

Social democratic tax policy updated

A study of the Norwegian tax reform of 1992

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Preface

People always advised me to pick a small, well-defined topic for the Master's thesis. As will become obvious once you start reading my thesis, I didn't listen very well. Instead, I chose to address a really big question. I'm glad I did. Working on this thesis is by far the most intellectually stimulating exercise I have ever undertaken. It has given me the opportunity to dig into a fascinating theoretical literature, speak to people with extraordinary knowledge, and most importantly, gain in-depth understanding of a complex issue.

In particular, the interviews with policy-makers and experts sparked my interest for the subject and gave the project a clearer direction. I would therefore like to thank all my informants for their contribution.

Moreover, I would like to thank those without whom this project would not have been feasible. My supervisor (fall 2008 and spring 2009), colleague and friend Bent Sofus Tranøy has been a great source of intellectual inspiration. Rather than pulling the brake, he has always stimulated my ambitions. My good friend Helge Renå has been a fantastic discussion partner throughout the process. The effort he has put into reading and commenting on my work is truly remarkable and will not be forgotten easily.

I am also grateful to my dad, who spent half a day fighting with an earlier draft and came back with excellent comments, and to Øivind Bratberg, who gave me good advice and supplied me with some very interesting literature.

Of course, I take full responsibility for all remaining errors, problems, flaws, shortcomings, inaccuracies and spelling mistakes.

Johan Christensen

Oslo, 22.05.09

Chapter 1: Introduction

1.1 Topic and research questions

The tax reform that came into effect in 1992 represents the most wide-reaching reform of the tax system in Norwegian history. The reform lowered the tax rates for both individuals and businesses drastically, cut down a whole forest of deduction schemes, and established new governing principles for tax policy. This instance of fundamental¹ policy change is the subject of the present study.

Since the tax system pays for the welfare system, the 1992 tax reform is part and parcel of the modern transformation of Norway's social democratic welfare state regime. Yet, our understanding of the outcome of the tax reform is underdeveloped. Did these policy changes represent the death of egalitarian social democratic tax policy or rather its resurrection? Couched in more analytical terms, the first question posed by this study is: **Did the Norwegian tax reform of 1992 imply a liberal policy shift or a rational updating of social democratic policy?**

Within the literature on institutional change in advanced political economies, a central argument is that these substantive outcomes of change are somehow contingent upon the process of change. Wolfgang Streeck and Kathleen Thelen (2005) argue that liberalization is usually the product of small, incremental changes in policy. Conversely, one would expect that non-liberal reforms are most often the result of large changes in policy.

This gives rise to the suspicion that the large scale of the tax policy changes in 1992 shaped the outcome of the reform, i.e. whether it led to liberalization or rational updating of policy. The second question explored by this study is thus: **How was the outcome of the 1992 tax reform conditioned by the large scale of policy change?**

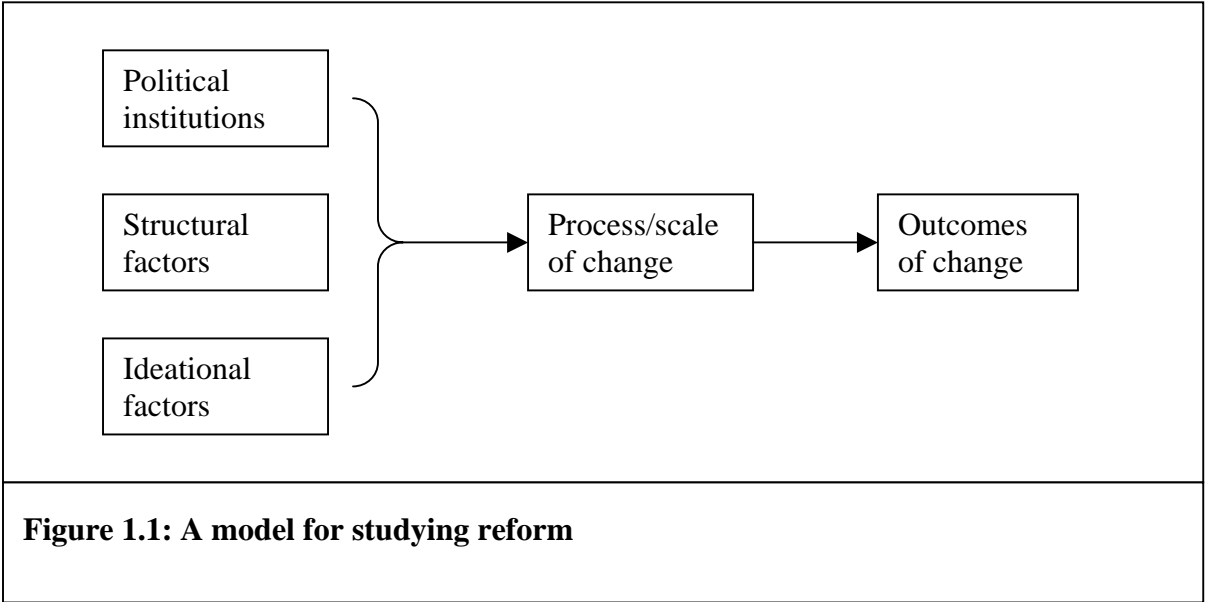
This potential relationship raises yet another question: What made large-scale reform possible? The institutionalist literature emphasizes the difficulty of such authoritative policy change, due to the status-quo bias of political institutions. However, I suspect that the

¹ To denote policy changes of large scale, I use the expressions 'large-scale', 'fundamental', 'authoritative', 'large', 'deep-seated', 'wide-reaching' and 'profound' inter-changeably.

consensual Norwegian political system represents an institutional setting that is more conducive to fundamental policy change. Hence, the third and final question of this study is: **What were the preconditions for large-scale tax reform?**

In other words, this study poses one descriptive and two explanatory questions about the Norwegian tax reform of 1992. The first question concerns the *outcome* of the reform, whereas the two latter questions are about the *process* that led to this outcome.

Expressed more schematically, the first question is about determining the value of the tax reform on the dependent variable ‘outcomes of policy change’, which is either liberalization or rational updating of policy (or a combination of the two). The aim of the second question is to explore the linkages between the value on the dependent variable and the value ‘large-scale reform’ on the independent variable ‘process of policy change’. The third question takes us one step further backwards in the causal chain, looking to explain large-scale reform. This means both identifying *which* variables account for the reform and *how* these variables produced large-scale policy change. I look at structural, ideational and institutional explanatory variables. Figure 1.1 provides a simple illustration of the assumed connection between the major variables in this study.



This study has a meso-level focus, as it investigates policy evolution in one particular area, that of taxation. I understand the more or less coherent set of policies in this area as a *policy*

*regime*². The tax system it treated as a whole, implying that the study is *not* limited to any specific part of tax policy or type of taxes, or to taxes collected at any particular level of government. This choice is justified by the ambition to examine the total outcomes of the tax system in terms of revenue-raising, redistribution and efficiency. Moreover, the different parts of tax policy are closely inter-connected, meaning that an analysis of one element in isolation can easily be misleading.

At issue in this study is the transformation of Norwegian tax policy since the 1980s. The study focuses on the 1992 tax reform, as this was the most significant policy change of the period. To understand the background for the reform, we follow the development of tax policy back to the mid-1970s. My in-depth investigation of the political process concentrates on the years from the release of an important public commission report on taxation in 1989 until the passage of the reform in 1991. To shed light on the implications of the reform, the study also scans the developments in policy and outcomes from 1992 up until today.

1.2 Substantive motivation

The primary motivation for this study is substantive. The study springs out of an interest for the transformation of the Norwegian welfare state regime since the 1980s. Did Norway abandon its social democratic welfare state model during these decades, or was the model rather updated to the political and economic environment of a new era? This question has been widely debated, and some works have attempted to analyze the issue in its entire breadth. In particular, Dølvik (2007) offers a comprehensive analysis. Yet, somewhat surprisingly, one of the integral elements of the Norwegian welfare state regime has been neglected in both public and scholarly debate: the tax system.

Simply, our understanding of how Norwegian tax policy has changed in recent decades is very limited. There is a dearth of political and political-economic research on the character of the major Norwegian reforms of tax policy, of which the 1992 reform was the most important. We do know that the 1992 tax reform virtually remade the entire tax system, but we are ignorant about the implications of these changes. Did the tax reform put an end to egalitarian social democratic tax policy and replace it with a liberal regime? This could be connected to

² This understanding of a 'policy regime' rests on weaker assumptions about coherence and stability in policy than the notion of 'institutional equilibrium' often employed in rational choice scholarship.

less redistribution, a weaker capacity to raise revenue, or more lenient taxation of business and capital. Such an evolution could have threatened the financial (and political) basis of the welfare state, providing pressures for retrenchment.

Or did the reform rather represent a successful updating of social democratic tax policy to new political-economic realities? It is possible that fundamental policy changes were necessary for the tax system to better achieve its core objectives in an increasingly complex economy. If this were the case, the 1992 tax reform could be regarded as a prerequisite for the survival and return of the social democratic model. For instance, a reform that reinforced the capacity to raise revenue would be consonant with the maintenance or continued expansion of the welfare state.

Thus, determining the outcomes of the 1992 Norwegian tax reform is the first goal of this study, expressed in the first research question. What does the existing literature tell us on this point? In Norway, tax policy issues have been treated almost exclusively by economists and law experts. As a consequence, the existing knowledge about the 1992 tax reform is limited in its perspective. While its legal aspects and economic effects are well covered, its broader political-economic implications are not. In the absence of such research, superficial analyses have shaped the perceptions of the 1992 tax reform.

An oft-repeated view is that the tax reform produced a dramatic growth in capital incomes, which benefited the well off and thereby increased income inequality (e.g. Dølvik 2007:310). However, this understanding of the 1992 tax reform is not only incomplete, it is also fallacious. Firstly, it focuses exclusively on the direct redistributive effect of the tax system, while ignoring tax policy's arguably more important function of generating revenue for redistribution in the welfare state. Secondly, the purported explosion in capital incomes upon closer investigation turns out to be a statistical artefact (Fjærli and Aaberge 2003).

Neither does the broader literature on the Scandinavian welfare state regimes have much to offer on the issue of tax policy change. This comprehensive and highly prodigious literature has focused on transfers and services (e.g. Korpi 1983; Hatland et al. 2001; Kumlin and Rothstein 2005) and labor market questions (e.g. Barth *et al.* 2003; Kongshøj Madsen 2005), while according little attention to the role of tax policy.

Fortunately, there are a couple of excellent political-economic studies of tax reforms in Sweden (Steinmo 1993; 2002) and Denmark (Ganghof 2007). As the three Scandinavian countries implemented similar reforms at approximately the same time, these studies constitute a relevant frame of reference for my analysis of the Norwegian case. The findings from these studies have inspired my hypotheses about the outcome of the Norwegian tax reform.

Steinmo (1993:165,171) finds that the Swedish tax reform of 1991 involved a shift in attention from equity goals towards efficiency concerns, and implied a downward redistribution of the tax burden. That is, the tax reform in Sweden represented a rupture with the old social democratic model and a shift in a liberal direction. Yet, in a more recent analysis of Swedish tax policy, Steinmo (2002) has revised this view. He finds that although “tax policy is most certainly adapting to the new political economic realities”, this has not meant “the end of redistribution” or the death of the Swedish welfare state (Steinmo 2002:841).

Steffen Ganghof presents a different analysis of recent tax reforms, based especially on the Danish case. He argues that reforms were primarily aimed at rationalization and upgrading: “The tax reforms did not fundamentally change the weighting of different tax policy goals (efficiency and equity) but tried to better achieve both goals” (Ganghof 2007:1066). Drastic changes in tax rules did not reverse the existing goals of tax policy; they were rather “a precondition for defending the underlying substantive status quo” of tax policy (Ganghof 2007:1062).

These alternative analyses give rise to my two hypotheses about the outcome of the Norwegian tax reform: ‘liberalization’ and ‘rational updating’. Put very briefly, liberalization would imply greater efficiency at the expense of equality, while rational updating would mean a better ability to achieve goals of both efficiency and equality. These two hypotheses are discussed in greater detail in section 2.1. To preview my findings, this study finds evidence for the latter hypothesis. The investigation shows that the Norwegian tax reform of 1992 was characterized by rational updating rather than liberalization.

1.3 Theoretical motivation

Although this study first and foremost addresses a substantive issue, it is at the same time theoretically motivated. In different ways, the study seeks to contribute to three theoretical debates. The first is the general discussion about the relationship between processes and outcomes of change. The second is the debate about the impact of Nordic political institutions on reform. The third concerns the interaction between factors behind tax reform, and more generally, behind economic policy change. Here, I briefly sketch these debates and how I aim to contribute to them. The theory is discussed in greater detail in chapter 2.

Firstly, the argument that *substantive outcomes of change* (i.e. liberalization or the lack thereof) are associated with specific *processes of change* (i.e. incremental change or large-scale reform) is central in the literature on institutional change in advanced political economies³. What this relationship looks like is at the very core of current scholarly debate. (For the full discussion, see section 2.2.).

Paul Pierson (2000) suggests that small, incremental policy change produces continuity in outcomes, while abrupt, large-scale change causes discontinuity in outcomes. Substantively, discontinuity in outcomes is often identified with liberalization or welfare state retrenchment, while continuity equals the lack thereof. Pierson's view is challenged by Streeck and Thelen (2005), who argue that major discontinuities often result from incremental policy changes. They contend that liberalization is usually the product of small, gradual changes in policy.

Conversely, one would expect that non-liberal reforms are most often the result of large changes in policy. Streeck and Thelen's (2005) argument strongly suggests such a relationship, but they do not devote further attention to the type of policy change characterized by the combination of fundamental reform and continuity in outcomes. However, they can place the Norwegian tax reform of 1992 into this category, as I find that this large-scale reform led to a rational updating of policy. The Norwegian case thus provides an opportunity to explore the relationship between fundamental policy change and continuity in

³ The notion of 'institutions' in this body of work encompasses 'policy regimes' as here defined. A policy regime can be regarded as a simple form of institution. The choice to conceptualize the Norwegian tax system narrowly, as a 'policy regime' rather than as an 'institution', reflects the particular character of tax policy. In the field of taxation, formal rules are all-important. Compared to other policy areas, tax *policy* can be identified more closely with tax *rules*. Therefore, we can avoid the more complex notion of 'institution'. This also distinguishes policies from political institutions, discussed in section 2.4.

outcomes. The present study can potentially shed light on the mechanisms that underlie this relationship and thereby contribute to the development of theory on this point.

Secondly, the literature on institutional change in advanced political economies emphasizes the *difficulty* of large-scale policy change. This is generally attributed to the status quo-bias of political institutions. Paul Pierson (2000) argues that increasing returns processes prevalent in politics generate growing barriers to fundamental policy shifts. Why the Norwegian political system was able to produce large-scale tax reform is therefore of theoretical interest.

There is reason to suspect that the consensual Nordic political systems represent institutional settings that under some conditions are conducive to large-scale policy change (see section 2.4). Tranøy (2000) argues that in times of crisis, the consensus-oriented Norwegian system can be expected to produce fundamental updating reform. But exactly how do Nordic political institutions potentially stimulate reform? By exploring the institutional mechanisms that contributed to large-scale tax reform in Norway, I seek to contribute to this discussion.

Thirdly, there is theoretical debate about the factors that explain change, both in tax policy and in economic policy more generally. (For the full discussion, see section 2.2.) How important are institutional, structural and ideational factors, respectively, and how do they interact to bring about change? Traditionally, structural factors have been emphasized in explanations of economic policy regime change. Yet, lately, scholars that stress the importance of ideas as causal factors have challenged this materialist approach.

Mark Blyth (1997; 2001) argues that structural explanations are incomplete, since structure can only account for the breakdown of an old regime, not the character of the new regime that replaces it. Therefore, economic ideas can be seen as “a key mediating variable between structural change in the economic realm and institutional change in the political realm” (Blyth 2001:5). The present study addresses this general debate by investigating the interaction between structural, ideational and institutional factors in the process that led to the Norwegian tax reform.

At the same time, the study speaks to the specific debate about the factors behind recent tax reforms. In the existing literature on tax policy change, structure, ideas and institutions are all regarded as sources of tax reform. Ganghof (2007) stresses the importance of domestic

structural factors, arguing that the structural problems of extant tax regimes gave impulses to fundamental tax reform in the 1980s and 90s. Others emphasize international structural factors, arguing that economic globalization has imposed major structural constraints on tax policy (e.g. Genschel 2002; Bretschger and Hettich 2002). Steinmo (2003), on the other hand, highlights the role of new policy ideas in accounting for the major tax reforms of the 80s and 90s. Moreover, Steinmo's (1993) seminal study of the evolution of tax policy in the USA, the UK and Sweden shows the deep impact of political institutions on tax policy change.

1.4 A historical institutionalist research strategy

The present study is based on a historical institutionalist (HI) strategy for framing research questions and developing explanations. This approach is usually juxtaposed to rational choice institutionalism. Basically, what distinguishes the HI strategy from rational choice modelling is the focus on large, substantive questions, as well as the construction of explanations that are sensitive to context and based on the combined effects of institutions and processes.

Firstly, historical institutionalists address *big, substantive research questions* rather than theoretical questions (Pierson and Skocpol 2002:3). "Historical institutionalists are primarily interested in understanding and explaining specific real world political outcomes," as Steinmo (2001) puts it. Accordingly, the main goal of the present study is substantive, namely to understand and account for major changes in Norwegian tax policy. HI research is inherently problem driven, in contrast to rational choice scholarship, which is usually more theory driven (cf. Shapiro 2005).

Secondly, to explain political outcomes, historical institutionalists investigate the "*combined effects of institutions and processes*" in historical context (Pierson and Skocpol 2002:3; emphasis in original). The present study analyzes how different structural and ideational processes interacted with political institutions during a specific historical period to bring about tax reform. This approach to explanation differs from rational choice modelling, which will often investigate the effect of one specific institution and accord less attention to contextual conditions. Historical institutionalists usually understand institutions as intervening or structuring variables among a large set of explanatory factors, rather than as the sole variable that has impact (Steinmo 2001).

A third feature that distinguishes HI from rational choice institutionalism is the perspective on *preference formation* (Thelen and Steinmo 1992). Historical institutionalists treat preferences as endogenous, whereas rational choice modelling has often assumed exogenous preferences. This difference is not as clear as before, as the issue of preferences is at the top of the agenda for theory development within rational choice scholarship. Yet, it is fair to say that HI scholars treat preferences as endogenous in a more fundamental sense: “[T]he definition of interests and objectives is created in institutional contexts and is not separable from them” (Zysman 1994:244). The present study adopts this understanding. One of the core issues of the analysis is how the preferences of political actors were shaped within the Norwegian institutional setting.

However, we should not exaggerate the differences between HI and rational choice institutionalism. For one, historical institutionalism is *not* incompatible with rational action. HI research – the present study included – is based on the assumption that “most people act rationally most of the time” (Steinmo 2001). Importantly, this refers to rationality in the broad sense of the word, not a notion of rationality confined to economic self-interest.

For another, many HI studies incorporate elements from rational choice theory. Most importantly, “historical institutionalists have ... taken on board the notion that institutions that solve collective action problems are particularly important in understanding political outcomes” (Thelen 1999:370). The notion of political institutions as systems that can generate cooperation is at the core of the present study. To explain how institutions contributed to collective political action, I borrow certain concepts and insights from more instrumental analyses.

1.5 Research design and methodology

The investigation of my research questions is designed as a case study. The case study design is appropriate, as it allows for in-depth investigation of both the outcomes of the 1992 Norwegian tax reform and the process behind it. Understanding this specific case is the first part of the case study’s double ambition (cf. Gerring 2004). The other part is to draw general inferences from this case to a broader class of cases. But what is the Norwegian tax reform of 1992 a case of? This question does not have one simple answer. Since my three research

questions refer to partly different bodies of theoretical literature, they give rise to different specifications of the broader class of cases.

First, the Norwegian tax reform is a case of modern tax policy change, in particular in the Nordic countries, when it comes to understanding and explaining policy change (questions 1 and 3). Second, it is a case of a broader theoretical category, namely policy regime change in advanced political economies, when the link between processes and outcomes of change is at issue (question 2). This is also the potential scope for arguments about the interaction between structural, ideational and institutional factors behind policy change (question 3). Third, the Norwegian tax reform provides a case of how Nordic political institutions affect policy change (question 3).

Consonant with the historical institutionalist research strategy, this study takes a *mechanism-based approach* to explanation (cf. Pierson and Skocpol 2002:6). The goal is to explore the causal mechanisms that connect initial conditions to outcomes, not to estimate causal effects. This approach “seeks to explain a given social phenomenon ... by identifying the processes through which it is generated” (Mayntz 2004:238).

The ambition to uncover mechanisms goes hand in hand with the methodology of *process tracing*. Process tracing implies close-up investigation of every link in the chain of events that led to the large-scale 1992 tax reform. This is crucial to examine the combined effects of institutions and historical processes.

Specifically, this study relies on three main sources of data: qualitative interviews with policy-makers and experts; public documents; and secondary statistical economic literature. While qualitative interviews and public documents are used to trace the reform process, existing statistical economic studies are the main basis for the discussion of the outcome of reform. The research design and methodology of this study is discussed in detail in chapter 3.

1.6 The importance of tax policy

Finally, a brief introduction to the substance of tax policy is necessary to prepare the reader for the theoretical and empirical discussions that follow. Why is tax policy important, and what are its main functions?

The tax system represents an integral element of a country's welfare state regime or welfare capitalism. The basic purpose of taxation is to finance the activities of the public sector. In advanced political economies, particularly in the Scandinavian countries, a large portion of public spending goes to welfare services and transfers. In 2008, social protection and health care accounted for 56,7 percent of Norwegian public spending, according to Statistics Norway. Simply put, *taxes pay for the welfare state*. Although this statement is fairly trivial, its implications are crucial for understanding the importance of tax policy.

First, the capacity to raise tax *revenue* constrains the size of the welfare state. Since the tax system represents the income side of the welfare state, it also constitutes its budget constraint. The scope for welfare state spending is limited by two features of the tax system: first, how effective it is in terms of raising revenue, and second, how much taxes people are willing to pay. In other words, the government's opportunity to conduct welfare policy will increase with both the effectiveness and the popular acceptance of tax policy.

This is the case even for Norway, which benefits from large petroleum incomes. Taxes are necessary to make room in the real economy for the activities of the public sector. Through taxation, resources – such as human capital – are transferred from the private sector to the public sector.

Second, taxation influences *economic efficiency*. Basic economic theory says that taxes entail efficiency losses, since they distort the incentives of firms and individuals⁴. More interestingly, the size of the efficiency loss varies with the type of taxation, since different taxes affect the economy in different ways. Therefore, *how* we tax determines the economic costs associated with raising revenue through taxation. The tax costs for the economy depend both on the chosen tax mix – i.e. the combination of different types of taxes – and on the specific design of each tax.

⁴ Taxes that correct externalities constitute an exception, as they are meant to prevent efficiency losses by confronting firms or individuals with the social economic costs and benefits of production or consumption.

An important implication is that the economic cost of the welfare state⁵ is partly determined by how the tax system is designed (Lindert 2004). A more efficient tax system makes the welfare state less costly in economic terms.

More broadly, tax policy strongly influences the working of the economy. Taxes affect the economic decisions of individuals and businesses. For individuals, taxes influence the choice between work and leisure, between consumption and savings, and between different forms of savings. While one tax system may give people incentives to work and put the money in the bank, another system may induce individuals to borrow money and buy real estate. For businesses, taxes affect both the decision of whether to invest or not, and the choices between different types of investments and between alternative ways to finance investments. One tax system may deter investments, while another may favor loan-financed investments.

Third, tax policy has a *redistributive* function. Welfare policy and tax policy are alternative arenas for redistribution, since they constitute respectively the spending side and the income side of the welfare state. While benefits are distributed through welfare policy, tax policy distributes burdens. To achieve a desired level of redistribution, policy-makers can thus choose different combinations of welfare policy and tax policy. For instance, minimal redistribution in the tax system can be compensated by strongly redistributive welfare policies.

Taxes have different effects in terms of redistribution, as they can be either proportional, progressive or regressive. Taxes are proportional if they represent the same proportion of income at all income levels. They are progressive if they take away a higher percentage of income from high-income earners than from low-income earners. Conversely, regressive taxes represent a larger proportion of income for those at low income levels compared to those at high levels of income.

Importantly, the total redistributive effect of the tax system depends both on the chosen mix of taxes and the specific design of these taxes. Some types of taxes are generally more redistributive than others. Wealth taxes and regular income taxes are usually progressive,

⁵ The term “cost of the welfare state” does not imply that the costs associated with the welfare state are greater than its benefits. It simply refers to the fact that the welfare state mainly has to be financed through taxes that distort economic choices to a smaller or larger degree. Taxes that are less distortionary will lower the total tax costs associated with the welfare state.

while consumption taxes and payroll taxes are often proportional or even regressive. For instance, a flat consumption tax will normally be *de facto* regressive, since low-income earners use a larger portion of their income on consumption than high-income earners. The specific structure of each tax also has distributive implications. Tax ceilings generally make taxes more regressive, while tax floors or standard deductions make them more progressive.

Additionally, so-called ‘tax expenditures’ have considerable effects on redistribution (Ervik 2000). Tax expenditures refer to the forgone revenues from taxing some assets more leniently than what is the norm in the tax system. These ‘expenditures’ normally take the form of deductions or low value assessments of assets, which may have highly asymmetrical effects. For instance, lenient taxation of owner-occupied housing privileges those with (large) houses.

In sum, how tax policy is designed is important for three main reasons. First, it determines the revenue-raising capacity of the tax system, which constrains the size of the welfare state. Second, it influences the working of the economy and partly determines the economic costs of the welfare state. Third, it affects the distribution of income.

1.7 Outline of the study

The study is structured as follows: In chapter 2, I present hypotheses, theory and relevant existing literature. This chapter is divided into five sections. In the first section, I present the two hypotheses about the character of reform, liberalization and rational updating. In the second section, I sketch the theoretical discussion about the relation between processes/scale and outcomes of institutional change in advanced political economies. Section 2.3 discusses the existing literature on structural and ideational sources of tax policy change. In section 2.4, I address the workings of political institutions in the Nordic countries. Finally, I discuss the roles of key political actors operating within this institutional context (section 2.5).

The third chapter is devoted to research design and methodology. In chapters 4 and 5, I present the results from my empirical investigation. The process that led to reform is the subject of chapter 4, while chapter 5 is about the outcome of reform. Chapter 6 contains the analysis, where I bring theory and data together to answer my research questions. Chapter 7 concludes and suggests topics for further research.

Chapter 2: Theory

2.1 Liberalization or rational updating?

2.1.1 Two hypotheses about the outcome of the 1992 tax reform

The first research question is descriptive and addresses the character of tax policy change: *Did the Norwegian tax reform of 1992 imply a liberal policy shift or a rational updating of social democratic policy?* In the literature on recent tax policy change there are two main views of the reforms of this era. The first is that tax policy was subject to *liberalization*, with attention shifting from equity to efficiency goals. The alternative view is that tax policy was *rationaly updated*, as policy-makers found more effective means to achieve a fixed set of goals. These views are the basis for my two hypotheses about the Norwegian tax reform of 1992, since they suggest the two different paths tax policy could have taken at this crossroads.

The hypotheses, which I refer to as ‘liberalization’ and ‘rational updating’, are also tied to a more general discussion in the literature on policy regime change in advanced political economies. In this section, I develop the two hypotheses, describing both their general features and their specific implications for tax policy in Norway.

2.1.2 Liberalization

The first and most conventional hypothesis is that of **liberalization**. Liberalization is regarded as a dominant contemporary trend both in works on tax policy change and in the broader literature on changes in advanced political economies. Generally, liberalization is often identified as a shift to a more market-based political-economic logic that involves larger freedom for private economic actors (e.g. Streeck and Thelen 2005).

In the tax field, the discussion about liberalization is more oriented towards the balance between policy objectives of efficiency and equality, as well as the corresponding outcomes. In the tax reforms of the 1980s and 90s, some analysts see a “shift in policy paradigm” where the goal of efficiency was given increasing weight relative to that of equity (Swank and Steinmo 2002:643,651). Steinmo finds “an unmistakably common trend: Tax reform has now

come to mean the redistribution of existing tax burdens downward” (Steinmo 1993:156). That is, policy change in a liberal direction is identified with a shift from equity towards efficiency.

Accordingly, I conceptualize ‘liberalization’ as a *shift in policy objectives from equality towards efficiency and a corresponding development in outcomes*. Liberalization implies greater efficiency at the expense of equality. Thus, I regard a weakened ability to generate economic equality as a necessary precondition for classifying a development as liberal.

The proposed “big trade-off” (Okun 1975) between efficiency and equity constitutes the basis for this notion of liberalization. This basic tenet of neo-classical economic thought implies that stronger redistribution leads to lower efficiency, while higher efficiency means less redistribution. In this trade-off, liberalization can be equated with giving priority to the goal of efficiency over that of equality: Redistributive efforts are problematic since they hurt efficiency, and should therefore be reduced.

More generally, this neo-classical view implies that government intervention should be limited, since it distorts the working of free, competitive markets, thereby impeding an optimal allocation of resources. Liberalization thus involves loosening the grip on private economic actors, so that they can make free economic choices that generate economic efficiency.

What are the specific implications of this hypothesis for tax policy in Norway? On the policy regime level, the liberalization hypothesis corresponds to a shift from a traditional interventionist social democratic tax policy model to a liberal regime.

Liberalization would change the weight accorded to different objectives of tax policy. On the one hand, liberalization implies a stronger concern for efficiency and the free operation of markets. More lenient tax treatment of business and mobile capital would be the logical consequence. Thus, the outcomes related to liberalization would be greater economic efficiency and a lighter tax burden on business and capital.

On the other hand, a liberal tax policy regime would accord *less* weight to goals of redistribution. This applies both to the direct redistribution within the tax system and the indirect redistribution based on raising revenue for the welfare state. Thus, liberalization

would be related to outcomes of higher inequality, either because of a downward shift of the tax burden or a weakened capacity to finance redistributive welfare policy.

To summarize, the first hypothesis is that the 1992 Norwegian tax reform changed policy in a liberal direction. In terms of policy objectives, this would imply a shift from equity to efficiency concerns. In terms of outcomes, liberalization would be associated with higher economic efficiency and a lower tax burden on business/capital, combined with greater inequality and a reduced ability to finance the welfare state.

2.1.3 Rational updating

The alternative hypothesis about how Norwegian tax policy developed is what I label **rational updating**. This hypothesis has two basic elements. ‘Rational’ refers to using more rational policy means to achieve a fixed set of goals. ‘Updating’ means adapting policy to new political-economic environments. Hence, *rational updating of policy means to better achieve established objectives by adapting policy means to new political-economic realities*.

Though rarely stated explicitly, this hypothesis is anchored both in the general literature on changes in advanced political economies and in discussions of tax policy change. On a general level, Hacker (2005) and Streeck and Thelen (2005) provide a theoretical foundation for rational updating. The latter pair write that “institutions require active maintenance; to remain what they are they need to be reset and refocused, or sometimes more fundamentally recalibrated and renegotiated, in response to changes in the political and economic environment” (Streeck and Thelen 2005:24). The point is that policy changes are often necessary to better achieve the core objectives of a policy regime. Policy changes can be of a predominantly rational character, and do not necessarily imply changes in the substance of a policy regime.

Paul Pierson (2001) also writes about rational reforms in his discussion of welfare state restructuring. He mentions ‘rationalization’ as one of two reform types under the general dimension of ‘recalibration’. Pierson defines rationalization as the “modification of programmes in line with new ideas about how to achieve established goals” (Pierson 2001:425).

In the tax field, Steffen Ganghof's analyses of modern tax reforms strongly suggest the idea of rational updating. He argues that reforms were primarily aimed at rationalization and upgrading: "The tax reforms did not fundamentally change the weighting of different tax policy goals (efficiency and equity) but tried to better achieve both goals" (Ganghof 2007:1066). Policy changes were necessary to ensure continuity in outcomes. Drastic changes in tax rules did not reverse the existing goals of tax policy; they were rather "a precondition for defending the underlying substantive status quo" of tax policy (Ganghof 2007:1062).

Steinmo's recent analysis of Swedish tax policy also partly suggests the hypothesis of rational updating. His point is that although "tax policy is most certainly adapting to the new political economic realities", this has not meant "the end of redistribution" or the death of the Swedish welfare state (Steinmo 2002:841).

Whereas the hypothesis of liberalization implies a shift in objectives, rational updating entails continuity in objectives. Existing goals are not reversed or altered; only the policy means for achieving these goals change. Contrary to the first hypothesis, rational updating does not assume that there is a trade-off between efficiency and equality. The notion of rational updating implies that it is possible to better achieve both goals simultaneously, or at least to increase efficiency without hurting equality, and vice versa.

Identifying 'rational' policy change is a challenging exercise analytically. For one, the term 'rational updating' is defined by stability regarding objectives and amelioration in terms of achieving them. Can policy changes really be wholly neutral and rational? My answer would be that although changes can never be completely neutral, in some cases the continuity in objectives/outcomes will be more significant than the discontinuity. A notion of rational policy change is warranted, as we clearly do not want to identify all modern changes in economic policy as liberalization (cf. Pierson 2001:425).

Yet, wouldn't all policy-makers claim that their policies are rational, since they aim to better achieve goals? To meet this challenge, it is essential to base the evaluation of policy change primarily on outcomes. This study undertakes a thorough investigation of the outcomes of policy change to determine whether liberalization or rational updating characterized the 1992 tax reform.

What are the specific implications of the rational updating hypothesis for tax policy in Norway? On the policy regime level, this hypothesis corresponds to replacing the traditional social democratic model with a modern social democratic tax policy regime.

Rational updating implies continuity in the core objectives of tax policy. Such policy change would thus reconcile the goals of efficiency, revenue-raising and redistribution. Efficiency in taxation would not be pursued at the expense of equity. The outcome of rational updating for the tax system would be both greater economic efficiency *and* a greater total redistributive capacity. Increased redistributive capacity means a strengthened ability to finance the welfare state and/or greater direct redistribution within the tax system.

To sum up, the second hypothesis is that Norwegian tax policy moved in a rational direction in the 1992 reform. This is associated with continuity in objectives. In terms of outcomes, this would imply *greater efficiency combined with more effective revenue-raising and stability in the distribution of tax burdens*. Table 2.1 summarizes the implications of the two hypotheses for changes in the outcomes of tax policy.

Table 2.1: Implications of the hypotheses for outcomes of tax policy change

Outcome variable	Hypothesis	
	<i>Liberalization</i>	<i>Rational updating</i>
1. Efficiency	Greater	Greater
2. Treatment of capital	More lenient	Same as before or tougher
3. Capacity to finance welfare state	Weaker	Same as before or stronger
4. Direct redistribution	Weaker	Same as before or stronger

2.2 Linking outcomes and processes of change

2.2.1 Institutional change in advanced political economies

The second research question of this study – *How was the outcome of the 1992 tax reform conditioned by the large scale of policy change?* – is inspired by the literature on institutional change in advanced political economies. Substantively, this body of work has addressed the *character and outcomes* of the major changes that have taken place in various policy areas

and broader institutions since the 1980s. Theoretically, it has been concerned with understanding *processes* of change. However, it is the link between the two that constitutes the decisive point at issue in this literature. The argument that substantial outcomes are associated with specific types of institutional change represents the very *raison d'être* of this line of theoretical effort.

Most scholars of institutional change support the proposition that there is a relationship between outcomes and processes of change. What this relationship looks like, however, is the subject of intense academic debate. The discussion about what type of institutional change gives rise to specific substantive outcomes is arguably the most important current debate in the field. There are two major positions in this discussion: the first associated with Paul Pierson's work; the other most clearly represented by Kathleen Thelen and colleagues. I first present these two positions, before I go on to argue that the kind of change I find in Norwegian tax policy represents a related but distinct theoretical category that has been given little attention in this literature.

2.2.2 Path dependence and the lack of retrenchment

The first position is based on the work of Paul Pierson and others on welfare state retrenchment. The substantial question posed by the "retrenchment literature" is whether the welfare states of advanced democracies have been dismantled as a consequence of increasing strains. The main finding is that the welfare state has proven remarkably resilient to change. Although there have been cuts, most systems of social protection have resisted fundamental shifts. The result of increasing pressures has not been across-the-board retrenchment or liberalization, but rather limited restructuring of the advanced welfare state (Pierson 2001). Thus, the substantive outcome has been *continuity rather than change*.

The retrenchment literature is, however, equally concerned with processes of change as with outcomes. Regarding processes, the dominant finding is that changes have been incremental, not abrupt. Taken together, "most reforms in most countries [have been] incremental rather than radical, and focused on restructuring rather than straightforward dismantling" as Pierson sums up an anthology on changes in advanced welfare states (Pierson 2001:420).

Paul Pierson makes the conceptual link between these two findings, arguing that the outcome of limited retrenchment is associated with a specific process of institutional change, namely incremental, path dependent change. Welfare state institutions have not been dismantled, because they tend to evolve according to a path dependent logic. As institutions develop along a particular path, processes of increasing returns are set into motion, which make it increasingly difficult to exist the existing path. These processes produce significant barriers to fundamental policy shifts. Change, therefore, will mostly be incremental, amounting only to adjustments and adaptations within the existing path.

According to this view, the process of change thus accounts for the outcome of change, namely institutional stability. Simply put, *incremental processes of change produce outcomes of institutional continuity*. Arguments about path dependence account for institutional persistence.

However, the outcome to be explained is not always institutional stability. Major institutional changes do indeed occur. The path dependence literature usually points to the concept of “critical junctures” to make sense of fundamental shifts of this kind. Critical junctures are the moments of creation or innovation “where the usual structural constraints on action are lifted or eased” (Mahoney and Thelen 2009), often caused by large exogenous shocks. During such critical moments, radical shifts from one institutional path to another are possible.

A common theoretical view is that institutional development over long periods of time incorporates both the logics of path dependence and critical junctures. This is often called the *punctuated equilibrium model*. Institutional change is characterized by long path dependent continuities that are periodically interrupted by critical moments when radical shifts occur (Pempel 1998). In the stretches of time between these rare critical junctures, institutions develop in path dependent ways.

Arguments about path dependence and critical junctures should not be conflated, as stressed by Pierson (2000). The two concepts point to diametrically opposite logics of change. Path dependence arguments emphasize the barriers to change that explain stability, while arguments about critical junctures stress the lifting of these barriers, which accounts for major ruptures. However, they give rise to complementary hypotheses about the relationship

between processes and outcomes of change. While incremental path dependent change produces institutional continuity, *abrupt change (at critical junctures) causes discontinuity.*

2.2.3 Liberalization through gradual transformation

Wolfgang Streeck and Kathleen Thelen criticize this punctuated equilibrium model, arguing that there are “severe limits to models of change that draw a sharp line between institutional stability and institutional change” (Streeck and Thelen 2005:8, applies also to next quotes). Separating the analysis of institutional continuity and rupture, they argue, imposes a bias on our understanding of the relationship between processes and outcomes of change. This conceptual framework only provides for “either incremental change supporting institutional continuity through reproductive adaptation, or disruptive change causing institutional breakdown and innovation and thereby resulting in discontinuity”.

Equating incremental change with continuity and abrupt change with discontinuity is misleading, they argue, since discontinuities can also arise from incremental changes: “Far-reaching change can be accomplished through the accumulation of small, often seemingly insignificant adjustments”. To account for this possibility, they suggest that we distinguish clearly between “*processes of change*, which may be incremental or abrupt, and *results of change*, which may amount to either continuity or discontinuity”. This is presented in a two-by-two matrix, reproduced under (Table 2.2).

Table 2.2: Types of institutional change: processes and results

	Result of change	
Process of change	Continuity	Discontinuity
Incremental change	1. Reproduction by adaptation	3. Gradual transformation
Abrupt change	2. Survival and return	4. Breakdown and replacement

Source: Streeck and Thelen (2005:9)

This typology of institutional change maps out four possible combinations of processes and results of change. But the typology also represents four possible *connections* between the

character of the change process and the outcome of change. Cell 1 represents Pierson's view, which conceives of incremental change as adaptive and reproductive, thus implying continuity. Cell 4 corresponds to arguments about critical junctures, where abrupt change causes institutional rupture. Taken together, the punctuated equilibrium model allows for institutional change of types 1 and 4.

Streeck and Thelen, however, emphasize institutional change of type 3, which they term 'gradual transformation'. "In reality," they argue, there can be "dramatic institutional reconfiguration beneath the surface of apparent stability or adaptive self-reproduction, as a result of an accumulation over longer periods of time of subtle incremental changes" (Streeck and Thelen 2005:8). They regard this as a frequent – maybe even the predominant – type of institutional change in the political economy of modern capitalism. But due to the dominance of the punctuated equilibrium model, these processes of gradual transformation are poorly understood.

Their basic point is that institutional discontinuity is not necessarily the result of abrupt change brought about by exogenous shocks. On the contrary, major transformations of institutions are most often produced by series of small, seemingly insignificant changes. This represents an alternative view of the relationship between processes and outcomes of change: *Major discontinuities result from incremental change.*

In the context of modern political economies, discontinuity is inextricably linked to liberalization. Streeck and Thelen's argument is based on the observation that advanced industrial democracies have gone through a process of liberalization since the 1980s that has fundamentally altered their political economies. They thus present a rival view of the substantive outcome of the pressures put on advanced political economies. Contrary to the 'retrenchment' and 'Varieties of Capitalism' literatures, which emphasize continuity and the lack of convergence, they stress the significance of the changes that have taken place. They see "a process of liberalization [that] involves a major recasting of the system of democratic capitalism as we know it" (Streeck and Thelen 2005:5).

Liberalization, however, has not been produced by disruptive changes caused by exogenous shocks. Quite the opposite: "[A]n essential and defining characteristic of the ongoing worldwide liberalization of advanced political economies is that it evolves in the form of

gradual change that takes place within, and is conditioned and constrained by, the very same postwar institutions that it is reforming or even dissolving” (Streeck and Thelen 2005:4).

The authors thus observe a relationship between the outcome of liberalization and incremental processes of institutional change. These processes of gradual but transformative change are of four kinds (Mahoney and Thelen 2009:15-17). First, *displacement* occurs when old rules are replaced with new ones, for instance when private institutions are introduced that compete with and eventually supplant public schemes. Second, *layering* implies that new rules are added to existing rules, thereby altering the logic of an institution. Third, *drift* describes processes where shifts in the context of policies alter the effects of policies that are not updated (Hacker 2005). That is, even if policies are not changed, changing environments can bring about significant changes in the outcomes of policies. For instance, public welfare schemes may decay because they are not tended to. Fourth, *conversion* occurs when existing rules are interpreted or enacted in new ways. Often, actors exploit the ambiguities of institutional rules, filling institutions with new goals or functions.

Streeck and Thelen argue that gradual transformation processes of these kinds abound in the recent development of advanced political economies. This brings them to ask whether the connection between incremental processes of change and outcomes of liberalization is of a more general character: “Could it be that measures of liberalization are somehow particularly suited to being imposed gradually and without disruption?” (Streeck and Thelen 2005:33). They support this suspicion by pointing out that liberalization seldom requires political mobilization, as the typology of gradual transformative change suggests. Liberalization can be brought about without dismantling existing institutions, simply by doing nothing or by changing institutions from within.

Streeck and Thelen thereby provide an argument about the linkage between processes and outcomes of institutional change that runs counter to Pierson’s understanding. While Pierson’s view is that incremental change causes continuity and lack of retrenchment, they argue that gradual change privileges discontinuity in the form of liberalization.

2.2.4 Fundamental changes, continuity in outcomes

The possible linkages between processes and outcomes of institutional change are, however, not exhausted. Returning to the typology of institutional change in table 1, the punctuated equilibrium model corresponds to cells 1 and 4, while the model of gradual transformation occupies cell 3. What about the combination of abrupt change and continuity in outcomes (cell 2)? Streeck and Thelen note that “there often is considerable continuity through and in spite of historical break points”, tentatively referring to this type of change as ‘survival and return’ (Streeck and Thelen 2005:8). This category of institutional change is not given further attention, though.

However, the kind of change that I find in the Norwegian tax reform of 1992 seems to fit this category. My empirical investigation reveals a remarkable stability in outcomes, despite – or perhaps because of – abrupt policy change. This type of institutional change appears compatible with the argument advanced by Streeck and Thelen. The criticism of equating processes of change with outcomes applies here as well: Neither does incremental change signify continuity in outcomes, nor does abrupt change imply discontinuity. Their claim is that liberalization often results from the gradual change generated by the failure to adapt policy to changing environments (see also Hacker 2005):

“[I]nstitutions require active maintenance; to remain what they are they need to be reset and refocused, or sometimes more fundamentally recalibrated and renegotiated, in response to changes in the political and economic environment in which they are embedded [...] Without such tending ... they can be subject to erosion or atrophy through *drift*” (Streeck and Thelen 2005:24, emphasis in original)

This argument, which underpins the claim about ‘gradual, but transformative’ change, also implicitly supports the type of institutional change characterized by continuity in outcomes through disruptive large-scale reform. In this view, liberalization often occurs due to the lack of major reform that updates an institution to a new economic or social environment. The logical implication is that major, updating reforms can indeed produce institutional continuity and deter liberalization. Ganghof advances the same point with regard to tax policy, arguing that “drastic changes in the legal status quo (policies) may be necessary to defend the underlying substantive status quo (outcomes)” (Ganghof 2007:1081).

This argument can be pushed even further: *Could there be a connection between non-liberalization and abrupt, fundamental reform?* Again, this suspicion mirrors Streeck and Thelen's speculation about a general relationship between gradual change and liberalization. While liberalization can easily proceed without mobilization, updating institutions to changing contexts is a more difficult task that requires mobilization. That is, liberalization does not depend on large reforms, while non-liberalization by means of recalibrating institutions does.

“Non-liberal reforms in a market economy seem to require ‘political moments’ in which strong governments create and enforce rules that individual actors have to follow, even if they would on their own prefer not to do so”, Streeck and Thelen (2005:33) write. As the authors suggest, organizing capitalism today may face far stronger collective action problems than liberalization within capitalism.

However, their emphasis on ‘strong government’ as the only solution to these problems seems misleading. Broad, political coalitions behind reform represent a strong – and perhaps more viable – alternative. That is, collective political action by broad coalitions appears to be the most important condition for fundamental non-liberal reform.

2.2.5 Summary of the discussion of outcomes and processes of change

What is the relationship between processes of institutional change and substantial outcomes in advanced political economies? In the preceding discussion, I have presented two conceptual models, which each give rise to two types of institutional change. The *punctuated equilibrium model* suggests that incremental changes imply continuity in outcomes, while abrupt changes produce discontinuity. Pierson explains lack of retrenchment with the path dependent character of institutional change (‘reproduction by adaptation’). Major institutional discontinuities (‘breakdown and replacement’), on the other hand, are understood as the product of disruptive change at critical junctures.

Streeck and Thelen present an alternative model, arguing that the connection between processes and outcomes of institutional change has the opposite sign. Discontinuity in the form of liberalization most often occurs through incremental changes (‘gradual

transformation’). Conversely, and based on the same logic, non-liberalization in the sense of updating institutions may require abrupt, large-scale reforms (‘survival and return’). My study of the 1992 Norwegian tax reform explores this type of institutional change, examining the linkages between fundamental reform and rational updating.

2.3 Sources of change

2.3.1 Structure and ideas as sources of change

The previous section discussed the relationship between processes and outcomes of change. We now take one step back in the causal chain, examining the factors that give rise to changes in policy. Policy change can be regarded as the product of two elements: first, the sources of change – either structural or ideational – and second, the political institutions that process the impulses for change that emanate from these sources. This model is consonant with the historical institutionalist approach (see section 1.4). Change in a policy regime is regarded as the result of how outside historical processes – at both the international and national level – interact with developments within the policy regime itself, and how these potential sources of change are processed through decision-making institutions.

This section addresses the sources of change, while political institutions are the subject of section 2.4. ‘Sources of change’ simply refer to the things that give policy-makers reason to change policy. This could be problems associated with existing policy or the prospect of better effects from new policies. Sometimes the sources of change are abrupt shocks (as wars or crises), in other cases features that have developed over a long period of time. Sources of change can be divided into two categories: *structural* factors and *ideational* factors.

Traditionally, structural factors have been emphasized in explanations of institutional change. The basic contention is that changes in structure account for changes in institutions or policy regimes. Structural factors can be either international or domestic, and either external or internal to the policy regime in question. In this section, I discuss two potential structural sources of change in the Norwegian tax policy regime. First, in section 2.3.2, I address the internal structural problems of the existing tax system (which are also related to the broader economy). Second, in section 2.3.3, I discuss increased economic internationalization.

Yet, the last two decades this materialist approach has been challenged by scholars that emphasize the importance of ideas as causal factors behind institutional change in the political economy (Blyth 1997). That is, changes in policy regimes may in part be explained by the emergence and development of new economic ideas. This is a reasonable hypothesis also in the area of tax policy (see Steinmo 2003). Therefore, in addition to structural factors, I discuss the development of new economic ideas about taxation as a source of tax policy change in Norway (section 2.3.4).

Before looking closer at these potential sources of tax policy change, a notion of the relationship between structural and ideational causal factors is necessary. Are material and ideational factors mutually exclusive or compatible? Mark M. Blyth (1997; 2001) presents a convincing argument for the latter. His main contention is that although structural factors are important, they can only bring us halfway in explaining policy regime change. “While structural factors may explain why a particular institutional equilibrium becomes unstable, such a model does not explain why the new equilibrium takes the specific form that it does” (Blyth 2001:4). That is, structural explanations of institutional change are incomplete, since they are “indeterminate regarding subsequent institutional form” (Blyth 2001:26)

Therefore, ideas are essential components of explanations of policy regime change. While structure may account for the breakdown of the old regime, ideas will often form the substance of the new policy regime. Economic ideas often serve as institutional blueprints, since they not only define structural problems but also project the solutions that will resolve these problems. Therefore, economic ideas can be seen as “a key mediating variable between structural change in the economic realm and institutional change in the political realm” (Blyth 2001:5).

Thus, in accounting for change in Norwegian tax policy, the question is not only what the crucial sources of change were. It is equally important to determine how structural and ideational factors interacted or complemented each other in producing change.

In the following, I present the existing literature on what is believed to be the important sources of modern tax policy change. This literature provides the theoretical foundations for the two hypotheses of liberalization and rationalization. I first discuss structural factors, both at the national and the international level, before I turn to ideational factors. Under each

heading, I start with the general theory, before zooming in on the theoretical discussion specific to the Nordic countries.

2.3.2 Domestic structural factors: extant tax policy and economic context

Which structural factors could have given impulses to tax policy change in Norway? In this sub-section, I discuss the existing literature on the structural problems of the old tax policy regime. This includes a brief look at the relation between the tax system and macro-economic performance. In the next sub-section, I discuss the international structural constraints represented by increased economic globalization.

Any account of changes in tax policy must be based on a notion of the system that existed previously. That is, looking at the character and evolution of tax systems from the 1960s to the 80s is a precondition for understanding the subsequent changes in tax policy. Scholars seem to agree that the problems of the existing tax system gave important impulses to change. Some even argue that the character of the old tax policy regime prepared the ground for a certain kind of change. However, an analysis of the tax systems in the decades preceding reform can lend support to both the hypotheses of liberalization and rationalization.

What characterized the old tax policy regime? Up to the 1980s, policy-makers generally regarded tax policy as a tool for achieving a large array of goals. In addition to raising revenue, tax systems were used to promote redistribution and manipulated to achieve various industrial policy ends, among other things. Tax policy was to a large degree interventionist, as policy-makers used tax incentives as a solution to virtually any problem (Steinmo 2003:215-7).

The resulting tax systems tended to be messy and complicated, presenting firms and individuals with a number of different deductions and loopholes. Thus, effective tax burdens rarely corresponded to formal tax rates. While nominal rates were often high and progressive, the real tax burden was modest, as corporations made use of different tax incentives and individuals claimed generous deductions.

The tax systems of the Nordic countries represented no exception in this regard. Rather, these features were accentuated in the Nordic tax systems. While the Nordic countries had some of

the highest formal tax rates in the world, this was compensated by generous deductions and tax incentives (Ganghof 2007:1068). This owed, however, to a couple of features particular to the Nordic tax systems. For individuals, tax treatment of owner-occupied housing was extremely favorable. For firms, strong tax incentives to keep capital inside the company implied lenient taxation. These features had important implications for both the ability to achieve political goals through the tax system (outcomes) and the political-economic logic in the Nordic countries.

The tax treatment of owner-occupied housing was perhaps the most important peculiarity of the Nordic income tax systems (Ganghof 2005:80-81). Tax rules for housing were extremely favorable, as the returns to housing investments were taxed lightly or not at all while interest payments were fully deductible. Interest expenses could be deducted against the highest marginal tax rate, so that those facing the highest tax rates had the greatest opportunities for tax deductions.

The liberal rules for interest deductibility gave rise to several problems (Ganghof 2005:81). First, the revenue from personal capital income tax was low or even negative. The Scandinavian countries actually suffered revenue losses from personal taxes on capital income at times during the 1980s (Sørensen 1998:16). Ganghof sees this as part of an implicit tax differentiation between labor and capital income, where policy-makers concerned with growth sought to impose lower effective tax rates on the latter. He argues, however, that this strategy had gotten out of hand, the tax burden on capital income dropping way below what was rational (Ganghof 2007:1061).

Second, the allocation of resources was inefficient and the savings ratio of households low. The tax rules induced people to borrow money and invest in real estate, instead of putting aside savings that could be invested in production. Third, formal progressiveness in the income tax led to little effective redistribution, since the biggest earners had the largest loans and therefore enjoyed the largest tax deductions for interest. Thus, this feature of Nordic tax systems undermined equity, efficiency and revenue goals alike.

Moreover, this tax regime contributed to *macro-economic instability* in the 1980s. In Norway, the combination of generous rules for interest deduction and credit liberalization fuelled an uncontrolled credit expansion in the mid-1980s (Tranøy 2000: chap. 3). The boom years of

1984 to 1987 were followed by economic downturn, partly due to a tightening of tax policy in 1987. In the late 1980s and early 1990s, the Norwegian economy was in a deep crisis, with negative growth and soaring unemployment. These serious macro-economic problems add to the other structural deficiencies of the old tax policy regime.

Another particular feature of Nordic tax policy was the active use of tax incentives to direct the flow of capital. As such, tax policy was one element of interventionist industrial policy (Steinmo 2002:842). Specifically, Nordic tax systems provided corporations with incentives to lock capital inside the firm. Tax rules supported a logic of ‘retain and reinvest’, since capital owners avoided taxation if they left profits in the company instead of collecting dividends (Steinmo 1993).

This political-economic logic promoted investments in production that could generate long-term growth and employment. As such, it also provided stability for all the stakeholders in the companies. The main problem with the tax incentives for locking in profits, however, was that capital was not put to its most productive use. The allocation of capital was inefficient, since profits were reinvested in companies instead of flowing to where they would give the largest returns. Additionally, these tax incentives provided corporations with small effective tax burdens (Steinmo 1993:42).

How did experiences with the existing tax system influence tax policy change from the 1980s? Primarily, the deficiencies associated with Nordic tax systems provide a theoretical foundation for the hypothesis of rational updating. Logically, the room for rational policy change will increase with the irrationality of existing policy. For instance, “the effective capital income tax burden that had developed up to the early 1980s was extremely low so that subsequent tax reforms could cut marginal tax rates on mobile types of capital income while increasing tax revenue” (Ganghof 2007:1059).

Ganghof forcefully argues that tax systems of the 1970s and 80s suffered from serious deficiencies, which laid the ground for rational updating reforms. Reforms were primarily a response to these problems. Ganghof’s view is that the “tax reforms of the 1980s and 1990s were first and foremost efforts to rationalize the existing approach to differentiated income taxation,” which was feasible since “the pathological variants ... that had developed up to the

late 1970s turned out to undermine efficiency, progressivity and revenue raising alike” (Ganghof 2007:1066). One might also add macro-economic stability to this list.

This suggests continuity in the balance of policy goals. Since the existing system was largely inefficient in achieving its objectives, reforming it did not confront policy-makers with a clear trade-off between efficiency and equity goals. Instead, they could maintain all the core ambitions of tax policy. That is, “tax reforms did not fundamentally change the weighting of different tax policy goals (efficiency and equity) but tried to better achieve both goals” (Ganghof 2007:1066).

However, the problems of the Nordic tax systems of the 70s and 80s can also lead us to expect liberalization. Some interpreted the deficient tax systems as proof that government could not effectively pursue redistribution or industrial policy through taxation (Steinmo 2003). Sky-high marginal tax rates became a symbol for the trade-off between efficiency and equality. And the interventionist strategy of directing capital flows and locking profits into firms produced distortions in the allocation of investments that impeded growth and innovation. This provided a rationale for abandoning interventionist and highly redistributive tax policy. Thus, the problems of existing tax systems could bring policy-makers to shift the balance of tax policy objectives from equity towards efficiency. Leaving the structural problems of existing tax systems, we now turn to structural constraints on the international level.

2.3.3 International structural factors: economic globalization

Theory on the impact of economic globalization represents an important foundation for the general hypothesis of liberalization. Economic globalization can be identified as the increasing internationalization of the economy. At the heart of this development is the freer movement across national borders of mobile factors of production, especially mobile capital. According to globalization theory, this process has clear implications for tax policy. (For thorough discussions, see for instance Genschel (2002) or Hagen *et al.* (1998).)

The standard argument is that internationalization increases the exit possibilities for mobile factors, thereby strengthening the bargaining position of these factors, most importantly mobile capital (Swank and Steinmo 2002). Since mobile capital can move around freely, it will – *ceteris paribus* – flow to the country with the lowest capital tax rate. This engenders tax

competition between countries, as governments have incentives to lower taxes to keep (and attract) mobile capital. This will set off a race to the bottom in tax rates on capital.

There are thus two clear implications of economic internationalization for tax policy (Genschel 2002:247). First, it would make it more difficult for states to raise tax revenue, leading to a lower total level of taxation and a weakened capacity to finance the welfare state. Second, it would shift the tax burden from mobile to immobile tax bases, i.e. from mobile capital to immobile labor, consumption, and real estate. This means more lenient taxation of business and capital. It also implies a more regressive tax mix, which will reduce the direct redistributive effect of the tax system (Ganghof 2001; Hagen *et al.* 1998). Globalization theory thus predicts that the process of economic internationalization will provide strong structural impulses towards a liberalization of tax policy.

There are, however, alternative theories about the impact of internationalization. Generally, they emphasize that globalization also creates other pressures that conflict with the race to the bottom-logic. Peter Katzenstein's (1983; 1985) classical argument is that an open economy makes citizens more vulnerable to the adverse effects of external economic shocks. This increases demands for a social safety net, pushing the government to expand social protection.

Swank and Steinmo (2002:646; Steinmo 2002:840) spell out the implications of this kind of argument for tax policy change. They argue that the need to maintain revenue in the context of rising needs, constrains the downward pressure on taxation of mobile capital. These conflicting pressures induce governments to pursue other policies than effective tax cuts or tax shifts from mobile to immobile factor. One solution is cutting statutory tax rates while reducing deductions. This makes sense since statutory tax rates on capital are important for determining where mobile capital is invested (Ganghof 2006).

Swank and Steinmo (2002:646) predict that while the content of tax policy will change in this manner, there will be little room to alter relative tax burdens. That is, the conflicting pressures of internationalization produce changes in tax structure but continuity in the distribution of tax burdens.

This argument clearly points in the direction of rational updating. Rather than leading to liberalization, economic internationalization would induce governments to find more rational

ways to raise revenue for social protection in this new economic context. The weighting of goals would remain virtually unchanged, as the growing political pressures for equity balance out the increasing economic concerns for efficiency. The impulse would rather be to design policies that better achieve both goals.

As this discussion shows, the process of economic internationalization can be argued to give impulses to either liberalization or rational updating. This conclusion suggests that institutions at the national level will be crucial for shaping outcomes. (Although obvious, this point is underemphasized in the globalization literature, which tends to privilege structural explanations.) The policy response will depend on how these pressures manifest in the specific national political-economic context, and on how decision-making institutions perceive and process these pressures.

What does the empirical evidence tell us about the impact of globalization on tax policy? One conclusion that emerges from this enormous body of literature is that there has been no clear “race to the bottom” in taxation of capital (e.g. Genschel 2002; Swank and Steinmo 2002). Although rates have gone down, the revenue from capital has not been reduced significantly. Genschel argues that the predictions from globalization theory find little support, as OECD countries have “neither suffered a dramatic decrease in total tax revenue nor experienced a clear shift of the tax burden from mobile to immobile bases” (Genschel 2002:246). In this sense, there has been no clear liberalization.

However, some studies do find support for the prediction that internationalization will force governments to lower taxes on highly mobile assets. For instance, Bretschger and Hettich (2002) find a negative impact from globalization on capital taxes when measuring capital taxes by effective tax rates instead of revenue.

Even if internationalization has not reduced the tax burden on mobile capital, scholars seem to agree that it has constrained national tax policy. Notably, tax competition has prevented governments from increasing taxes in response to growing needs and stronger calls for spending (Genschel 2002). There seem to be strong limits on how much revenue can be raised from taxes on mobile capital without hurting competitiveness.

However, this would depend on the existing tax system. Even if there are clear limitations to how much revenue can be raised from mobile capital, old tax systems did not necessarily fully exploit this potential. In the Nordic countries, the existing practice of implicit differentiation in income taxation implied a rather low tax burden on capital (Ganghof 2005; 2007). Even if the Nordic states were forced to cut rates on some types of capital income, they could “increase the tax burden on less sensitive types of capital income that had been taxed very lightly in the past” (Ganghof 2007:1067).

Therefore, “adjustment to tax competition did not have to lead to revenue losses” (Ganghof 2007:1067). “[T]he Nordic welfare states, among others, have managed to adapt to increased economic internationalization and *increase* capital income tax revenue” argues Ganghof (2005:86, emphasis in original). This point clearly backs up the hypothesis of rationalization with regard to the Nordic countries.

2.3.4 Ideational factors: new ideas about tax policy

So far we have discussed structural factors behind tax policy change. We now turn to ideational factors, namely the emergence and development of novel *ideas* about tax policy. How can new economic ideas influence policy? Diffusion is the key concept here, as ideas will have little influence if they are only shared by a group of university professors without connections to policy-makers. In democratic systems, ideas will often have deep impact on policy only if they gain popular acceptance. That means that they have to be transmitted not only from experts to politicians, but also from elites to the consciousness of regular people (Blyth 2001:237).

What does the existing literature tell us on the subject of the new tax policy ideas that emerged internationally? What were their content, and to what extent and how did they gain influence?

During the 1980s, ideas about what constituted ‘good’ tax policy shifted markedly. In the 1960s and 70s policy-makers and experts alike had perceived of tax policy as a tool to achieve a large array of goals, and tax policy instruments were used as a solution for virtually any problem. The new tax reform doctrine that emerged in the 1980s, however, largely abandoned the belief that government could effectively use taxation for redistributive or industrial policy

ends (Steinmo 2003:219). In practice, the new reform ideas implied lowering tax rates while cutting tax deductions and incentives – so-called ‘rate reduction, base broadening’.

Yet, ideas about policy don’t just appear out of thin air, they are “formed in political, economic and institutional contexts” (Steinmo 2003:228). How was this process of idea change related to the structural factors discussed in the previous two sections? Steinmo argues that new ideas about tax policy emerged mainly because of the negative experiences with existing tax systems: “[E]xperiences with poorly designed and implemented tax policies helped shape the attitudes and beliefs of politicians, economists and tax officials about what reforms were necessary and desirable” (Steinmo 2003:228). Policy ideas were thus first and foremost problem solutions.

Moreover, the formation of ideas took place within the structural context of increasing international economic mobility. Although this shaped ideas, it did not determine them, argues Steinmo. Policy ideas were not just an instrument through which structure affected policy; ideas exerted an important independent influence on policy. Globalization rather appears to have opened the door for innovative ideas about taxation. The new policy ideas that emerged were crucial both for what policy was selected and for how policies spread (Steinmo 2003:207).

This shift in tax policy ideas represents another theoretical foundation for the hypothesis of liberalization in tax policy. The new tax policy doctrine was conceived under the Reagan administration in the USA and first implemented in the 1986 Tax Reform Act. As such, it was part of the liberal ideological shift of the 1980s in the western world. Steinmo even suggests that “tax policy was the leading edge in this new political tide” (Steinmo 2003:217).

The new ideas about tax policy clearly altered the weighting of policy objectives. There was a “marked shift in the concerns of academic tax experts from equity toward efficiency, ” as one observer puts it (McLure 1984:266). The goal of vertical equity disappeared from the agenda, while concerns about efficiency and growth came to the fore (Steinmo 2003:225).

The ideas embodied in the American tax reform inspired reform of tax systems all across the world. Sandford speaks of a tax reform ‘movement’, claiming that “even more remarkable than the widespread nature of tax reform, has been the similarity across countries” (Sandford

1993:10). These reforms were all based on the principle of ‘rate reduction, base broadening’. Moreover, Steinmo (2003:221) argues that the diffusion of the new tax policy ideas led to a remarkable convergence in views. Key policy makers in advanced OECD countries – on both the right and left side of politics – came to share these ideas about what constituted effective tax policy.

Steffen Ganghof (2005), however, challenges the interpretation that tax reforms worldwide were based on the diffusion of neo-liberal ideas. What tax reforms of the late 80s and early 90s had in common, he argues, was a “shift *towards* less interventionist and simpler income taxation” (Ganghof 2005:79, emphasis in original). But within this broad wave, countries based their reforms on different principles for tax system design. “[T]here were in effect two different models or blueprints for how to make income taxation market-conforming: CIT [comprehensive income tax] and DIT [dual income tax]” (Ganghof 2005:79).

The idea behind the comprehensive income tax (CIT) is to tax all forms of income jointly and according to the same rate schedule. The dual income tax (DIT) model, on the other hand, is based on the principle of systematic differentiation between the taxation of capital and labor. While capital income is taxed at a relatively low, flat rate, taxation of labor income is progressive with a higher top marginal rate (Ganghof 2005; Sørensen 1998).

Although both models strongly emphasize market-conforming capital income taxation, they differ in the extent to which they imply liberalization. “[T]he CIT-blueprint fits better into ‘neoliberal economic orthodoxy’ than the DIT-blueprint”, argues Ganghof (2005:79). The CIT model was most closely approximated in the liberal market economies, like the USA, New Zealand, and Great Britain.

In the Nordic countries, however, experts and policy-makers developed the dual income tax model as an alternative blueprint for income tax reform (Ganghof 2005:80). The model was conceived in Denmark early in the 1980s, at the same time as similar ideas were discussed in Norway (cf. NOU 1984). In practice, Norway was the country that implemented the DIT model most consistently (Sørensen 1998:5), while reforms based on the DIT ideal were also implemented in Sweden and Finland. We should be careful not to overstate the Nordic exceptionality, though, as Nordic tax reforms followed principles similar to those that underlay reforms elsewhere in the OECD: reducing tax rates and broadening tax bases. But

abandoning the principle of comprehensiveness for that of duality certainly represented a “special novel feature” (Sørensen 1998:1).

Why would the dual income tax model be less neo-liberal? Basically, the DIT model responds to efficiency concerns at the same time as it potentially strengthens the capacity to raise revenue and still allows for some redistribution. That is, the DIT model does not preclude the continued pursuit of these goals.

First, taxing all types of capital at the same rate leads to *efficiency* in the allocation of investments. Second, although the direct effect of lowering nominal rates is revenue loss, a low, flat tax rate on capital makes it possible to increase *revenue* in other ways. For one, it is easier for policy-makers to include more types of capital income in the tax base, thus broadening the income base from which revenue can be extracted. For another, it reduces the tax rate against which interest expenses can be deducted, thereby limiting the loss of revenue (Ganghof 2005:81). Third, the differentiation between taxation of labor and capital income allows policy-makers both to raise larger revenues from wage earners and to maintain a progressive tax on labor, which represents an important element of *redistribution*.

This means that reforms based on DIT ideals do not necessarily imply a shift in the balance of objectives. Rather, within the broad reform movement, the DIT model can be regarded as a foundation for the pursuit of established goals through new policies. This supports the hypothesis of rational updating. There is no clear shift from equity to efficiency concerns, as the principles behind DIT reform allow for continued attention to revenue-raising and redistribution.

To sum up, the emergence of new tax policy ideas is the second process believed to have influenced tax policy change in advanced OECD countries. Many observers identify these ideas with neo-liberal ideology and regard their diffusion as the basis for liberalization of tax systems. However, the DIT model developed in the Nordic countries appears considerably less liberal and more consistent with rational updating. In the empirical investigation, the crucial issues will thus be exactly which ideas inspired tax reform, and to what extent these ideas were put into practice.

2.4 Political institutions

2.4.1 The influence of political institutions on politics and policy

The discussions of structural and ideational sources of tax policy change in the previous section show that liberalization and rational updating are both plausible hypotheses about the outcome of the 1992 Norwegian tax reform. Yet, whether these sources give rise to a liberal or a rational policy change will depend on *political institutions*. The institutional setting shapes both the perceptions of structural problems and constraints, the development and transmission of ideas, and the political processes of policy change. The topic of this section is how Norwegian political institutions influence processes and outcomes of policy change.

To start with the fundamentals: What are political institutions, and how do they shape policy? I understand political institutions simply as a state's legislative, executive and administrative bodies, and their regular practices. For instance, this definition encompasses work in the ministries, public commissions and regularized consultations with interest groups. The basic tenet of the institutionalist tradition is that political institutions shape policy by structuring politics. Different political institutions lead to different politics, which produce cross-national variation in policies. There is, however, less agreement on how and to what extent this happens.

The present study leans on Sven Steinmo's wide notion of how institutions structure politics. He argues that political institutions (1) define *which actors dominate* the policy-making process, (2) shape the *strategies* of these actors, and (3) influence their *policy preferences* (Steinmo 1993; 2002). Thus, the perspective of this study is that political institutions shape the dynamics and outcomes of policy change by structuring the participation, strategies and preferences of political actors.

The Norwegian tax reform of 1992 was a case of large-scale policy change. Hence, this section continues with a general discussion of what kind of institutional settings are conducive to fundamental change. I then discuss specifically whether the Norwegian institutional setting is favorable to authoritative policy change. I argue that the consensual character of the Norwegian political system may be conducive to large-scale, updating policy change. I then sketch the main features of the Norwegian model of consensual policy-making. The final

section of this chapter (2.5) looks at the role of political actors operating within this institutional context.

2.4.2 Political institutions and large-scale policy change

To what extent do political institutions allow for authoritative policy change? And what kind of institutional settings favor such change? The institutionalist literature on change in advanced political economies has tended to emphasize the *difficulty of authoritative policy change* due to the high barriers to change represented by political institutions and actors. This conclusion is partly based on features of *all* political institutions, and partly on features of *specific* political institutional settings.

In his famous article about path dependence and increasing returns, Paul Pierson (2000) presents a general argument about how the dynamics of politics make fundamental policy shifts difficult. His point is that increasing returns processes prevalent in politics generate growing barriers to fundamental policy shifts, which privileges incremental, path dependent change. Therefore, authoritative policy change is generally difficult in politics.

Nonetheless, the difficulty of authoritative policy change is believed to vary between different political systems. Some institutional settings have a stronger status quo bias than others. Tsebelis' (1995) 'veto player' framework is often used to model this variation. This theory says that the barriers to reform grow with the number of actors or bodies that can veto change, with the ideological distance between the actors, and with their degree of internal cohesion.

Systems with many veto players or veto points will thus present high barriers to authoritative policy change. For instance, Hacker (2005) finds that the multiple veto points of American political institutions make fundamental, policy-updating reforms very difficult, and also gives actors incentives to pursue strategies that further heighten the barriers to change.

Conversely, institutional settings with few veto points/players will be more conducive to large-scale policy change. In such settings, governments have greater opportunity to implement authoritative policy change on their own. Typically, the majoritarian political systems characterized by majority voting and few institutional checks represent this kind of institutional setting. Prominent examples are the UK, Australia and New Zealand. In these

systems, it is easier for the government to implement large-scale reform, since it usually controls an absolute majority in parliament.

Yet, the veto player framework only provides part of the answer to when large-scale policy change is possible. As suggested in section 2.2.4, fundamental policy change is not necessarily the result of strong governments exerting unchecked power. It can also be the product of broad-based political compromise. That is, *institutional settings characterized by a consensual style of policy-making may also be conducive to large-scale reform*. The Nordic political systems represent this kind of institutional setting.

Consensual systems do not really conform to the logic of the veto player framework. As political parties within these systems usually work together rather than against each other, the notion of ‘veto’ seems misleading analytically. Often, policy compromises include more parties than what is necessary for a legislative majority, so that determining which of the parties that have ‘veto’ power is difficult (and perhaps not very fruitful). This does not mean that change will automatically be easier in consensual systems. It simply suggests that we need other tools to analyze under which circumstances these systems are conducive to change.

Putting more emphasis on institutional culture may give us greater analytical leverage on the consensual systems. The simple cultural argument is that in consensual settings, parties are more inclined to work together, which *ceteris paribus* makes it easier to agree on fundamental reforms. The government will invite the opposition to participate in policy-formulation, and the opposition will seek to influence the government’s reform proposals rather than to block them.

2.4.3 Do Norwegian political institutions favor large-scale reform?

Corresponding to the general discussion, there are two perspectives on whether Norwegian political institutions favor large-scale reform. The first view is that authoritative policy change is difficult in Norway because of the large number of veto players. Since the mid-70s, minority coalition governments and multiple parties represented in parliament have been typical features of the Norwegian political system. The argument is that this fragmentation of power has made it difficult for Norwegian governments to pursue fundamental reform (e.g. Christensen and Lægreid 2007:9). “Such conditions create problems with executive

governance; that is, with the central capacity to decide on and implement policies,” as Christensen (2003:169) argues.

However, the present study rests on an alternative view. This view emphasizes that the consensual style of policy-making in Norwegian political institutions makes authoritative policy change possible. Or at least, consensual politics makes large-scale reform feasible under certain conditions.

Tranøy (2000), drawing on Katzenstein (1983; 1985), argues that *in times of crisis* the consensus-oriented Norwegian system can be expected to produce fundamental updating reform. This contention is pertinent to this study, as the Norwegian economy was in crisis from the mid-1980s until the early 1990s, with first an uncontrolled credit expansion and then a strong economic downturn (see section 2.3.2).

Tranøy argues that in the absence of crisis, the compromise culture will impede large-scale change. But in the presence of crisis, “the real strength of this culture and institutional set up as a system for producing tough decisions can be expected to come through ... [I]n such circumstances elites can be expected to cut through what in good times appeared to be irreconcilable differences, redefine interests through learning and find new common ground” (Tranøy 2000:87).

This argument not only posits a relationship between consensual political institutions and large-scale reform. It also suggests a link between consensus-based large-scale reform and outcomes of rational updating. That is, authoritative policy change that is founded on broad consensus – rather than on a strong government acting alone – may be more conducive to continuity in outcomes. In times of crisis, political actors in the Norwegian system come together to improve policy through fundamental but balanced policy revisions. This suggests rational updating rather than liberalization. Hence, the Norwegian institutional setting may constitute an important element in the explanation of the process of change and the substantial outcomes of the 1992 tax reform.

In the next sub-sections, I discuss consensual policy-making in Norwegian political institutions. I first look at the link between politics and policy in the Nordic model of decision-making. Second, I discuss the three dimensions of consensus and the corresponding

implications for policy output. Third, I sketch the structural features and mechanisms that generate consensus in the Nordic systems.

2.4.4 A Nordic model of decision-making

In the literature, the workings of Norwegian political institutions are regarded as very similar to those of the other Nordic countries. Many scholars have argued that there is a distinct Nordic model of decision-making (e.g. Elder *et al.* 1982; Arter 1999; Hilson 2008). Not only do political institutions in the Nordic countries work in similar ways, they also diverge significantly from the political dynamics of other advanced democracies. For this reason, the following theoretical discussion concerns the *Nordic* model of government. Where the Norwegian political system differs from the others, this is pointed out.

An attempt at summarizing this model would be that Nordic political institutions produce *consensual politics capable of generating rational and stable policies*. This definition touches both the character of politics, policy, and the link between the two.

First, politics in the Nordic countries are predominantly consensual rather than adversarial (Elder *et al.* 1982). As opposed to conflictual systems like the British, Nordic politics are more about cooperation than confrontation. With reference to Steinmo's conceptualization, Nordic political institutions allow a multitude of actors to take part in policy-formulation, provide incentives for cooperative strategies and generate convergence in preferences.

Second, these consensual politics are connected to a relatively strong ability to produce public policy. That is, Nordic political institutions are more workshops than talk shops. The capacity to produce policy sets the Nordic political systems apart from the consensual but immobilist systems of many consociational democracies (Arter 1999:147).

Third, Nordic decision-making institutions arguably produce policies that are generally rational and robust. That is, decisions are both well founded – in the sense that they are based on expert knowledge – and stable, seldom being reversed by subsequent government of different political color. In this respect, the Nordic systems differ markedly from for instance the British political system, where policy tends to be less expert-based, and where a change of government often implies considerable policy shifts (e.g. Steinmo 1993).

These brief points place the Nordic decision-making model in a comparative perspective and suggest that Nordic political institutions may be expected to transform interests and preferences into policies in a specific way. However, exploring the specific mechanisms at work within these institutions is crucial for understanding *how* they might shape processes and outcomes of change.

The concept of ‘consensual policy-making’ will necessarily be at the centre of a discussion of the concrete workings of the Nordic decision-making model. ‘Consensus’ implies that decisions rest on agreement among all the major parties to them. I will first explore the three dimensions of consensus in Nordic political institutions (sub-section 2.4.5), and then go on to show how ‘consensus’ has both a static and a dynamic component (sub-section 2.4.6).

2.4.5 Three dimensions of consensus

In Nordic decision-making, one can speak of consensus along three dimensions: (1) among political parties, (2) between politicians and experts, and (3) between government and organized interests. These three axes of consensus are important for several reasons. In terms of politics, they suggest both who the dominant actors in policy-making are (a multitude) and what kind of political strategies they employ (cooperative). But the three dimensions of consensus also give us a clue about the character of policy output.

First, consensus along the purely political dimension implies that the political parties in the Nordic countries to a large extent are willing to work together to find compromises on important policy issues (Arter 1999: chap. 9). The result in terms of policy is often compromises that to some degree reflect the preferences of all parties behind them. A crucial point is that this consensus not only applies to a specific moment, but to politics *over time*. For instance, governments of different political color alternating in power may together carry out a coherent sequence of policy changes. More generally, the implication is that compromises tend to stick and that policy will exhibit greater stability.

Second, the relationship between politicians and experts is marked by cooperation and mutual respect. Expert knowledge is generally regarded as a necessary foundation for efficient policy solutions to political problems. Observers have thus applied labels such as ‘technocracy’ and

‘social engineering’ to the Nordic systems (Lane 1992; Slagstad 1998). Most importantly, civil servants play a large role in the policy formulation process (e.g. Olsen 1980). But also experts on public commissions may have considerable influence on policy. Taken together, this suggests that policy emanating from Nordic decision-making institutions will be highly rational. With reference to the previous point, expert recommendations often constitute the basis for political compromise. The involvement of the bureaucracy also strengthens the stability of policy, since policy solutions will be firmly anchored in the bureaucracy.

Third, government works closely with interest groups in the formulation of policy (Olsen 1983; Nordby 1994). This practice is often described as corporatism. Most importantly, economic policy-making usually involves intense consultation with the central trade union and employer federations. There are especially strong ties between social democratic parties and trade unions on the one hand (Arter 1999:147), and conservative parties and employers on the other. These organizations are exceptionally strong in the Nordic countries and represent political players that cannot be ignored (Pierson 2001). Large changes in economic policy rarely pass without the consent of the industrial partners. Policy arrived at through consultation typically enjoys strong legitimacy among interest groups, which increases its robustness. The other side of the coin is the possibility of policy that caters to special interests.

2.4.6 Structural features and mechanisms for consensus-generation

Is consensus a structural feature underlying politics in the Nordic countries, or is it generated through political institutions? Nordic consensual policy-making appears to be a combination of the two. While the structural conditions clearly favor consensual politics, the ability to reach compromise is greatly enhanced by mechanisms operative in the political system.

Structurally, the Nordic countries are small with homogenous populations that historically have enjoyed strong equality in economic and social terms. This has a couple of important implications. First, there is – in comparative perspective – little variation in values and attitudes, what Lijphart (1969) labels a “homogenous political culture”. Norms and values are widely shared, something that is reflected in the political system (Christensen and Peters 1999). There is much common ground upon which political solutions can be founded. The political distance between the main parties is generally small – in certain areas minuscule. In

other words, there is relative *initial consensus*, which lays the ground for the politics of compromise and thus also policy compromises.

A related point is that these structural conditions have contributed to high trust and social cohesion in the Nordic countries, including strong trust in political institutions. This appears to support compromise decisions, since the electorate is more confident that losses in one area will be compensated by gains in another.

Second, the small size of the Nordic countries has given rise to strong personal relations within political elites. This personalisation appears to facilitate political cooperation. As Arter points out, “the christian-name relations between decision-makers has enhanced the tendency to ‘win some, lose some’ compromises” (Arter 1999:149).

However, this is only part of the story. It is difficult to separate these structural preconditions cleanly from institutions, since the features they give rise to are constituted within political institutions and thus shaped by them. For instance, the idea of an initial consensus only makes sense within some kind of political-institutional context. This again suggests the importance of Nordic political institutions in general, and of the mechanisms for consensus-generation at work within these institutions in particular. We now turn to these specific mechanisms.

The procedures for preparing public policy in the Nordic countries are generally very elaborate and deliberative (Arter 1999). On the way from registration of political problems to the implementation of policy, there are (at least) four major mechanisms at work that tend to generate consensus along one or more dimensions.

The practice of appointing *public commissions* of enquiry to investigate major policy issues is usually the first step towards policy reform, and represents an important mechanism for consensus-generation (e.g. Elder *et al.* 1982). Commissions are either composed exclusively of experts – both bureaucratic and external – or incorporate politicians and representatives from interest groups as well. Commission work usually has a strong rational bias, as the appropriate basis for conclusions is ‘objective’ knowledge and arguments about what is best for society as a whole. The commission produces a joint report, usually with common policy recommendations, which lays the ground for the subsequent process towards policy change.

Public commissions potentially generate consensus by influencing both the strategies and the preferences of actors – along all three dimensions. For one, commission reports can produce convergence in political preferences, as initially diverging (or unspecified) views are revised (or formed) in the face of new arguments. This also concerns the politician-expert dimension, as expert knowledge is applied to concrete political problems and politicians are exposed to expert arguments.

For another, the work of the public commissions can make it easier for political actors to pursue cooperative political strategies. Commission reports often serve as a neutral and rational point of reference for political compromise. Information about the positions of other players and a clear idea about a compromise outcome lower the costs of committing to cooperation for reform.

The second mechanism for consensus-generation is *policy work in the bureaucracy*. Major policy proposals are usually based on intensive work in the ministries over a long period of time. During these processes, the political leadership and the bureaucrats work closely together. This interaction generates shared understandings of problems and solutions between politicians and experts in the public service. More specifically, the preferences of the incumbent party tend to shift in a rationalistic direction, as the political leadership in the ministries is exposed to expert arguments. Additionally, intense bureaucratic scrutiny seems to enhance the prospects for cooperative political strategies in the same way as commission reports. When a proposition is well researched, the opposition's uncertainty about outcomes decreases, making it easier to engage in political cooperation.

The third mechanism is the formal and informal *consultation with interest groups* as part of the policy process (Olsen 1983; Nordby 1994). Formally, a wide array of organized interests are integrated in policy-formulation through the remiss procedure. Informal consultations with the peak trade union and employer federations, however, are usually more politically consequential. This institutionalized practice influences the strategies of interest groups, giving them incentives to pursue a line of compromise inside the system rather than one of confrontation outside the system. Thereby, it strengthens consensus between government and interest groups.

Fourth and finally, *parliamentary committees* represent a strong mechanism for generating compromise between political parties (Arter 1999: chap. 9). In Norway, the real work in parliament takes place in the committees. Here, government proposals are subject to intense discussion and bargaining behind closed doors. The committee then delivers its opinion, which in many cases is unanimous, and in nearly all cases is passed by parliament without amendments. Parliamentary committees are thus bodies with both great discretion and an atmosphere for speaking freely and brokering deals. This induces political parties to pursue strategies of compromise, as the benefits from striking political deals increase, while the costs of abandoning earlier positions decrease.

To sum up, Nordic political institutions shape policies by structuring politics. First, they allow a multitude of actors to participate in the formulation of policy. In addition to the party in government, bureaucratic experts have a strong role, and also opposition parties and interest groups potentially have considerable influence. Second, Nordic political institutions appear to induce actors to pursue strategies of cooperation. A number of mechanisms lower the costs of engaging in collective action to reach compromise. Third, institutional practices influence the policy preferences of actors, potentially generating convergence towards solutions based on expert knowledge and rational reasoning. Altogether, the institutional setting appears to favor stable, rationally founded policy compromises.

2.5 Political actors: Labor and Conservatives

2.5.1 Institutions and actors

To think that political institutions alone could explain processes and outcomes of policy change, however, would be an illusion. Institutions and the organizations/actors that operate within them are in permanent interaction, shaping both each other and the policy output (North 1990). Even if institutions influence the preferences and strategies of actors, it is after all actors that think and act. Actors desire policy change or stability, decide whether to work with or against each other, and support or reject reform proposals. To account for the development of tax policy, therefore, we need a notion of the specific actors working within this institutional setting. That is, in the field of tax policy, what strategies could we expect the important actors within Nordic political institutions to pursue?

I focus on two specific actors: Labor and Conservative parties. The reason is that these two can be expected to be the crucial actors in economic policy-making in Norway from the 1980s onwards. The social democratic Labor party dominated Norwegian politics from the end of the war, while the blue wave of the 1980s brought the Conservative party to power. The question is then: Could we expect the Norwegian Labor party and Conservative party, respectively, to work for tax policy change in the 1980s and 90s? And if so: for what kind of change?

In the literature on institutional change in advanced political economies, the structure of the political struggle within institutions typically accounts for change (or the lack thereof). This is usually a battle between the defenders and the opponents of the welfare state or the old political-economic regime. For instance, a coalition of the welfare state's defenders block dismantling reform (Pierson 2001), or opponents of the welfare state let services decay by blocking recalibration reform (Hacker 2005).

When it comes to Norwegian tax policy in the 1980s and 90s, however, identifying defenders and opponents is not straightforward. Labor and Conservatives alike would have had reasons for both defending and opposing the existing tax regime. Neither were their preferences clear-cut, nor was the choice of strategy for pursuing them obvious. On the basis of these ambiguities, we can sketch out the alternative strategies for each of the parties.

2.5.2 The Labor party

The old tax policy regime can be considered as an integral part of the broader social democratic post-war economic model. There were high ambitions for both redistribution and industrial policy through taxation. Rates were strongly progressive, while tax incentives allowed politicians to direct capital to sectors or businesses considered important. Among Social Democrats, these ideas still had considerable support in the 1980s.

On the other hand, the existing literature suggests that the old tax system was largely ineffective in achieving its objectives, both of equity, efficiency and revenue (Ganghof 2007). This likely worried many social democrats, especially since it threatened the welfare state, the very heart of the social democratic model. Not only did a malfunctioning tax system weaken the financial basis of the welfare state, it could also threaten its legitimacy.

The choice for Labor was therefore whether to scrap the tax policy component of the traditional social democratic model – including the great ambitions for redistributive taxation and active industrial policy – for the prospect of a better functioning but more market-based system. And more crucially: to what extent and in what manner should they conform tax policy to the economic logic of free markets?

In his study of Swedish tax policy development, Steinmo discusses the strategy of the Social Democrats in this situation. Within the party and the labor movement more broadly, there were considerable divisions on the subject of tax reform. The Social Democratic Finance Minister, however, was a strong proponent of taking a more market-oriented course. In the end, this view prevailed. The Social Democrats struck a deal with the Liberal party, securing support for a tax policy reform that represented a clear turn in a more market-oriented direction (Steinmo 1993:185-191).

Although Steinmo finds a case of strong social democratic reformism, his account also suggests that this course was not inevitable. Generally, Nordic social democratic parties appear to have faced situations of real choice. They could work more or less actively for reform, and they could pursue more or less market-oriented reform agendas.

2.5.3 The Conservative party

Likewise, we can reasonably expect that the Conservative party was ambivalent with regard to the existing tax system, albeit for different reasons. Conservatives were generally opposed to the high total level of taxation and high marginal tax rates on individuals.

On the other hand, the existing literature suggests that some of the Conservatives' core constituencies profited from the extant tax system. Because of all the tax incentives and deductions, certain sectors and businesses in practice paid little or no taxes. And liberal interest deduction rules favored those with high incomes and the ability to take up large loans (Ganghof 2007). Moreover, Conservatives profited politically from a tax system that worked badly. The greater the pathologies of the tax system, the more people identified with the conservative opposition to taxation.

This leads to an interesting discussion concerning the strategies of Conservative parties: First, a reasonable assumption is that Conservatives would work whole-heartedly for a purely liberal reform. But given the choice between some kind of reform and no reform, what would they choose? The preceding discussion suggests that the answer is not obvious.

The crucial decision for Conservative parties thus appears to have been whether to work for reform or block reform. Hacker (2005) provides a thorough discussion of these alternative Conservative strategies in his study of US welfare state retrenchment. His point is that for Conservatives with the political goal of liberalization, working against updating reforms can be a more effective strategy than actively pursuing liberal reform.

This point seems relevant for the politics of Norwegian tax policy in the 1980s as well. Not only was blocking tax reform potentially politically advantageous for the Conservatives. It could also have represented an effective assault on the welfare state. Without tax reform, both the financial basis and the legitimacy of the welfare state could wither away. However, whether the opposition to the welfare state was sufficiently strong among Norwegian Conservatives is questionable.

Also, Hacker (2005:75) points out that a blocking strategy is especially effective when the barriers to institutional change are high. In Norway, Conservative parties were not strong enough to block reform by themselves, implying that Labor and centrist parties could have passed reform without Conservative support. For Conservatives, working against reform thus implied the risk of ending up with a reform they had had no influence over. The question remains, however, how actively and on what terms Norwegian Conservatives would participate in the tax reform process. As this marks the end of our discussion of theoretical issues, we now to the research design and methodology of the study.

Chapter 3: Research design and methodology

3.1 A case study of the 1992 Norwegian tax reform

How do I investigate the research questions? This chapter discusses the research design and the methodology I use to study the Norwegian tax reform of 1992. The present study is designed as a case study and takes a mechanism-based approach to explanation. It relies mainly on the methodology of process tracing, based on data from qualitative interviews and public documents. It must be noted that this methodological discussion concerns the explanatory part of the research question. To answer the descriptive part - what was the outcome of the 1992 reform? - I mainly rely on existing statistical studies. This method is commented under section 3.5.

In this chapter, I outline my approach and discuss both the reasons for choosing it and the problems and weaknesses related to it. First, I present the double ambition of this case study (section 3.2). Then, I sketch the mechanism-based approach, and discuss it in terms of internal and external validity (section 3.3). In section 3.4, I outline the main features of the methodology of process tracing. Finally, in section 3.5, I discuss the specific methods and sources of data used, with particular attention to the qualitative interviews.

3.2 The double ambition of the case study

This piece of research on tax policy change in Norway is designed as a case study. It is “an intensive study of a single unit for the purpose of understanding a larger class of (similar) units” (Gerring 2004:342). At the core of this notion of case studies is their double function. Case studies are at the same time studies of something particular and something general. “The case study research design constructs cases from a single unit while remaining attentive to inferences that span similar units outside the formal scope of investigation”, as Gerring (2004:353) puts it.

Thus, case studies aim both to develop specific propositions about the unit in question *and* to draw general inferences from these findings to a larger set of units. In other words, case studies have the double ambition of *explanation of a specific case* and *generalization to a*

class of cases (Gerring 2007:76). These two endeavours are closely related, as findings about the particular case constitute the empirical basis for making general inferences.

This double ambition is fundamental in the present study. For one, this is a study of a particular unit in itself, that is, of tax policy change in Norway since the 1980s. The goal is to determine the outcome of tax policy changes and to explain what brought about large-scale tax policy reform. This includes the investigation of the specific interactions between variables. At the same time, this is a case study of a broader class of units. The aim is to generalize findings from this case across a larger set of cases.

But what exactly is the Norwegian tax reform of 1992 a case of? As Ragin (1992) and others point out, this is a theoretical question. Since my three research questions refer to partly different bodies of theoretical literature, they give rise to different specifications of the theoretical universe. “[D]ifferent propositions within the same work commonly apply to different populations”, notes Gerring (2004:345). Also, arguments may have both a manifest and a potential scope (Gerring 2007:83). That is, a proposition may be clearly relevant for a limited set of cases, but also potentially applicable to a broader category. To handle this complexity, a differentiated definition of the theoretical universe is necessary.

First, the Norwegian tax reform is a case of modern tax policy change, in particular in the Nordic countries, when it comes to understanding and explaining policy change (questions 1 and 3). Second, it is a case of a broader theoretical category, namely policy regime change in advanced political economies, when the link between processes and outcomes of change is at issue (question 2). This is also the potential scope for arguments about the interaction between structural, ideational and institutional factors behind policy change (question 3). Third, the Norwegian tax reform provides a case of how Nordic political institutions affect policy change (question 3).

3.3 A mechanism-based approach

3.3.1 The search for social mechanisms

How do I attempt to realize the double ambition of causal explanation (internal validity) and generalization (external validity) through the study of a single unit? I employ the approach of

causal reconstruction, or what some would call a mechanism-based approach. This approach “does not look for statistical relationships among variables but ... seeks to explain a given social phenomenon ... by identifying the processes through which it is generated” (Mayntz 2004:238).

My study is therefore devoted to the search for *mechanisms*, that is, “recurrent processes linking specified initial conditions and a specific outcome” (Mayntz 2004:241). The goal is to uncover both mechanisms that bring about large-scale policy change – institutional mechanisms in particular – and mechanisms that connect large-scale reform to substantive outcomes. This approach is closely tied to the method of process-tracing, which I will discuss in section 3.3. In this section, I start at the fundamental level, by presenting the ontological assumptions of this approach. I then discuss the approach in terms of causal explanation, before I turn to the question of generalization.

3.3.2 Ontological assumptions

Ontology is a set of assumptions about how the world works (independent of our perceptions). Ontological assumptions are fundamental in research, as “[w]hat one finds is contingent upon what one looks for, and what one looks for is contingent upon what one expects to find” (Gerring 2004:351). Ontologically, case studies occupy a middle ground between the extreme nomothetic and ideographic positions (Gerring 2004:352). Case study research is based on the assumption that units are neither entirely comparable nor non-comparable. If units were all the same, studying one case in particular would not make sense. If units had nothing in common, the concept of a ‘case’ loses its meaning.

The approach of causal reconstruction is thus founded on the assumption that (some) sequences of real events have similar properties. These are referred to as *causal mechanisms*, which can be defined as “sequences of causally linked events that occur repeatedly in reality if certain conditions are given” (Mayntz 2004:241). In other words, mechanisms constitute the causal chain – the intermediate steps – between an initial cause X and an outcome Y.

3.3.3 Causal explanation

How fruitful is the mechanism-based approach for causal explanation? Causal reconstruction constitutes an approach to causal explanation that differs markedly from correlational analysis in quantitative research. While correlational analysis seeks to establish the *causal effect* from variable X on variable Y, the goal of causal reconstruction is to find the *causal mechanisms* that connect X and Y. Whereas the former approach estimates the statistical relationship between variables, the aim of the latter is to find out *why* such a relationship exists. In other words, causal reconstruction means spelling out the causal chain that connects initial conditions to outcomes (Mayntz 2004:254).

As a consequence, case studies based on causal reconstruction give us greater causal insight into mechanisms than effects (Gerring 2004:348). Case studies are usually unfit to determine the strength and probability of the effect of X on Y. They can, however, tell us a great deal about the causal chain through which this effect works. The basic argument is that detailed investigation of processes can bring the researcher so close to the empirical world that the distinct causal links leading to an outcome are rendered visible. Case studies – if well constructed – allow the researcher to “peer into the box of causality,” as Gerring (2004:348) puts it. In particular, close-up investigation often gives researchers the opportunity to examine the motivations of the actors involved. This insight into the intentions of actors is crucial for establishing causality.

Moreover, George and Bennett (2005:22) argue that this approach is favorable for investigating *complex causality*. They contend that causal reconstruction is necessary to uncover complex interactions and allows for the modelling of such complex causal relations. Since the present study seeks to explore the interactions between structural, ideational and institutional factors, this represents an important reason for employing the mechanism-based approach.

Yet, does the inability to ascertain causal effects make the approach of causal reconstruction inferior to correlational analysis in terms of internal validity? King, Keohane and Verba (1994), for instance, suggest that causal mechanisms are somehow less important to causal explanation than causal effects. George and Bennett (2005), Gerring (2004) and Mayntz (2004), however, all argue that the two elements are equally important, and complementary.

On the one hand, the search for mechanisms is usually based on an observed or suspected regularity or correlation (Mayntz 2004:253). Logically, the “what” question investigated through correlational analysis is prior to the “how” question studied through causal reconstruction. On the other hand, finding plausible mechanisms that connect X to Y is a necessary condition for moving from covariation to causation (Gerring 2004:348). As large-N statistical analysis offers “inherently limited representations of causal processes” (Mayntz 2004:238), causal reconstruction is crucial to fill in the large explanatory gaps.

3.3.4 Generalization

The second important question concerns the external validity of the mechanism-based approach. To what extent can we generalize the findings from a case study based on causal reconstruction? Traditionally, the view that one cannot draw general inferences from case studies has been common. The argument is that a single case does not tell us anything general about a larger class of units, since it is not representative of this class (e.g. Geddes 2003:134). Due to the problem of representativeness, case study research is relatively weaker in terms of external than internal validity (Gerring 2007:43).

However, it would be wrong to conclude that case studies are worthless for generating general insights. Case study research relies on a different type of generalization, often labelled ‘analytical generalization’ (Yin 2003:10). Although a single case can never be statistically representative of a larger population, it can be analytically representative. That is, the observed unit can be regarded as typical of a larger class of units (Walton 1992:125). Provided that the unit is indeed typical, findings from this one case will be relevant for the larger class of cases.

Analytical generalization is therefore based on theoretical arguments about the similarities between cases. The validity of general inferences drawn from a case depends on our ability to define how the unit of observation fits into a theoretical universe. Importantly, this kind of generalization involves processes, not correlations (Mayntz 2004:238). The goal is to find general mechanisms, not general covariations. A case is analytically representative when we can expect the causal processes in this case to be similar to those that characterize a broader class of cases. When this is the case, our observations regarding the causal mechanisms in this

unit can increase our general understanding of this kind of causal processes (Walton 1992:134-135).

An important objection is that this kind of generalization does not allow for the falsification of theory. As single cases are not statistically representative, rigorous testing of theory is impossible. On the basis that confirmation or disconfirmation of theory is integral to the research enterprise, some would question the contribution of case studies to the progress of general theory. However, although case studies are generally unfit to confirm or disconfirm theory, they contribute to *theory development* in a broader sense (George and Bennett 2005). The mechanism-based approach implies detailed exploration of theoretical relationships, which may allow us to refine, elaborate or specify theory.

In relation to this, it is important to note that the goal of case studies is usually to develop limited rather than broad generalizations. Arguments often apply to a specific region or a specific type of systems. As George and Bennett (2005:31) point out, “case study researchers generally sacrifice the parsimony and broad applicability of their theories to develop cumulatively contingent generalizations that apply to well-defined types or subtypes of cases with a high degree of explanatory richness”. This applies also to the present study, as the manifest scope of its arguments is a limited number of units. Yet, this does not exclude that findings can potentially contribute to a broader theoretical debate as well.

3.4 A methodology of process tracing

This study employs the method of *process tracing* (George and Bennett 2005; Gerring 2007) to investigate the research question. Process tracing involves the minute tracing of every link in the chain of events that led to a specific outcome. This is in line with a mechanism-based approach, as close-up empirical investigation of processes is crucial in the search for causal mechanisms. I investigate the process behind the 1992 Norwegian tax reform in detail, with the aim of determining which mechanisms generated reform. By tracing this process, I try to ascertain *how* structural, ideational and institutional contributed to large-scale reform. In particular, process tracing allows me to study the specific interaction between these factors.

But what exactly does process tracing imply? I would describe this method as close-up empirical investigation focused on the pieces of reality that are part of a specific causal

process. In other words, it is the combination of in-depth study and focus on causal chains that characterizes this method.

However, is getting really close to the empirical world a sufficient condition for identifying mechanisms? Gerring (2007:180) rejects this contention, arguing that process tracing relies heavily on general assumptions about the world, which can be either highly theoretical or commonsensical. Epistemologically, it is the combination of empirical study and general knowledge that makes it possible to determine the causal mechanisms behind an outcome. To make sense of the empirical observations of a process at the micro level, the researcher needs to assume a great deal about how the world functions. Gerring contends that “case study research usually relies heavily on contextual evidence and deductive logic to reconstruct causality within a single case” (Gerring 2007:172).

To reconstruct causality, the method of process tracing in practice relies on a “*counterfactual style of analysis*,” Gerring argues (2007:182, emphasis added). When tracing a process, the “multiple links cannot be tested in a rigorous fashion. Usually, the author is forced to reconstruct a plausible account on the basis of what I have called Counterfactual Comparison (what would have happened if X1 were different?)”.

This point is highly relevant for the present study. In my study, counterfactual reasoning is important in the construction of arguments about causal links. In particular, thought experiments of this kind help determine the necessary conditions for an outcome. I agree with Berman (2001:243), who argues that “counterfactual arguments [represent] a powerful tool in assessing the validity of different causal hypotheses”.

3.4 Specific methods and data sources

3.4.1 Methods: purpose, strengths and weaknesses

This study relies on three main sources of data: interviews with policy-makers and experts; public documents; and secondary statistical economic literature. These types of data are used for different purposes. While interviews and public documents are used to trace the reform process, existing statistical economic studies are the basis for the discussion of the outcome of reform. I first briefly present my use of secondary literature and public documents, before I

give a lengthy discussion of the interviews, which deserve particular methodological attention. I discuss the reasons for using each kind of data, the specific method employed, and the related weaknesses and pitfalls.

3.4.2 Secondary use of statistical studies

To determine the outcome of tax reform, this study relies mainly on existing quantitative studies. These are statistical studies that estimate the effect of tax policy changes on key variables such as equality, efficiency, revenue, etc. Mostly, these studies are produced by researchers at Statistics Norway. My use of these sources amounts to interpreting their conclusions carefully and reporting the relevant results and the conditions for these estimates. In terms of validity, the main problem with relying on these data is a possible bias towards effects of reform than can be quantified. To reduce this problem, I have complemented the quantitative data with key actors' interpretations of the consequences of the 1992 tax reform, as provided by the qualitative interviews.

3.4.3 Reading of public documents

The reading of public documents has been fundamental for understanding how Norwegian tax policy has developed. In particular, public commission reports (NOU 1984; NOU 1989; NOU 2003) have provided invaluable insight, both into the objectives and workings of the Norwegian tax system and into the evolution of tax policy ideas in a Norwegian context. In addition, the official political documents from the years preceding the 1992 tax reform were part of the analysis of this reform process.

However, this study uses the latter type of documents with caution. Relying exclusively on this kind of tax policy documents entails problems in terms of validity, as such documents mainly treat tax rules. In the tax area, the relation between rules and outcomes is often counterintuitive. For instance, high formal tax rates do not necessarily imply strong real redistribution. Thus, reading tax policy documents can give rise to wrong conclusions without an interpretation of how these rules work in practice. In this regard, the interviews played an important role.

3.4.4 Qualitative interviews with policy-makers and experts

In this study, interviews with policy-makers and experts constitute the most important source of primary empirical data. In late 2008 and early 2009, I conducted interviews with 13 central policy-makers and experts in the tax area (cf. Table 3.1). The policy-makers interviewed were important figures in the development of Norwegian tax policy from the 1970s to the 2000s. In particular, I spoke to most of the central actors in the process leading up to the 1992 tax reform.

Six former Norwegian Finance Ministers were interviewed. Between them, these politicians were at the head of the Ministry of Finance for 20 out of the 30 years from 1971 to 2000. In particular, I spoke to all three Finance Ministers in the ‘reform years’ from 1986 to 1992. Among the Finance Ministers interviewed, four were from the Labor Party, one from the Conservative Party, and one from the Centre Party.

In addition, I interviewed the two Under-secretaries of State that were responsible for tax policy in the Ministry of Finance in the final years before reform – one belonging to the Conservative Party, one to the Labor party. I also spoke to the two Members of Parliament that were most involved in tax policy questions in the same period, and who were central in the political bargaining process that led up to the 1992 tax reform. One belonged to the Labor party, the other to the Conservatives. Additionally, I interviewed the two leading tax policy bureaucrats from the late 1980s onwards, plus an academic expert on tax policy.

Table 3.1: Interviews with policy-makers and experts

Name	Position	Party	Period	Date of interview
1. Ragnar Christiansen	Finance Minister	Labor	1971-72	03.02.09
2. Per Kleppe	Finance Minister	Labor	1973-79	14.10.08
3. Arne Skauge	Finance Minister	Conservative	1986, 89-90	26.01.09
4. Gunnar Berge	Finance Minister	Labor	1986-89	19.01.09
5. Sigbjørn Johnsen	Finance Minister	Labor	1990-96	12.02.09
6. Gudmund Restad	Finance Minister	Centre	1997-2000	02.02.09
7. Trond Reinertsen	Under-Secretary of State, Ministry of Finance	Conservative	1989-1990	04.02.09
8. Svein Harald Øygard	Under-Secretary of State,	Labor	1990-1994	13.02.09

	Ministry of Finance			
9. Johan C. Løken	Member of Parliament, Finance Committee	Conservative	1983-93	09.02.09
10. Thor-Eirik Gulbrandsen	Member of Parliament, Finance Committee	Labor	1981-85, 89- 93	07.02.09
11. Hans Henrik Scheel	Head of Department for Tax Economy, Ministry of Finance		1993- present	02.02.09
12. Thorbjørn Gjølstad	Head of Department for Tax Law, Ministry of Finance		1989- present	02.02.09
13. Vidar Christiansen	Professor of Economics, University of Oslo			11.02.09

The interviews were semi-structured, in the sense that they were based on a set of broad topics with corresponding questions. The interview guide is enclosed in appendix 1. The attention accorded to different topics varied, however, depending on the particular role and knowledge of the interviewees. The length of the interviews ranged from 45 minutes to three hours. All but two of the interviews were conducted face-to-face; the remaining two were done by telephone. The interviews were all personal, except for one double interview. The two economic bureaucrats were interviewed together, at their own request.

The qualitative interviews served a couple of distinct purposes. First and foremost, they were used to trace the political-administrative process leading up to the 1992 tax reform. The interviews provided invaluable insight into the attitudes, motivations and actions of different political actors. Crucially, the interviews illuminated the knowledge and the political judgments upon which the actions of policy-makers were founded. They clearly suggested which factors were important for the movement towards reform and which were not. The interviews thus constituted the basis for the explanation of reform, by shedding light on the causal chain that led from initial conditions to the passage of reform.

Second, the interviews illuminated the substantive development in Norwegian tax policy. They contributed to the understanding of how the tax system worked in different periods, and to the analysis of the substance of major policy shifts. In particular, the interviews with top bureaucrats and experts were important in this regard.

Problems of validity

There are, however, important methodological challenges related to qualitative interviewing. I first discuss problems of validity, then the reliability of the interview data. The question of validity concerns whether the collected data shed light on the issue we want to investigate. In this regard, the selection of informants is of particular interest. The methodological problem is that an unbalanced selection of informants could bias my interpretation of the reform process. If I only spoke to actors of a certain type, or with certain political affiliations or attitudes, I would run the risk of only hearing one part of the story. This would weaken my ability to draw valid inferences about the causal process.

Did I speak to the right people, or were important voices left out? I would argue that the selection of interviews is balanced both between different political views and between politicians and experts. First, both sides of politics, as well as different fractions within both left and right parties, are represented among the informants. Second, I spoke to both ‘pure’ politicians and ‘pure’ economists, as well as actors who had one foot in each camp.

The absence of representatives from unions or employers among the informants, however, represents a possible bias. The reason for leaving them out was that the other informants did not point out these organizations as particularly important in the tax reform process. The possibility that this has biased my understanding of the reform process is reduced by the fact that I posed explicit questions about the role of organizations in every interview. There is little reason to believe that these actors would understate the role of unions and employers, as corporatist influence is widely regarded as legitimate in the Norwegian system.

On a brighter note, the very limited number of policy-makers deeply involved in a technical field like tax policy made it possible to speak to pretty much all the central actors behind the 1992 reform. Provided that data are reliable and the investigation properly carried out, this enhances the prospects for presenting a valid picture of the process.

Problems of reliability

The second question concerns the reliability of the interview data. Can we trust what the informants say? How can we know that they speak the truth? If the accounts offered by informants are systematically biased or imprecise, we could draw wrong conclusions regarding what caused reform. I first discuss three particular problems: biases for political

reasons, post-hoc rationalization, and group dynamics. Then I discuss the techniques used to verify statements.

A first problem of reliability is that informants may distort information for political reasons. For instance, they may glorify the attitudes and actions of their own party, or exaggerate its importance in the reform process. To some degree, this is inevitable, as actors saw the process from different angles and cannot be expected to give a fully objective account of what happened. But more intentional misrepresentations are also possible. However, in this case the issue of investigation is not sensitive politically, as the reform process took place 20 years ago. None of the informants are any longer active politicians, which weakens their incentives to withhold or distort information.

Likely, post-hoc rationalization represents a more serious problem to the reliability of the interview data. Looking back, actors may unintentionally present their actions as more rational than what was really the case. For instance, actors may easily forget their initial opposition to what turned out to be a good solution, or their initial support for a system that today appears to have been highly inefficient.

This is a particular problem when trying to explain reform. The accounts offered by informants tend to emphasize that a particular reform was the only alternative or that “its time had come”. Although this may be true to some extent, the situation was likely less harmonic and the solutions less obvious at the time. This poses a serious challenge to the researcher. That the events at issue in this investigation occurred twenty years back (or more) likely exacerbates this problem.

Group dynamics represent a third problem, and is particular to the key interview with the two leading bureaucrats. The concern is that group interaction may bias interview data by amplifying certain perspectives and suppressing others. In particular, it may generate conformity to ‘appropriate’ opinions. However, two features of the interview in question appear to reduce this problem. First, the two interviewees were on an equal footing. They were on the same level in the bureaucratic hierarchy and had equally long experience. Thus, none of them appeared to have the power to influence the views expressed by the other. Second, they were equally active during the interview, both of them interrupting the other to offer supplementary information or a slightly divergent view.

To deal with these problems of reliability, cross-checking information was crucial. I employed this technique actively, checking the statements of my informants both against each other and against other information. Regarding the latter, confronting interview statements with actual actions in the relevant period was an important technique to limit post-hoc rationalization. Challenging the informants' statements in this manner often produced more nuanced accounts.

The former was even more important, as informants from both sides of politics and both politics and bureaucracy made it possible to gather multiple views on key issues. This was a powerful tool for ensuring the reliability of data, as it revealed both issues where the statements of differently placed actors corresponded perfectly, and areas where opinions differed – often along the political dimension. Where different pieces of information were (partly) incompatible, I have noted the divergences and drawn my conclusions with great caution.

Chapter 4: The reform process

4.1 The process in brief

In chapters 4 and 5 I present the empirical data. Chapter 5 discusses the outcomes of the 1992 tax reform. There, I find that the change in policy was characterized by rational updating rather than liberalization. In this chapter, I map out the process behind this reform. This is an analytical narrative about how large-scale tax reform became possible. It accounts for the crucial factors behind reform – structural, ideational and institutional – and the historical context in which they interacted.

I begin by sketching the *status quo ante*, i.e. the Norwegian tax policy regime of the 1970s and early 1980s (section 4.2). This tax structure was characterized by high tax rates and generous deductions. In section 4.3, I discuss how key political actors regarded this tax system. While the Labor party had great concerns about its effects on equality, the Conservatives criticized the high rate-regime for discouraging work and business, but were reluctant to give up the deductions. Economic experts had yet another definition of problems. Inspired by new ideas about taxation, they emphasized the negative effects of the tax system on efficiency (section 4.4). In sum, there was demand for tax reform in the early 1980s, but both the strength of this desire and the rationale for change varied among the central actors.

However, the boom and bust of the Norwegian economy in the mid-1980s – where tax policy played a major part – shook things up. Section 4.5 looks at the sequence of macro-economic events that precipitated a more fundamental remaking of tax policy. The tax policy ideas that were subsequently developed by the Aarbakke public tax commission provided the solutions necessary for such a reform (section 4.6). This blueprint served as the foundation for a tax reform compromise.

Section 4.7 looks at the political-administrative process from the publication of the Aarbakke report in 1989 to the tax reform proposition presented in 1991. In this period, the alternation in power and the emergence of economist politicians stimulated the reform effort. The last section (4.8) concerns the final reform negotiations in parliament, where Labor and Conservatives cooperated closely to finalize the tax reform. Table 4.1 provides an overview of the most important tax policy events and the governments in the period from 1980 to 1992.

Table 4.1: Important tax policy events and Norwegian governments from 1980 to 1992

	Norwegian tax policy events	Governments	External events
1980	> Labor tax reform proposal voted down by Conservatives	Labor minority PM: Nordli FM: Sand	
1981	> Appointment of Aune commission on personal taxation	Labor minority PM: Brundtland FM: Sand	
1982		Conservative minority PM: Willoch FM: Presthus	
1983			
1984	> Aune report: recommends 'rate reduction, base broadening' reform of personal taxation	Bourgeois majority coalition (H/KrF/Sp) PM: Willoch (H) FM: Presthus (H); Skauge (H)	Economic boom in Norway – credit expansion
1985			
1986			US tax reform
1987	> Personal tax reform passed (gross tax reform)	Labor minority PM: Brundtland FM: Berge	Danish tax reform (DIT)
1988	> Appointment of Aarbakke commission on corporate and capital taxation		Recession in Norway
1989	> October: Aarbakke report: recommends reform of entire tax system based on DIT > October: Labor endorse Aarbakke conclusions in budget		
1990	> May: Conservative white paper on tax reform	Bourgeois minority coalition (H/KrF/Sp) PM: Syse (H) FM: Skauge (H)	
1991	> April: Labor tax reform proposition > April-June: Negotiations in parliament between Labor and Conservatives > June: Tax reform passed	Labor minority PM: Brundtland FM: Johnsen	Swedish tax reform (DIT)
1992	> January: Tax reform enters into effect		

Abbreviations: DIT – dual income tax model; PM – Prime Minister; FM – Finance Minister; Ap – Labor party (*Arbeiderpartiet*); H – Conservative party (*Høyre*); KrF – Christian People's Party (*Kristelig Folkeparti*); Sp – Centre party (agrarian) (*Senterpartiet*)

4.2 The old tax policy regime

4.2.1 Activist post-war tax policy

In this section, I sketch the main features of the post-war Norwegian tax policy regime and how it evolved in the late 1970s and early 1980s. The structural problems of this system gave rise to demand for tax reform, as is discussed in sections 4.2 and 4.3.

The Norwegian post-war tax policy regime is best described as activist. Politicians employed tax policy as a tool for achieving a large array of goals, notably objectives of equality and social policy, industrial policy and district policy. For one, ambitions for redistributing income and wealth through taxation were high. For another, policy-makers actively used tax policy instruments to spur growth in certain sectors and businesses. Government directed the flow of capital by influencing the relative profitability of different investments through the tax code. Tax rules both favored investments in some sectors and businesses over others and privileged a certain type of capital use. Specifically, tax incentives made it profitable for corporations to retain and reinvest capital in the company.

4.2.2 A 'high rate, large deductions' regime

This tax policy doctrine translated into a tax system characterized by *high nominal rates and strong progression combined with a large number of tax deductions*. Top marginal personal tax rates were between 75 and 80 percent, while the corporate tax rate hovered around 50 percent. At the same time, the system allowed for generous tax deductions, both for businesses and individuals. Corporations could lower their tax burden or avoid taxes altogether if they channelled their profits into certain types of investments or funds that were exempt from taxation.

Most important in personal taxation were the rules for deduction of interest payments. The value of interest deductions represented nearly half the total value of deductions in 1982 (NOU 1984:50). The Norwegian interest deduction scheme was particularly generous, as the interest cost on loans could be deducted up to the highest marginal personal tax rate. That is, sufficiently large interest payments could lower a person's tax burden to zero. The interest deduction rules were not balanced by income taxation of the returns from homeownership, either, as these taxes were relatively low.

During the 1970s, Norwegian tax policy evolved in a manner that further accentuated this tax structure. On the one hand, the Labor government increased formal tax rates. Adding to this, high inflation lifted large groups of people into tax brackets where they faced higher tax rates, as government lagged behind with adjusting cut-off points. The proportion of taxpayers facing a marginal tax rate of 50 percent or more increased from 4 percent in 1973 to 16 percent in 1979 (NOU 2003:138).

On the other hand, deductions for both businesses and individuals were expanded from the late 1970s onwards. First, as a response to the economic crisis in the 70s, the Labor government introduced a number of new tax schemes and deductions for corporations to boost investments and growth. However, the deductions were not removed when the economy recovered, and thus became permanent. Second, in the early 1980s the Conservative government implemented new rules for depreciation and capital placement in funds that implied lenient taxation of capital in businesses. Thus, tax deductions and incentives implemented for different industrial policy reasons accumulated over the years, resulting in a hollowed-out corporate tax system.

The trend in personal taxation was similar. “All in all, there has been strong growth in the system of deductions,” concludes the Norwegian public commission report on personal taxation from 1984 (NOU 1984:65). Both the number of deductions and their value increased. The total nominal value of deductions increased by 130 percent from 1976 to 1982, while gross earnings grew by 92 percent in the same period. In particular, interest deductions grew dramatically. The nominal value of deductions for interest payments trebled (199 % increase) from 1976 to 1982.

4.2.3 Mutually reinforcing dynamics

Moreover, the processes of raising taxes and increasing deductions were mutually reinforcing, something which is emphasized by several informants and supported by the public commission report from 1984. Because of high formal tax rates, policy-makers had to expand corporate deductions further to achieve the industrial policy goal of growth. One informant describes this a political strategy of window-dressing: “Politicians hung on to high rates as a shining weapon for redistribution. But at the same time they reduced its effect by

implementing a number of deductions and favorable depreciation rules”. The same applied to personal taxation, where high marginal tax rates on an increasing number of taxpayers put pressure on politicians to make deduction schemes more generous.

The other way around, larger deductions led to higher rates. Generous deductions implied a narrow tax base, which meant a lower capacity to raise revenue at a given tax rate. Therefore, to maintain (and increase) revenue, the expansion of tax deductions had to be compensated by a hike in formal tax rates. The Norwegian tax system of the early 1980s was thus characterized by high formal rates both for businesses and individuals, but a relatively narrow tax base because of generous deductions.

What were the effects of this tax structure? Generally, the structure of high formal rates and large deductions led to *a large gap between actual income and taxable income*. How much a person or firm really earned corresponded weakly with how much was liable for taxation. Moreover, this gap was wider for some types of income than others. As we will see in the two following sections, the lack of correspondence between real and taxable income was a problem both in terms of equality and efficiency.

Sections 4.3 and 4.4 discuss the deficiencies of this tax structure, as perceived by political actors and experts, respectively. While the equity effects of the tax system concerned the Labor party and the high marginal rates on work and business angered Conservatives (section 4.3), experts emphasized the negative effects of the tax structure on efficiency (section 4.4).

4.3 Political perspectives on the tax system

4.3.1 Different tax policy views

How did central political actors regard the old tax regime? This section discusses the problems of the tax system as perceived by the Labor party (and the broader labor movement) and the Conservative party (and its constituencies). I focus on these two parties, as they were the two main political forces in Norway in the 1980s and early 1990s in general, and in questions of tax policy in particular. A sketch of the tax policy views of these actors is necessary to understand their demand for reform (or the lack thereof) and their actions in the process that led up to tax reform in 1992.

The Labor party was largely critical of the tax system from the late 1970s, based on the lack of fairness and effective redistribution in the tax system. Their desire for tax reform was considerable already in 1980 and grew steadily through the decade. The Conservative party, on the other hand, opposed the high marginal tax rates on work and business. Yet, they were very sceptical to a tax reform that would imply deduction cuts. The Conservative leadership warmed to the idea of reform only in the late 1980s.

4.3.2 Labor: equity concerns and demand for reform

The Labor party's criticism of the tax system was based on concerns about redistribution and fairness. This line can be drawn back to the early 1970s, as some policy-makers became aware that the many deductions impeded effective redistribution in tax policy. "The tax policy doctrine of fairness down to the smallest detail, covered over an ocean of unfairness," as a Labor politician active at the beginning of the 1970s put it.

This description is even more fitting for the Norwegian tax system of the early 1980s. The distance between the social democratic ideals of redistribution and the realities of the tax policy regime could hardly have been greater. The Norwegian tax system was ineffective in terms of redistribution both between capital and labor and among wage earners.

First, capital was effectively subjected to much more lenient taxation than labor (NOU 1984:12). Wage earners had to shoulder most of the tax burden, while the burden on capital owners was relatively light. Generous tax rules regarding depreciation and placement of capital in funds implied that businesses often had very little or even zero taxable income. The bias in favor of capital increased throughout the 1970s and early 1980s with the growth in such rules (NOU 1984:72). Very lenient capital taxation is thus one important feature of the Norwegian tax system of the early 1980s.

Second, the tax system generated little effective redistribution among people at different income levels. Though formal progression in personal taxation was strong, real progression was weak (NOU 1984). The reason was that generous deductions strongly reduced or even erased the formal progression of the tax system. Tax deductions were overall regressive, as the value of deductions systematically represented a larger part of income for those with

higher incomes (NOU 1984:65). As a result, those with high real incomes often had modest taxable incomes.

In particular, this was the result of the interest deduction scheme. Contrary to popular belief at the time, borrowing money was not primarily an activity for those who had little from before. In reality, the higher your income was, the larger were your loans. Since interest payments were fully deductible, this implied that the interest deduction scheme was strongly regressive: High-income earners facing high formal tax rates enjoyed relatively larger interest deductions than those with modest incomes (Ganghof 2006:95).

The regressive character of the interest deduction scheme was reinforced by the unequal access to loans. The Norwegian credit-rationing regime generally implied that those with a strong personal economy most easily obtained loans (NOU 1984:65). Because they had greater access to loans, high-income earners could exploit the tax benefits associated with borrowing money to a larger extent than those with lower incomes.

Moreover, the unequal ability of taxpayers to make use of the many deduction schemes of the tax system further weakened its redistributive capacity (NOU 1984:90). Those with the greatest economic resources had a greater capacity to study tax rules and find out how to benefit from them. The complexity of the Norwegian tax system further strengthened this bias, since it increased the information asymmetries between those with great economic resources and the rest. Additionally, the greater incentives (and possibilities) of those with high incomes to hide assets from taxation further limited effective redistribution.

In the Labor party, awareness of the tax system's negative effects on equality increased from the late 1970s onwards. In particular, the problems associated with the interest deduction scheme rose to the top of Labor's political agenda. The dominant view within the Labor movement was that the value of interest deductions had to be limited somehow. Hence, already in 1978, Labor Finance Minister Per Kleppe prepared a draft for tax reform that would reduce the value of interest deductions by introducing a tax element against which interest payments could not be deducted. But this proposal was clumsily handled by Labor and had lost political momentum before it reached parliament in 1980. There, the opposition led by the Conservatives voted it down.

However, towards the end of its term in 1981, the Labor government took a more indirect step towards tax reform by appointing a public commission to evaluate and propose changes to the system of personal taxation (the Aune commission).

The labor movement's demands for a more just tax system increased in the following years, fuelled by a series of revelations about the real effects of the tax system. The criticism of the interest deduction scheme was coupled with the popular outrage over 'non-taxpayers', i.e. those who had large incomes, but paid no taxes. This group became the political symbol for the unfairness associated with the large gap between real and taxable income in the existing regime.

It is safe to say that the entire labor movement shared the criticism of the tax system on equity grounds. Beyond this point, however, views diverged. Roughly, there were two basic attitudes regarding the tax system. The first was the traditional socialist view that forcefully denounced the lack of equality and redistribution in taxation, but supported the existing 'high rate' tax policy regime. This attitude was dominant at the grass-root level of the Labor party, in the Socialist Left party and in the trade unions. They believed that the problem was not the tax structure in itself, but the specific rules that privileged the well off. Tax policy should still be highly ambitious in terms of redistribution, and high tax rates and strong progression were necessary to achieve this end. This view remained strong throughout the 1980s on the left wing of Norwegian politics.

However, more influential was the reformist attitude dominant among the leadership, the economists and the technocrats within the Labor party. This view rejected the tax policy doctrine of high rates and large deductions altogether. The rejection of the old regime was based on the negative experiences of the 1970s and early 80s with selective, interventionist tax policy. The reformists felt that the existing tax regime was at odds with the whole set of basic social democratic values, as it was ineffective in terms of both redistributing income, generating revenue, stimulating economic growth, securing macro-economic stability, and discouraging tax avoidance. This convinced Labor party elites that fundamental policy change was needed.

Hence, Labor party elites desired and promoted tax reform throughout the 1980s. The sentiment that reform was necessary spread within the party from 1980 onwards. Importantly,

the reformist view also eventually incorporated the efficiency critique of the tax system, which was championed by economic experts (see section 4.3). However, it should be emphasized that among social democratic elites the primary rationale for tax reform was redistribution and fairness in personal taxation, while the concern about efficient corporate taxation was added only in the mid-1980s.

4.3.3 Conservatives: traditional views and reluctance towards reform

The Conservative party opposed the tax system on classical grounds. Tax rates were too high, both for individuals and businesses, they argued. In personal taxation, high top marginal rates and strong progression damaged the incentives to work. Likewise, high corporate tax rates discouraged productive activity in businesses. In other words, the predominant concern for the Conservatives was to provide favorable conditions for businesses and individuals who wanted to earn money, accumulate wealth and create economic growth.

It must be noted, however, that Norwegian Conservatives' attitudes to taxation were moderate in a comparative perspective. The Conservative party had contributed to the expansion of the welfare state and still supported the greater part of it. As they were fully aware that this had to be financed by large tax revenues, they were not contrary to a relatively high total level of taxation.

Nevertheless, Labor's policy of raising tax rates in the 1970s sparked fierce opposition from the Conservative party and business interests. Top marginal personal rates that hit 80 percent, whopping rates even on regular incomes (because of bracket creep), and the removal of the rule that limited *total* taxation to 80 percent of income constituted what Conservatives saw as a tax policy destructive to productive activity.

In addition, Conservatives criticized the complexity of the tax system. The many different tax schemes placed an unnecessary administrative burden both on businesses, individuals and public agencies. Conservatives were also sceptical about Labor's traditional tax policy dirigisme, of which specific tax incentives were the clearest symbol.

However, at the same time as Conservatives fiercely opposed high tax rates, they were reluctant to remove the generous deduction schemes. In the eyes of conservatives, deductions

ensured that tax burdens under the Norwegian high rate regime were tolerable. And not just tolerable: many businesses faced effective tax burdens that were much lower than they could ever dream of under a ‘low rate, few deductions’ regime. Likewise, the interest deduction scheme was very beneficial to many high-income earners, virtually erasing their tax burden. As businesses and people with high incomes were the main constituencies of the Conservative party, Conservatives were naturally concerned with looking after their interests. Thus, the existing tax system’s rather lenient treatment of these groups shaped Conservatives’ attitude towards this tax structure.

Even though they wanted to lower tax rates, the reluctance to simultaneously remove the large deductions led the Conservative party to oppose reform of the tax system in the 1980s. In 1980, the Conservatives voted down Labor’s tax reform proposal that would limit the value of interest deductions, on the grounds that it was dangerous to abandon the principle of allowing deductions for expenses related to income-earning (Kleppe 2003). The Conservative party also torpedoed similar proposals put forward by the Aune public tax commission in 1984 (NOU 1984), and likewise voted against the reform based on these proposals that was passed in 1987 (see section 4.5).

The Conservative party’s negative attitude to tax reform represents the most basic reason why it took so long to fundamentally change the tax system. It is somewhat ironic that the Conservative party – for which opposition to taxation was a core issue – were *de facto* the strongest defenders of the basic structure of the old tax policy regime.

The resistance towards tax reform owed to the dominance of very traditional ideas about taxation in the leadership of the Conservative party in the 1980s. Conservative party elites appear to have been more concerned about catering to business interests and the well off than about creating a well-functioning economy and an efficient allocation of resources. Apart from the basic economic argument that high tax rates discouraged work and production, ideas about economic efficiency (which are discussed in section 4.4) did not inspire the Conservative leadership. Throughout the 1980s, those in charge in the Conservative party were largely ignorant of more sophisticated economic theory about the effects of taxation for efficiency, as one informant pointed out.

It was not until the late 1980s that a more reformist and efficiency-oriented view gained influence in the Conservative party. This was associated with the emergence of ‘economist politicians’ within the party, and had important implications for reform, as I will discuss in section 4.7.

4.4 Experts and the new ideas about efficiency

4.4.1 The emergence of efficiency-based analysis

The structural problems of the old tax policy regime were not only related to the lack of redistribution (as emphasized by Labor) and the disincentives to work and do business (which concerned Conservatives). In this section, we look at how experts became more and more preoccupied by the effects of the tax structure on *economic efficiency*. Among bureaucrats in the Ministry of Finance there was a general shift in thinking towards efficiency-based tax economic analysis, which was inspired by novel international ideas about taxation. The new ideas both improved the analysis of the tax system and influenced the tax policy priorities of policy-makers.

Thus, this section is about the influence of economic ideas and the relationship between ideas and structural problems. I first sketch the shift in ideas about taxation, then look at the efficiency effects of the old tax policy regime.

4.4.2 Novel tax economic ideas

In the decades after the war, international economic research paid very little attention to the subject of taxation. It was only around 1970 that the field of tax economy emerged, as economists developed more sophisticated theory about the economic effects of taxation. Throughout the 1970s and into the 1980s, economists in this field produced advanced theoretical propositions, econometric models and methodological tools. This theoretical progress influenced the thinking of Norwegian economists working with taxation, both academics and bureaucrats.

In Norway, macro economy had dominated the economic research agenda ever since the war, profoundly influencing Norwegian economic thought. Norwegian Nobel laureate in

economics Ragnar Frisch and colleagues developed sophisticated macroeconomic models that became an integral part of the government's economic planning. On the other hand, micro economy and questions about resource allocation were to some extent neglected. As a consequence, Norwegian economists working with taxes were for a long time more concerned with redistribution than efficiency. This was the case both at the universities and in the Ministry of Finance.

The emergence of 'modern' tax theory abroad, however, brought about a marked shift in ideas among economic bureaucrats during the 1980s. For instance, an interviewee who left the Ministry of Finance in 1980 was "struck by how much the bureaucrats' attitudes towards tax policy had changed" when he returned in 1989. In this period, traditional thoughts about taxation as a tool for both social and industrial policy were gradually replaced by ideas that emphasized the effects of taxation on economic efficiency.

In particular, economic bureaucrats came to emphasize the principles of *neutrality* and *symmetry* in taxation. Neutrality means that all types of capital income are subject to the same effective tax rate. This principle implies that the tax system should be neutral between different types of investments, different forms of ownership, alternative sources of financing, etc. Symmetry means treating incomes and corresponding expenses in the same way. When income is taxed at a certain rate, costs should be deducted against the same rate.

Hence, within the Ministry of Finance, attention shifted to the 'tax wedges' and total efficiency losses associated with different types of taxes. Yet, it would be wrong to conclude that the economists in the ministry thereby abandoned goals about equality. Rather, efficiency concerns complemented equity concerns. As one politician pointed out, traditional ideals of social justice remained strong in the Ministry of Finance throughout the period.

The influence of the new way of thinking owed mainly to the fact that practical economists found the new models useful. Bureaucrats' negative practical experiences with the existing tax policy regime fit well into the new analytical framework. That is, novel theoretical models shed light upon features of the tax system that economists in the ministry suspected were contributing to economic problems.

4.4.3 The inefficiencies of the old tax policy regime

Economic analyses in the early 1980s revealed that the Norwegian tax structure of high rates and generous deductions created large inefficiencies. Basically, the large and variable gap between real income and taxable income implied that what was profitable before taxation was not the same as what was profitable after taxation (NOU 1984:62). In other words, the tax structure distorted economic choices considerably. This concerned both corporate and personal taxation.

Corporate taxation was far from neutral, as investments of certain kinds or in certain sectors were subject to more favorable tax treatment than others. This privileged economy activity in sectors where income was taxed leniently or not at all and expenses could be deducted from taxation (NOU 1984:62). It also directed capital to uses that were exempt from taxation or lowly taxed.

In economic terms this was inefficient, since it influenced the relative profitability of investments. The investments that were most profitable before taxation were not the most profitable after taxation. This implied that capital was not allocated to where it would have given the highest returns. According to several informants, the lock-in of capital in businesses was a particular problem. Lock-in limited the returns to capital, since capital was reinvested (with variable returns) instead of flowing to the investments that would give the highest returns. In other words, the use of resources was irrational (NOU 1984:61).

The tax system also distorted the economic decisions of individuals. Most importantly, tax rules strongly favored investments in real estate over financial savings (NOU 1984:73). The tax system strongly discouraged putting your money in the bank or in stocks. As a consequence, financial savings in Norway had actually been negative every year since the war. Conversely, tax rules – particularly the interest deduction scheme – strongly encouraged taking up loans to invest in houses. The Norwegian tax structure diverted capital from productive investments and into real estate. The macro-economic environment strengthened these incentives. As we will see in section 4.5, this became a huge problem in the mid-1980s, when high inflation and a nominal interest rate that was held artificially low contributed to negative real interest rates.

4.4.4 Reasons for reform

New ideas about taxation were important because they improved the analysis of the existing tax policy regime, which had previously been somewhat neglected. This raised the consciousness about the deficiencies of the tax system, thereby providing a stronger rationale for reform. Moreover, the new ideas generated solutions that corresponded to these problems.

The clearest expression of this is the report of the Aune commission published in 1984. This report thoroughly evaluated both the efficiency and the equity aspects of personal taxation, and showed that the tax system largely failed in both respects. The report concludes that under the existing tax policy regime the “main objectives of the tax system are not achieved in an effective way” and “taxation contributes too little to promoting the primary goals of tax policy” (NOU 1984:13,61).

My informants - central tax policy-makers and bureaucrats in the 1980s and 90s - share this conclusion: The Norwegian tax system of the early 1980s was fundamentally flawed. “There were at least ten points where the absurdity burst into your eyes,” as one put it. Several describe the whole tax system as a giant Swiss cheese, where you could crawl into one hole and out of another without paying taxes. Or as another informant sums it up: “In terms of redistribution, the old system was ineffective, and increasingly so. In terms of efficiency, it was bad, going on horrible. It had simply reached the end of the road.” It is safe to say that the structural problems that concerned Norwegian policy-makers – and provided the reason for reform – were located within the Norwegian tax system, not at the international level.

To deal with these problems, the Aune report proposed a larger tax element on gross income (i.e. income before deductions), combined with lower and less progressive taxation of net income and the elimination of a number of deductions. Yet, the political preconditions for tax policy change were not present when the commission released its report in 1984. The bourgeois government led by the Conservative Kåre Willoch left the commission’s recommendations dead in the water. The Conservative government did not feel that tax policy change was urgent. Thus, their reluctance was the direct reason that reform was not pursued.

On a deeper level, the large gap between politicians and experts in the understanding of tax policy appears to have been a barrier to reform. In the mid-1980s, the new economic ideas

about efficiency in taxation had only just started to spread to the key political parties. Even though there were political actors - especially the Labor party - that supported policy change, the political milieu lacked politicians that were inspired by new tax policy ideas and ready to drive large-scale reform.

4.5 The macro-economic middle-game

4.5.1 Tax policy and macro-economic instability

So far, we have discussed the effects of the old tax regime on equality and efficiency, which were predominantly negative and gave rise to a demand for reform among policy-makers. However, in the mid-1980s the tax system also contributed to serious macro-economic problems. This gave the issue of tax policy change greater urgency. The sequence of events that followed, led up to the tax reform in 1992.

As we will see in this section, the generous interest deduction scheme contributed to the uncontrolled credit expansion during the boom years from 1984 to 1987. This triggered political action in the tax field, bringing policy-makers to pass a reform of personal taxation in 1987, which gradually limited the value of interest deductions. However, the tightening of tax policy contributed strongly to the subsequent economic downturn. From 1988, Norway went into recession, which precipitated a fundamental structural reform of tax policy.

4.5.2 Credit expansion and economic boom

The tax system was one of the factors that contributed to the uncontrolled credit expansion of the mid-1980s (cf. Tranøy 2000: chap. 3). As you will recall from section 4.4, the tax rules for interest deduction made borrowing money very profitable. Interest payments could be deducted up to the highest marginal tax rate, which implied that the more you borrowed, the less you would pay in taxes. Combined with high inflation and an interest rate that was set artificially low, this led to a negative post-tax interest rate in the late 1970s and early 1980s (NOU 2003:63). For those with average incomes, the post-tax real interest rate hit bottom at minus 6 percent in 1981, only crawling up to zero in 1984, where it stayed until 1987.

As long as there was credit rationing, the profitability of borrowing money was mainly a problem in terms of equity, since those with high incomes would get loans more easily. But the credit liberalization of the early 1980s turned this into a huge macro-economic problem. People now had both the motive and the opportunity to borrow large amounts of money, and the result was a hyper-expansion in the Norwegian credit market from 1984 to 1987 (Tranøy 2000:97).

4.5.3 The 1987 personal tax reform

The realization among politicians that the credit market was out of control – and that the interest deduction scheme was partly to blame – triggered tax policy action (Tranøy 2000:188-191). Introducing a gross element in income taxation to limit the value of interest deductions had been championed by Labor since the late 1970s and clearly recommended by the 1984 Aune public commission on personal taxation. In the spring of 1987, at last, it became possible politically.

A reform compromise was hammered out by Labor (in government at the time) and the centre parties (Fagerberg *et al.* 1990:86). The Conservative party also participated in the reform negotiations and influenced the chosen solution, but voted against the final compromise. The reform was passed anyway with the votes of Labor, the Christian People's Party and the Centre Party. The reform introduced a surtax on high incomes, against which interest payments could not be deducted. At the same time it implied cuts in marginal tax rates every year until 1992, which effectively reduced the value of interest deductions.

However, this was “too much, too late” (Tranøy 2000: chap. 5). Combined with falling inflation and high interest rates, the consequence of the tightening of tax policy was that the post-tax real interest climbed steeply, hitting 5 percent in 1989. This real interest rate shock stifled the Norwegian economy. It went into a recession in 1988, which soon became a depression (Tranøy 2000:191).

4.5.4 The economic downturn

Growth in Norwegian mainland GDP was negative both in 1988 and 1989, as shown in Figure 4.1. The gravity of this economic crisis is evident from the fact that these are the only two

years of negative growth in Norway from 1958 up until today. Moreover, employment fell every year from 1988 to 1992, while unemployment skyrocketed from 2 percent in 1987 to 5 percent in 1989, before reaching nearly 6 percent in 1992 (cf. Figure 4.1).

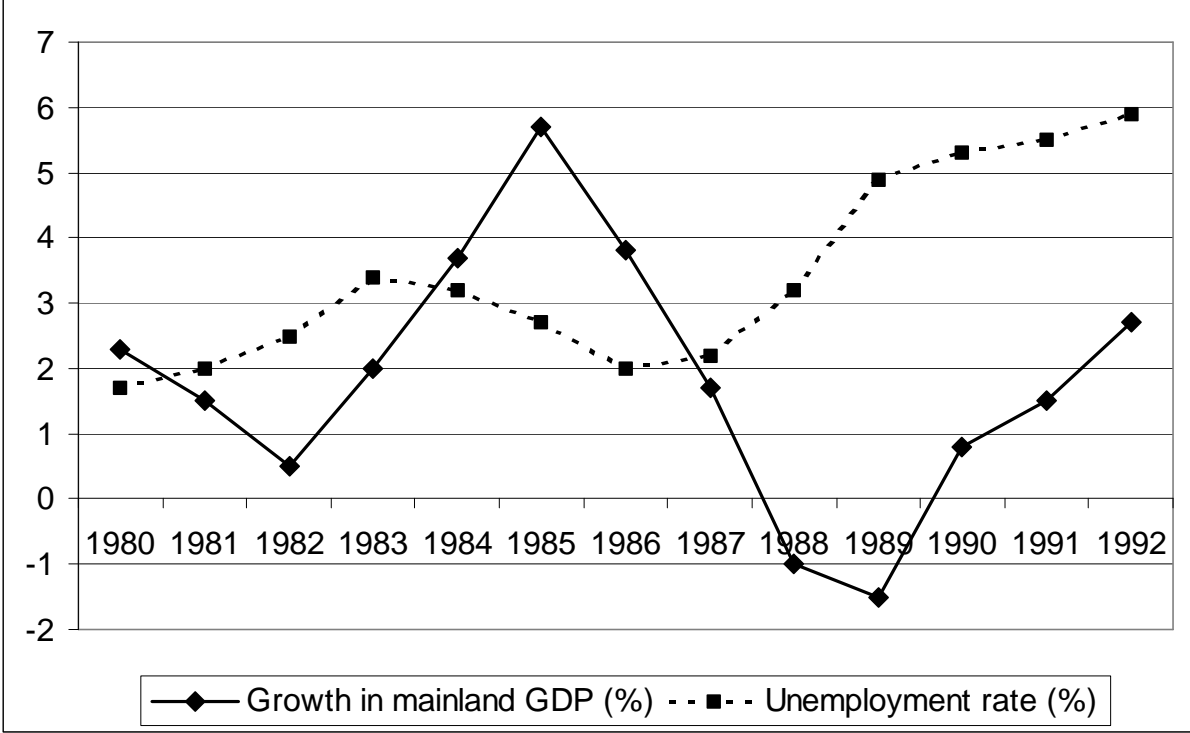


Figure 4.1: Growth in mainland GDP and unemployment rate for Norway 1980-1992

Source: Statistics Norway

The economic crisis laid the ground for more fundamental changes in tax policy. Remaking the tax system was regarded as a structural reform that was necessary to get the economy back on its feet, as one key policy-makers related. The crisis gave rise to a common sentiment among key political actors that something needed to be done to the tax system. “The time was ripe for reform,” as several informants put it.

Yet, it is more accurate to say that the crisis precipitated reform efforts, than that it directly caused reform. In the context of economic crisis, the political-administrative complex moved determinedly towards reform in the period from 1989 to 1991. The process would likely have taken longer and been subject to greater political disagreement had it not been for the economic crisis. However, features of the reform process are crucial independent elements in

the explanation of the 1992 tax reform. Most importantly, the adaptation and development of tax policy ideas – by experts on the Aarbakke public commission and in the bureaucracy – provided the policy solutions for reform. This is the topic of the next section.

4.6 The Aarbakke report: a blueprint for reform

4.6.1 The importance of the Aarbakke report

The importance of the Aarbakke report for the 1992 tax reform cannot be overstated. In the interviews, all the central decision-makers of the time emphasize the great influence of the work of this public commission. Not only did the 1989 Aarbakke report provide the *substance* of the subsequent reform. Its blueprint for reform also gave a strong impulse towards the *political* realization of fundamental tax policy change.

In this section, we first define the place of the Aarbakke commission in the reform process. Second, we look at how the policy solutions of the Aarbakke report were the result of adaptation and development of new tax policy ideas. Finally, we discuss how the report affected the process towards tax reform.

4.6.2 The issue of corporate taxation

To understand why the Aarbakke report was so important for the 1992 reform, the distinction between personal and corporate taxation is crucial. Until the late 1980s, reform efforts were all about *personal taxation*. The 1987 reform, which was based on the 1984 Aune report, only concerned the taxation of individuals.

The Aune commission suggested, however, that to create a well-functioning tax system, it was absolutely necessary to look into the issue of *corporate taxation* as well. Firstly, many of the structural problems of the tax system had their origin in the corporate tax regime. Secondly, the two parts of tax policy were by no means independent of each other. More and more economic activity took place in the blurry area between these two regimes, and sophisticated solutions were needed to deal with this.

Compared to personal taxation, corporate taxation is extremely technical and difficult to understand for others than experts. Thus, even though politicians had agreed on personal tax reform in 1987, what to do with corporate taxation was largely in the blue. This was the background for the Labor government's appointment of the Aarbakke commission in March 1988. The commission was exclusively made up of experts, and its primary task was to examine potential changes in the taxation of businesses and capital. The work of the Aarbakke commission should not be understood in isolation, though, as bureaucrats in the Ministry of Finance had already initiated the work with developing solutions for corporate taxation.

4.6.3 The development of tax policy ideas

The work of the Aarbakke commission (and the economic bureaucracy) was clearly inspired by the international wave of 'rate reduction, base broadening' tax reforms. The major US tax reform of 1986, the Danish tax reform of 1987 and the plans for tax reform in Sweden represented important examples for Norwegian experts. While novel tax economic theory had supplied Norwegian experts with a new way of thinking about taxation (cf. section 4.4.2), the tax reforms of the 1980s provided more concrete *policy ideas*.

The tax policy doctrine of market-conforming, neutral and symmetrical taxation was actively promoted by the OECD. The organization provided documents and statistical databases to facilitate reforms of this kind in countries like Norway. By spreading this material, the OECD stimulated the exchange of ideas, knowledge and experiences across borders. "The steady flow of documents from the OECD was an important source of inspiration for the economists in the bureaucracy," as one informant recalls.

Interestingly, the influence from abroad appears to have been much stronger in terms of ideas than structure. The ideas that were imported in this period first and foremost provided answers to the domestic structural problems of tax systems, not to international structural constraints. Economic internationalization had not yet become an important issue: "In the 1980s there was little talk of capital mobility. Policy-makers were not really afraid that businesses would move to other countries. This discussion is relatively new," one expert observed. Accordingly, economic globalization was not treated as an important tax policy concern in the Aarbakke report.

How specific were the ideas from abroad that inspired Norwegian bureaucrats and policy-makers? The interviews suggest that the tax reform movement mainly provided a general inspiration. Even though reforms around the world shared some fundamental principles, groups of countries chose different concrete policies to realize these principles. The broad range of examples – rather than any specific reform – inspired Norwegian experts. Nordic experiences were of particular interest, as they supplied examples of the opportunities and limits of reform in economies very similar to that of Norway.

Although international tax policy ideas provided a framework for reform, their influence on the solutions proposed by the Aarbakke commission should not be overstated. The work of the economic bureaucracy and the commission is better described as policy development than imitation. International tax policy ideas were just the point departure, as Norwegian experts further developed, specified and adapted these to the Norwegian context. Experts drew on ideas and perspectives from abroad to design policy solution that could answer the specific problems of the Norwegian tax system.

Although concerns about neutrality and efficiency guided the development of policy, experts were at the same time attentive to concerns about equality and fairness. It is fair to say that both the Ministry of Finance and the Aarbakke commission sought to develop variants within the frame of the international tax policy doctrine that were in line with equity goals. To a considerable extent this was possible, as for instance the principle of equal treatment represented a common ground for efficiency and equity goals.

Important in this respect, the Aarbakke commission proposed a dual income tax (DIT) model, i.e. a tax regime that differentiated between a moderate, flat tax on capital income and a higher, progressive tax on labor income. To a larger extent than other reform blueprints, the DIT model aimed to reconcile efficiency concerns with objectives of revenue-raising and redistribution. The principle of dual taxation had already been suggested by the Aune commission report in 1984 and put into practice by the Danish reform of 1987. However, the Aarbakke report proposed the purest and most sophisticated version of the DIT model so far.

4.6.4 The political implications

The report published by the Aarbakke commission in the fall of 1989 was an impressive piece of policy work. It proposed a total solution for corporate taxation, including a model for splitting personal and corporate income in small businesses. The Aarbakke report represented the culmination of years of effort by national experts in the field of tax economy. The work of the commission not only supplied the content of reform, however. The reform blueprint also generated convergence in policy preferences and made it easier for political actors to pursue cooperative strategies towards reform.

Firstly, the Aarbakke report brought the tax policy preferences of politicians more into line with the views of experts. The thorough analysis presented in the report exposed political actors to economic reasoning about problems and solutions in corporate taxation. This directed political views on tax policy in a more rationalist direction. This also implied more compatible preferences in the Labor party and the Conservative party. Provided with a common base of ‘neutral’ information about the corporate tax system, more similar problem definitions emerged within the two parties. This contributed to political consensus.

Secondly, the Aarbakke report facilitated political cooperation by giving politicians a blueprint for a consensus solution. This made it clearer to political actors what the final reform would look like if they were to pursue a strategy of cooperation. The concrete proposal of the commission reduced the uncertainty associated with pursuing such a strategy, and thus made cooperation a more viable alternative. This was especially the case for the Conservative party, which had so far been very reluctant to engage in tax reform action. The political-administrative process towards reform that followed the Aarbakke report is the subject of the next section.

4.7 Political relay towards reform

4.7.1 Political institutions and the reform process

The release of the Aarbakke report was followed by a remarkable political process towards reform. This section looks at the political relay that led up to Labor’s tax reform proposition in 1991, while section 4.8 is about the final reform negotiations in the Norwegian parliament – the Storting. The political process that led to large-scale tax reform was stimulated by

Norwegian political institutions. The institutional setting shaped the interaction between political parties and between politicians and experts in a way that favored cooperation, leading to a broad-based reform compromise.

In this section, we first look at which actors dominated the reform process. Second, we see how the alternation in power during this period actually stimulated – rather than stifled – reform efforts. Third, we discuss how the reform was driven by the emergence of ‘economist politicians’.

4.7.2 The dominant actors

Which actors dominated the policy-making process that led up to the 1992 tax reform? The evidence on this point is unambiguous: The Labor party, the Conservative party and the bureaucracy in the Ministry of Finance were by far the most important actors in this process. The political control of the process shifted between Labor and Conservatives, while the economic bureaucracy (flanked by external economic experts) dominated the formulation of policy.

How about the rest of the political parties? In 1987, the middle parties – i.e. the Christian People’s party and the Centre party (agrarian) – had been key tax policy players, as their votes ensured a majority for the personal tax reform. This time they only played a marginal role. Although they were present, as members of both the bourgeois cabinet and the Finance committee in parliament, these parties neither influenced the political process nor the substance of reform to any significant extent. Except for the few special areas of tax policy where they had strong opinions (e.g. agriculture), the middle parties mostly tagged along with the two larger parties. The Socialist Left party and the populist right Progressive party were even less important.

As in any major issue of economic policy, the main union confederation LO and employers’ association NHO were consulted throughout the tax reform process. Within the labor movement, there were several rounds of discussions between Labor’s people in the Ministry of Finance and leaders and economists in LO. However, regarding tax reform LO was primarily a responsible conversation partner, not a strong independent voice.

The main reason was that Labor party elites and LO elites agreed on the basic definition of problems and the necessity of reform. Apart from certain absolute demands concerning the wealth tax, redistribution and specific issues of industrial policy, LO supported the reform effort. In particular, top LO economists and LO leader Yngve Hågensen came to share Labor's ideas about remaking tax policy. Thus, they primarily cooperated in the search for appropriate tax policy solutions, rather than confronting the Labor party with strong particular demands.

Neither the main employers' association NHO played a particularly important role in the tax reform process. The Conservative party had regular meetings with NHO, but as one politician recalls, these were often of a "ritual" character. Regarding tax reform, NHO had little to say about the broad lines of reform, but had strong and detailed opinions in specific areas of corporate taxation. In some of these areas, NHO was heard, but generally they had little influence on the design of the tax reform.

As the account up to this point suggests, tax reform was dependent on consensus along two dimensions: both between the two major political parties and between politicians and experts. For one, Labor and Conservatives, who had different problem definitions in tax policy, needed to reach agreement. Second, the solutions proposed by experts had to be linked to the problems perceived by politicians.

4.7.3 Alternation in power

The period from the publication of the Aarbakke report in the fall of 1989 to the Labor's tax reform proposition in the spring of 1991 was characterized by frequent alternation in government. Surprisingly, this did not stifle reform efforts. Instead, Labor and Conservatives seized upon this opportunity to produce a series of important political documents. Thus, alternation actually facilitated the commitment to tax reform. The Norwegian institutional context contributed strongly to these positive dynamics.

In Norway, the 'conservative wave' of the 1980s put an end to a long period of Labor government, and more generally to the post-war electoral dominance of the Labor party. From 1981 onwards the electorate was more evenly distributed between the blocks. This ushered in an era of more frequent alternation in power and more unstable governments. In the late

1980s and early 90s, government shifted back and forth between the Labor party and the so-called 'bourgeois parties', i.e. the Conservatives, the Christian People's Party and the Centre Party (agrarian).

In 1986, a Labor government led by Gro Harlem Brundtland took over from the centre-right coalition government headed by Conservative Kåre Willoch. The Brundtland government, with Gunnar Berge as Finance Minister, lasted until the elections in the fall of 1989. They were succeeded by a new Conservative-led 'bourgeois' coalition, this time under the direction of Jan P. Syse and with Conservative Arne Skauge as Finance Minister. This government fell apart after little over a year, giving way to a new Labor government in November 1990. Again, Brundtland was the Prime Minister, while Sigbjørn Johnsen took over as Finance Minister.

Thus, three different governments were in power during the period from the release of the Aarbakke report in October 1989 until the tax reform proposition in the spring of 1991. What is interesting is that this instability actually stimulated the political process towards tax reform. Under alternating government, the institutionalized production of official political documents became a vehicle for reform. Labor and Conservatives used these documents actively to commit to reform as power shifted back and forth between them.

In the fall of 1989, the outgoing Labor government endorsed the conclusion of the Aarbakke report in its budget commentaries. In May 1990, Conservative Finance Minister Skauge presented a white paper to parliament inspired by the report. Its content is well summarized in the title: "Guidelines for reforms of corporate and capital taxation, and consequences for personal taxation" (St.meld nr. 48 (1990-91)). This document sketched the basic principles for a revision of the tax system. The Labor opposition responded to the white paper with detailed comments, outlining a more concrete – and slightly divergent – proposal for reform. A few months later, Labor moved back into the Ministry of Finance, where they continued the work towards reform. In the spring of 1991, Finance Minister Johnsen presented the tax reform proposition to the Storting. This proposition was based upon the Aarbakke report and to a large extent in line with the Conservative white paper from 1990.

One reason why alternation in power stimulated reform was that it brought politicians and experts closer together. Both Labor and Conservative politicians were put in touch with the

practical work and the way of thinking in the Ministry of Finance. Intense interaction between politicians and bureaucrats is typical of Norwegian political institutions. In this case, interaction within the Ministry of Finance exposed political actors from both sides to rationalist arguments about tax policy design. This generated convergence towards the views held by experts, both in the definition of problems and in preferences regarding solutions. “Because of the shifts in government, both parties had worked with the important questions, and there was a fundamentally positive attitude in both camps,” one informant related. Shared views provided a strong basis for politicians and bureaucrats in the ministry working together towards reform.

Even more importantly, alternation in government gave Labor and Conservatives the opportunity to take crucial political steps towards consensual reform. Shifting power facilitated cooperation. “Through this alternation, a broad political ownership was built,” one central actor observed. Basically, the alternation in power triggered an institutional commitment mechanism. The institutional setting allowed the parties to credibly commit to the broad reform solution.

Yet, it appears that commitment had a slightly different meaning for the two parties. The Labor party, which was almost unitary in the tax issue, intentionally used official documents to signal their positions. The Labor government with Finance Minister Berge actually rushed the release of the Aarbakke report (NOU 1989:11), so that it would have time to comment on its conclusions before leaving office. Likewise, Labor’s thorough and detailed response to the Conservative white paper was an intentional move to show their general support for the reform initiative, while at the same spelling out the points of disagreement.

The conservative camp, however, was divided in the tax issue. It appears that the fraction of the Conservative party that controlled the Ministry of Finance (described in the next subsection) used official documents to commit the party to tax reform. Conservative Finance Minister Skauge worked hard to finalize the white paper, which was meant to both outline a credible Conservative position regarding reform and send the signal that Conservatives were ready to move towards a large-scale tax policy revision.

These political documents reduced the other party’s uncertainty about where their political ‘opponents’ stood, making it easier to make further moves towards reform. “It was possible to

calculate the opponent's attitude in advance, since they had committed already," one informant observed. The alternation in power thus facilitated cooperative strategies.

4.7.4 The emergence of economist politicians

During the same period, another important development stimulated reform efforts. This was the emergence of 'economist politicians' within both the Conservative party and the Labor party. The economist politicians were crucial as the drivers of the tax reform process. Their emergence both conditioned the positive effect of alternation in power on reform, and contributed to generating support for reform.

In both parties, politicians that identified strongly with economic arguments won influence in the late 1980s. These 'economist politicians' were handed the central positions in economic policy-making. Most importantly, they gained control over the Ministry of Finance, but they also played an important role in the Storting. The emergence of economist politicians had impact on the tax policy positions of the parties, especially within the Conservative party.

As discussed in sub-section 4.3.3, modern economic thought was surprisingly marginal among the Conservative leadership in the 1980s. It was really not until the bourgeois coalition won power in 1989 that politicians inspired by ideas about economic efficiency gained considerable influence. In the Syse government, Arne Skauge was appointed Finance Minister and Trond Reinertsen under-secretary of state. Both were strongly inspired by modern economic thought. As opposed to traditional conservative, they clearly rejected the existing tax structure, including the generous deduction schemes for businesses and individuals. They were convinced that fundamental tax policy reform was needed, as the existing tax structure could not produce efficient economic outcomes.

Skauge did clearly not belong to the mainstream in the Norwegian Conservative Party. The label 'economist politician' fits Skauge well, as he put great emphasis on economic rationality and identified strongly with economists, those in the Ministry of Finance in particular. Some even describe him as "light blue" politically. Skauge had already served as Trade Minister in the early 1980s and a short stint as Finance Minister in 1986.

Under-Secretary Reinertsen was even more of an economist and less of a politician. Reinertsen had no political experience and had been a party member only for a couple of years. Yet, he was offered the job because of his economic expertise. Reinertsen had a Ph.D. in monetary theory from an American university, had worked in the Norwegian Ministry of Finance for five years, and was a business leader. A strong proponent of modern economic theory, Reinertsen felt a closer relation to the bureaucrats in the ministry than to the politicians in the party.

Economist politicians also appeared within the Labor Party in the late 1980s, though in a less abrupt manner than in the Conservative party. Within Labor, the ‘economist politicians’ fell into two categories. First, there were the career politicians that had solid economic knowledge and were highly perceptible to economic arguments. Sigbjørn Johnsen – Finance Minister from 1990 – was the most important representative for this category. Johnsen had economic training and had been member of the Finance Committee in the Storting since 1980.

Second, and complementary, there were the economists in supporting political positions, who provided important economic expertise. Bjørn Skogstad Aamo who served as Under-Secretary in the Ministry of Finance from 1986 to 1989 was one such figure. Another social economist, Svein Harald Øygard, played an even more important role. Øygard was economic advisor for Labor in parliament from 1989 and then Under-Secretary in the Ministry of Finance from 1990. Øygard had little experience from politics, but had previously worked in the tax department of the Ministry of Finance. He thus provided the Labor party with crucial economic insight in the tax reform work⁶.

The economist politicians controlled the Ministry of Finance in the crucial years from 1989 to 1991 when government was alternating back and forth between Labor and Conservatives. Their ascent to power appears to have been a precondition for the rapid political process towards reform that ensued. The alternation in power made it easier for political actors to commit to reform. Yet, economist politicians at the head of the Ministry of Finance strengthened both the desire to move towards fundamental tax policy change and the capacity to work out such a reform. Their emergence forged a strong reform alliance between politicians and bureaucrats in the Ministry of Finance, based on shared views.

⁶ In February 2009, Øygard was hired as Governor of the Icelandic Central Bank to stabilize the economy left in ruins by the international financial crisis.

The emergence of economist politicians at the head of the Ministry of Finance dramatically narrowed the gap in perceptions between experts and politicians. The economist politicians to a large extent shared the bureaucrats' rational, economic analyses of problems and solutions. And they shared these views mainly because they had solid economic insight and in some cases had worked within the field of tax policy. The ability of the class of economist politicians to understand such a complex policy area proved crucial. Because of this, experts and politicians in the ministry did not only find common ground, they agreed on a fundamental level. Further, this shared basic analysis gave rise to a strong common feeling that the tax system needed fundamental reform.

This engendered intense cooperation for reform between political leadership and bureaucrats in the ministry. The benefits were mutual. For civil servants, it was much easier to work closely with politicians who understood the basic problems and dilemmas of tax policy. Also, as there for several years had been a strong desire for fundamental reform among bureaucrats, they were happy to find politicians willing to pursue 'their' case. For politicians, the wholehearted support from a bureaucracy with great economic insight and work capacity provided crucial support for the political reform mission.

In other words, a potent coalition was forged that made the Ministry of Finance a powerhouse for reform. Economic bureaucrats teamed up with the economist politicians of the incumbent party, first Labor, then the Conservatives, then Labor again. The strong political-administrative consensus unleashed the policy-making forces of the Ministry of Finance. The years between 1989 and 1991 thus represented a period of intensive tax policy work in the ministry.

The emergence of economist politicians also contributed to reform in another way. As they had one foot in each camp, these politicians helped bridge the gap between the economic and political spheres. The economist politicians undertook the crucial task of translating economic arguments about tax policy into political arguments. As one of them describes: "My role was partly to build bridges, as I had an ability to translate economics into terms that were politically comprehensible. Translating insights into examples and showing how things worked was crucial."

This translation was essential for building broader political and popular support for reform. It clarified the connection between what people perceived as problems in the tax system and the solutions that experts envisaged. The political leadership in the Ministry of Finance put great emphasis on communicating this to party members at the grass-root level. In so doing, they generated a shift in preferences within the parties, winning over many traditionalists. This ensured acceptance – if not enthusiasm – for the reform proposal in the file and rank of the parties.

The communication with the general public was equally important. The Labor party was especially active in this regard, staging a massive media campaign in late 1990 and early 1991 to explain to people why the tax system needed fixing, and how their reform proposal would mend it. At the very least, this increased popular understanding and acceptance for some of the changes to come.

4.8 The final reform negotiations

The political relay described in the previous section led to the Labor government's tax reform proposition to parliament in April 1991. This section concerns the final phase of the tax reform process, namely the reform negotiations in parliament. These negotiations were an outstanding example of political cooperation. Based on mutual trust, the Labor and Conservative representatives worked closely together to finalize the tax reform. The institutional setting shaped this cooperation, as mutual confidence was a function of interaction in parliament's finance committee. This unique cooperation allowed politicians to pass the tax reform compromise quickly, which precluded the build-up of political opposition.

In April 1991, Labor Finance Minister Johnsen could finally send a proposition for tax reform to parliament. The proposition was the result of intensive policy work in the Ministry of Finance based on the recommendations of the Aarbakke report. To pass the reform, Labor needed to strike a deal with the opposition in parliament. And to ensure that the reform would stick, Labor wanted as broad political agreement as possible.

In practice, this implied reaching a compromise with the Conservative party. As these two parties together had a solid majority in parliament, the middle parties would have little other choice than to support reform. And as subsequent elections would most likely also produce a

majority for Labor and Conservatives together, a reform compromise between these two would be robust over time.

In the Norwegian political system, the real political work of parliament is carried out in the committees. The final negotiations over tax reform thus took place in the financial committee of the Storting. On the committee, there were representatives from all the major political parties. But in practice, the tax reform proposition quickly became the subject of bilateral negotiations between Labor and Conservatives. Two members of the committee undertook the daunting task of hammering out the details of a reform compromise: Thor-Eirik Gulbrandsen from the Labor party (who formally led the committee's work with the proposition) and Johan C. Løken from the Conservative party.

Interestingly, these two did not belong to the caste of reformist economist politicians. Gulbrandsen had studied social economy, but was neither inspired by arguments about economic rationality nor familiar with modern tax policy ideas. Gulbrandsen did in fact belong to the more radical left wing of the party and was in opposition to the Labor party elite. His views regarding economic policy were moderate, however. Løken, on the other hand, was trained in forest economics and had great experience with economic policy-making from the financial committee. But politically he belonged to the traditional conservative mainstream, and he was sceptical of the modern tax policy ideas promoted by the former Conservative Finance Minister Skauge.

Nevertheless, Gulbrandsen and Løken played a crucial role in finalizing the tax reform. The pair literally worked day and night to hammer out all the details of the reform compromise. Not only did they reach agreement on all points, so that Labor and Conservatives could present a common proposal. They also did so incredibly quickly, which ensured that the Storting could pass the reform before the long summer break. A delay would have given opponents of reform time to organize, which could have put the whole reform in jeopardy.

The negotiations between Gulbrandsen and Løken were an outstanding example of political cooperation. "Our cooperation was unique. I don't think anyone has worked the way we did, neither before nor afterwards," as one of them put it. In the final phase, the two of them worked through a long list of issues where Labor and Conservatives had diverging views, dividing the issues between them. If Labor conceded on one issue, their view would prevail in

the next question. Through this pragmatic process of give and take, the final pieces of the tax reform were put into place.

What made this kind of political cooperation possible? The fundamental precondition was that Gulbrandsen and Løken had the political backing or confidence of their respective parties. At this point, especially the Labor party, but also the Conservatives, were intent on striking a reform compromise. Through the preceding process the two parties had defined a common frame for tax reform, and within these limits they were willing to stretch far to reach a final specific reform agreement.

The detailed negotiations between Gulbrandsen and Løken were instrumental to this end. This raises the question of how autonomous they really were. It appears that the Conservative Løken had a stronger independent role than Labor's Gulbrandsen. For Labor, the political leadership in the Ministry of Finance held a tight grip on the process. This meant that even though Gulbrandsen was the one negotiating in the front room, there was someone in the back room making the important calls.

Løken appears to have acted more on his own, which makes his role more ambiguous. On the one hand, he was extremely loyal to the party and determined to extract the best possible tax reform deal for the Conservatives. On the other hand, he acknowledged the strong need for reform and thus actively promoted the reform compromise to the Conservative leadership and the broader party. While some suggest that Løken was co-opted by the Labor reformists and 'betrayed' the Conservative mainstream, others say that he maximized the Conservative's influence on the final reform deal.

One piece of evidence for the latter interpretation is that the final reform was more liberal than Labor's reform proposition in a couple of important respects. Firstly, the model for splitting income into labor and capital components was loosened. As we will see in the next chapter, the ineffective income-splitting model became the greatest problem of the new tax system in terms of equality. Secondly, a tax amnesty for businesses' capital reserves was included in the reform, after lobbying from the employers' association (NHO). This allowed businesses to dissolve the tax-motivated capital reserves built up under the old regime when the new tax rules came into force in 1992.

The second precondition for the close cooperation on the committee was strong, personal trust. “Without mutual trust and confidence, we could not have landed the reform,” commented one informant. Give-and-take bargaining of the kind described was possible because the central politicians trusted each other one hundred percent. The cooperation between Gulbrandsen and Løken worked seamlessly because both trusted that the other party was sincere about his room for manoeuvre and would not balk on agreements. This mutual trust had two interrelated sources.

The first source was institutional. Repeated interaction over many years in the Storting’s finance committee had produced trustful relationships between political opponents. Through day-to-day committee work, they came to know what they could expect of the others. The trustful relation between Gulbrandsen and Løken was based on the accumulated impressions from years of interaction on the committee. Their experience of the other party as honest and trustworthy allowed for close cooperation. Moreover, experiences with similar reform processes seem to have had an influence on the committee’s work. One informant points to the tax reform negotiations in 1987 as an important foundation for the political cooperation in 1991.

The second source was personal, as strong mutual trust was also a function of tight personal relations between central actors. Although this is typical of the Norwegian political system, relationships were especially tight in this case. That is, both Gulbrandsen and Løken were close personal friends of Finance Minister Johnsen. And Under-secretary Øygaard had worked closely with Johnsen and Gulbrandsen in parliament for several years. It is beyond doubt that these personal relations facilitated the cooperation for reform. One informant described this well: “Political and personal relationships are essential in this kind of reform process. Personal chemistry comes into play. I have experienced in politics that when there are frictions on the personal level, everything becomes more difficult.”

Chapter 5: The objectives and outcomes of reform

5.1 Shift or continuity?

While chapter 4 looked at the process that led to the 1992 tax reform, this chapter is about the objectives and outcomes of the reform. Here, I present empirical data that shed light on whether the reform implied liberalization or rational updating. While greater efficiency at the expense of equality would indicate liberalization, a strengthened ability to achieve goals of both efficiency and equality would suggest rational updating (cf. section 2.1). The following discussion is based on existing studies of the tax reform and its effects, particularly statistical economic analyses, as well as the interviews with policy-makers and experts.

First, I look at the objectives behind the 1992 tax reform (section 5.2). Then, I present the output of reform, i.e. the substantive changes in tax rules (section 5.3). In section 5.4, I sketch the consequences of the reform for the functioning of the economy. Finally, I discuss the outcomes of the reform in terms of efficiency and growth, treatment of business/capital, capacity to finance the welfare state, and direct redistribution (section 5.5).

5.2 The reform objectives

Did the objectives of tax policy shift from redistribution towards efficiency with the 1992 reform? The interviews suggest that this was not the case. *Equality and efficiency appear to have been equally important concerns behind the reform.* There was a double rationale behind the main features of the reform. The reform architects sought to increase efficiency while at the same time strengthening the capacity both to raise revenue and redistribute directly.

The goal of economic efficiency was clearly given much larger weight in the 1992 reform than earlier. But rather than crowding out other core objectives, it complemented them. The architects behind tax reform were more concerned about an efficient allocation of resources than before, but they were not less concerned with revenue-raising and equality.

Generating revenue to finance the welfare state remained the core goal of tax policy, as it had been all through the post-war period. However, a central aim of the 1992 reform was to raise revenue *more effectively*. First, this implied raising revenue at a limited cost to the economy.

Second, it meant designing a tax system where revenues would grow automatically with the expansion of the economy. The goal was to bolster the long-term capacity to finance the welfare state.

Equality was also an important concern behind reform, although it appears that policy-makers thought differently about this goal than before. For one, policy-makers were less optimistic about the direct redistributive potential of tax policy. The ideological belief that high taxes would produce strong redistribution had subsided. Instead, policy-makers thought more practically about which tax measures could bring about real redistribution at tolerable costs. The 1992 reform was thus based on more moderate – some would say more realistic – ambitions about direct redistribution in the tax system.

For another, the question of horizontal equality received more attention. Horizontal equality implies equal taxation of individuals that are equal in economic terms. Thus, equal treatment and fairness became more important goals in the 1992 tax reform.

5.3 The reform output

5.3.1 Rate reductions, base broadening

What kind of reform did policy-makers implement to realize these objectives? Just like other tax reforms of the era, the Norwegian 1992 reform was one of ‘rate reduction, base broadening’. However, its particularities are arguably more striking. Not only did the Norwegian reform go further than other reforms in cutting rates and broadening bases. It also applied the principle of neutral taxation more rigorously than elsewhere and introduced a sophisticated dual income tax model.

In line with the international trend, the Norwegian tax reform of 1992 cut rates and broadened bases. This process had been in motion since 1987, with gradual reductions of formal tax rates and expansions of the tax base. The rationale behind lower rates was both to reduce efficiency losses and to remove the strong incentives for tax avoidance and tax planning. Base broadening was meant to ensure both a more efficient allocation of resources and greater fairness in taxation, as broader bases implied closer correspondence between actual and taxable income.

The Norwegian tax reform, however, went further than most other countries in both cutting statutory tax rates and broadening bases by removing deductions. On the one hand, formal tax rates both for individuals and corporations were cut dramatically. The top marginal tax rate for individuals (including social contributions) was lowered from around 70 percent in 1986 to just under 50 percent in 1992 (Ganghof 2006:94). The corporate tax rate, which had been fixed at 50 percent until 1991, was cut to 28 percent in 1992.

On the other hand, the tax base was expanded, meaning that more of the income of both persons and businesses became subject to effective taxation. This involved the elimination or limitation of a large number of deductions and other generous tax schemes. For corporations, this included the abolition of tax-favored funds and generous depreciation allowances. For individuals, the value of interest deductions was limited and several specific deductions removed or replaced by general deduction

The Norwegian tax reform not only went further in cutting rates and deductions. It generally applied principles meant to ensure economic efficiency in a more rigorous manner than other reforms. In particular, the principles of neutrality and symmetry were implemented in almost all areas. Neutrality meant that all types of capital income became subject to the same effective tax rate. This implied a uniform effective tax rate, irrespective of the type of investment, the form of ownership, or the source of financing. Symmetry meant that incomes and corresponding expenses were treated in the same way. When income was taxed at a certain rate, costs could be deducted against the same rate.

5.3.2 The dual income tax model

Equally characteristic as its attention to neutral taxation, was the specific tax model introduced by the reform, namely the ‘dual income tax’ (DIT) model. This model explicitly differentiates taxation between labor and capital income. Although this was not the first dual model, it was the most pure and sophisticated of its kind. The dual income tax model was attractive since it reconciled the efficiency principles of neutrality and symmetry with other crucial objectives, notably redistribution and revenue-raising. “The overall objective of the 1992 reform was to achieve a moderate taxation of capital income that is neutral in a very

broad sense, while maintaining the distributional role of a progressive tax on labour income,” as Christiansen (2004:9) points out.

In the reform, this model was realized through the introduction of two distinct tax bases, ‘regular income’ and ‘personal income’ (NOU 2003:59). ‘Regular income’ is calculated for both individuals and corporations. Included in regular income are all types of taxable income from labor, corporate activity and capital. Taxable income equals total income minus deductions. The 1992 reform introduced a flat tax rate of 28 percent on regular income, which has not been changed since.

‘Personal income’, however, is calculated only for individuals. ‘Personal income’ includes income from labor and pensions, without deductions of any kind. This income is subject to social security tax and surtax. The social security contribution was set at 7,8 percent for salaried workers. In addition, a surtax of 13,5 percent was levied on incomes above a certain threshold.

These tax rules implied different treatment of labor and capital income, which is the hallmark of the DIT model. While capital income was taxed at a uniform flat rate of 28 percent, the taxation of labor income was progressive with a top marginal rate of 49,3 percent (28+7,8+13,5) for a salaried worker.

Differential treatment of labor and capital income, however, requires that you are able to distinguish between these types of income in practice. While this is simple in the case of regular workers or large corporations, it is prohibitively difficult when it comes to small companies and the self-employed. To deal with this problem, the 1992 reform introduced an *income-splitting model* meant to serve as a bridge between personal and corporate taxation.

This model applied to sole proprietorships, partnerships and corporations with active owners, that is, the types of firms where the returns to labor effort and capital assets were by definition entangled. Basically, it implied that for firms with ‘active owners’, part of the income was counted as labor income and therefore taxed at a higher rate. An ‘active owner’ was defined as someone who owned at least two thirds of the firm.

The single taxation of all kinds of capital income represented another important feature of the 1992 reform. In this regard, the reform was extremely loyal to the principle of neutrality. To

avoid discrimination of corporate investment, the reform introduced rules to prevent the double taxation of the profits of shareholders, whether they were dividends or capital gains (Christiansen 2004:10). Two novel measures were important to this effect.

First, for dividends, an imputation system gave shareholders full tax credit against the personal tax on dividends for profits that had already been taxed at the corporate level. Second, for capital gains, a method called RISK was to prevent double taxation between corporation and individual. This method implied adjusting the tax value of shares for profit retentions, so that capital gains that reflected already-taxed retained earnings would not be taxed again.

The 1992 reform did not, however, extend the principles of symmetry and neutrality to all areas. The reform maintained the feature that most blatantly violated these principles, namely the favorable tax treatment of owner-occupied housing. The tax system continued to privilege income from housing capital over other types of capital income. In particular, the value assessment of houses for taxation remained far below market value (Christiansen 2004:11).

5.4 The reform effects on the functioning of the economy

The 1992 tax reform engendered major changes in the functioning of the Norwegian economy. Most importantly, more neutral taxation of capital income led to a freer flow of capital. Also, limits on interest deductions meant higher after-tax real interest rates, which influenced savings and investment decisions.

A number of the reform elements contributed to more neutral taxation of capital income. First, the reform eliminated deduction schemes, made depreciation rules more realistic, and severely limited firms' opportunities to avoid tax by putting profits in funds. Second, it introduced a uniform tax rate on capital income. Third, single taxation of all kinds of capital income was established.

In this way, the 1992 reform effectively levelled the playing field. A free, competitive market for capital replaced the old regime of specific tax incentives and directed capital flows. This was indeed a radical shift. "The tax reform was a steam roller that rolled over stumps and

bumps with considerable brutality and evened it all out,” as one informant vividly described it.

The former tax system was weak in terms of neutrality, meaning that it strongly favored certain types of investment over others. In particular, the tax system gave firms incentives to retain profits and reinvest them in real capital. This locked capital into the companies. The 1992 reform, however, removed these incentives. Tax rules no longer increased the after-tax profitability of investments that were not the most profitable before tax. The new tax system was to a large degree neutral between different investments. Thus, capital owners were induced to channel their investments to where they would give the largest returns. The result was an increased flow of capital. Some see this as an important impulse to the growing financialization of the Norwegian economy in the 1990s and 2000s, as the reform stimulated the flow of financial capital.

The unlocking of capital had a couple of important economic implications. First, it generated higher and more equal returns to capital, at the same time as investments in real capital fell. From 1991 to 1993, there was a strong increase in the returns to capital. Although this was mainly caused by a booming economy, it appears that the tax reform triggered a shift in capital returns to a higher level (NOU 2003:64). While there was a 13,3 percent return to capital on average in the period 1970-1991, the average between 1992 and 2001 was 18,8 percent. Moreover, the freer flow of capital generated convergence in the rates of return in the economy (Christiansen 2004:12).

While the returns to capital rose, the investments in real capital fell. Under the former tax system investments in capital were favored, giving rise to a very capital-intensive production structure. These incentives disappeared with the 1992 reform. As a consequence, the level of real investment as a percentage of operating profits shifted markedly downwards from the two decades preceding reform to the decade following reform.

Second, the unlocking of capital triggered a sharp rise in distributed profits. While the former tax system strongly favored keeping profits in the company instead of handing them out as dividends, the new tax rules did not discriminate between dividends and capital gains. As mentioned, dividends were only subject to taxation on the corporate level. Thus, more of the companies' profits were taken out as dividends and less as capital gains. Total dividends

increased exponentially through the 1990s. Partly, this was explained by the distribution of old profits that had been hidden in tax-free funds. But it was also a direct consequence of more neutral capital taxation.

Moreover, the 1992 reform reduced the gap between the real interest rate before and after tax by limiting interest deductions. This implied increased neutrality between saving and consumption, and led to a higher savings rate. Also, the new tax rules were neutral between the alternative ways of financing investments (loans, retained profits or equity capital). As a consequence, the part of investments financed through loans decreased, while the equity capital in Norwegian corporations increased.

5.5 The reform outcomes

5.5.1 The outcomes of reform in brief

The three preceding sub-sections have treated the objectives of reform, the output of reform, and the consequences of reform for the workings of the economy. However, the most important question remains: What were the outcomes of the 1992 reform?

In terms of efficiency and growth, the 1992 reform can be described as a considerable success. A better allocation of resources appears to have generated higher returns to capital and a gain in total welfare. Also, the reform likely had dynamic effects that contributed to strong economic growth in Norway in the 1990s.

However, this did not imply more lenient treatment of capital. Tax revenue from corporations as a percentage of GDP increased considerably in the years after reform. The main reason was that capital income that had previously been hidden was made visible and liable to taxation. More generally, the reform strengthened the long-term capacity of the tax system to finance the welfare state. The elimination of deductions put an end to the revenue leakages of the old system, and the introduction of dual income tax model ensured high revenues from labor income.

In terms of equality, the 1992 reform was partially successful. The reform neither led to a clear increase in inequality nor much stronger redistribution. The contribution of taxation to

income redistribution increased from before to after reform, but did not fully match the increase in pre-tax income inequality. In particular, the income-splitting model represented a problem in terms of equality.

In the following, I present the detailed discussions of the reform outcomes on each of these variables: efficiency and growth, treatment of business/capital, revenue-raising capacity, and equality. The discussion is primarily based on a survey of statistical economic analyses.

5.5.2 Effects on efficiency and growth

The 1992 tax reform was clearly a success in terms of efficiency and growth. Not only did a more optimal allocation of resources increase total welfare. Experts also believe that the tax reform was an important factor behind Norway's strong economic performance in the 1990s.

As discussed in sub-section 5.4, the tax reform freed up the flow of capital, leading to higher and less dispersed returns to capital. Thus, it seems clear that the reform generated a better allocation of resources between sectors and businesses. A more optimal use of resources meant a welfare gain for the Norwegian society as a whole. The estimate of the most comprehensive empirical study is that tax reform led to an increase in total welfare equivalent to a 0,75 percent growth in private consumption per year (Holmøy and Vennemo 1995). Other studies find an increase of between 1 and 2 percent (NOU 2003:62).

However, Holmøy and Vennemo's estimate is conservative, as it does not incorporate dynamic effects. This likely underestimates the effect on economic growth, as the tax reform affected the behavior of economic actors, both regarding savings, investment and work. As discussed in section 5.4, savings went up, while the investments in real capital fell. Studies also find a certain increase in labor supply (cf. NOU 2003:67).

Experts generally believe that the dynamic effects of the reform provided an important stimulus to economic growth (cf. NOU 2003; van den Noord 2000). The tax reform coincided with the beginning of a period of strong economic performance in Norway. Although this growth is mainly attributed to the positive business cycle, tax reform probably also played a significant role. In particular, the growth from 1992 onwards was not nearly as capital-

intensive as it had been earlier. Thus, it appears that the tax reform generated a growth within Norwegian businesses that was based on other factors than intensive capital use.

5.5.3 Effects on the treatment of business/capital

Increased efficiency can be interpreted both as an expression of liberalization and rationalization. To determine if the tax reform primarily represented the former or the latter, an important additional variable is how corporations/capital were treated. Did the 1992 tax reform imply more lenient treatment of capital, as the liberalization hypothesis predicts?

At first glance, this seems to be the case. In 1992, Norway cut the corporate tax rate to a lower level than in other countries and abolished the double taxation of dividends (van den Noord 2000:14-15). The 1992 reform also included a tax amnesty for corporations, allowing them to dissolve old capital reserves free of tax. Distributed profits increased exponentially in the years following reform, generating enormous incomes for wealthy capital owners. This explosion in dividends did, however, only to a limited extent reflect a real growth in capital incomes, as we discuss in the next sub-section.

Yet, the development in the total tax revenue from corporations does not match the hypothesis of liberalization. Tax revenue from corporations actually *increased* considerably in the years after reform, both in absolute terms and as a percentage of GDP. While the corporate tax take made up between 2 and 2,5 percent of mainland GDP in the period 1977-1991, it increased rapidly in the years following reform, hitting over 5 percent in 2000.

Although some of the increase is explained by income shifting to the corporate tax base, the main reason for the revenue growth is that capital income that had previously been hidden was pulled out into the light. Under the old regime, large profits were kept inside corporations and the corresponding increase in value channelled to owners as capital gains that were neither taxed nor registered (Fjærli and Aaberge 2003:399). The new tax regime made these incomes visible and liable to taxation.

The growth in tax revenues from corporations clearly suggests that the treatment of capital did *not* become more lenient. Rather, the tax reform seems to have stimulated growth in businesses while at the same time increasing their effective tax burden. The combination of a

low corporate tax rate and few deductions proved far more effective than the old tax regime in generating revenue from corporations.

5.5.4 Effects on the capacity to raise revenue

Raising revenue to finance the public sector is the fundamental objective of tax policy. Arguably, paying for the welfare state is also the tax system's most important contribution to redistribution, as welfare transfers account for about three fourths of total redistribution in Norway (St.meld. nr. 9 (2008-2009):111). Therefore, to determine whether the 1992 tax reform implied liberalization or rational updating, its consequences for the ability to raise revenue are of utmost importance. Did the tax reform strengthen or weaken the long-term capacity to finance the welfare state?

In absolute terms, tax revenues increased rapidly after 1992. Even though there has been a strong increase in GDP, tax revenue as a percentage of GDP has since remained stable or even increased marginally. This suggests that rather than limiting the growth of the welfare state, the tax system has allowed its continued expansion.

As a revenue-raising machine, the post-1992 tax system appears to be much stronger than the old one. Importantly, the elimination of deductions put an end to the enormous leakages of the old system. This broadening of the tax base made it possible to raise a larger amount of revenue with much lower statutory rates.

Also, the reform ensured that revenues grew automatically with the expansion of the economy. That is, larger revenues were generated by default and did not necessitate continual political adjustments. The reliance on flat rates with few exceptions – like the 25 percent value-added tax and the 28 percent tax on regular income – was crucial to this end.

Moreover, the dual income tax (DIT) model introduced by the tax reform appears to have been particularly effective in terms of raising revenue. The different rates on labor and capital income have allowed the government to raise larger revenues from labor than they could have with a comprehensive income tax (CIT). And as we saw in the previous sub-section, corporate tax revenues have also increased despite much lower statutory rates. In sum, the 1992 reform

strengthened the ability of the tax system to finance the Norwegian welfare state. This supports the hypothesis of rational updating.

5.5.5 Effects on equality

Finally, what was the outcome of the 1992 tax reform in terms of economic equality? A common perception is that the tax reform ushered in an era of higher income inequality in Norway. And indeed, when we employ the standard definition of income, the statistics reveal that income inequality soared during the 1990s. The Gini coefficient increased from 0,224 in 1986 to 0,255 in 1996 and 0,276 in 2000, a total growth of 23 percent (NOU 2003:70).

The observed increase in inequality is almost entirely explained by an exponential growth in capital incomes after the tax reform, especially in dividends and profits from realization of stocks. The total value of these two types of capital income increased tenfold from 1991 to 1996, rising from about 2 to nearly 20 billion NOK (2006 value) (Fjærli and Aaberge 2003:401). Inequality increased since it was almost exclusively high-income households that received these kinds of capital income. For instance, the top 10 percent in the income distribution received 90 percent of dividends. If dividends and profits from stocks are excluded, inequality measured by Gini coefficient is unchanged from before to after the reform (NOU 2003:71).

However, these statistics likely overestimate the growth in inequality. A considerable part of the observed increase in inequality is due to the fact that capital incomes were made more visible after the tax reform (Fjærli and Aaberge 2003). Before reform, the tax system gave owners incentives to keep profits in the business rather than collecting dividends. Instead, the returns to capital were taken out as stock profits that were tax-free and did not appear in official statistics. This changed with the tax reform, as it implied equal treatment of all types of capital income. As a consequence, more of the profits in businesses were handed out as dividends. Also, new rules for taxing stock profits meant that a larger portion of these gains was made visible. Therefore, the registered increase in capital incomes and the corresponding growth in inequality are largely a *statistical artefact*, and they do not reflect the real development in incomes.

Statisticians have employed an alternative income definition to get a more correct estimate of the development in income inequality, understood as the differences in the possibility for consumption between households⁷.

Contrary to the results from the standard measurement, the alternative estimates show only a marginal increase in income inequality in the period around tax reform. The Gini coefficient increased from 0,233 in 1986 to 0,243 in 1996 and 0,242 in 2000, a total growth of only 4 percent (NOU 2003:72). Further, the estimates show that this growth in inequality is not explained by higher capital incomes for the wealthy, but by developments at the bottom of the income spectrum (Fjærli and Aaberge 2003:407). Thus, the contention that the 1992 tax reform led to a strong increase in inequality based on large capital incomes for the wealthy, finds little support in these data.

But what exactly was the effect of the changes in tax policy on redistribution? An analysis of changes in the tax burden on different income groups suggests a more progressive distribution. From 1986 to 2000, the effective tax burden decreased marginally for the bottom 60 percent of households in the income distribution, while it increased a little for the top 40 percent (NOU 2003:72-73). Also, estimates from Statistics Norway (2002) show that the contribution of taxation to income redistribution increased from the period before reform to the period after. The tax system made the increase in income inequality – which was mostly driven by the wage development – less severe.

However, when also taking the development in pre-tax income into account, Thoresen (2002) finds that the real progressiveness of the tax system decreased from 1991 to 1999. The reason is that the inequality in the distribution of income before tax increased, without a corresponding increase in the inequality in the distribution of the tax burden. In other words, the tax system did not cancel out the increase in pre-tax income inequality. An important reason for this appears to have been that the DIT model's wide gap between the tax rates on labor and capital motivated income shifting. This allowed high-income earners to lower their tax burden. Yet, the 1992 tax reform in itself only accounts for a small portion of the decrease in real progressiveness. Subsequent adjustments in the income-splitting model and lack of

⁷ Instead of measuring the dividends or stock profits that are realized in a given year, they estimate the long-term consumption possibilities from capital investments. For details, see Fjærli and Aaberge (2003).

index regulation of benefits are more important factors for explaining this decrease (Thoresen 2002).

A reasonable conclusion would be that the 1992 tax reform neither led to a clear increase in inequality nor much stronger redistribution. On the one hand, the contribution of taxation to income redistribution increased from before to after reform, preventing a large increase in inequality. On the other hand, the stronger progressiveness in the distribution of the tax burden did not fully match the increase in pre-tax income inequality. *On balance, the result of the 1992 reform appears to be continuity in terms of equity.*

5.6 Empirical epilogue

What happened afterwards? On the one hand, the 1992 tax reform proved remarkably robust, as the core principles it introduced have not been abandoned. The broad lines of tax policy today are the same as they were in 1992. On the other hand, there were a number of minor yet consequential changes during the 1990s and a new major reform in 2006 that revised the 1992 reform.

Almost instantly after the reform in 1992, politicians started pecking away at the income-splitting model. This model was the most vulnerable part of the tax system, as it represented the bridge between personal and corporate taxation. The model had already been alleviated during the reform negotiations. After the reform, a series of additional minor changes were passed, all of which served to facilitate the reclassification of income from the labor to the capital tax base. This made the income-splitting model increasingly ineffective. It allowed many individuals with high labor incomes to shift income so that they faced a considerably lower tax rate. An expression for this is that the proportion of corporations subject to income-splitting fell from 55 percent in 1992 to 32 percent in 2000 (Christiansen 2004). Due to this, the tax system's direct redistributive effect deteriorated somewhat during the 1990s.

There were also other minor changes in the following years. In 1996, the bourgeois opposition in parliament passed a reform of shipping taxation that the government was forced to implement. The reform gave the shipping sector a large *de facto* tax break, as profits were exempt of taxation as long as they were kept in the company. In personal taxation, the Labor government introduced an extra bracket in the surtax in 2000, increasing the tax rate on the

highest labor incomes by 6 percent. This was subsequently reversed by the Conservative coalition in power from 2001 to 2005.

In 2004, a new tax reform was passed, which entered into effect in 2006. This reform was in the spirit of the 1992 reform, but introduced novel solutions in areas where the 1992 reform had failed. Most importantly, it narrowed the gap between the effective tax rate on labor income and capital income for individuals. The income shifting motivated by this large rate gap had represented a headache for policy-makers ever since 1992.

To deal with this, the 2006 reform replaced the income-splitting model with the so-called shareholder model. The shareholder model implies double taxation of dividends and stock profits above an imputed normal rate of return. This meant tightened taxation of capital, as personal capital income was now taxed first 28 percent at the corporate level and then an additional 28 percent of the remaining income at the personal level. In practice, however, this tightening has had little effect so far due to its timing. As the entrance values of stocks were calculated in 2005 when the stock market was at a peak, the calculated taxable income from this source has been modest.

Chapter 6: Analysis

6.1 The analysis in brief

What was the result of the Norwegian tax reform of 1992, and how can we explain this outcome? This chapter presents the analysis of these questions, which is based on my empirical investigation and illuminated by the theoretical literature. To preview the main findings: The 1992 reform was primarily characterized by *rational updating* rather than liberalization. This is discussed in section 6.2. Why was the Norwegian tax system move in a rational instead of a liberal direction? In section 6.3, I argue that this outcome depended on the process of change. Rational updating was possible only because a *fundamental reform* was passed.

But why was large-scale reform feasible? In section 6.4, I analyze the structural, ideational and institutional preconditions for the reform. Section 6.5 explores the specific interactions between these factors and highlights the mechanisms that contributed to reform.

6.2 The reform outcome: rational updating

The first major finding of this study is that the Norwegian tax reform of 1992 was characterized by rational updating rather than liberalization. Tax policy did not take off in a liberal direction; it stayed on the social democratic ‘middle way’. The middle way was fundamentally recalibrated, though. The 1992 reform evened out the bumpy road of activist post-war tax policy, turning the Norwegian tax system into a smooth highway of neutral taxation. As a consequence, the Norwegian economy could accelerate, and the state could collect larger road tolls (that is, tax revenues). In other words, the 1992 tax reform did not mark the death of social democratic tax policy; it should rather be regarded as a crucial element in the modernization of the social democratic project.

As shown in section 5.5, the 1992 tax reform was a success in terms of economic efficiency and growth. Tax reform generated a better allocation of resources and higher returns to capital, and its dynamic effects likely contributed to the strong economic growth in Norway in the 1990s. Greater efficiency, however, did not come at the expense of equality. The total ability of the tax system to generate outcomes of equality was reinforced by the reform, not

weakened. This matches the hypothesis of rational updating and contradicts the liberalization hypothesis.

Most importantly, the reform strengthened the capacity of the tax system to raise revenue to pay for the welfare state. In particular, three features contributed to this: First, the elimination of deductions put an end to the revenue leakages of the old system; second, the dual income tax model ensured high revenues from labor income; and third, new rules made previously hidden capital income visible and liable to taxation. The reform did however maintain the generous tax treatment of owner-occupied housing, which implied forgone tax revenue. But on balance the reform made tax policy better able to fulfil its core function of raising revenue. This also constitutes the tax system's most important contribution to redistribution, as welfare transfers account for three fourths of total redistribution in Norway. As such, the reform of tax policy allowed the continued expansion of the Norwegian welfare state.

At the same time, the reform did not weaken the redistribution of income *within* the tax system. The oft-repeated accusation that the tax reform produced a surge in income inequality turns out to be based on a statistical artefact. What the statistical studies show is that the reform neither led to a clear increase nor decrease in economic inequality, even though the ineffective income-splitting model represented a growing problem in terms of equality.

My findings do not support Swank and Steinmo's (2002:643,651) contention that the tax reforms of the early 1990s implied a "shift in policy paradigm". According to Hall (1993), a paradigm shift in economic policy involves a reformulation of the basic goals and ends of policy. In the Norwegian tax reform, however, the changes in policy means were far more important than the changes in policy goals. Revenue-raising remained the core objective of policy, and concerns about efficiency did not replace equity objectives. The investigation shows that equality and efficiency were equally important concerns behind the reform in 1992. As such, my findings support to argument that "tax reforms did not fundamentally change the weighting of different tax policy goals (efficiency and equity) but tried to better achieve both goals" (Ganghof 2007:1066).

Yet, my study suggests that Ganghof's interpretation is a bit too simple, as it gives the impression of perfect continuity in objectives. This conclusion does not fit the Norwegian case, as the goal of economic efficiency was clearly more important in the 1992 reform than

before. The point is rather that instead of crowding out other core objectives, the goal of efficiency complemented the other goals. That is, tax reform was not a zero-sum game. The architects behind tax reform were more concerned about an efficient allocation of resources than previously, but they were not less preoccupied with equality and raising revenue. Thus, one could say that policy-makers became more concerned with raising revenue and redistributing income *at a limited cost to the economy*.

However, there is reason to be cautious about the general scope of this analysis. Although the findings are relevant for the general understanding of the wave of tax reforms, they are most clearly applicable to the analysis of tax policy change in the Nordic countries. An important reason for this is that the Nordic countries all implemented dual income tax (DIT) models, which differed from the models chosen in other countries. In the closing chapter I briefly discuss the Norwegian case in a comparative perspective.

6.3 Rational updating through large-scale reform

6.3.1 Liberal inertia, rational reform

Why was the Norwegian tax system subject to rational updating rather than liberalization? I argue that this outcome depended on the process of change. Rationalization was possible because a *large-scale reform* was implemented. Authoritative policy change appears to have been a necessary precondition for the rational updating of the tax system.

Within-case comparison constitutes the main empirical basis for this claim. When we look at the development of tax policy in Norway from 1980 until today, there are several instances of policy change (or the lack thereof) and corresponding outcomes. These cases suggest a systematic relationship between processes of change and outcomes of change. When there is incremental policy change – or no change at all – the outcome is most often liberalization. Instances of large-scale policy change, on the other hand, result in rational updating.

Let us first look at the periods of incremental policy change. During the 1980s, the lack of major policy change made the tax system increasingly deficient. The tax system was subject to more and more subversive action that undermined its ability to redistribute income and generate revenue, leading to *de facto* liberalization. The dynamics of tax policy in the decade

following the 1992 reform were slightly different. Almost instantly after the reform, politicians started pecking away at the system. Several minor changes were passed, most of them relating to the income-splitting model. These incremental changes represented alleviations of the tax rules, making it easier to reclassify income from the labor to the capital tax base. This undermined the tax system's ability both to redistribute and to raise revenue. Thus, during both periods, incremental changes to tax policy implied liberalization.

The three instances of large or medium-scale policy change, on the contrary, led to rationalization. First, the medium-scale 1987 tax reform introduced a limit on interest deductions, which increased the actual tax burden on the well off and strengthened the capacity to raise revenue. Second, the fundamental 1992 tax reform was mainly characterized by rational updating, as argued in section 6.2. Third, the comprehensive 2006 tax reform removed the incentives to reclassify income and tightened capital taxation by introducing double taxation of dividends.

6.3.2 Institutional theory revisited

These findings are incompatible with Pierson's view (and more broadly the punctuated equilibrium model) of the relationship between processes and outcomes of change (see section 2.2.2). Pierson (2000) argues that incremental processes of change produce continuity in outcomes. His contention is that path dependent change precludes welfare state retrenchment/liberalization. However, my investigation of Norwegian tax policy shows that adjustments within the existing policy path generated discontinuity in outcomes in the form of liberalization. Path dependent change did not prevent liberalization, it actually promoted it.

Pierson's argument about path dependence is complemented with the argument about critical junctures. This says that at critical moments, radical shifts will occur that cause discontinuity in outcomes. Again, the present case seems to defy this logic. The early 1990s can be understood as a critical juncture in Norwegian tax policy, which produced major policy change that shaped the contours of the tax system for decades to come. Yet, this fundamental remaking of tax policy produced continuity in outcomes. At this critical moment, policy-makers did not send tax policy off in a different (and liberal) direction; they reoriented the tax system towards its core objectives. More broadly, the critical junctures of 1987, 1991 and 2004 were actually the only instances of policy change that produced continuity in outcomes.

All in all, my findings are consonant with Streeck and Thelen's (2005) critique of the punctuated equilibrium model of change. Neither can incremental change be equated to continuity in outcomes, nor does abrupt change imply discontinuity in outcomes. Streeck and Thelen present an alternative view of the relationship between processes and outcomes of change, arguing that (most) often, incremental change is the source of discontinuity in the form of liberalization. The Norwegian tax policy case supports this alternative view.

When the tax system was not tended to, it was subject to erosion through *drift* (cf. Hacker 2005). The inability to update policies to an increasingly complex economic environment made the tax system falter. Policies drifted off from the core objectives of the tax system. To a growing extent, the old tax policy regime gave free play to the subversive actions of the firms and individuals with sufficient resources to engage in tax planning and avoidance. This weakened the capacity of the tax system to raise revenue and redistribute income, implying liberalization as here defined.

Conversely, when the tax system was subjected to major changes, rational updating resulted. The 1992 reform is a striking example of the combination of drastic policy change and continuity in outcomes. Even though Streeck and Thelen do not elaborate on this type of institutional change, this finding is perfectly consistent with their argument. As they put it, "institutions require active maintenance; to remain what they are they need to be reset and refocused, or sometimes more fundamentally recalibrated and renegotiated, in response to changes in the political and economic environment in which they are embedded" (Streeck and Thelen 2005:24).

The Norwegian tax reform of 1992 implied a fundamental recalibration of the tax system, which allowed it to effectively maintain its core objectives. Through reform, tax policy means were updated to handle the complexity of a modern economy. Given the new political-economic context, the reform reunited policy means with objectives. As Ganghof (2007:1081) argues, drastic changes in tax rules were necessary to defend the underlying substantive status quo. Large changes were key to preserving the essential aim of tax policy, namely to finance the welfare state and redistribute income at a limited cost to the economy.

With reference to the discussion about path dependence, this case shows how a change of policy paths was a precondition for rational updating. The existing tax policy path turned out to be a dead end. As the economic environment changed, it became virtually impossible to achieve the core objectives of the tax system through adjustments within the existing path. In Norway, tax policy started to break off this path in 1987 with the passage of the personal tax reform, before the definitive rupture occurred in 1992. This shift of policy paths produced more rational tax policy and deterred liberalization.

6.3.3 Mechanisms that link large-scale reform to rational updating

Yet, this study also had the explicit aim of *exploring the mechanisms* underlying a potential relationship between fundamental reform and continuity in outcomes. What is it about large-scale policy change that can make it conducive to rational updating? A discussion of the mechanisms at work in our case – the Norwegian tax reform of 1992 – can illuminate this general question.

My investigation suggests three (more or less) general mechanisms that link large-scale reform to outcomes of rational updating. First, large reforms increase the participation of experts in policy-formulation. Second, fundamental policy change allows for more coherent solutions. Third, comprehensive policy change may shore up political opposition, since groups that lose from one reform measure will often benefit from another measure.

A first characteristic of major reforms of the political economy is that experts have a more important role in the formulation of policy. Large-scale reform tends to privilege the participation of internal and external experts relative to that of politicians. This is especially true in the field of tax policy. While incremental changes can be made by politicians alone, larger changes per definition involve experts. That is, the probability that experts are not involved in policy-formulation will decrease with the size of policy change.

Stronger expert involvement in policy-formulation can be expected to increase the rationality of policy solutions. The point is not that experts per definition will provide better solutions than politicians. But on average, expert influence will lower the probability of irrational policy changes. Hence, one possible link from large-scale reform to rational outcomes goes through the participation of experts in designing policy. (An important objection is that

outcomes will depend on the views of experts. Economic experts may for instance be strongly in favor of liberalization. Thus, it may be necessary to add a condition to the argument, namely that experts do not actively pursue a liberal agenda.)

In the case of Norwegian tax policy, there are clear indications that such a mechanism is at work. Several incremental tax policy changes have been implemented by politicians against the advice of experts, and have led to liberalization. For instance, this was the case with the changes in the income-splitting model after 1992 and in shipping taxation in 1996.

Second, instances of major policy change open for more coherent solutions. The remaking of an entire system (or large parts of it) allows policy-makers – both politicians and experts – to think more systematically about policy design. For instance, large reform gives policy-makers the opportunity to apply general principles to an entire policy area. This will privilege coherent policy solutions. Small changes appear to have the opposite effect, as they are conducive to ad hoc-solutions.

Generally, we can expect coherent policy to imply more rational solutions. This is clearly the case in the area of tax policy. Coherence appears to be a prerequisite for good tax policy, as there are strong inter-linkages between different elements of the tax system. The effect of one tax rule or scheme is highly contingent upon other rules. For instance, high statutory tax rates do not imply high effective tax rates if they are combined with large deductions. In addition, the uniform application of general tax principles is in line with the economic idea about neutrality. The economic argument is that neutral taxation leads to efficiency in the allocation of resources. Hence, the second possible link from large-scale reform to rational outcomes goes through coherent policy solutions.

Third, large reform means that policy-makers can make simultaneous changes to a large number of schemes. Incremental change, on the other hand, is usually limited to a single scheme. Isolated restrictive policy changes are bound to create some clear losers and are therefore often met with fierce opposition. But when measures are bundled together, gains and losses may be distributed pretty evenly. Changing many schemes at the same time may thus shore up political opposition, since groups that lose from one reform measure will often benefit from another. Thereby, large-scale reform can make it easier to gain acceptance for rational policy measures.

This logic was apparent in the case of Norwegian tax policy. Policy-makers found it difficult to eliminate or limit generous deduction schemes, since the groups that benefited from a particular tax deduction would always fiercely oppose such proposals. Major reform, however, meant that those who lost from the elimination of a deduction would benefit from other policy changes, such as rate cuts. On balance, few groups were clear losers, something that reduced political opposition.

6.3.4 Beyond large-scale reform: the sources of rational updating

However, to explain the outcome of rational updating, it is also necessary to look beyond the general features of large-scale reform. The answer to why the Norwegian tax reform resulted in more rational policy (rather than more liberal policy) lies partly in the factors that caused large-scale reform in this case. These structural, ideational and institutional preconditions for reform are the subject of the next section. The influence of these factors on the outcome of rational updating can be summarized as follows:

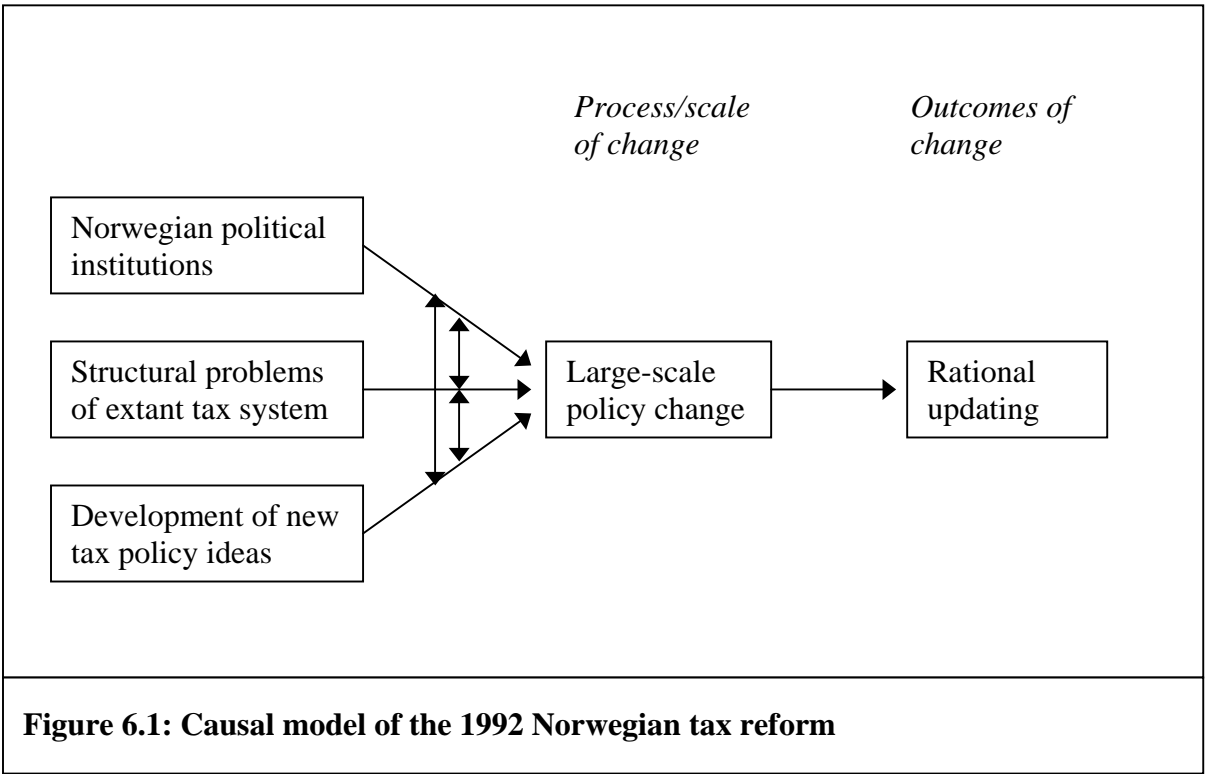
Firstly, the serious structural deficiencies of the existing tax regime gave policy-makers large room for rational updating of policy. Secondly, new tax policy ideas, taken from abroad and further developed by national experts, provided policy-makers with a blueprint for how to better achieve the core tax policy goals. Thirdly, the fact that large-scale reform was the product of broad political consensus – rather than strong government – ensured a balanced reform and precluded liberalization. Since broad-based compromise can largely be explained by the Norwegian institutional setting, this represents a link between Nordic-style political institutions and rational updating of policy.

6.4 Explaining large-scale reform

6.4.1 The preconditions for large-scale reform

The large-scale tax reform of 1992 led to a rational updating of tax policy. But why was it possible for political actors to agree upon such a fundamental reform? My investigation suggests that there were three necessary preconditions. First, the huge problems of the existing tax system were a *structural* precondition for reform. A tax structure that was

deficient and increasingly harmful to the economy represented the reason why politicians wanted reform. Second, the development of new economic ideas about taxation constituted an *ideational* precondition for large-scale reform. These ideas provided policy-makers with the substance of reform. Third, Norwegian political institutions were an *institutional* precondition for large-scale reform. By shaping the preferences and strategies of the main political actors, these institutions generated the political agreement on reform. Figure 6.1 provides a simple model to illustrate how these factors influenced reform.



In other words, structural, ideational and institutional factors are all necessary to account for the 1992 tax reform. In this section, I look at the role of each of them in turn. In section 6.5, I analyze how the specific interactions between these factors produced reform. It warrants emphasis, however, that these factors explain reform in the sense that they shape the preferences and actions of human agents. It is after all actors that perceive structural problems, pick up and spread ideas, and pursue political action within institutions. In this account, politicians from the Labor and Conservative parties, as well as economic bureaucrats, are the most important actors.

6.4.2 Structural problems of the tax system

In explaining developments in tax policy since the 1980s, the tax literature has put great emphasis on structural factors, especially those at the international level. It has become conventional wisdom that economic internationalization has imposed strong structural constraints on tax policy-makers (e.g. Swank and Steinmo 2002; Ganghof 2006). Interestingly, I find that international structural factors were not at all important for the Norwegian tax reform of 1992. The interviews reveal that international tax competition was not a major concern for Norwegian policy-makers during the 1980s. Ganghof misses the mark when he writes of the Norwegian reform that “[t]he most important reform goal was to achieve competitive [...] capital income taxation” (Ganghof 2006:96).

We can partly attribute the finding that economic internationalization was not important for the 1992 reform to the fact that the discussion about international capital mobility first really emerged at a later point in time. But another important reason is that under the Norwegian tax regime of the 1970s and 80s, the effective tax rate on capital was very low. The low effective taxes on capital were partly the result of an intentional policy aimed at stimulating production in businesses, and partly the unintended consequence of the many deduction schemes. Thus, mobile capital already carried very little of the tax burden, albeit for other reasons than the fear of capital flight. Because of this, there was no structural pressure to shift the tax burden from this income base to immobile income sources.

The Norwegian tax reform was instead motivated by *structural factors on the domestic level*. That is, the structural problems of the extant Norwegian tax system represented the rationale for reform. This finding is consistent with Ganghof’s (2007) argument that the tax reforms of the 80s and 90s were first and foremost a response to the pathologies of the existing tax policy regimes.

In the late 1970s and early 1980s, the Norwegian tax system grew more and more deficient. From the outset, Labor saw the tax system as a problem in terms of equality and fairness, while the Conservatives regarded it as an impediment to production. However, during the 1980s, policy-makers from both parties became increasingly aware that the existing ‘high rate, large deductions’ tax regime was ineffective both in terms of revenue-raising, redistribution, allocation of resources, and economic growth.

The inability of the tax system to achieve its core goals was the source of the desire for policy change among politicians. That is, it generated the *demand* for reform. Yet, an important reason why it took politicians so many years to agree on some kind of tax reform, was that this demand was much stronger in the Labor party than in the Conservative party. Labor party elites clearly wanted reform already in 1980, while in the Conservative party leadership a sceptical attitude to reform prevailed for a long time. Those in charge in the Conservative party did not become convinced that reform was needed until the late 1980s.

When finally a strong common feeling emerged that something needed to be done about tax policy, it was because of the catastrophic macro-economic effects of the tax system from the mid-1980s onwards. First, the hyper-expansion of credit from 1984 to 1987 partly driven by generous interest deduction rules made politicians realize that personal tax reform was necessary. Second, the subsequent economic downturn convinced central policy-makers that the entire tax system needed deep-seated structural reform. This development confirms Tranøy's (2000:87) predictions about the impact of crisis on reform. In the absence of crisis, policy-makers were unable to revise the tax system. Only when the economy was expanding uncontrollably or contracting dramatically were reforms effectuated.

Taken together, the increasing structural problems of tax policy gave politicians strong reasons to want reform. Without this rationale, large-scale policy change would not have been possible. The inertia in the early 1980s showed that reform was not feasible in the absence of a strong common demand for change. In other words, structural problems were crucial for reform in the sense that they opened up a political space for large-scale policy change.

Moreover, the serious deficiencies of the existing regime gave policy-makers large *room* for rational updating of policy. In this regard, the Norwegian case supports the point that rationalization of policy was possible partly because the old tax regimes "turned out to undermine efficiency, progressivity, and revenue-raising alike" (Ganghof 2007:1066).

However, huge structural problems were not a sufficient condition for the 1992 reform. Although policy-makers were aware of the equity and efficiency problems of the tax system, they were for a long time neither able to ascertain the appropriate solutions nor agree on major policy changes. Even the strong economic downturn did not generate immediate

reform. This means that structural factors can only take us so far in accounting for reform. Structure needs to be complemented with ideas and institutions, which in the case of Norwegian tax reform were crucial explanatory factors.

6.4.3 New tax policy ideas

New economic ideas about taxation were a second necessary precondition for fundamental reform, as they provided its substance. Modern tax policy ideas originally emerged abroad, but were further developed, adapted and specified by experts on the national level. This process reached its climax in the 1989 Aarbakke public commission report. In the 1992 reform, policy-makers adopted its conclusions more or less wholesale. The reform introduced the particular version of the dual income tax (DIT) model recommended by the Aarbakke commission. Thus, new ideas about tax policy made up the content of reform.

The observation that ideas provided the *substantive* prerequisite for policy change speaks to a more general discussion. Lieberman argues that “institutional approaches in political science are limited in their capacity to account for the substantive course of politics [...] Ideas ... can fill this explanatory gap [as] they constitute much of the substantive raw material upon which institutional theory feeds” (Lieberman 2002:697). The case of tax reform in Norway shows the relevance of this point. Any account of the reform that ignored the role of ideas would have been incomplete.

The kind of fundamental reform that was passed in 1992 would not have been possible without the novel tax policy ideas. The development of ideas that proceeded throughout the 1980s effectively pushed the possibility frontier for tax reform. When Finance Minister Sigbjørn Johnsen presented the tax reform in 1991, he said: “This reform came ten years too late”. However, a reform of this calibre would have been unthinkable only a decade earlier.

This finding supports Blyth’s argument that new economic ideas are the “prerequisite of radical policy changes”. Novel ideas allow policy regimes to break out of the normal logic of incremental change: “While it is true that policy changes in advanced capitalist states tend to be incremental, nonetheless the espousal of critical economic ideas is clearly related to periods of deep-seated institutional reform” (Blyth 1997:246). The logical implication of this argument would be that the outcome of such fundamental reform is conditioned by the

character of the critical ideas. As such, the adaptation and further development of tax policy ideas by Norwegian experts is part of the explanation for why rational updating was the outcome of the large-scale Norwegian tax reform.

Ideas represent an independent explanatory factor for the 1992 reform. They were neither the product of structural conditions nor institutional processes. However, the role of new tax policy ideas must be understood in relation with both structure and institutions. The influence of ideas on policy was contingent upon, on the one hand, their ability to respond to structural problems, and on the other hand, their constitution and transmission within political institutions. These relationships will be discussed in section 6.5.

6.4.4 Norwegian political institutions

Political institutions capable of generating political consensus represented the third precondition for fundamental tax reform. Norwegian political institutions structured politics in a way that favored broad agreement on reform. In our case, there was both growing demand for reform and eventually a supply of solutions. But decision-making institutions were crucial for bringing about reform as they moulded and joined demand and supply. The institutional setting both stimulated *convergence in preferences* among political actors around expert solutions, and facilitated the *pursuit of cooperative political strategies*.

In particular, institutions influenced the strategies of the Conservative party, which had an ambivalent attitude to reform. Institutional features tipped the balance in favor of the reformist strategy in the Conservative camp, by lowering the costs of working for fundamental policy change relative to working against it. This made it possible for politicians to reach a reform compromise.

The Norwegian tax reform of 1992 would not have been possible without this positive influence from political institutions. Or more precisely, a reform as fundamental, well founded and broadly agreed upon as the 1992 reform could not have resulted without the intervention of these institutional factors.

These findings are of particular theoretical interest. It supports the hypothesis that Nordic-style political institutions provide an environment that is conducive to authoritative policy

change, at least under certain conditions. In the institutionalist literature on change in advanced political economies the central argument is that the dynamics of political institutions make large-scale reform *difficult* (Pierson 2000; Streeck and Thelen 2005). For instance, American institutions are found to provide high institutional barriers to reform and give political actors disincentives to pursue reform strategies (Hacker 2005).

Norwegian decision-making institutions, however, can be argued to have the opposite effect. In the case of tax policy, political institutions *facilitated* large-scale updating reform. Institutional features lowered the barriers to reform and encouraged political actors to commit to fundamental policy change, rather than block it. The clearest expression for this is the actions of the Conservative party, for whom this choice was very real. While Hacker (2005) argues that American political institutions gave conservatives in opposition to the welfare system incentives to work *against* reform, I find that the Norwegian institutional setting induced conservatives sceptical of taxation to work *for* tax reform.

More generally, the findings confirm the main theoretical expectations regarding political institutions in the Nordic countries, namely that they produce consensual politics that generate rational and stable policies. In our case, political institutions generated consensus both between politicians and experts and among political parties. (Although unions and employers were not as central as expected, also they were party to the reform compromise.) Consensus along these two axes produced a balanced reform that was robust both economically and politically.

Thus, the fact that large-scale reform was the product of broad political consensus appears to have privileged the outcome of rational updating. Liberalization seems a far more likely outcome when implemented by a strong government acting alone, than when it is based on broad consensus among political actors. This argument suggests a link between Nordic-style political institutions and rational updating of policy. The consensual character of these political systems appears to make them conducive to large-scale updating reform.

Lastly, the importance of institutional factors relative to other explanatory factors warrants discussion. Although institutions were crucial for the outcome, they cannot explain reform alone. The institutional generation of reform agreement was based upon both the rationale for reform provided by structural problems and the substantial reform solutions stemming from

novel tax policy ideas. And the context of economic crisis represents at least part of the explanation why decision-making institutions could produce large-scale reform.

Such an understanding of the relationship between structure, ideas and institutions helps us explain why the Norwegian decision-making system was not able to generate tax reform before 1992. Institutional factors alone cannot explain this fact, as the institutional setting was more or less constant through the 1980s and early 1990s. What changed, however, was the structural and ideational input. In the late 1980s, increasing structural problems had generated a common feeling in the Labor party and important parts of the Conservative party that reform was needed, and experts had developed highly sophisticated tax policy ideas. This provided the necessary raw material out of which institutions could shape tax reform.

6.5 The mechanisms behind reform

6.5.1 Interaction between structure, ideas and institutions

In the preceding section, I discussed the influence of respectively structural, ideational and institutional factors on the 1992 tax reform. In this section, I look at the specific mechanisms through which these factors produced large-scale policy change. That is, I explore the causal pathways that connect these variables to the reform. The interaction between structural, ideational and institutional variables is at the core of this account.

I first discuss the relationship between ideas and structure (6.5.2). New economic ideas were influential on policy because they ‘fit’ well with the structural environment. Second, I look at the interaction between institutions and ideas. On the one hand, ideas responded well to the deficiencies of the tax system partly because they were constituted within Norwegian political institutions (6.5.3). On the other hand, institutional features increased the ideational influence on policy by stimulating the transmission of new tax policy ideas between actors (6.5.4). Finally, I discuss how features of Norwegian political institutions made it easier for political actors to pursue cooperative strategies (6.5.5).

6.5.2 Structure and ideas

The linkage between structural and ideational factors was crucial for the 1992 tax reform. The importance of each factor for reform was contingent upon the presence of the other. Neither factor was important in isolation. But together, they had profound influence on reform.

However grave they were, the structural problems of the tax system did not in themselves bring about large-scale policy change. Rather, we can say that the dissatisfaction with the existing tax system opened up a *political space*. This space needed to be filled. In our case, ideas took on this role. While structural problems generated the demand for reform among political actors, ideas supplied them with the solutions.

This observation supports Blyth's (2001) argument about the relation between structural and ideational factors. In the tax case, structural factors only bring us halfway in explaining policy regime change. While structural problems account for the instability of the extant regime, they tell us nothing about what a new regime would look like. That is, structural explanations are indeterminate regarding the outcome of reform.

Therefore, ideas are crucial components of explanations of policy regime change. New economic ideas provided the substance of the tax policy regime established by the 1992 reform. The sophisticated dual income tax (DIT) model that was introduced was the product of idea development. As such, ideas constituted the crucial link between the deficiencies of the old system and the tax reform meant to improve it. Thus, we can understand economic ideas as "key mediating variables" (Blyth 2001:5) between structural change in the economic sphere and policy regime change in the political realm.

Yet, the political space created by structural problems could not have been filled with any kind of ideas. The "responsiveness of ideas to particular problems" (Berman 2001:236) is crucial. New ideas about taxation became an important mediating variable because they responded well to the deficiencies of the tax system, as perceived by the main political actors.

First, these ideas provided a cognitive framework that illuminated why the existing tax regime was unable to achieve its goals. They presented a theoretical explanation for many of the economic problems experienced by policy-makers. Second, the ideas projected solutions that

could answer these problems. The DIT blueprint clearly outlined the changes needed to make the tax system more effective. As a consequence, policy-makers came to regard these ideas as relevant for tax policy.

In other words, novel tax policy ideas were influential since they ‘fit’ the structural environment. The effect of ideas was contingent upon their applicability to actual, structural problems. It appears that policy ideas without this strong attachment to the structural reality would not have had nearly the same influence.

Relevant to the general tax literature, it appears that the DIT model responded particularly well to the structural problems faced by Norwegian policy-makers. This supports Ganghof’s (2005:82) argument that the DIT model is attractive because it matches the structural constraints and incentives confronting policy-makers. Yet, it is important to note that it was the responsiveness to domestic structural problems that made the DIT model attractive in the first place. Later on, however, the model has also proven to be beneficial in the context of stronger international tax competition (cf. Ganghof 2005).

6.5.3 Institutions and the constitution of ideas

It is important to recognize, however, that the relationship between ideas and structure was constituted within an institutional context. Structural problems were perceived through political institutions, and the development of tax policy ideas also partly took place within these institutional confines. In our case, political institutions were important in shaping the relationship between structural and ideational factors, as they forged the link between the problems of the tax system and the solutions provided by economic experts.

Why ideas responded well to structural problems is in part explained by institutional factors. Ideas fit partly because they were thoroughly processed at the national level. Tax ideas from abroad were further developed, adapted and specified by experts within the confines of Norwegian political institutions. This resembles the process of “imitation and innovation” found by Westney (1987) in her study of the transfer of Western organizational models to Japan. The development of tax policy ideas took place in public commissions and in the Ministry of Finance. This work greatly enhanced the relevance of new tax policy ideas for the Norwegian system.

Moreover, this process brought tax policy ideas into line with existing *ideology*. That is, the further development of economic ideas within the Norwegian institutional context produced tax policy solutions that were more compatible with the social democratic ideology held by the majority of Norwegian politicians. The presence of strong social democratic norms in the Norwegian economic bureaucracy appears to constitute part of the explanation for this.

More specifically, the dual income tax model that was developed put particular emphasis on objectives of equity and revenue-raising. This made the new tax policy ideas appealing to social democrats in search of new ideas that could better advance their project of equity and growth. That the ideas provided an answer to equity concerns made them acceptable politically, which was a condition for their influence on policy. Thus, the influence of ideas was also contingent upon their fit with the existing, institutionalized ideology.

We can conclude that the ideational influence on reform was contingent upon the constitution of tax policy ideas within the Norwegian institutional setting, since this increased their fit with both the structural and ideological environment.

6.5.4 Institutions and the transmission of ideas

The interaction between ideas and institutions was consequential for reform in another way as well. Ideas can only influence policy if they are taken up by the actors who decide on policy. Thus, the effect of ideas on policy is contingent upon their diffusion, first from experts to politicians, but also from political elites to regular party members and the general public (Blyth 2001:237). As our case shows, political institutions shape this diffusion. New economic ideas could exert considerable influence on tax reform only because institutional features stimulated their transmission. The institutional setting generated convergence in political preferences around these ideas, thereby forging both the substantive and the political basis for reform. Three mechanisms accounted for the transmission of ideas.

First, *commission reports* were crucial for the spreading of novel ideas about taxation from economic experts to politicians. These reports applied new economic ideas directly to the Norwegian tax system and developed concrete policy proposals. Thereby, they influenced the opinions of political elites, making central actors in both the main parties regard new tax

policy ideas as appropriate solutions to the problems of the tax system. Thus, the preferences of political elites converged towards the views of economic experts.

Second, ideas were transmitted from experts to politicians through their close *cooperation in the Ministry of Finance*. Intense interaction with bureaucrats exposed political actors from both sides to rationalist arguments about tax policy design. This shaped the views of politicians, generating political consent to new policy ideas.

Third, *economist politicians* played an important role in the transmission of tax policy ideas from political-administrative elites to the broader parties and the public. These individuals actively translated economic arguments about tax policy into politically comprehensible terms. This translation increased the acceptance for new, often counterintuitive tax policy ideas. It was thus essential for building broader political support for the reform.

6.5.5 Institutions and political strategies

Convergence in political preferences around expert solutions was a necessary, though not sufficient condition for reform. As simple game-theoretic models will tell you, compatible preferences do not ensure actual cooperation. Political actors still needed to work together to arrive at a reform compromise. Thus, the ability to pass reform depended on the strategies of political parties.

While the Labor party could be counted on to cooperate for reform, this choice was far less obvious for the Conservative party, even in the late 1980s. The Conservative leadership wanted tax reform, but not at any price. As the reform outcome was uncertain, Conservatives were reticent to pursue reform wholeheartedly. The gains from a better tax system had to be weighted against the potential losses from a more strict tax system and from losing their no. 1 political issue.

In this situation, the influence from the institutional setting on the strategies of the political parties was crucial. Features of Norwegian political institutions facilitated the pursuit of cooperative strategies by reducing both the transaction costs of the reform process and the uncertainty related to the reform outcome. It appears that this tipped the balance in the Conservative party in favor of moving towards reform. The result was collective political

action for reform. In other words, political institutions contributed to reform by shaping not only preferences, but also strategies.

More specifically, three institutional mechanisms generated political agreement: First, *commission reports* served as a *focal point* for cooperation. They provided a ‘neutral’ solution that both Labor and Conservative politicians could rally around. The reports reduced the uncertainty about what would be the outcome of a reform process, thereby making it easier for the political actors to engage in reform work.

Second, the production of *official political documents* under alternating government worked as a *commitment mechanism*. While power shifted between Labor and Conservatives, both parties actively used official documents to signal their positions. That is, the institutionalized production of documents allowed them to commit to a broad reform solution. This reduced the uncertainty about where the other player stood in the tax question, making it easier for both to move towards reform.

Third, *parliamentary committee* work induced actors to cooperate to arrive at a final reform deal. The committee for financial questions represented an environment of deep mutual trust generated by repeated interaction and personal relations. Trust facilitated collective action. The committee work thus allowed political opponents to work out a comprehensive, ‘win some, lose some’ reform compromise.

Chapter 7: Conclusions

7.1 Summary of the main findings

Since the research questions have already been thoroughly answered in chapter 6, this closing chapter only offers a brief recapitulation of the main findings: Firstly, the empirical investigation shows that the Norwegian tax reform of 1992 was characterized by rational updating of policy rather than liberalization.

Secondly, it appears that this outcome was contingent upon the large scale of policy change. I find three mechanisms that link large-scale reform to rational updating: the large role of experts in policy-formulation, the possibility of coherent policy solutions, and the even distribution of wins and losses.

Thirdly, the close-up investigation of the reform process reveals that there were three major preconditions for large-scale tax reform: The huge *structural* problems of the existing tax system; the development and adaptation of new tax policy *ideas*; and the consensus-generating features of Norwegian political *institutions*. The interaction between these factors brought political actors to agreement on a deep-seated reform of the Norwegian tax system.

The rest of this chapter is devoted to the broader substantive and theoretical implications of these findings. I first discuss the 1992 tax reform as an integral element of social democratic modernization in Norway. Then I look at the findings from the Norwegian tax reform in a comparative perspective, raising the question of whether the Scandinavian tax regimes exhibit a particular development. Finally, I spell out the implications of this study for theory on institutional change in advanced political economic. I also indicate important areas for further research.

7.2 Social democratic modernization

In the introduction, I stated that this study was motivated by an interest in the transformation of the Norwegian welfare state regime since the 1980s. Did Norway abandon its social democratic welfare state model in this period, or was the model rather updated to the political and economic environment of a new era? My investigation of the most significant tax reform

in this period supports the latter hypothesis. I find that tax policy continued along a new and improved social democratic ‘middle way’ rather than take off in a liberal direction.

This finding is consonant with Jon Erik Dølvik’s contention that the changes in the Norwegian political economy the last quarter of a century are best summarized as “social democratic modernization” (Dølvik 2007:291, my translation). The transformation of the Norwegian political economy, he argues, has been characterized by “the combination of economic modernization, institutional continuity and a relatively egalitarian income distribution” (Dølvik 2007:289).

The Norwegian tax reform of 1992 should be regarded as a crucial precondition for this development. Not only did the reform stimulate economic activity by levelling the playing field for businesses and unlocking capital. It simultaneously strengthened the capacity to finance the welfare state and maintained the direct redistribution in the tax system. These important implications of the tax reform for the Norwegian welfare state regime more than suggest that welfare state scholars need to be more attentive to issues of tax policy.

Although the 1992 tax reform was largely successful in these regards, we should not be blind to its shortcomings and more problematic implications. One important area that escaped the rational updating of policy was the taxation of owner-occupied housing. This issue proved so politically sensitive that policy-makers were unable to implement changes. Hence, the tax system continues to privilege income from housing capital over other types of capital income. This represents the greatest inefficiency of the Norwegian tax regime. On the other hand, taxation of housing is Norway’s largest unexploited reserve of tax revenue, which may prove valuable for future policy-makers.

Moreover, the 1992 tax reform laid the ground for the growing *financialization* of the Norwegian economy. Gerda Krippner defines financialization as “a pattern of accumulation in which profits accrue primarily through financial channels rather than through trade and commodity production” (Krippner 2005:174). The reform’s introduction of uniform capital taxation and the removal of tax incentives for lock-in of capital in businesses stimulated the free flow of financial capital. In light of the breakdown of the financial system in 2008 and the current economic crisis, this development can be regarded as problematic. Yet, it would be wrong to say that tax reform contributed to uncontrolled financial capitalism, as the reform

actually introduced a corporate tax regime that implied more effective regulation and monitoring of capital.

On balance, I would argue that these problems were clearly outweighed by the benefits of the 1992 tax reform for the Norwegian economy. The tax reform appears to represent part of the background for Norway's strong economic and social performance the last 15 years. The present study backs up the argument that "[a]n important precondition for the comeback of the Nordic models was the restructuring of the political-economic regimes that took place in connection with the crisis at the beginning of the 1990s" (Dølvik 2007:288).

But what made this fundamental restructuring possible? My study of the 1992 tax reform also provides an analysis of this question. I find that political actors were able to agree on reform partly because Norwegian political institutions stimulated consensus. Institutions both generated convergence in preferences among political actors around expert solutions, and facilitated the pursuit of cooperative political strategies. In the context of economic crisis, this was enough to produce a broad-based reform compromise. This supports Tranøy's (2000) assertion that in times of crisis the consensus-oriented Norwegian system is conducive to large-scale updating reform. Yet, this issue requires more systematic investigation. How and under what conditions the Norwegian political system may favor reform is an important topic for further research.

7.3 Tax reform in a Scandinavian perspective

The finding that the Norwegian tax reform of 1992 led to rational updating resonates well with recent analyses of tax policy change in Sweden (Steinmo 2002) and Denmark (Ganghof 2007). In all the Scandinavian countries, the tax reforms of around 1990 appear to have updated policy to a new economic environment rather than shift policy in a liberal direction. These tax reforms have neither put an end to the welfare state or the ambition of equality.

One important explanation for this is that the Nordic countries all implemented dual income tax (DIT) models, which differed from the models chosen in other countries. (Denmark, however, reverted to a hybrid model in 1993.) Ganghof (2005) argues that the DIT model is less neo-liberal than other tax models, as it combines efficiency with a strong capacity to raise revenue and leaves room for some redistribution. My investigation supports this argument.

The ability of the 1992 Norwegian tax reform to reconcile efficiency and equity goals owed partly to the choice of the DIT model.

Thus, there appears to be a particular affinity between this model and the egalitarian goals of social democracy. Pushing the argument even further, one could say that the DIT model is the incarnation of modern social democratic tax policy. Identifying social democracy with a tax model that explicitly discriminates against labor income may seem odd. Yet, I believe this illustrates the inherent pragmatism of contemporary social democratic policy in the Nordic countries. To be able to achieve a set of goals that is much the same as before, policy-makers have introduced policy means that are less conventional, but more effective.

This suggests that the Scandinavian countries represent something of an exception in the field of tax policy. Although greater efficiency and market-conformity was the common tune of tax policy change all across the world, tax reforms in the Scandinavian countries appear to have been particularly sensitive to concerns about revenue and redistribution. This conclusion echoes much of the literature on changes in welfare state regimes: Rather than converge in a liberal direction, Scandinavian tax policy regimes seem to follow a particular development trajectory.

Yet, we should be cautious not to exaggerate the similarities. The tax systems of Norway, Sweden and Denmark all have important particularities. Moreover, tax policy developments in recent years suggest a partial divergence. The right-wing government in Denmark introduced a ‘tax freeze’ in 2002, which implied that no tax rate could be increased. The Danish government is also currently planning a large-scale tax reform that critics describe as strongly liberal. Compared to this, the Norwegian tax reform of 2006 seems to have had a more egalitarian profile. In Sweden, the tax system has not been subjected to major reform since 1991. These different Scandinavian development paths show that further investigation is necessary. Comparative analysis of the modern evolution of tax policy in the Scandinavian countries stands out as an important task for future research.

7.4 Implications for theory

The findings of this study also contribute to the broad theoretical debate about institutional change. The investigation of the Norwegian tax reform revealed an outcome that was

qualitatively different from liberalization, which is usually regarded as the dominant trend in advanced political economies (Streeck and Thelen 2005). The reform was instead characterized by continuity in basic objectives and updating of policy means. I have referred to this as ‘rational updating’. Yet, this term is chosen in want of better theoretical concepts.

In the literature on institutional changes in advanced political economies, the conceptualization of changes that are *not* characterized by liberalization has been somewhat neglected. Usually, changes of this kind are defined negatively, for instance as “non-liberal” (Streeck and Thelen 2005:33) or as “lack of retrenchment” (Pierson 2001). Yet, to develop the theoretical understanding of such changes, it is essential to determine what they *are*, not just what they are not.

Pierson (2001) has made perhaps the most significant effort in this regard, by developing dimensions of welfare state restructuring. In particular, his notion of ‘recalibration’ is relevant for the understanding of updating policy change. However, we need stronger theoretical concepts that are applicable to changes in the whole political economy, not only to welfare state restructuring.

Further, the preconditions for continuity in the outcomes of policy should be subjected to closer investigation by scholars. The conventional wisdom is that continuity in outcomes is produced by incremental, path dependent change (Pierson 2000). Contrary to this view, my study suggests that fundamental policy change may be necessary to ensure continuity in outcomes. Just as small changes or no changes can produce discontinuity (Streeck and Thelen 2005; Hacker 2005), large changes may be conducive to continuity. The present study points out some features of large-scale reforms that may account for such a relationship (see section 7.1). Yet, these are only tentative statements about mechanisms. The relationship between deep-seated policy change and rational updating of policy should be explored in much greater detail.

However, it would be an illusion to think that the scale of change by itself can explain the outcome of rational updating. Deficient tax systems and novel ideas about taxation gave rise to large tax reforms all across the world in the 1980s and 90s. The outcomes differed: In some countries it was close to a liberal policy shift, in other places it was mainly a rational updating of policy.

My investigation strongly suggests that the outcome of large-scale reform is contingent upon institutional factors. In Norway the rational updating of policy was a function of political institutions in at least two ways. For one, broad political consensus ensured a balanced reform and precluded clearly liberal solutions. For another, the institutional setting shaped the development of tax policy ideas. Ideas that were largely liberal at the outset were moulded into a tax model that reconciled efficiency concerns with objectives of revenue-raising and redistribution. Other institutional settings likely shaped tax reform outcomes in a different manner. Therefore, future research ought to explore whether political institutions *systematically* condition the shape of the relationship between processes and outcomes of policy change.

Lastly, it is appropriate to point out one important limitation of this study. There is reason to believe that dynamics of change will vary somewhat from one issue area to the other, depending on the structure of interests and the character of the issue. For instance, in areas where interests are concentrated and constituents well organized, changing the status quo will be very difficult (Pierson 2001). The present study has not explored the potential implications of the particular features of tax policy. One hypothesis is that interests in tax policy are so widely dispersed that change would be relatively easy. An alternative hypothesis is that tax policy issues are so politically sensitive that large changes are prohibitively difficult. Needless to say, this issue requires further investigation.

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Appendix 1: Interview guide

Topic 1: Personal role in tax policy-making

- Background and knowledge of tax policy?
- Formal position?
- How did you participate in tax policy-making?
- Which decision-making processes were you part of?

Topic 2: Norwegian tax policy in general

- What are the particular features of Norwegian tax-policy?
- What have been the core objectives of tax policy in Norway, and how have they been weighted against each other?
- How would you describe the relation between the tax system and the welfare state?
- To what degree does the tax system contribute to redistribution?

Topic 3: The background for reform: the development in tax policy

- What characterized the post-war Norwegian tax policy regime?
- How did tax policy evolve in the 1970s and 80s?
- What were the most important problems of the old tax policy regime?

Topic 4: Ideas and inspiration for reform

- To what extent did ideas inspire the 1992 tax reform?
- What was the source of these ideas?
- To what extent was Norwegian inspired by reforms abroad?
- To what extent did international structural pressures motivate the reform?

Topic 5: The political process leading up to reform in 1992

- Who were the main actors in the political process that led to reform, and what role did they play?
- How would you describe the tax policy views of the key political parties, unions and employers?
- Which factors made the 1992 tax reform possible?
- What characterized the relationship between politicians and bureaucrats?
- What characterized the relationship between the key political actors?

Topic 6: The objectives and outcomes of the 1992 reform

- What were the most important objectives of the 1992 reform?
- How did the reform balance objectives of efficiency and equality?
- Was there continuity or discontinuity in goals?
- Did the reform imply liberalization or rather updating of existing policy?
- In your opinion, did the reform achieve its basic objectives?
- How did the reform influence efficiency, growth, redistribution and the capacity to raise revenue?

Topic 7: The evolution of tax policy since 1992

- How did tax policy develop after the reform?
- How was the 2006 reform related to the 1992 reform?