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The taxman tools up: An event history study of the introduction of the personal income tax☆

Toke S. Aidt[a,*], Peter S. Jensen[b]

[a] Faculty of Economics, University of Cambridge, Cambridge CB3 9DD, United Kingdom
[b] Department of Border Region Studies, University of Southern Denmark, Alsion 2, DK-6400 Sonderborg, Denmark

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ABSTRACT

The introduction of income taxation was a landmark in the historical development of the fiscal state of the now developed world. This paper presents an event history study of the adoption of the income tax in 17 countries from western Europe, north America, Oceania and Japan between 1815 and 1939. We find evidence that spending pressures, reductions in tax collection costs and to a lesser extent social learning played a significant role for the adoption decision. We also find evidence that the extension of the franchise at first *reduced* the likelihood of adoption of the income tax, but eventually as universal suffrage was approached increased the likelihood.

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1. Introduction

In 2006 more than 30% of total tax revenue derived from the personal income tax in the United Kingdom; in the years after it was first introduced in 1842, the yield was less than half of that. During the intervening 164 years, the income tax, not only in the United Kingdom, but all over the (now) developed world moved from the margins to the center of the fiscal state. During the same period, the size of government increased dramatically in proportion to the size of the economy (Tanzi and Schuknecht, 2000). A variety of economic and political explanations have been advanced to explain this (see, e.g., Lindert, 2004a,b). One important idea, promoted, for example, by Becker and Mulligan (2003), is that efficient taxes are behind big government. If so, this begs a deeper question, namely what causes a society to innovate and adopt efficient taxes? The income tax is arguably one of the most important tax innovations of the past 200 years, only rivalled by the value added tax. Gaining a better understanding of how and why it came into being would therefore provide another important stepping stone towards understanding the sources of growth in government.

The purpose of this paper is to study the factors behind the differential timing of income taxation in western Europe, north America, Oceania and Japan. The decision to add the income tax to the arsenal of revenue raising instruments spanned almost a

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* Corresponding author. Tel.: +44 1223 335231; fax: +44 1223 335475.
E-mail addresses: toke.aidt@econ.cam.ac.uk (T.S. Aidt), psj@sam.sdu.dk (P.S. Jensen).

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century for these countries. The first country to introduce a nation-wide personal income tax was the United Kingdom in 1842; the last was Switzerland in 1939. In between these extremes, other western European countries, the USA, Canada, New Zealand, Australia and Japan introduced taxation of personal incomes. We are interested in four potential reasons for adopting the income tax. The first set of reasons is related to political factors such as the extension of the franchise, the degree of political competition, the secret ballot and the importance of left-wing parties. The second set of reasons relates to the possibility of social learning or spatial diffusion, i.e., the idea that late adopters observe the results achieved by early adopters and base their adoption decision on this. The third set of reason relates to tax collection technology or costs, while the fourth set relates to wars and other pressures on the public purse.

There exists plenty of circumstantial evidence that these factors mattered for the decision to adopt the income tax. Peters (1991, p. 231), for example, argues that "with the extension of the franchise and the birth of labor movements and socialist parties came demands for greater redistribution through the tax system, and particularly for greater use of income and profit taxation to raise the needed revenues for increasingly active governments." At the same time, there is also ample anecdotal evidence that politicians aiming at introducing an income tax at home took notice of what happened abroad. For example, the Austrian income tax introduced in 1849 was explicitly modelled on the British income tax (Sieghart, 1898). In France the repeated, but unsuccessful, attempts to introduce an income tax throughout the later part of the 19th century took much of its inspiration from Prussia and Britain.[1] Likewise, when Britain introduced the income tax in 1842, many Dutch politicians were inspired. The minister responsible for the first income tax bill was, however, forced to resign, and it was not until 1893 that the income tax was finally adopted in the Netherlands (Smit, 2002). Many authors also believe that systematic reductions in tax collection costs matter greatly (e.g., Riezman and Slemrod, 1987). Moreover, economic history is littered with examples of early attempts to introduce income taxation that subsequently failed because of the lack of fiscal capacity to extract sufficient yields. Finally, the fact that many countries resorted to temporary taxation of incomes in times of war strongly suggests that fiscal pressures might have played a key role in spreading income taxation during the 19th and early 20th century.

To quantify the importance of these factors, we offer an event history study of the adoption of lasting income taxation in 17 countries from western Europe, north America, Oceania and Japan between 1815 and 1939. The idea is to model the (conditional) probability that a country which has not yet adopted the income tax adopts it in a given year as a function of the four factors outlined above. We find evidence that spending pressures, reductions in tax collection costs and to a lesser extent social learning played a significant role for the adoption decision. Surprisingly, we also find evidence that the extension of the franchise at first *reduced* the likelihood of the income tax, but eventually as universal suffrage was approached, increased the likelihood. The introduction of the secret ballot added significantly to the adoption probability. The rise of left-wing parties, on the other hand, did not play any role. Neither did GDP per capita, the size of a country nor its demographic structure.

The paper is related to a growing literature on the historical roots of the fiscal state. Lindert (1994), Boix (2003), Lindert (2004a, b), Aidt et al. (2006), Aidt and Jensen (in press) and others report quantitative evidence on the factors that drove tax and spending decisions during the 19th and early 20th century.[2] We complement these studies with an event history study of the historical origins of the income tax.[3] Our study is directly related to a small literature on tax innovations. Berry and Berry (1992) study the timing of new taxes, levied either on income or on gasoline, among US states during various sub-periods of the 20th century. They report evidence that states were less likely to adopt an income tax in election years and more likely to adopt it if the state legislature was controlled by a liberal party.[4] Evidence from outside US states is scarce. One exception is Ashworth et al. (2006) who study the adoption of environmental taxes among Flemish municipalities in the 1990s. They also find evidence that adoptions are less likely in election years and more likely in municipalities controlled by a left-wing party. In addition, they find evidence of social learning in that the likelihood of adoption in a particular municipality increases if its neighbors (both geographically and ideologically) have adopted in the past. We shall comment in more detail on these findings when we discuss our results in Section 5. A virtue of our setting relative to the previous studies is that it spans a period of time during which major political reforms took place. This allows us to investigate the role of institutional reform, such as the extension of the franchise or the secret ballot, in facilitating tax innovations. One problem with our setting, however, is that tax adoption decisions are not made against the backdrop of a common institutional framework, as in the case of states or municipalities. Another problem is that we observe relatively few tax innovations (17) spread over a long period of time (97 years). To deal with the former problem, we pay special attention to unobserved heterogeneity. To deal with the latter problem, we report results corrected for the bias that may arise when events are rare.

The rest of the paper is organized as follows. In Section 2, we provide a brief history of income taxation in the 17 countries in our sample. In Section 3, we formulate the hypotheses to be tested and discuss how to measure the four sets of potential determinants of the decision to introduce the income tax. In Section 4, we set out the empirical strategy. In Section 5, we report the main results

[1] In 1893, for example, three income tax proposals were discussed. The first was simply an extension of the personal property tax (contribution personnelle et mobilière). The second was one based on the Prussian model of a lump-sum income tax (impôt global or impôt sur le revenu). The third was the stoppage-at-source (PAYE) income tax based on the English model, known as the impôt cédulaire or the impôt sur les revenue (Seligman, 1911, Chapter 2; Willis, 1895).

[2] There is also a related literature on the development of the fiscal state after the Second World War. This include among others Peltzman (1980), Riezman and Slemrod (1987), Husted and Kenny (1997), Becker and Mulligan (2003), Persson and Tabellini (2003) and Kenny and Winer (2006).

[3] This methodology is frequently used to study the factors that cause governments to adopt new policies. Some examples include Berry and Berry (1990), who study adoption of state lotteries in the USA, Canon and Baum (1981), who study adoption of tort law innovations among USA states, and Meissner (2005) who studies the diffusion of the gold standard between 1870-1913.

[4] Democrats are assumed "liberal" except in the Southern states where they are assumed "conservative".

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