressive taxes,
therefore also appealing to the economic interests of lower-income voters whom may otherwise
not vote for a conservative, but whose support is necessary to form government.

A government’s capacity to win re-election, and thus achieve their policy priorities, is
dependent upon their ability to ensure social benefits are distributed broadly across society (Hale,
2002, p.367). According to this logic, a conservative government concerned with shifting
towards the median voter and concurrently distributing benefits broadly across society is left
with two options which provide considerable electoral benefits: reduce VAT or increase social
spending. Reducing progressive taxation is unsuitable because the benefits would not be broadly
divided across society. For example, about a third of Canadians tax filers are currently exempt
from income tax, a number predicted to grow in future years (Hale, 2002, p.368). Similarly, a
deficit-ridden government would want to spread out associated costs by making these costs more
diffuse, thus limiting the marginal effect on individual voters. Ideology ensures that a
conservative government following distributive logic will be more likely to focus on freezing
spending rather than increasing taxes, even if this results in deficit-reduction being less effective,
due to the long-term nature of the cuts.

For a conservative government with a surplus though, reducing other regressive taxes,
such as social security deductions, would provide minimal electoral benefits, not only because it
is seen by many as a corporate tax (Prasad, 2006, p.26-27), but also because, like income taxes,
the benefits would not be as broadly distributed as with a VAT reduction. Also, these other
regressive taxes are often dedicated to financing popular programs, such as public pension plans,
so their reduction may not result in surplus reduction, but may consequentially threaten the
financial stability of these popular programs. Therefore, a conservative government attempting
to show that it is moving towards the centre of the political spectrum would prefer to focus their policy choices on a consumer-based regressive tax with a broad base, such as VAT.

Table 3.1 Favoured Policy Instruments for Macroeconomic and Distributive Logics

<table>
<thead>
<tr>
<th></th>
<th>Macroeconomic Logic</th>
<th>Distributive Logic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Surplus</td>
<td>Greater VAT Dependence (eg. lower rates for other taxes)</td>
<td>Less VAT Dependence (eg. lower VAT rate)</td>
</tr>
<tr>
<td>Deficit</td>
<td>Greater VAT Dependence (eg. higher VAT rate)</td>
<td>Reduced Spending (via long-term cuts)</td>
</tr>
</tbody>
</table>

Since the actions associated with these macroeconomic and distributive logics often oppose each other, particularly for conservative governments (See Table 3.1), it is important to determine which perspective will succeed in a particular policy-making decision. Context determines which line of logic will be adopted, and consequently, which specific tax instrument the government will favour when determining tax increase and reduction strategies. There is a natural tendency, especially for governments within highly competitive political systems, to favour distributive logic unless conditions are present which construct economic logic as more politically beneficial than following a traditional electoral perspective. Governments within these highly competitive systems, such as minority governments and majority governments where there is a dominant opposition, are more vulnerable because even small variations in vote share can result in a loss of political power. Therefore, the immediate net electoral benefits associated with following distributive logic becomes far more vital, until conditions occur which provide an even greater electoral benefit for shifting to economic logic.

A government will be more likely to follow macroeconomic logic the more dire economic circumstances become, and if sufficient blame-avoidance opportunities exist. Each is
a necessary, but not sufficient, variable allowing the government to follow macroeconomic logic. Due to this, if a government favours utilizing consumption taxes as their preferred policy instrument instead of other alternatives, this does not necessarily indicate an ideologically-based consumption tax policy preference, but rather is likely a necessary tool to achieve political goals.

The reason dire economic circumstances play an important role in determining policy trade-offs is because they result in various domestic consequences. These consequences may include increased interest payments, elevated interest rates, devalued currency, high inflation, deterioration of investor confidence, high unemployment rate, and numerous other possibilities. The public may, and likely will, blame the government for failing to prevent these conditions. If the economic crisis is severe, electoral punishment for these situations may even exceed voter retribution levels that are typically reserved for tax increases. In these conditions, the government may be more politically successful if it chooses to combat a severe economic crisis, as long as it also possesses blame-avoidance opportunities to mitigate the blame associated with their unpopular policy tools.

There are several conditions which determine the availability of blame avoidance opportunities. First is whether the government governs alone, or as a member of a coalition. By forming a political coalition with their main electoral rivals, the government can successfully ‘circle the wagons,’ without legitimate fear of electoral reprisal (Weaver, 1986, p.388-389). This allows parties within a coalition government to, not only avoid blame, but even continue avoiding blame for supplementary economic-logic decisions which are made. This is because opposition parties within the coalition fear “that they will be punished by voters for causing the collapse of the government” (Weaver, 1986, p.393), therefore they will be inclined to continue stay in a coalition, and continue circling the wagons.

While circling of the wagons may prevent losing vote share to your coalition partners, difficult policy choices may still result in losing voter support to third parties. Even in these
situations, political damages may be mitigated. Where there are significant visible deficit-associated economic problems and these crises are salient among the electorate, the government may ‘redefine the issue’ if the crisis is solved. Any residual anger among the electorate in response to painful policy decisions can be partially offset by redefining the issue as successful fiscal rehabilitation (Weaver, 1986, p.386). By shifting voter attention away from unpopular policy choices towards popular policy results, the risk of either coalition member losing vote share to third parties can be largely minimized.

Governments that are not in a coalition, and govern alone, can defer electoral punishment for painful policy decisions, not only by redefining the issue as a successful balanced budget, but also through creation of a scapegoat (Weaver, 1986, p.387). This can be done by blaming the previous government for their construction of dismal fiscal conditions. Discrediting a former government can also minimize the threat that the opposition will pose in the following election (Pal & Weaver, 2003, p.28). This blame avoidance tool is most effective if the previous government was unpopular.

Finally, if the policy choice involves multiple levels of government, they can scapegoat a separate level of government. Where legislative authority over tax policy decisions is blurred, the government can blame a sub-national authority, such as a provincial government, for an unpopular tax increase. This can be especially effective in situations where the sub-national government is controlled by an opposition political party. They also may ‘pass the buck’ of tax increases to sub-national governments, potentially by reducing transfer payments, thus forcing the sub-national find a new revenue source for its program spending (Weaver, 1986, p.386).

In summary, the presence of either surpluses or deficits determines the direction of policy change, but not the specific policy instruments which will be utilized. For an insecure government, the choice over policy instruments is based on whether or not necessary conditions exist. If both dire economic circumstances and adequate blame avoidance opportunities exist,
then the government will adopt macroeconomic policies. If these conditions do not both exist, then the government will adopt distributive policies.
4. EMPIRICAL ANALYSIS

4.1 Canada

As described in the introduction, the Canadian government chose to focus its fiscal capacity towards a consumption tax reduction. According to the logic of the previous section, this policy outcome occurred because the electoral benefits of following distributive logic outweighed those associated with macroeconomic logic. Therefore, in Canada, the Conservative government favoured distributive logic rather than macroeconomic logic. This occurred because they did not face a dire economic situation; therefore the political rewards for pursuing macroeconomic logic would have been minimal. Also, they were not presented with significant blame-avoidance opportunities. Therefore, the political rewards associated with distributive logic were greater than macroeconomic logic. This is what caused the government to focus fiscal capacity on GST decreases, consequently shifting overall tax reliance away from consumption taxes.

During the 1990's, the majority Liberal government engaged in significant welfare state retrenchment, drastically dropping spending from $120 billion in 1993-4 to $108 billion in 1996-7 (Lewis, 2003, p.174). These spending reductions, combined with the introduction of the GST by the previous government, resulted in chronic structural surpluses, beginning in the 1997-8 fiscal year (Lewis, 2003, p.186). It expanded into a massive Canadian surplus of $13.2 billion during the fiscal year prior to the first GST decrease, the largest surplus in the G8 as a proportion of GDP (Chase, 2006). These surpluses created the fiscal capacity to consider either re-funding programs or easing tax burdens. While the Liberal government took some advantage of these opportunities, ample fiscal capacity still remained by the time the Conservative government took office.
While there were several ways in which the Conservative government spent their budgetary surplus within their first budget, the most significant by far was the GST reduction. Their principal budgetary change involved a one percent GST reduction, estimated to result in an $8.69 billion revenue reduction over a two year period (Department of Finance Canada, 2006, p.202). The government also curtailed a personal income tax reduction, implemented by the previous government, effectively raising the income tax rate from 15 percent to 15.5 percent (Laghi & Chase, 2006). They also re-introduced a plan to eliminate double taxation of dividends obtained from large corporations. This idea was originally proposed by the previous Liberal government, but was scrapped as part of their minority government’s concessions to an opposition party. This tax reduction was the second biggest original tax policy idea proposed in the budget, but still only amounted to $685 million over two years (Department of Finance Canada, 2006, p.202).

The impact of the GST reduction even dwarfed spending increases, which were largely concentrated in four priority areas. These amounted to an annual direct program expense increase of $2.6 billion, when measures introduced by the previous government are excluded (Department of Finance Canada, 2006, p.170). Even if one interprets tax expenditures as forms of spending, their aggregate impact only cost $5.01 billion over a two year period (Department of Finance Canada, 2006, p.202). Other budgetary changes were comparatively minor, or were already introduced by the previous government. Overall, this consumption tax decrease represented a larger fiscal impact than all other proposed spending increases and tax reductions combined, showing its clear role as the government’s preferred policy instrument.

Although the GST reduction was a key election promise for Stephen Harper’s Conservative Party, similar key election promises had been made, and broken, by the previous

---

2 This government revenue estimate differs from the estimate provided in the introduction, because the GST reduction did not apply to the first portion of the 2006 fiscal year.
Liberal government of Jean Chrétien. Chrétien promised to eliminate the GST upon forming government in 1993, but ignored this promise with no electoral punishment. This was due in part to the GST’s decreased salience among the public by 1994.

Prior to commencing, this paper must dispel a popular conception that simmering public discontent associated with the GST provided the electoral incentive for the Conservative’s GST reduction. While this public anger played a primary causal role in the electoral demise of their political predecessor, the Progressive Conservative Party, by mid-1994, public resentment had largely dissipated, with only 38 percent public support for a GST reduction remaining (Hale, 2002, p.219). This is comparable to public support for other modes of tax relief. By the time the Conservative Party was elected in 2006, public resentment of the GST was not noticeably different than typical opposition towards all taxation.

Before it can be determined that the GST was chosen because distributive motivations possessed greater political incentives than macroeconomic motivations, this paper must definitively determine that the GST was the best tool, from the Conservative’s perspective, for achieving those distributive objectives. First, what were the government’s criteria for an ideal policy choice? Harper wanted to choose a policy which would make him “the champion of working families in this country” (Laghi & Chase, 2006, ¶1). Harper and his Conservative Party were seen by much of the electorate as extremists. Early in the election, 47 per cent of Canadians polled said they believed he held extreme views (Howlett, 2005).

This perspective was extremely detrimental for a minority government with aspirations to become a majority in the following election. In order to achieve this majority status, the party needed to appeal to voters who would otherwise be reluctant to vote for a conservative party. Specifically, Harper needed a way of appealing to the huge middle-class constituency, and even some lower-income voters who may have shared similar social ideologies, but believed that the
Conservatives were out of touch with their personal economic realities ("How conservative," 2006).

The GST was chosen as the Conservative government’s preferred policy instrument, not because the choice was extremely popular among the electorate, but because it signaled to the public that the party was willing to ideologically moderate itself. The Conservatives had two options for achieving this perception: increase spending or make the tax system more progressive. Either option had the potential of showing the public that Harper was willing to shift the ratio of overall wealth back towards the median voter.

If spending and consumption taxes provide comparable distributive incentives, it is understandable that the deciding factor between the two would be the party’s ideology. It was evident that ideology played a definitive role in solidifying the Conservative’s choice to focus on decreasing taxes, instead of increasing spending. Their claim, while they were still official opposition, that chronic surpluses are a symptom of arbitrarily high tax rates, show an ideological predisposition towards lowering taxes, rather than increasing spending (MacCharles, 2004). “[L]ow taxes that allow individuals to make financial decisions for themselves, in a country where the government has a low profile and slim spending ways, were the mainstays of right-wing philosophy” (Scoffield, 2006), up until the 2006 election at least. It is naïve to believe that the Conservative Party’s ideology shifted so drastically within an election cycle, and more probable to believe that these uncharacteristic policy choices were done purely for electoral expediency.

As with any political party seeking electoral expediency, they were forced to accept some increases in program spending. Even these concessions were influenced by conservative ideology and the prospect of future electoral consequences though. The Conservative government accomplished this by focusing spending on key priority programs, such as the $1200 annual subsidy for child-care expenses which, as a taxable replacement of a pre-existing
childcare program, cannot even be truly construed as original expenditures. Spending tended to focus on tax expenditures, which not only fit the Conservative’s tax reduction ideology, but has limited inflationary cost potential (Kingissepp, 2006).

Due to this role of ideological preference, the government’s outstanding option was to make the taxation system more progressive, a choice typically associated with leftist governments. The significance of this shift should not be underestimated. Only six years earlier, the Party’s predecessor, the Canadian Alliance, advocated the idea of introducing a flat tax. “Using government fiscal policies to meddle with the direction of the nation was considered un-conservative” (Scoffield, 2006). Conservatives believed progressive income tax reduced employment incentives, but once elected, had to make the tax system more progressive as a signal to the electorate that they were willing to moderate their policy ideals.

In order to make the tax system more progressive, Harper had two options: increase progressive taxes, such as income taxes, or decrease regressive taxes. Obviously increasing taxes was not a positive electoral option, so Harper had little choice but to focus on decreasing regressive taxes. He then had to determine which regressive tax to reduce: GST or social security deductions. While both accomplish the same goal of making the tax system more progressive, only one choice, GST, does not risk counteracting the tax reduction’s overriding purpose. Since social security deductions are a labour cost borne at least partially by corporations, it can be seen as a corporate tax reduction, thus hurting its helpfulness in portraying a more moderate image of Harper.

Now that the GST has been isolated as the Conservative government’s ideal policy instrument for achieving distributive aspirations, it must be determined why the political value of

---

3 In reality Harper did also increase the progressive income tax rate from 15% to 15.5%. Although the lower 15% rate was never officially finalized by the previous Liberal government due to the sudden election, Revenue Canada had already begun collecting the lower rate. As a result, taxpayers would have noticed increased paycheck deductions for the second half of 2006, after Harper’s budget was passed. Though, in comparison to the GST decrease, this tax increase was still relatively minor.
those aspirations outweighed the benefits associated with following macroeconomic logic. It is clear that shifting emphasis towards consumption taxes would have been the Conservative’s ideal policy instrument for achieving macroeconomic logic. Economics professor Jim Davies from the University of Western Ontario notes that “[m]ost serious work done by economists who specialize in public finance indicates that the GST is a more efficient tax source than the income tax” (“Economists,” 2005, ¶13), while economist and Conservative-supporter Christopher Ragan remarked that the Conservative decision to focus tax reduction on the GST is just “[s]tupid, stupid, stupid, stupid.” (“Economists,” 2005, ¶2). Due to the efficiency characteristics associated with VAT, and the pro flat tax sentiments professed by the core constituency of the Conservative party, it should be obvious that the party’s macroeconomic logic clearly favoured shifting greater overall tax reliance towards the GST, not away from it as actually occurred.

In this situation, following electoral logic provided Harper with a voter premium beyond what he would have received pursuing macroeconomic logic. Macroeconomic policies would have been successful in appeasing his core constituency, but it would have done little to attract new voters. On the other hand, by choosing to focus tax reductions on the GST, Harper was not only successful in appeasing his political base by sustaining traditional conservative values, but was also simultaneously able to aim at attracting new, left-of-centre voters (Laghi, 2006).

The absence of adequate blame avoidance opportunities appears to be responsible for the distributive choice possessing a greater electoral value than the macroeconomic choice. If adequate blame avoidance opportunities existed, the Conservatives would likely have also attempted to achieve some macroeconomic strategies, in addition to the electoral benefits provided by a GST reduction. Evidence of this blame avoidance opportunism is clearly manifest in Harper’s decentralization policies. Decentralization facilitated the Conservatives to pursue their economic logic of reducing future expenditures. Since decentralization is a way to ‘pass the buck’ to provincial governments, it is an effective blame avoidance strategy to allow future
welfare state retrenchment (Pierson, 1994, p.16-17) in programs where the government fears severe risk of inflationary costs, such as Medicare ("Harper’s,” 2006). This decentralization occurred despite a typical reluctance of federal governments to reduce spending during a surplus when available revenues abound. This retrenchment policy was feasible because of the available blame avoidance opportunity.

Unfortunately for Harper, the lack of other prominent blame avoidance opportunities limited his pursuit of further macroeconomic goals. Since the Conservatives were not a member of a coalition government, they were unable to circle the wagons. Given that in most provinces the GST is an exclusive federal jurisdiction, he was also unable to pass the buck to his provincial counterparts. Harper was also unable to scapegoat the incompetent policies of his opposition predecessor, Paul Martin. Harper could not legitimately convince voters that Martin had maintained artificially high income tax or corporate tax levels, because Martin had made visible attempts to decrease both progressive taxes.

Finally, if the Conservatives had attempted to adopt their macroeconomic logic, with the principal goal of benefiting domestic economic conditions, redefining the issue to offset voter discontent would have been difficult, if not impossible. This is because a marginal economic improvement is typically not salient a concern for voters when the country is already in the midst of an economic boom (Lewis, 2003: 17). Therefore, the political windfall of further assisting economic conditions would be minimal, preventing issue-redefining efforts from adequately deflecting public dissatisfaction associated with the government not shifting towards the median voter.

Without the availability of the above blame avoidance techniques, Harper’s Conservatives were relegated to adopting policies based on distributive logic. If these opportunities existed, the political value of following his macroeconomic objectives would have been appreciably enhanced. If this had occurred, the likelihood of Harper choosing to focus his
available revenues on an alternate tax policy instrument that more adequately adapted to his economic preferences would have been significantly elevated. It is still possible that Harper would have felt compelled to reduce GST levels, but potentially the shift would have been a less dominant budgetary feature.

4.2 Germany

In a mirrored manifestation of Canada’s policy choice, the German government chose to focus its fiscal capacity towards a consumption tax reduction. While both country’s outcomes are centralized around consumption taxes as the primary policy mechanism, as this paper’s theoretical logic explains, both outcomes occurred for opposite reasons. Unlike in Canada, the German outcome occurred because the electoral benefits of following macroeconomic logic outweighed those associated with distributive logic.

Therefore, in Germany, the CDU/CSU government favoured macroeconomic logic rather than distributive logic. This transpired because the fiscal and economic conditions in Germany were so dismal that the consequences of ignoring the effects would create a significant negative vote share impact for the CDU/CSU. Consequently, there were significant benefits associated with following macroeconomic logic. Even though these conditions existed, the political benefits of pursuing distributive logic were still greater than those achieved by pursuing macroeconomic logic. This balance was shifted in favour of macroeconomic preferences once the presence of blame-avoidance opportunities was taken into account though. This is what caused the German government to embark on consumption tax increases which would have been politically infeasible in alternate situations.

German reunification was responsible for a massive inflation in program spending. Social spending costs increased steadily until the late 1990’s. As large scale eastern unemployment was absorbed by Germany’s welfare system, spending skyrocketed to an extent
never before observed in a western democracy. Social spending increased to such an extent that it dwarfed even Sweden, with social expenditures in East Germany peaking at 55.5% of GDP in 1992 (Leibfried & Obinger, 2004, p.205). For the purposes of this paper, vertical expansion refers to raising per capita social spending, while horizontal expansion refers to expanding the quantity of individuals entitled to directly benefit from social spending. While the government did attempt to reduce vertical expansion of social spending, these attempts were dwarfed by horizontal expansion, the long term costs of which will inevitably spiral upwards as the population ages (Anderson, 1999, p.42-43).

This proliferation of program growth resulted in chronic deficits, so large that, not only did they violate EU regulations, but also the German constitution. The German constitution dictates borrowing is not allowed to exceed investments, and the euro zone rules dictate that a member state’s deficit cannot exceed three percent of GDP (Benoit, 2006). Therefore, while the Canadian Conservative government was choosing how to spend their budgetary surplus, the German government faced a choice about how to shrink their deficit.

In order to shrink the deficit, the German government chose to focus on revenue-raising via a consumption tax increase. Like Canada, Germany’s primary budgetary change also involved VAT, but instead concerned an increased rate from 16 percent to 19 percent, estimated to result in a €20 billion revenue increase in the first year alone (“German government,” 2006). A third of this revenue was earmarked to allow a reduction in unemployment insurance contributions from 6.5 to 4.5 percent (Bundesregierung, 2006a). The other major tax change involved an increase in the maximum income tax rate to 45 percent, for earners over €250,000 (Bundesregierung, 2006b). Tangible spending increases in priority areas roughly cancelled out the impact of billions of dollars worth of tax expenditure reductions, therefore minimizing the relative fiscal impact of program spending as a budgetary policy instrument. Mirroring the
results of the Canadian changes, the revenue raised from the VAT increase in Germany was more substantial than the net revenue change of all other budgetary measures combined.

Germany’s policy choices may appear slightly more predictable than Canada’s choices. First, VAT is the most efficient means of raising large revenues while maintaining international competitiveness, which will be later described in greater detail. Second, Germany’s increase satisfied an EU policy that encourages the convergence member states’s VAT rates. Though this is the case, this ‘efficient’ policy choice had been largely ignored by previous administrations, even in the midst of continuous deficits. In regards to the EU policy, several other EU countries have largely ignored this directive, specifically because it remains an optional choice. This shows that, while Germany’s policy decision may appear to be less puzzling, policy inaction was still a fundamental possibility.

Before it can be determined that the VAT was chosen because macroeconomic motivations possessed greater political incentives than distributive motivations, this paper must definitively determine that the VAT was the best tool, from the CDU/CSU’s perspective, for achieving those macroeconomic objectives. When attempting to extract a country from chronic deficits, the government typically has two options: reduce spending or increase taxes. Although the CDU/CSU understood that some form of spending reductions were necessary to slow deficit growth, they also understood that spending cuts alone would not reverse current deficits.

Attempts to balance the budget had previously been made, by using expenditure reductions as the predominant policy tool, but these attempts had failed to achieve consequential results, other than perhaps public anger from many leftist individuals towards the previous left-leaning SPD government, especially for their Hartz IV reforms (Borak, 2005). These spending cuts failed because they controlled the growth of vertical expenditures, but were largely ineffectual for controlling horizontal growth perpetuated by a legacy of reunification. Even these cuts created significant public discontent. It was clear to the CDU/CSU government that
spending reductions alone would be insufficient for balancing the budget within a single electoral mandate. Not only this, but freezing spending levels appeared to be the extent of the public’s patience.

Dramatic cuts appeared to be, not only unpopular, but also politically infeasible. This is evident because the government was only willing to attempt relatively long-term spending cuts. For example, in July 2006, the grand coalition announced that it would increase health insurance funding by 0.5% for one year, followed by a subsequent freeze on government contributions. ("Germany: coalition," 2006). This is clearly retrenchment, though from a long-term perspective, since a freeze effectively lowers funding once inflation is taken into account. As a result, tax increases were left as the remaining viable policy option.

The next question is why did the Merkel government choose to focus on regressive taxes, VAT in particular, as opposed to other taxes? Because the answer is based on macroeconomic justification rather than distributive logic, unlike the Canadian example, the rationalization behind it has little to do with direct appeals to the electorate, and instead regards perceived macroeconomic efficiency. The Merkel government’s macroeconomic policy perspective was directly influenced by important limitations of other tax options.

As compared to other taxes, VAT has a substantially larger revenue-raising capability with each percentage point augmentation (Lindert, 2005; Kato, 2003). The most important factor in this revenue-raising capability is the broad tax base of regressive taxes, and consumption taxes in particular. The 2007 VAT increase was expected to generate additional revenues of 1% of GDP (OECD, 2006b, p.66). Due to the much shallower tax base of individuals who are eligible to pay progressive taxes, it is difficult to imagine this massive revenue windfall being achieved through dependence on alternate tax streams, such as income tax or corporate taxes. After all, just like in Canada, a significant minority of the population, even the working population, earn
less income than the basic personal exemption amount, and thus are ineligible to pay income
taxes.

Since the German unemployment rate was already precariously high (Conradt, 2006, p.24) dramatically increasing income taxes had the potential to provide a further disincentive for employment, thereby actually resulting in a net decrease of income tax revenues. This result could occur while simultaneously also resulting in increased unemployment rates, consequently inflating demand for already overburdened social security resources (Benoit, 2006). The Merkel government’s careful avoidance of this potential scenario is evident by observing the marginalization of their income tax increase to a relatively small portion of the tax system, only the top income bracket.

The prospective impact of specific tax increases on an already struggling economy is also the reason that the CDU/CSU chose VAT among available regressive tax options. In fact, a third of the revenue windfall associated with the VAT increase was earmarked to provide a reduction in social security deductions (OECD, 2006b, p.66). The Merkel government considered this reduction vital to regaining the international competitiveness of German businesses, thus increasing the demand for labour, reducing unemployment, and consequently raising additional income tax revenue. Obviously, for Merkel, increasing social security deductions was not a legitimate regressive tax option. Due to the process of elimination, VAT remained as the preferred policy choice of the CDU/CSU.

Though it is now clear why VAT was Merkel’s preferred macroeconomic tool, it is not plainly obvious why her government believed adopting it provided greater political advantages than would be provided by traditional distributive logic. After all, typically a government, especially a coalition government in a highly competitive political system, will avoid dramatically increasing taxes, and instead attempt to leave the medium and long term consequences of fiscal deterioration to future governments.
The paramount reason for this result is that the damage created by permitting the economic and fiscal crisis to continue, even in the short-term, would create greater political difficulties than the blame the CDU/CSU government would absorb due to a tax increase. In other words, the harm created by following distributive logic would outweigh the harm created by following blame-avoidance mitigated macroeconomic logic. In addition, the German government was able to pursue macroeconomic choices which were unavailable to the Canadian government, due to the German availability of blame-avoidance techniques.

First, it is necessary to convey how the German economic crisis posed an even greater political threat than a substantial tax increase. The most obvious consequences of the budget deficit were its illegality, both domestically and within the European Union. These created policy limitations for the German government, since it essentially restricted the government’s legislative authority to increase funding in areas of government priorities. Further spending in these areas would constitute a constitutional violation, and therefore could potentially be overturned by the judicial system. Also, since many of the relevant EU fiscal rules were designed by Germany in order to constrain the policies of other countries, Germany’s international credibility would be threatened if the government continued to ignore these same regulations.

The deficit also lowered investor confidence in German businesses. This hindered economic growth, elevated unemployment rates, and decreased its international competitiveness (Flockton, 2001). In fact, shortly before the 2005 election, 85% of voters believed unemployment was one of the top two issues facing the country (Schmitt & Wust, 2006, p.40). These various consequences were also so important to the Merkel government that they explicitly declared that the primary intention of the German VAT rate increase was to eliminate the government’s budget deficit (“German government,” 2006). In fact, two-thirds of the VAT increase was earmarked specifically for deficit-reduction. In addition to the shift from social
security taxation towards VAT in order to combat unemployment, this policy choice attempted to combat these detrimental political effects associated with poor economic performance.

Even all these fiscal crisis consequences would still not have been substantial enough to outweigh the albatross of the politically painful macroeconomic reforms, had adequate blame avoidance tools not been available. The most important tool the CDU/CSU had available in their arsenal was the ability to circle the wagons. The CDU/CSU and SPD received remarkably similar proportions of votes in the 2005 election, 36.81% and 36.16% respectively (Langenbacher, 2006, p.7). Whether in an attempt to maintain its traditional policy influence, or as an effort to reiterate its relevance among the electorate following an election where they suffered colossal vote share losses to third parties, the SPD joined with the CDU/CSU to form the ‘grand coalition.’ While the SPD gained policy concessions, especially an income tax increase for individuals within the highest tax bracket, the CDU/CSU gained virtual immunity against policy criticisms arising from their main opposition.

The CDU/CSU realized that any consumption tax increases would anger lower-income individuals and labour unions. By agreeing to accept the SPD into a coalition government, they were able to successfully avoid blame from these groups by circling the wagons around these unpopular policies, while simultaneously denying a viable electoral alternative to remaining dissatisfied societal groups. While both parties had lost substantial vote share to third parties, this vote share was divided relatively evenly among three opposition parties. Though obviously a disturbing turn of events for the two major parties, it could hardly be construed as a legitimate threat towards their electoral dominance. The FDP, with the highest support among the parties, only received 9.93%, and their support was highly regionalized (Langenbacher, 2006, p.7).

Since the SPD are the CDU/CSU’s primary electoral threat, the SPD’s support of identical budgetary legislation meant that labour unions would only have limited success in persuading voters to punish either coalition member, due to a lack of feasible party alternatives.
Although public hostility is always created whenever taxes are increased, these strategies allowed the consequences of this criticism to be maintained at relatively tolerable levels. Since the SPD were now equally responsible for the painful tax increases, voters could no longer plausibly punish the CDU/CSU for its policy choices by instead voting for the opposition party. Due to their successful combination of blame avoidance strategies and compromise, the government was willing and able to simultaneously reduce long-term spending and significantly increase taxes, a strategy that would likely be political suicide in other situations.

The other major blame-avoidance tool that the government utilized was redefining the issue. They attempted to redefine the taxes as a facilitation of deficit-reduction. By shifting the agenda away from the issue of painful tax increases, and toward the reward of a balanced budget and other successful policy outcomes, the government was able to shift public attention, at least somewhat, away from these negative issues, and towards more positive results. They were able to achieve this because of high public salience in regards to economic-related issues (Helms, 2006, p.64), as well as Merkel’s ability to balance the budget years before expectations (“German government,” 2007, ¶1). Therefore, despite the painful tax increases, CDU/CSU’s support actually increased to 40% from the 36.81% that they achieved in the 2005 election (“Merkel,” 2008).

It should be clear, that regardless of the economic advances made by the Merkel government, the opposition would have fully taken advantage of public resentment over welfare state retrenchment and amplification of voter’s individual tax burdens. This was prevented by the inclusion of the opposition in the government coalition, thereby permitting macroeconomic logic to be considered a feasible choice for the CDU/CSU government. If these blame-avoidance options were not available, it is likely that the German government would have chosen to continue its trend of virtual policy stability, albeit with token attempts to keep economic conditions from reaching disaster levels. This would be a reasonable expectation, because the
resulting political consequences for the CDU/CSU government would have likely been politically advantageous, as compared to the political consequences if they had chosen to earnestly engage in deficit-reduction, in absence of blame-avoidance opportunities.
5. CONCLUSION

This thesis has attempted to show how governments make decisions regarding tax policy trade-offs. It has shown that, for insecure governments, the electoral consequences of these policy decisions are the predominant factors influencing their decision-making. This is the case because insecure governments must be constantly more aware of electoral consequences than a secure government which has less risk of losing a future election. These secure governments therefore have greater flexibility to adopt ideologically-based policies, and adapt to other political influences which insecure governments cannot enjoy.

While this paper has specifically focused on two case studies, this divergence in taxation choice can be understood as a microcosm of similar actions taken throughout the OECD. During the period of less than a decade since the turn of the millennium, there has been no clear trajectory in the direction of value-added tax rates, or the comparative reliance that each country places on consumption taxes as compared to overall taxation ratios. Within this time span, seven OECD countries have decided to increase their VAT rates, while five have turned towards a decrease (OECD, 2006a). Although they share many common influences, such as forces of globalization, public opinion, and even institutional similarities, these developed welfare states have all chosen such divergent tax policy choices in order to solve their individual country’s fiscal and policy dilemmas. Understanding the trade-offs countries must make between opposing influences may assist in explaining the majority of these divergences.

Despite these similarities though, there is one commonality that all these governments share: electoral ambitions. While new governments may believe that the act of shifting tax burdens according to their individual ideological preferences is a right, or even responsibility, of their mandate, this belief does not occur in a vacuum. Any competent government realizes that their ability to make future ideologically-based policy decisions is dependent upon their
willingness to moderate their current ideologically-based policy demands. Therefore, a
government’s decision-making processes are constantly infused with the realization that their
actions will all produce electoral consequences. As a result, a government must consider, not
just how an individual factor will affect their future electoral prospects, but rather how the
combination of all these factors act in aggregate to make each prospective policy choice more or
less politically favourable.

This implies that, while traditional policy influences, such as public opinion and
globalization, play an important role, they may not directly affect policy outcomes, but instead
increase or decrease existing political incentives attached to pursuing overarching political
strategies. For example, while a regionally-divided party system or a PR-based electoral system
may increase the likelihood that a party will attempt an appeal towards the median voter, each
does this indirectly by fragmenting the party system, and thus making the political system more
competitive, therefore increasing the political incentives for the government to moderate their
policy objectives. In this way, political incentives can be compared to a stock market, where
numerous factors may influence the stock’s value, but typically the actual numeric value is what
is directly relevant to whether the owner will sell, buy, or hold the stock. In this way, traditional
influences may play a more indirect role on policy outcomes than would otherwise be assumed.

Trade-offs are associated with all policy choices, but this thesis has attempted to
demonstrate why governments consider the trade-offs associated with a particular policy choice
to have differing advantageous value depending on the situation. It has determined that the
political value of a policy, and hence its likelihood of being chosen as a preferred policy tool, is
dependent upon how a particular situational context affects the policy’s associated electoral
benefits. In particular, the prospect of a minority government, or an otherwise politically-at-risk
government, enacting policies primarily because of their macroeconomic benefits is dependent
upon the existence of both severe and chronic economic conditions, as well as the availability of
blame avoidance mechanisms. As noted previously, a government will pursue ideologically-based policies whenever circumstances allow for this. These particular conditions simply provide a suitable context to make these policy choices politically 'possible.'

A government's ability to pursue macroeconomic policies, in the absence of these conditions, is feasible if the government believes that such a choice will not pose a risk for their future electoral prospects. A majority government with a divided opposition is an example of such a scenario. Most importantly, any government can typically be expected to pursue its ideological priorities, as long as the electoral consequences of following these priorities do not threaten their ability to pursue future ideological priorities.
REFERENCES


German government says it will balance its budget this year, 3 years ahead of expectations. (2007, September 28). The Associated Press.


Germany politics: A grand coalition? (2005, August 18). EIU ViewsWire,

Germany: coalition agrees controversial health system reforms under cover of world cup; Q2 GDP growth expected to have been strongest since 2001. (2006, July 11). Hilfe Daily Briefing.


How conservative is the Conservative budget? (2006, May 3). Globe and Mail (Canada),


Japan must learn from Germany's tax hike. (2006, June 29). The Yomiuri Shimbun,


Merkel leads polls, despite disappointment with German government. (2008, April 18). *Deutsche Presse-Agentu*.


