Political Economy of Taxation

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Abstract

This review uses theories of political economy to provide an analytical history of systems of taxation, focusing on the determinants of total tax revenue, tax structure, and tax administration. We show that most premodern states extracted very little revenue and that total revenue increased substantially in the nineteenth century, and we explore the possibility that tax revenues have hit a ceiling in the developed world. Our history of tax structure begins by discussing the highly regressive premodern tax systems, turns to the causes of the rise of progressive taxation in the twentieth century, and concludes by arguing that the short era of progressive taxation may be ending. The sections on tax administration discuss the many varieties of premodern patrimonialism, the determinants of the development and diffusion of bureaucratic administration, and the difficulty of taxing wealth in the modern world.

INTRODUCTION

Taxation has always been a central issue in political economy because it is one of the main activities of all states and a necessary condition for everything else states do. It is the core feature of state capacity. This review provides an analytical history of taxation from the earliest states and empires to the present, focusing on the structural and institutional determinants of tax revenue (taxation/GDP), tax structure (what and who are taxed), and tax administration (how taxes are assessed and collected). Our focus throughout is on the causes of the origins and development of tax systems, as previous summaries of the literature on taxation in sociology have discussed the consequences of taxation for other aspects of politics and society (Campbell 1993, Martin & Prasad 2014).

We have two main goals: (*a*) to outline and evaluate the most important theoretical debates about taxation; and (*b*) to provide a broad summary of the main developments in the history of taxation, including a few speculations about future trends. For example, we show that states extracted very little revenue prior to the nineteenth century, document the causes of the rapid increases since then, and explore the possibility that tax revenue has hit a ceiling in developed countries. Our analysis of tax structure focuses on the transformative effects of the income tax, the dominance of regressive indirect taxes in contemporary states with the highest revenue, and the rise and possible decline of progressive taxation. The history of bureaucratization, from its origin in Qin China to its diffusion to Europe a couple of millennia later, is the main focus of our discussion of tax administration, but we also explore debates about the sources of quasivoluntary compliance (Levi 1988) among taxpayers and the difficulty of taxing the rich in contemporary states.

The historical dimension of this review is important for three reasons. First, it complements the last review of taxation in this journal (Gould & Baker 2002), which focused on taxation in contemporary democratic states. Second, if we want to develop and test general theories of taxation, we need to avoid the presentist and Western biases in contemporary social science and look at a much broader range of historical cases. Third, owing to the partially path-dependent nature of the evolution of tax institutions, we cannot fully understand them without knowing their history (Acemoglu & Robinson 2012, Fukuyama 2011, Pierson 2000, Steinmo 2010). We thus divide our discussions of tax revenue, tax structure, and tax administration into premodern and modern eras. Within each section, we identify major turning points leading from premodern to modern tax systems. Although the exact timing of the transition from premodern to modern varies somewhat across these aspects of taxation, the main turning point is the Industrial Revolution, as it facilitates both the direct taxation of income and the spread of centralized bureaucratic administration.

The structure of our review is built on an emerging consensus in political economy on three issues. First, most important political outcomes are the joint product of structural conditions and institutions. Until fairly recently, there was an unfortunate division of labor in the study of politics, with sociologists concentrating on social structure and social groups/movements and political scientists focusing more on political institutions. Building on Greif (2006), Levi (1988), and North (1990), recent work in political economy has transcended this divide (Acemoglu & Robinson 2012, Fukuyama 2011, Steinmo 2010). We follow their lead—each of our sections begins with structural causes, then moves to political institutions and interactions between the two. Second, there is also an emerging cross-disciplinary consensus on a contractual view of tax systems (Bang 2015, Kiser & Barzel 1991, Levi 1988, Martin et al. 2009, North & Weingast 1989). In all (not just democratic) states, fiscal systems are based on (implicit or explicit) contracts, between rulers and those ruled, that govern taxation and spending, and the relationship between the two. How this fiscal contract is made, modified, and enforced is a recurring theme of our analysis. Third, beginning with Mann's (1984) stress on infrastructural power and continuing with the focus on state capacity in many recent works (Acemoglu & Robinson 2012, Besley & Persson 2011, Hoffman 2015, Lieberman 2003), scholars have been increasingly concerned with the implementation of state policy. We build on this work by focusing on the development of effective administration and exploring its effects on other aspects of taxation.

TAX REVENUE IN PREMODERN STATES

Premodern rulers were not rapacious leviathans devouring large shares of economic production. Prior to the Industrial Revolution, very few states were able to extract much revenue from their populations. Premodern states and empires were low-taxation societies (Bang 2015, p. 552; see also Monson 2015, O'Brien 2012, Scheidel 2015) that rarely extracted more than 5% of GDP (Bean 1973, p. 212; Mann 1993, p. 369).

There are several reasons these states could not get much tax revenue. First, there was not much to tax. Economic growth is the main long-term motor of increasing tax revenue/GDP (Wagner's Law) (Wagner & Weber 1977). Because there was little or no growth in per capita income prior to the Industrial Revolution (Clark 2007; North et al. 2009, p. 3), we should not expect much growth in tax revenue. Of course, there were significant variations in levels of economic development in premodern states, and where capitalism developed earlier, tax revenue was higher (Tilly 1990).

Second, class power limited state revenue. Premodern autocrats needed the support of aristocratic landowners (and often the leaders of religious organizations) to maintain their power, and they purchased that support almost everywhere by giving them an exemption from (at least direct) taxation. In addition to this, aristocrats also limited rulers' taxation of peasants. Because landowners and rulers were competing to extract resources from peasants, aristocrats often sided with peasants in their attempts to prevent rulers from increasing their taxes (Brenner 1976, Monson & Scheidel 2015b).

Third, the demand for state spending was limited. War was the main source of the demand for tax revenue in all premodern states (Ertman 1997, Kiser & Linton 2002, Tilly 1990), and the tax revenue of states did begin to increase in early modern Europe owing to a dramatic increase in the frequency and scale of warfare (O'Brien 2012). However, the argument that war is the main motor increasing tax revenue in less-developed states does not work well outside Europe (see Centeno 2002 on Latin America and Herbst 2000 on Africa). Moreover, the part of this argument that is rarely noted is that war was practically the only source of demand for taxation prior to the nineteenth century (only a few premodern states provided infrastructure like irrigation systems or welfare, such as grain redistribution).

Fourth, the capacity of the state to collect taxes was very limited. Rulers of states could neither afford nor control a sufficient number of officials to adequately assess and collect taxes (see the section on premodern administration below). As a result, prior to the development of the income tax, tax revenue was only loosely connected to economic production or wealth. Rulers either sold the rights to collect taxes to private tax farmers (privatized collection agents) or accepted fixed lump sum payments from localities. Over time, these stable, low tax levels came to be viewed as customary or based on tradition (Weber 1978a), making them even more resistant to change.

The nineteenth century is a turning point in the transition to the much higher revenues of modern Western states for three main reasons. First, the development of democratic institutions dramatically lowers the transaction costs of creating and enforcing fiscal contracts between taxpayers and rulers. Kiser & Barzel (1991) show how the medieval English parliament begins to increase tax revenue by increasing the ability of monarchs to bargain with and to make credible commitments to taxpayers, and North & Weingast (1989) show how the Glorious Revolution of 1688 increased tax revenue further via the same causal mechanisms. Democracy also facilitates the development of state legitimacy and quasivoluntary compliance, decreasing the costs of tax collection and the amount of tax evasion (Levi 1988). Finally, democracy raises the expectations of citizens as to what states should provide, increasing the demand for public goods.

Most premodern states relied on inefficient forms of patrimonial administration, so administrative advances also increased state revenue. Although the Protestant Reformation brought some administrative improvements in Europe (Becker et al. 2016, Ertman 1997, Gorski 2003), the main transformation came later in England. The bureaucratization of the British excise administration in the late seventeenth century dramatically increased revenue (Brewer 1990, Ertman 1997); the Prussian state increased its efficiency beginning about the same time, although the causes are debated (Gorski 1995, 2003; Kiser & Schneider 1994); and the French Revolution ushered in many successful administrative reforms (Kiser & Kane 2001). By 1850, in part due to the much delayed diffusion of Chinese administrative techniques (see below), centralized bureaucratic administration was in place in most developed states.

The third determinant of increasing tax revenue is a substantial increase in the demand for state spending. As a result of the development of industrial capitalism, there were increasing demands for spending on infrastructure, education, and social welfare (Wilensky 2002). In the 1760s, European states spent about 25% of their budgets on civil expenses; by 1900 that was up to about 75% (Mann 1993, p. 375). Infrastructure and education spending took off between 1870 and 1911, and modern welfare state spending began in Bismarck's Germany in the 1880s (Baldwin 1999) and increased substantially with Keynesian policies in response to the depression in the 1930s. Asia is an interesting outlier in this respect: Because firms and families provided substantial welfare benefits, there was less demand for state spending on welfare, and therefore less upward pressure on taxes (Cacciatore et al. 2006, p. 92; Steinmo 2010).

As a result of these three factors, tax revenue/GDP increased from about 5% in most states up to 1700, to about 9% by 1900, and 20% by 1950 in OECD countries (Scheve & Stasavage 2016, p. 10). Tax revenue was now on a historically novel upward trajectory.

TAX STRUCTURE IN PREMODERN STATES

Premodern states taxed a large and diverse array of things, but the basic tax structure was usually pretty simple: They taxed people (using forced labor or poll taxes), land or its produce (in kind or in money), and the movement of goods (via customs on external borders and many types of internal sales and excise taxes) (Kiser & Levi 2015, p. 559; Tarschys 1988).[1]

The two most important features of premodern tax structure are its loose relation to the economy (so tax revenue was not highly correlated with economic fluctuations) and its extreme regressivity. Administrative limitations prevented states from measuring actual economic production, so direct taxation had to rely on a series of rough proxies for wealth, such as the number of chimneys or windows in a house. Moreover, the dispersed nature of land made collection costs very high. Goods moving through bottlenecks, such as ports or town gates, were much easier to tax, so countries with more trade could usually raise more revenue (Tarschys 1988, Tilly 1990). The main variations in premodern tax structures were a function of the level of development of urban centers, trade, and capitalism. States lacking these things relied on direct taxation of people and/or land, whereas states in more economically developed areas had a more varied tax structure and a greater reliance on indirect customs and excise taxes.

[1] Premodern states also got a lot of revenue from nontax sources, such as state lands, fees, and monopolies; they were domain states as well as tax states (Schumpeter 1991 [1918]). But we focus only on tax revenue.

The highly regressive nature of premodern tax structures was a product of tax exemptions given to aristocratic landowners and religious organizations. Direct taxes were mainly paid by conquered subjects, religious minorities, and peasants. Indirect taxes, generally more regressive than direct taxes, were actually the least regressive part of premodern tax systems. Therefore, tax regressivity was highest in the most agrarian states (usually only peasants were paying) and was somewhat less regressive in states with some capitalist development (because merchants and guilds paid as well). The most extreme examples of the latter were the Greek city-states in the classical era (510–323 BC). Because of a rare combination of early democracy, a high level of trade, and stability, taxation was less regressive in Greece than elsewhere in the premodern world (Mackil 2015); there was even regular direct taxation of wealthy citizens (Ober 2015, p. 494).

The most important turning point in the history of premodern tax structure, responsible for both linking taxes more tightly to the economy and for dramatically increasing progressivity, is the development of the income tax. Britain is again the leading edge of this transition, experimenting with the income tax in 1798–1802 (to pay for the Napoleonic wars) and instituting it permanently in 1842. The income tax diffused throughout Europe fairly quickly, and by 1920, it was being used in almost all developed European economies (Scheve & Stasavage 2016). The main virtue of the income tax was that it linked taxation to economic production more tightly than any prior tax, so states could better ensure that economic growth produced more tax revenue. Although the income tax did not significantly increase tax revenues in this initial phase, because it was usually limited to the very rich, the development of the income tax is the most significant turning point in the emergence of progressive taxation (estate and capital taxes were also important).

There are two main determinants of the origins of the income tax, democracy and war. Democracy is a necessary condition for the development of progressive income taxation. As the franchise expands, the average income of voters declines, so the median voter favors progressive taxation of income. For example, Mehrotra (2004) documents the important role of organized labor in pushing for the US income tax. Scheve & Stasavage (2010, 2016; and see 2012 for an application to inheritance taxes) show that democracy alone is insufficient to explain the rise of progressive income taxes; mass warfare is another necessary condition. Mass conscription for World War I and World War II produced a demand for progressive taxation by activating fairness norms. When working-class voters saw that older, wealthier people were less likely to fight and were more likely to profit economically from war, they demanded progressive income taxation as a fair way to more equally distribute the costs of war (see also Daunton 2007, p. 30; Lockhart 2003; Steinmo 2003, pp. 210–12). By the end of World War I, progressive income taxation had become a significant part of the tax structure of most European democratic states. In 1930, taxes on income and profits accounted for over 55% of total tax revenue in Sweden, about 30% in the United Kingdom, and about 15% in the United States (Steinmo 1993).

The diffusion of progressive income taxation was incomplete, partial in most European states, and even slower and less complete in Asia (Steinmo 2010). Income taxation developed much later in Asia and is still not used to the same extent. The ratio of direct to indirect taxation in Asia is less than half that in Europe, and even the states with the highest income taxes (Japan and South Korea) are well below the OECD average (Martinez-Vazquez 2011, pp. 4–7).

TAX ADMINISTRATION IN PREMODERN STATES

Tax administration can be modeled using agency theory, with rulers as principals, and state officials as agents (Kiser 1999, Klitgaard 1988, Rose-Ackerman 1978). We can begin with simple rational choice assumptions: Rulers want to maximize net revenue given the tax rate (revenue collected minus the costs of collection, agent corruption, and tax evasion) while maintaining their security of rule; tax agents want to maximize their (legal and corrupt) income from their job; and taxpayers want to minimize their tax payments (we loosen the last assumption when discussing legitimacy and quasivoluntary compliance below). The organizational determinants of the efficiency of administration (defined as maximizing net tax revenue given the tax rate) are the form of recruitment of agents, the effectiveness of monitoring agents, and the ability to use positive and negative sanctions to affect agent behavior. In different structural conditions, and for different types of taxes, different forms of agency relations (types of recruitment, monitoring, and sanctioning) are most efficient.

The size, geography, and climate of a country affect the efficiency of administration by determining the cost and difficulty of monitoring agents. The effects of these aspects of the natural environment on the efficiency of tax collection are contingent on the level of development of technologies of communications, transportation, and information processing (Weber 1978a, p. 224). When these technologies of control are not developed (as in the premodern era), monitoring capacity is poor, and centralized bureaucracies relying on weak sanctions (fixed salaries, promotion, and dismissal) are inefficient.

Premodern rulers compensated for poor monitoring in three ways: using stronger sanctions (Becker & Stigler 1974), relying on agents they personally trusted, or using extreme forms of decentralization. All of these solutions are aspects of what Weber (1978a,b) called patrimonialism, a broad concept referring to several different types of administrative forms, including tax farming and slave agents (both provide stronger sanctions); recruiting kin and agents with patronage ties (personal trust); and using feudalism, prebendalism (e.g., the Ottoman timar system), or local notables, e.g., English justices of the peace (extreme decentralization).

In premodern states, different types of taxes were collected using different types of patrimonial agency relations; the tax structure dictated tax administration. Tax farming (a way to strengthen sanctions by making agents full residual claimants) was generally used for indirect taxes (customs, sales, excise) and decentralization was used for most direct taxes (usually on land) for three reasons (this paragraph draws on Kiser 1994). First, the revenue from indirect taxes is more mobile and less predictable because there is more variation over time, making the detection of corruption and evasion more difficult. Second, measurement problems that lead to bribery in exchange for underassessment are more severe for indirect than for direct taxation because of the difficulty of checking/repeating measurement (unlike land, the goods move on). As a result of both of these factors, bureaucratic agents on fixed salaries collecting indirect taxes are expected to be very corrupt when the monitoring capacity of principals is poor. These problems can only be mitigated by privatizing tax collection, thus making agents residual claimants with strong incentives to collect as much tax as possible. This problem with tax farming, strong incentives making agents overzealous in tax collection, is the reason it is rarely used for direct tax collection. Many assets tapped by direct taxation have a high capital component (e.g., land), so a system like tax farming that often leads to overtaxation has more negative (longer-term) effects. Therefore, rulers generally used decentralized forms of agency, for example, feudalism, prebendalism, and local notables to collect land taxes.

The main turning point in the evolution of tax administration is the development and diffusion of bureaucratic organization. The origins of bureaucratic administration occurred in two distinct phases. Qin China (221–206 BCE) was the leading edge of administrative bureaucratization (Fukuyama 2011, pp. 110–24; Kiser & Cai 2003), but it did not diffuse to Europe until the eighteenth century.[2] Why did a partially bureaucratized administrative system develop in Qin China

[2] Of course, other premodern states also had some bureaucratic elements. Pharaonic Egypt was certainly partially bureaucratic, but there are too few documents related directly to their tax administration to say much with certainty (Jursa & Moreno Garcia 2015, p. 139).

about two millennia before it did in European states? The Warring States era (481–221 BCE) that preceded the Qin unification of China created the necessary conditions for bureaucratization by creating a bureaucratic model (based on Legalist philosophy), facilitating the development of roads, and providing trained and disciplined personnel. The Chinese case illustrates that bureaucratization is not just a function of efficiency considerations, but of power as well. The weakening of the power of aristocrats was a necessary condition for bureaucratization because aristocrats were embedded in lucrative positions in patrimonial administrations and did not want to give them up. Bureaucratization often occurs only after revolutions or devastating wars sweep away aristocratic power (Kiser & Kane 2001, Kiser & Schneider 1994, Skocpol 1979). The main factor differentiating Qin China from other states and empires was the extreme weakness of the aristocracy produced by an unusually long period of severe warfare. Extensive aristocratic warfare killed much of the dominant class, allowing rulers to hire agents on the basis of merit rather than aristocratic status. Although Qin China was more bureaucratic than any other state or empire prior to the seventeenth century, it was far from completely bureaucratic. Bureaucratization was limited to top officials in the central administration located in the capital. The reason for this is that top officials are much easier to monitor; they are less numerous and less distant than lower-level officials. The lower levels of Chinese administration were patrimonial, relying on local notables, ad hoc clerks, and runners to collect taxes (Huang 1974).

Most European civil administrations bureaucratized in the nineteenth century. The first reason for this is that improvements in transportation enhanced monitoring capacity. Land transportation speeds began to significantly increase only with the development of railroads; prior to that time, early modern states could move information and officials no faster than they could in the Roman Empire because all premodern states had to rely on horse relay systems (Braudel 1995, p. 369; Wachter 1987, p. 96). England developed aspects of bureaucratic administration (especially in excise taxation) prior to other European states (Brewer 1990, Ertman 1997), owing mainly to its relatively small size and more rapid development of effective communications and transportation systems (Geiger 1994, p. 19; Szostak 1991, pp. 55–57) but also owing to its early revolution (Kiser & Kane 2001). Like the extensive warfare in Qin China, early modern revolutions swept away entrenched elites with interests in blocking reforms. The French Revolution also facilitated bureaucratization in France (Kiser & Kane 2001), and the Napoleonic conquests swept away aristocratic power and furthered bureaucratization in Prussia (Gorski 1995, Kiser & Schneider 1994). In addition to this, the Chinese model of bureaucracy, especially of recruitment based on merit, was discovered by enlightenment philosophers such as Voltaire, and in 1858 became the basis for the Northcote-Trevelyan Report, which led to bureaucratic reforms in hiring state officials in England, and later in other European states.

As a result of economic development, shifts in power, and the diffusion of new models of organization, bureaucratic administration became entrenched in the developed world. It was carried to most of the rest of the world mainly by colonialism. As agency theory predicts, bureaucratic administration was not effective in most of these colonies owing to the lack of development of transportation and communications technologies necessary for good monitoring (see Kiser & Sacks 2011 on Africa).

TAX REVENUE IN MODERN STATES

The increases in tax revenue in the late nineteenth and early twentieth centuries were far from uniform. By far the greatest differences across contemporary states are between more and less economically developed parts of the world. Tax revenue/GDP in 2010 averaged about 33% in OECD countries (OECD 2016) and about 10–15% in less-developed parts of the world

(Bird et al. 2008). There are two main reasons for this difference. The first is Wagner's Law, which states that tax revenue/GDP rises with per capita income (Easterly & Rebelo 1993). The second is administrative problems; it is not uncommon for half or more of all taxes to go uncollected (Bird 1989, p. 316; see also Kiser & Sacks 2011). Slater (2010) argues that, without significant internal or external threats, rulers of less-developed states lacked sufficient incentives to improve their administrative capacities, thus limiting increases in tax revenue.

Our primary focus is explaining differences across contemporary developed democratic states. The largest differences are between social democratic states like Denmark and Sweden at the top and liberal democratic states like the United States and Asian states at the bottom. These differences are substantial: In 2010, tax revenue/GDP was 45% in Denmark and 43% in Sweden, in contrast to only 23% in the United States and 29% in Japan (OECD 2016). Narrowing our scope to the developed world significantly decreases the variation in both structural conditions and administrative capacities across our cases, so it should not be surprising that differences in the forms of democratic institutions explain most of the differences in tax revenue.

Democratic institutions are especially important in modern states because of the recent transformation of the relationship between taxation and spending. There are three main ways in which taxation can be related to spending (Levi & Kiser 2014). The first is not at all; many premodern states collected irregular tribute from subjects without promising anything in return (Bang 2015; Tarschys 1988, pp. 2–4). In this situation, democratic institutions are not important because there is no contract to be enforced. The second is a tight one-to-one relationship in which a particular tax is collected to fund a particular service, often called earmarking. Prior to the nineteenth century, this was the usual relationship between taxing and spending in most states (Webber & Wildavsky 1986, p. 29). One of its main virtues was that monitoring the contract—whether that tax was used to fund that service—was fairly easy. This is no longer true in most modern states; although earmarking is used for a few things, more often there is a much looser relationship between taxing and spending. In the third relationship between taxing and spending, most taxes are paid into a general fund that is used to cover a wide variety of expenses, making the contract linking tax payments to state services much more difficult to monitor. In the context of general fund taxation, institutional arrangements to facilitate the making and enforcing of fiscal contracts are especially important.

Democracy alone does not ensure effective institutions (Fukuyama 2011, North et al. 2009). In spite of the many reasons to think that democracy should affect tax systems and the evidence that representative institutions increased tax revenue in premodern states (Daunton 2007, North & Weingast 1989), the relationship between democracy and tax revenue in contemporary states is unclear. Bird et al. (2008, pp. 64, 68) find that democracy increases tax revenue/GDP, but Easterly & Rebelo (1993, p. 436) show that the relationship disappears in studies that control for income per capita, and Profeta et al. (2013) find no relationship when using country-level fixed effects. Because samples and measures vary across studies, it is difficult to compare the findings; additional research would be very useful. Another reason for the mixed results might be the importance of sequence. D'Arcy (2012) shows that if democracy develops before strong state capacity, as it did in many less-developed states, it will not increase tax revenue/GDP. It increased tax revenue/GDP in early modern Europe because high state capacity preceded democratization in most cases.

Many of the differences in how much tax modern states collect can be explained by differences between types of democratic institutions (for a more detailed discussion of these arguments, see Gould & Baker 2002). Political systems with fewer veto players (with unicameral legislatures, without coalition governments, and without a president possessing veto power) tend to have higher tax revenue. The reason is that the greater the number of veto players, the less policy change (Tsebelis 2000, Tsebelis & Chang 2004). Because tax revenue tends to increase over time in modern states, inhibiting policy change decreases revenue growth (Boix 2001). Parliamentary democracies have higher tax revenue than presidential systems (Steinmo & Tolbert 1998), and this relationship is stronger when the parliamentary system is dominated by one large party (Persson & Tabellini 2001, Timmons 2010). Several scholars agree that corporatist institutions that facilitate bargaining about taxation and spending policies (especially important in contemporary general fund taxation systems) produce higher tax revenue (Beramendi & Rueda 2007, Steinmo 1993). When leftist parties are in power, especially when their rule is stable, tax revenue also increases (Inclan et al. 2001, Timmons 2010). Finally, high electoral turnout also raises taxation/GDP (Boix 2001, Franzese 2002). These arguments explain why Sweden and Denmark—parliamentary, corporatist polities with few veto players, stable left governments, and high turnout—have the highest tax revenue in the world.

Tax structure also affects total tax revenue. Tax systems relying on regressive indirect taxes, such as Sweden and Denmark, have higher revenue than those relying on progressive income taxes. As Martin & Prasad (2014, pp. 335–36) note, there are competing explanations for this relationship. Economists and some sociologists have stressed fiscal illusion: Indirect taxes are less visible to taxpayers, thus allowing states to increase them with less resistance (Prasad 2012, Sausgruber & Tyran 2005, Wilensky 2002). Political scientists and sociologists have focused more on the role of policy-making institutions and class relations. They argue that progressive taxation tends to create and/or reinforce adversarial class relations, which undermine support for high taxes and large welfare states (Beramendi & Rueda 2007; Hays 2003; Prasad 2006, 2012). Most of this literature has focused empirically on Western states, but looking more closely at Asia might help adjudicate the debate. Developed Asian states appear to be anomalous for the theory of fiscal illusion because they have both a high ratio of indirect to direct taxes but low tax revenues/GDP (this combination is common in less-developed states).

Rothstein (2005, 2011) argues that the characteristics of administrative institutions were critical determinants of increases in tax revenue. The development of effective and fair administrative institutions in Sweden made taxpayers trust the state enough to be willing to pay high taxes. This is a compelling argument that should be tested in other cases. Is tax revenue affected more by policy-making institutions or by administrative institutions? For example, in Britain, democratization and bureaucratization both occurred in the late seventeenth century. Which is more responsible for the increase in tax revenue after the Glorious Revolution?

The last century has been marked by an onward-and-upward evolution of tax revenue (Mann 1993, p. 358). However, there are signs that tax revenue/GDP in developed democracies may be hitting a ceiling. Tax revenue/GDP in OECD countries increased 6.7% during 1980–1990 and 6.7% during 1990–2000, but it declined 4.3% in 2000–2010 (OECD 2016). Although we should exercise caution in extrapolating trends from only a couple of decades, there are reasons to think that the period of increasing tax rates may be ending. Scholars focusing on the relationship between globalization and taxation have mainly looked at the role of increasing capital mobility (see the discussion in the next section), but the increasing mobility of labor may be even more important. The relationship between population homogeneity and high taxation is well known. The highest levels of taxation are found in the (until quite recently) homogeneous Scandinavian social democracies, whereas the heterogeneous population of the United States has often been seen as the cause of its lower taxation and smaller welfare state (Alesina & Glaeser 2004). The increasing labor mobility caused by globalization has made many more societies racially, ethnically, and religiously heterogeneous, including Scandinavian social democracies. Because people are more likely to pay taxes (or make other sacrifices) for other in-group members than for members of other groups (Lieberman 2009), increasing heterogeneity leads to increasing opposition to high taxes to fund large welfare states (Eger 2010, Kymlicka & Banting 2006). The difficulty of maintaining a strong welfare state and an open immigration policy simultaneously—called the progressive's dilemma—may well end the era of increasing taxation.

A related question is whether Asian states will ever match the tax revenues collected in Europe. Tax revenue/GDP is lower in both developed and less-developed states in Asia than in their non-Asian counterparts at similar levels of development (Tanzi & Zee 2000, p. 303), leading to a debate about whether Asian states are violating Wagner's Law (see Chang 2002). The jury is still out, but the fact that tax policy is focused primarily on growth coupled with a low demand for welfare spending could well result in a lower ceiling on tax revenue in Asia than in Europe.

TAX STRUCTURE IN MODERN STATES

This section focuses primarily on the progressivity of taxation in developed democracies. The main structural factor impacting tax structure is globalization, but it has not led to the demise of capital taxes that some predicted. Variations in tax progressivity are mainly caused by the reliance on indirect (especially consumption) taxes in some states, and the greater use of progressive income taxes in others. After exploring this difference, we conclude our discussion by arguing that the era of progressive taxation might be ending. We note another emerging trend in tax structure—the use of taxation not to produce revenue but to internalize externalities.

Taxes on capital evolved in the twentieth century as part of the movement toward more progressive taxation in the West, and the United States was at the leading edge in this development (Prasad 2012, pp. 166–69). When globalization decreased the cost of capital mobility, some predicted a race to the bottom for taxes on capital (Rodrik 1997), but that has not happened (Campbell 2004, Ganghof & Genschel 2008, Garrett & Mitchell 2001, Swank & Steinmo 2002). The reason is that several factors—political institutions, political culture, and policy choices—mitigate the effect of globalization on capital taxes:

- States with more veto players cut capital taxes less (Hallerberg & Basinger 1998, p. 621).
- Societal fairness norms limit cuts on capital taxes (Plümper et al. 2009).
- States that maintain high capital tax rates to fund efficiency-enhancing public goods often attract more capital (Garrett & Mitchell 2001).
- States can maintain stable capital tax rates by increasing taxes on immobile capital to compensate for lowering rates on mobile capital (Steinmo 1993, p. 292; 2010).

For all of these reasons, the effects of globalization on capital tax rates have been minor.

The biggest difference in tax structure in modern Western states is between Northern European social democratic states' reliance on indirect consumption taxes and the reliance on direct income taxes in the United States. The two main determinants of this difference are political institutions and class relations. Steinmo (1993) and Beremendi & Rueda (2007) argue that the combination of social democracy (stable left party power) and corporatism (facilitating bargaining and credible commitments between capital and labor) leads to more regressive taxation, high tax revenue, and large welfare states. Workers are willing to pay high taxes because they trust the state to use them to provide public goods, and this trust is provided by corporatist and social democratic institutions. Hays (2003) shows that majoritarian political institutions result in the reliance on progressive income taxes, as working-class voters try to extract resources from the rich. Morgan & Prasad's (2009; see also Prasad 2012) explanation of the US reliance on progressive income taxes focuses more on the history of class relations. Because of the rapid rise of industrial capitalism in the United States, workers and small farmers feared the power of capitalists and imposed progressive income taxes on them. This tax structure exacerbated the adversarial nature of class relations, leading to the equilibrium of progressive taxation and low revenue.

At the end of the premodern era, progressive income taxes seemed to be the wave of the future. But is that still true? There are increasing signs that the era of progressive taxation is ending. Highly progressive income taxes began around World War I and peaked in the middle to late twentieth century, with average top marginal rates in the developed world over 60% until the 1980s, but they have recently dipped to under 40% (Scheve & Stasavage 2016; see also Piketty & Saez 2006). This is occurring despite increasing inequality, but Scheve & Stasavage (2010, 2016) show that inequality alone does not prompt more progressive taxation. Progressivity also declined in the last couple of decades in Japan (Steinmo 2010, pp. 135–38), suggesting that this may be a global and not just a Western trend.

The trend toward declining progressivity, which began in Northern European social democracies and is now spreading, is caused by several factors. First, progressivity causes increasing administrative problems in the globalized economy. The rich have opportunities to avoid and evade taxes by moving assets across national borders in ways that working-class taxpayers cannot, so countries that rely more on taxing the rich receive less net tax revenue (Lockhart 2003, Prasad 2012, p. 170). Second, highly progressive tax systems promote and reinforce adversarial class relations, which result in lower revenue (Beramendi & Rueda 2007, Prasad 2006), so states interested in increasing their tax revenue (in this era of high state debt that is becoming increasingly necessary) are forced to use more regressive taxes. Third, and part of this adversarial fiscal culture, Martin (2013) has shown that policy proposals to increase progressivity are often met by resistance from the rich and that these "rich people's movements" are often successful in blocking progressivity. Finally, Scheve & Stasavage (2016) note that the causal mechanism responsible for the initial rise of progressivity, mass conscription for war, is unlikely to occur again in the era of drone warfare. For all of these reasons, the decline of progressive taxation is likely to continue.

We tend to take for granted that the main function of taxation is to generate revenue, but there is an emerging trend of revenue-neutral taxes that are oriented to internalizing externalities. The best example of this is environmental taxation, and the leading edge is again Northern Europe. Although states have been taxing sources of energy for a long time, their goal was to raise revenue, and it still is in less-developed states (Bosquet 2000, p. 21; Parry et al. 2012, p. 116). This began to change in the 1990s, when Denmark and Sweden started to use energy taxes to decrease energy use and compensate for its negative environmental effects—to internalize the externalities (Albrecht 2006). Not only do these taxes correct an economic distortion, they are often made revenue neutral by being combined with decreases in distortive taxes (such as taxes on labor). They thus produce two economic benefits—internalizing the externalities of energy use and decreasing distortive labor taxes—known as the double dividend of environmental taxation (Albrecht 2006, Andersen & Ekins 2009, Pearce 1991). Taxes on the consumption of high-sugar foods such as soft drinks are moving in the same direction (Brownell & Frieden 2009). In contrast to traditional "sin taxes," which were mostly intended to provide revenue [taxes on sugar, salt, tobacco, and alcohol made up about half of all indirect tax revenue in Europe in 1900 (Mann 1993, p. 386)] and secondarily to decrease "sinful" behavior, new health taxes are oriented toward internalizing externalities of poor health choices in the context of publicly funded health care. Two-thirds of US states currently have some form of sugar tax (Cummings 2010, p. 274). With aging populations and increasing healthcare costs, we expect these emerging health taxes to increase in the future.

TAX ADMINISTRATION IN MODERN STATES

This section has two main goals: (*a*) to survey differences in the effectiveness of tax administration in the modern world and (*b*) to analyze the specific difficulties involved in taxing capital. A comparison of broad variations across the world indicates that economic development is the main determinant of administrative effectiveness. The most-developed countries (Northern Europe, the United States) perform best, countries slightly behind (Southern Europe, Eastern Europe) do significantly worse, and African states are by far the least effective.

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

Even in the best modern bureaucratic administrative systems, tax evasion is still a significant problem. For example, the tax gap—the percentage of total tax obligations that is not paid—for the US income tax is about 14%, and over half of the income of businesses is unreported (Slemrod 2007, pp. 28, 45). Between 1965 and 2010, tax evasion was by far the largest economic crime in the United States, averaging 5% of GDP (the total for all crimes is 7%) (Schneider 2013).

In the developed world, the ubiquity of centralized bureaucratic administration has decreased the utility of models, such as agency theory, that focus on organizational structure and incentives. There is very little variation on those dimensions. (The only notable exception is that some states are more prone to clientelistic recruitment of agents instead of hiring on merit, and this does have important consequences.) To explain variations in the developed world, we need to look more closely at the determinants of voluntary and quasivoluntary compliance by taxpayers (Frey & Torgler 2007, Levi 1988, Lieberman 2003, Zhang et al. 2016).

Weber (1978a) recognized the importance of taxpayers choosing to comply for improving administrative effectiveness, and Levi (1988) was the first to develop a model of the process: Citizens will comply with tax obligations if the state provides adequate public goods and if it ensures that other taxpayers comply (see also Bergman 2009, Daunton 2007, Frey 2003, Rothstein 2011). Studies of tax compliance in modern states consistently show that rational choice deterrence models based on the odds of getting caught and the severity of punishment explain some of the variation (Slemrod 2007, p. 43) but predict far more tax evasion than actually occurs (Alm & Torgler 2006, Torgler 2002). This strongly suggests that quasivoluntary compliance has important effects. Frey & Torgler (2007, pp. 146–53) show that perceptions about both the quality and legitimacy of government and the sense that other taxpayers are paying their taxes lead to higher tax compliance.

Differences in rates of quasivoluntary compliance help explain the higher levels of tax evasion in both Southern and Eastern Europe, but we must start with some effects of political and administrative institutions. Postcommunist countries were faced with "an acute crisis of state capacity" (Ganev 2005, p. 427) after the transition as a result of an "incapable tax administration" (Easter 2002, p. 621). One of the main problems was hiring on the basis of clientelism rather than merit, increasing the expense and decreasing the effectiveness of administration (Grzymala-Busse

2007, pp. 5–6). Differences in levels of corruption in postcommunist states were mainly a function of party competition; when sufficient competition existed, parties had incentives to create a more effective administration (Grzymala-Busse 2007, pp. 10–12). However, in addition to these institutional effects, fiscal culture is also important. The long period of imposed state socialism dramatically decreased the legitimacy of Eastern European states and led to the development of habits of noncompliance that persisted after the transition. Moreover, the knowledge that many other citizens were not paying their taxes further undermined quasivoluntary compliance, leading to a vicious circle of decreasing compliance (Kiser & Levi 2015).

The causes of high tax evasion in Southern Europe are similar. The Italian case is illustrative (this paragraph draws on Ginsborg 2006). The tax evasion rate in Italy is around 18–19%—roughly three times as much as in most OECD countries. The problem is especially severe in both the value-added tax (VAT) and income taxes. The main groups evading taxes in Italy are small businesses and people involved in the informal economy. One of the main causes is clientelistic recruitment of officials. In addition to that, Italian political culture views corruption of all types (including tax evasion) as both pervasive and morally neutral, such that people not engaging in corrupt practices are viewed not as moral but as suckers. The pervasiveness of this political culture makes tax collection extremely difficult, as taxpayers pay little or no moral/reputation cost for evasion (but see Zhang et al. 2016 for some interesting experimental findings that do not support this cultural explanation).

The most difficult administrative problem in modern states is taxing the rich. The income tax has made it much easier to tax salaried workers and to limit their ability to evade taxes, so the highest rates of tax evasion come from capitalists (Slemrod 2007, p. 29). Because it is now so easy to move assets across borders, it is becoming more difficult to tax the rich in the modern world. Globally, tax fraud and illegal cross-border capital flows are by far the most common and largest of all illegal transactions (Schneider 2013, p. 699). A great deal of wealth flows to unregulated tax havens, where it can escape national taxation, and recent attempts by the OECD to regulate these tax havens have failed (Sharman 2006, p. 12). How can this administrative problem be solved? Because the problem is the ability of the rich to move their wealth across national borders, Piketty (2014) suggests that the only solution is a global capital tax. This is obviously not politically feasible currently, but with the strengthening of various supranational political institutions, it may be possible (and necessary) in the future.

CONCLUSION

Systems of taxation are a product of structural conditions (especially economic structure and geopolitical relations), political institutions, and interactions between the two. For example, tax systems in premodern states were a function of a stagnant economic structure, aristocratic power, frequent warfare, and autocratic policy-making institutions. The resulting tax systems were characterized by low revenue, regressive tax structures, and ineffective patrimonial administrations. With the development and diffusion of industrial capitalism, systems of taxation were dramatically transformed. In modern states, tax systems have been shaped by rapid economic growth, increasing globalization, and the development of several varieties of democratic political institutions. The tax systems that have developed have been able to extract much more revenue, have become much more progressive, and have relied on centralized bureaucratic administrations that are much more effective than their premodern counterparts. Systems of taxation are also a product of interactions between their components. As we have shown throughout this review, tax administration shapes both tax revenue and tax structure, tax revenue affects tax administration, and tax structure affects both tax revenue/GDP and tax administration.

What does the future of taxation hold? First, we argue that the rapid increases in tax revenues/GDPs in the last 150 years may be ending, i.e., that we may have hit a ceiling on tax rates, in part because of the increasing heterogeneity of taxpayers. Second, we provide evidence that the era of progressive taxation—only about a century long—may also be ending. Third, we document an emerging trend toward revenue-neutral taxation oriented toward internalizing externalities. Fourth, we document the increasing difficulty of taxing the rich in a globalized economy and look at one possible solution. Systems of taxation are evolving in many interesting ways, and we can understand their evolution only by combining the best theories in political economy with a detailed knowledge of tax history. This article attempts to take a small step in that direction.

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Errata

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