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Conclusions and summary

SNS ECONOMIC POLICY GROUP REPORT 2005

Proposals for a Swedish tax reform

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SNS FÖRLAG

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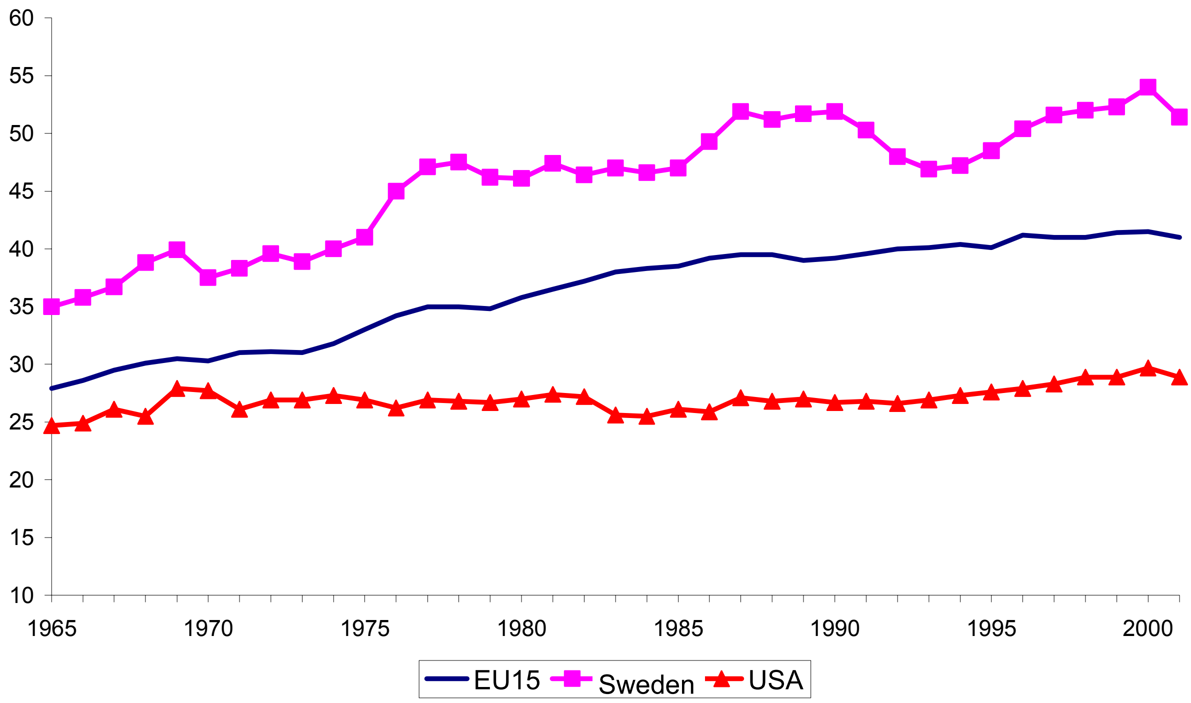
Proposals for a Swedish tax reform

It's time for a new tax reform. The risk at present is that taxes, particularly on labour, will continue to rise. Pressure for higher public expenditure as a result of demographic trends, not least, may force higher tax levels, unless a wise economic policy today puts us in a position to manage the future challenges. One important element of such an economic policy – apart from a fiscal policy that leads to a reduction of general government debt – is a tax policy that encourages more people to work and to work more hours.

Figure 1 Taxes as a percentage of GDP in Sweden, EU15 and USA 1965–2001

Per cent



Source: OECD Revenue Statistics.

The Economic Policy Group's recommendations

Introduce an earned income deduction for income from work

To strengthen incentives to work, the present basic deduction on tax returns should be partly replaced by an earned income deduction, mainly designed for people with annual incomes below SEK 250 000. One example might be to allow an earned income deduction of 20 per cent to be made on income from work exceeding SEK 100 000. At income levels over SEK 250 000, the earned income deduction would be phased out at the rate 5 per cent of additional income.

A more limited proposal, which might be a first step towards a more general earned income deduction, would be to aim the deduction towards a more narrowly defined group, such as lone parents or older members of the labour force.

Reduce state income tax to 20 per cent

The top five-percentage-point tier in state income tax should be abolished. Apart from the fact that a high marginal tax has negative effects for the labour supply, it reduces the wage premium for higher education, which weakens incentives for people to invest in education. Reducing the highest rate of state tax is also a means of preventing the scaling down of the earned income deduction from adding to the marginal tax effect faced by many medium income earners.

Introduce a tax deduction for household services

The economic efficiency arguments for tax relief for household services are underestimated in the public debate. Such tax relief, moreover, may have a positive impact on employment. Accordingly, tax relief should be drawn up, set at 50 per cent of the cost of labour for household services. The deduction will be allowed without any ceiling or limit on the amount, but should only apply to a limited range of services, primarily housework and home and garden maintenance. Some examples would be food preparation, cleaning and laundry.

Alleviate double taxation of returns on equity

Relief will be provided at company level, which will encourage investment. Normal returns on equity will be exempted from taxation at company level by allowing companies to make a deduction in the base for corporate taxation equivalent to this normal level of returns. This means that normal returns on equity will be taxed only once, at owner level. This would be a means of bringing about equal taxation of dividends, increases in the value of shares, and interest, up to a level of returns corresponding to the normal rate of interest on loan-financed investments. The proposal entails a reduction of the effective corporate tax rate.

Phase out wealth tax

Since it has been necessary to accept a number of reductions of wealth tax for certain types of assets and certain actors, one of the strongest arguments for abolishing wealth tax is its lack of legitimacy. The liquidity problems associated with wealth tax on unlisted assets and controlling shareholdings are additional arguments for abolishing this tax.

Close company rules and unlisted companies

To solve the problems associated with close companies, the marginal tax rate on labour and capital must be roughly equal. The solution in the long term is therefore to reduce the highest marginal effect for labour to bring it down to about 50 per cent. The most effective way of doing this is to set a ceiling above which no social insurance contributions will be charged. This ceiling can be set, for example, at ten base amounts. One step along the way is our proposal to lower state income tax to 20 per cent.

Introduce continuous capital gains taxation of quoted shares and mutual funds

Capital gains taxation of quoted shares and mutual funds should be replaced by a tax on actual returns during the year, irrespective of whether or not changes in value have been realised. At the same time the possibility of claiming an interest-bearing tax credit will be introduced to avoid the liquidity problems that continuous taxation can entail. A possible alternative would be to have a standardised taxation of capital gains, based on expected returns.

Transfer tax on insurance capital to the owner of the policy

The right to deduct pension savings can probably no longer be made conditional on savings being made in a Swedish insurance company. The Court of Justice of the European Communities has determined that such regulations are in conflict with the principle of freedom of establishment. It seems more efficient not to allow deductions for deposits in insurance companies, while making amounts paid out tax exempt. The standardised taxation currently applied to Swedish insurance companies can be transferred to the policy owner. In order to secure tax collection, the insurance company can continue to pay in taxes, though now as a preliminary tax deduction on behalf of the owner. The tax rate, however, could be a little below the normal rate for returns on capital, for example 25 per cent, to compensate for the fact that insurance capital has a lower degree of availability to savers than other savings.

Retain real estate tax but introduce the possibility of deferring tax

Real estate tax should be retained but the possibility of tax deferral should be introduced to solve liquidity problems. Individuals with incomes below a certain level will be able to defer payment of tax by means of an interest-bearing credit. The income-related relief that is now available and that generates marginal effects in income taxation will be abolished. Tenant-owner apartments should also be liable for real estate tax.

Revert to a more uniform value added tax

There are sound economic reasons for a broadly applied single rate of value added tax, and hence uniform taxation of consumption. This indeed was one of the basic points behind the 1990 tax reform. Most of the abatements of value added tax that have grown up over the years should therefore be cancelled. In total, VAT abatements result in tax losses of approximately SEK 25 billion, SEK 17 billion of which is attributable to the reduced rate of VAT on food.

Summary of the Economic Policy Group’s analysis

The fundamental tax structure established by the tax reform, with its orientation towards broader tax bases, lower tax rates, less progressive taxation of labour, and uniformity, should be retained.

However, there is good reason to implement a number of changes, not least so as to revert in some areas to the principles and basic structure of the tax reform. Since 1991 more than 250 changes have been made to the regulations in the tax system. Many of these have involved departures from the main principles behind the reform. One example is provided by the increasing number of instances of differentiation in value added tax. Another is the increased taxation of income from work, accompanied by greater progressivity. State tax has been raised in higher income tiers and more people have had to pay state tax. As a result of tax increases imposed by local government in recent years, the top marginal tax rate is now around 57 per cent.

Sweden and the world around us look different now than when the tax reform was implemented. The changes – including the ongoing process of internationalisation and changes in the labour market – raise new demands for adjustments in the Swedish tax system.

Unemployment is higher than 15 years ago and so, probably, is the equilibrium level of unemployment. At the same time, due to demographic developments, it has become even more important to increase employment and the number of hours worked in various ways, so as to promote the economy's potential capacity for growth. In addition to turning around the trend in the last few years towards increasingly heightened taxation of labour, there is therefore reason to consider new features in the income tax system to strengthen incentives to work and reduce the number of people living on transfers.

Internationalisation increases the potential mobility of several tax bases. In a world where capital is increasingly mobile, it would be an advantage to increase the competitiveness of Swedish investment alternatives, for example, by relieving double taxation so as to lower the effective corporate tax rate. Apart from stimulating investment, increased uniformity in the capital taxation system can also encourage a more efficient allocation of savings.

New playing field for tax policy

Internationalisation increases the potential mobility of several tax bases. This can limit the chances of determining the tax structure and level of tax rates at national level. However, both theoretical and empirical research indicates that the link between globalisation and tax policy is more multifaceted than that. There are many sides to globalisation, such as increased mobility of capital, more foreign ownership of the domestic capital stock, lower trade costs, enhanced sensitivity to external shocks and perhaps also a tendency towards higher public spending on infrastructure, as part of the competition for internationally mobile capital. These different aspects of economic integration pull in different directions where tax policy is concerned and the effects can cancel one another out. Even if there are indications that international tax competition drives down tax rates in some areas, the facts do not support the supposition that economic integration leads to a dramatic "race to the bottom", forcing governments to make severe cuts in the public sector.

Increased mobility of capital and national tax bases

Over the past 15 years, the corporate tax rates set by law have fallen dramatically throughout the OECD area. In spite of this, revenues from corporate tax have been stable relative to GDP or have even gone up. Some calculations suggest that the effective corporate tax rate has tended to decline. There are also indications that globalisation has been associated with an increase in the burden of taxes on labour relative to the tax burden on capital, at least in Western Europe.

Even if there is some evidence that the increased mobility of capital has driven down the actual capital tax rate, through tax competition, two other aspects of globalisation may have pulled in the opposite direction. Firstly, the increased proportion of foreign ownership of the domestic capital stock has given governments stronger motivation to shift part of the domestic tax burden to foreign capital owners by maintaining a high corporate tax rate. Secondly, reduced trade costs may have facilitated the emergence of geographical agglomerations of companies (clusters). If this leads to locally specific enhanced returns on capital, this gives governments an incentive to collect part of these returns by maintaining higher corporate taxation.

It is sometimes claimed that tax competition may have the advantage of imposing discipline on the political process and reducing the risk of rent-seeking and unproductive public expenditure. But tax competition seems a very indirect and imprecise tool for tackling problems of this kind. Even if tax competition can reduce the burden of taxes and bring down public expenditure, it is not obvious that this will necessarily eliminate the most ineffective spending programmes. Instead, it may harm the programmes that have the weakest support from special interests and bureaucrats.

Hours worked, labour force participation and taxation of labour

There is cause for scepticism regarding the prospects of significantly influencing unemployment levels by means of general tax reductions. There are sound reasons for asserting that the long-term effect on unemployment will be negligible as long as there is no change in the living standard of the unemployed relative to that of people who are in work. Empirical studies, moreover, provide little support for the view that any very great reduction in the unemployment level can be expected from general tax reductions. On the other hand, there are some arguments in favour of the idea that the *structure* of the tax system is significant. It may be a matter, for example, of increasing the pay-off from earned income relative to *given* transfer incomes, particularly unemployment benefits. Such reforms also in general make it more worthwhile to be in the labour force and should therefore encourage increased labour force participation and so lead, in time, to higher levels of employment.

One way to achieve this is by an earned income deduction for income from work, targeting people on relatively low incomes, which would strengthen incentives for those with the lowest earning potential to work. Possibly the deduction could initially be designed to target more narrowly defined categories, e.g. lone parents or older members of the labour force.

It is also important to encourage those who are already in work to supply more labour. Apart from lower marginal taxes, there may be other ways of encouraging a greater supply of hours worked, e.g. by making people's own work in the home or undeclared work less worthwhile than working on the market. One of the major sources of tax-induced distortions in the allocation of resources is that only time spent performing work on the market is taxed, not leisure time or time spent doing work in the home or doing undeclared work. By taxing goods and services that are alternatives to untaxed use of time more severely than other goods and services, or by levying lower taxes on – or even subsidising – goods and services that are substitutes for untaxed time use, it would be possible in principle to counteract some of the distortions arising from the taxation of labour. There are therefore efficiency arguments for subsidising childcare and other household services. Furthermore, it can be argued that a lower tax on household services may contribute to lower unemployment and increased employment.

Corporate and capital taxation

Swedish capital taxation needs to be looked over in a number of areas so as to make it more uniform and hence promote a more efficient allocation of savings and stimulate investment.

The double taxation of dividends leads to asymmetry in the choice between using equity or borrowed capital for financing. Allowing companies to make a deduction in the base for corporate tax equivalent to normal returns on equity will mean that normal returns on equity will be taxed only once, at owner level. This is a means of achieving greater equality in the taxation of dividends, increases in the value of shares, and interest income, up to a level of returns corresponding to a normal rate of interest on loan-financed investments.

Households choose to save via institutions, not directly in shares, partly because there are tax advantages to indirect savings. Direct ownership by households is taxed on the basis of actual returns. Mutual funds and insurance companies, on the other hand, are solely subject to standardised taxation of their capital gains. In view of this, the possibility is discussed of replacing capital gains tax on quoted shares and mutual funds with a tax on actual returns during the year, irrespective of whether or not changes in value have been realised. Another alternative is to have standardised taxation of capital gains based on expected returns.

In close companies, risk capital and labour inputs often complement one another and it is not entirely straightforward to determine what is a return on capital and what is a return on personal inputs of labour. The only solution for the special situation of close companies that is tenable in the long term is to make the marginal tax wedges on capital and labour about equally high.

Wealth tax includes mobile financial capital and in an increasingly internationalised economy it seems wiser to tax less volatile tax bases instead. This is what makes real estate tax an attractive tax from the point of view of the national economy. To an extent, this tax is a pure tax on land and does not suffer from any distortions at all. Furthermore, it is only reasonable that returns on equity in the form of real estate should be taxed in the same way as other returns on capital.

Financing the tax reform

Lower taxes must be financed, either by making corresponding reductions in public expenditure or by raising other taxes to compensate. This is particularly important bearing in mind the current position of fiscal policy in Sweden, where the government is having considerable difficulty in maintaining a public finances surplus in line with the official target of a surplus of 2 per cent of GDP over the business cycle.

”Dynamic effects” should not be counted on for financing. Admittedly, lower taxes can be expected to strengthen the supply side of the economy and so help raise tax receipts. The problem is that there is considerable uncertainty regarding both the order of magnitude of these positive effects and how quickly they will emerge.

Consequently, there is a risk that allowing deficits in the public finances and increased indebtedness will jeopardise the stability of financial policy. A principle of caution should therefore be applied in financial policy, according to which any tax reductions proposed must be fully financed by lower expenditures and/or compensatory tax increases in other areas. If this principle is followed, there will be no risk to the stability of the economy.

This, then, is the shape our proposals take: the abolition of tax credits, the real estate tax and a single rate of VAT will finance the reductions we propose in other areas.

SNS Economic Policy Group 2005, left to right: *Stefan Lundgren,* Associate Professor of Economics, President and CEO of SNS and Chairman of the Economic Policy Group; *Ann-Sofie Kolm,* Associate Professor of Economics at Stockholm University; *Erik Norrman,* Senior Lecturer in Economics at Lund University and tax consultant; and *Peter Birch Sørensen,* Professor of Economics at Copenhagen University and Chairman of the Economic Council of Denmark, an advisory body to the government and parliament of Denmark.

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