

B. Tax Expenditures in Finland: Legal Issues

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B1. The regulation of tax expenditures

The most significant tax expenditures (TEs) are included in the Finnish Income Tax Act (1535/1992), which contains provisions on personal income taxation. The rules on deductions, exemptions, allowances etc. are thus included in the substantive tax legislation. The term *tax expenditure* (in Finnish: *verotuki*) is not used in the chapters and sections in the tax law but occurs in the government proposals when a new expenditure is defined. The term is not defined in any law but rather by doctrine as “a deviation from the benchmark tax system”. The amendments that relate to TEs usually have political objectives and may thus be a result of political compromises. As opposed to the different forms of direct expenditures, the TEs have not until recently been comprehensively monitored, usually because of the unavailability of data.

TEs have been reported in Finland since 1988, despite not being mandatory by law. Some TEs were abolished and replaced by other compromises in the comprehensive income tax reforms in the 1990s, which strived to make taxation more equal and neutral. Since the new millennium the correct assessment of TEs have gathered more focus and as previously mentioned, the Ministry of Finance has given a mandate to the Government Institute for Economic Research (*VATT*) to publish annual reports on TEs. Since 2010 the TEs have been listed in the yearly budget document.

According to VATT, there are more than 180 recognized TEs in Finland during the Fiscal year 2012 and the total value of uncollected tax revenue amounts to an estimated 23 billion euro annually. The most important factor in defining a TE is the reduction in tax revenue. Calculations on revenue losses caused by TEs are based on the Revenue Forgone Method (see section A2.). The TEs in the Finnish tax system can roughly be divided into four categories: 1) tax expenditures by calculation; 2) tax expenditures that directly affect the price of merchandise and services; 3) automatic reductions by the tax authorities; and 4) tax expenditures by application. These categories are presented in more detail below.

B2. Tax expenditures in preparatory works

B.2.1. Introduction

Due to the government’s duty to account for TEs to the parliament, TEs are currently subjected to thorough assessment already in the preparatory stage of the legislation

process. Because the government proposals (*HE*) include detailed analysis they have status as a secondary source of law and are also meaningful for later interpretation. In the proposal the objectives for the TE are set, its effects are analyzed and a possible follow-up assessments is planned. Notable for the preparations of TEs in legislation is among others the influence of socio-economical reforms and other purely political objectives that pursue non-fiscal goals. Some of the legislation that contains TEs was originally drafted at a time when more lenient instructions for government proposals were applied and thus TEs in older legislation were less diligently assessed and often scarcely motivated. The concept of tax expenditure is often used but the analysis can be poorly executed and superficial. This may be a result of valuation problems or the lack of suitable data. For instance, the tax exemption for occupational health-care as a fringe benefit is defined as a TE but the calculation of revenue loss has proven too difficult and costly to estimate accurately with regards to the usefulness of the data.

The demands on the quality of all preparatory works have increased and specific instructions for government proposals require a more accurate estimation on the future impacts of the legislation. The objectives of the amendment are to be stated clearly, the foregone tax revenue by TEs are to be calculated and their impacts estimated. According to a report by the National Audit Office of Finland (*VTV*), the quality of the government proposals vary, yet the development has in recent years been positive. VTV also complemented the development of the quality in the government proposals in individual TE legislations. Especially the presentation of advance estimates of the amount of the TEs and the aspired benefits and effects have significantly improved. An example of a well-formulated and motivated government proposal is that of the Household Service Deduction Act (728/1997) and its subsequent amendments.

The following section gives an overview of the government proposals for the most significant TEs and how the TEs are justified, as well as how well the potential impacts of TEs are analyzed. The TEs are divided into categories based on how they are realized. All calculated revenue losses are based on estimates 2009-2012 by the VAT report *Muistiot 17* from 2011.

B.2.2. Tax expenditures based on calculation

Tax-exempt imputed rent of owner-occupied housing. Income Tax Act (1535/1992) 53 § 1), HE 200/1992. The taxation of imputed rent from housing, i.e. calculated income from living in an apartment owned by oneself, was originally subject to taxation because it was considered an vast advantage compared to those renting apartments. The tax on this implicit “capital income” was abolished in 1992 and has been defined as a TE since then. The calculated revenue loss is approximately 1,3 billion euro annually. In the government proposal the calculation on revenue loss is based on the Revenue Forgone Method and the impacts and objectives are all properly defined. The pros and cons of the amendment are also presented and connections to other

legislation are taken into account. The motivations were mainly political since the “income” had been considered an inappropriate tax base.

B.2.3. Automatic reductions by the tax authorities

Earned income deduction in municipal taxation. Income Tax Act (1535/1992) 145 §, HE 200/1992, amendment ITA (1126/1996). The calculated revenue loss is based on the Revenue Forgone Method and the calculated loss for the deduction is approximately 1,4 billion euro annually. The deduction was first intended to be temporary for the fiscal years 1992 and 1993, but was thereafter continued. The evaluation of the TE in the government proposal is adequate. The objectives relate to the income political comprehensive solution of 1992. The government proposal is on this section only a few lines.

Deduction of employees' statutory pension insurance contributions. Income Tax Act (1535/1992) 96 §, HE 200/1992. The revenue loss is based on the Revenue Forgone Method and the calculated revenue loss for the deduction is between 1,3 and 1,6 billion euro annually. The evaluation of the TE in the government proposal is satisfactory and consists of many pages of analysis. The objectives and the impacts are assessed and the revenue losses calculated. The target group of the TE is the entire working population and the benefits of maintaining an effective pension insurance system are put forth, yet no closer analysis on the actual chain of beneficiaries is made. The advantages and costs are estimated and the proposal also contains an assessment of the total benefit on society.

Pension deduction in municipal taxation. Income Tax Act (1535/1992) 101 §, HE 200/1992, amendment HE 1126/1996 (spousal deduction). The revenue loss is based on the Revenue Forgone Method and the calculated annual loss for the pension deduction from direct income in municipal taxation is approximately 1,2 billion euro. In the preparatory works for the TE the objectives are stated and the impacts analyzed and also the effects on behavioral changes in the target population taken into account. The amount of the revenue loss is estimated on beforehand and the benefits of the TE are specified. The costs are also analyzed but there is no risk assessment and no comparison to international legislation. In general, the TE is well justified in the government proposal.

Interest deduction of mortgage etc. Income Tax Act (1535/1992) 58 §, HE 200/1992. The interest deduction is the single largest rate deductible from capital income taxation. The calculated revenue loss for the interest deduction is between 410 and 570 million euro annually. The most relevant characteristic of the tax reform in 1992 was the strive to treat all capital income and related reductions symmetrically. The deduction right of mortgage interests was mainly a housing-political expenditure. In the government proposal the deduction right as expenditure has been analyzed comprehensively. The revenue loss is based on the Revenue Forgone Method and the

effects of behavioral changes in the target population are estimated. The objectives and impacts of the TE are also properly defined. The administrative costs due to the interest deductions have also been estimated. In addition, the government proposal includes a partial risk analysis and an international comparison. The Working Group for Developing the Finnish Tax System stated in its final report (51/2010, commonly referred to as the *Hetemäki report*) that the interest deductions should annually be decreased and finally abolished, as the taxation of all investments should strive to be unified. Moreover, the TE benefits the relatively wealthy population the most, especially since there is no cap on the size of the deduction from capital income. In the original government proposal the lenient taxation of investments has been justified especially by promoting the saving of private households, inflation protection points of view and administrative reasons.

Tax exempt child benefit. Child Benefit Act (796/1992), Income Tax Act (1535/1992) 90 §, HE 37/1992. The calculated annual revenue loss for the exemption is between 485 and 515 million euro. In the government proposal the amounts are carefully estimates and the effect of behavioral change in the targeted population are adequately assessed. The objectives are specified and the potential impacts analyzed. The target group and the benefits from the TE are also evaluated.

B.2.4. Tax expenditures that directly affect the price of merchandise and services

Reduced VAT rate on foodstuffs. VAT Act (1501/1994) 85 §, HE 111/1997. In Finland the standard value-added tax (VAT) is 23 % and considered part of the benchmark tax system and deviations from the standard rate are considered TEs. The TE in this case constitutes of the deduction of VAT in the consumer price for food:

- 31.8.2009:	17 %
1.9.2009 - 30.6.2010	12 %
1.7.2010 -	13 %

The calculated annual revenue loss for foodstuff and fodder is approximately 1,1 billion euro (510 million in 2009). In the government proposal for the TE the assessment criteria is scarce and even if the obvious political objectives and the benefits are presented (financially support purchase of foodstuff by consumers), the impacts are hardly specified. The government proposal does not contain any analysis on behavioral change in the target population through the TE, nor calculations on administrative or other costs consequent upon the deducted VAT. On the other hand, the government proposal presents arguments found in international comparison.

B.2.5. Tax expenditures by claim/application

Tax exempt capital transfer tax of first owner occupied real estate or apartment. Capital Transfer Act (931/1996) 11 and 25 §, HE 121/1996. Capital transfer tax is applied to all sales of real estate and securities ("*stamp tax*"). TE is created by

exemption of first owner occupied real estate or apartment. The calculated annual revenue loss for the exemption is approximately 40 million euro for real estates and 55 million euro for apartments. In the government proposal from 1996 the amount and the revenue loss is not estimated, nor are the costs assessed, this has been done in later assessment processes. The government proposal merely identifies the objectives and justifies the TE with the aspired benefits of the target population and the aimed taxation neutrality of capital transfers. The analysis is left very thin.

Tax exempt capital profit from selling own housing. Income Tax Act (1535/1992) 48 § 1), HE 200/1992. The deviation from the standard taxation on sales profit for sale of housing, that has been owned and used as owners dwelling for two years, is considered an exemption from the benchmark tax system and thus a TE. The revenue loss is based on the Revenue Forgone Method and the calculated annual revenue loss is approximately 1,3 billion euro. In the government proposal the specific objectives and impacts are not mentioned and the assessments of the benefits of the TE has great shortcomings. The argumentation is very thin, only a few lines. The 1992 government proposal merely states that capital profit from selling own housing will still be tax exempt.

Household service deduction. Household Deduction Act (728/1997), HE 85/1997; 72/1999; 140/2000; 146/2004; 256/2002; 117/2005. The calculated revenue loss for the household service deduction is approximately 390 million euro annually. The preparatory works are very well formulated and motivated. The deduction has been analyzed comprehensively. The effects of behavioral changes in the target population are estimated. The objectives and impacts of the TE are also properly defined, being among others to encourage spending and to prevent black economy and tax circumvention. The administrative costs due to the interest deductions have been estimated. The government proposal also includes a partial risk analysis. The proposal contains an international comparison and presents empiric data from different European countries.

Overall the quality in the government proposals of individual TEs have improved significantly in newer government proposals. Especially the estimates of the amount of the TEs and the aspired benefits and effects have are very satisfactory executed. On the other hand, the effects of behavioral changes in the target population are seldom measured and the drafts rarely feature plans for the subsequent analysis of the impacts that the instructions stipulate. In addition, the follow-up of whether the set objectives have been reached, have had significant shortcomings in comparison to that of direct expenditures. Despite the strive to improve the assessment of TEs in government proposals, there is continually the risk that assessments are fulfilled superficially in order to comply with instructions, thereby thwarting the original purpose of a more thorough analysis.

Despite of this, the development in recent years is positive and the justifications of the TEs and the analysis of the impacts in preparatory works are completed by the subsequent reporting procedures by VATT.

B3. Problems with tax expenditures

B.3.1. Constitutional problems

The acceptance and use of tax expenditures have not given rise to any real constitutional problems in Finland, although some aspects need to be considered when TEs are introduced in legislation. TEs have come under criticism as they constitute deviations from the benchmark tax system and therefore necessarily constitute revenue loss for the state. Also, assessments of TEs in government proposals are rarely conducted with the same scrutiny as direct expenditures (DEs) (More about tax expenditures vs. direct expenditures in section C.) Furthermore, TEs are not included in the budget frames on public spending but should neither be used as a way of circumventing these tight frames.

The National Audit Office of Finland (VTV) examines the state's financial management and budget compliance. In its tax expenditure report from 2007¹ VTV examined how the Finnish government fulfills its duty to account for the TEs to the parliament, according to the provisions in the constitution of Finland (731/1999) and the national Budget Act (423/1988). The government must take all known appropriations and other factors that are financially relevant into account in the yearly budget document. These can for instance include accurate estimates about the effects that expenditures have on society and the economy. According to the VTV report the assessment of TEs in the state's financial management has not been adequate in relation to their financial impact. In 2005, the government accounted for the TEs in a one-page summary in that year's Government's statement of Annual Accounts. TEs are seldom subjected to follow-ups and there is no registration procedure of achieved social benefits or financial profits. VTV has urged that assessments on the largest TEs impacts on society should be conducted regularly. The critique was taken into account and in the past few years the TEs have been reported more diligently at central government level and the data is now more comprehensive (More about how data on TEs are currently reported in section A2.). Calculations of tax expenditures are thus up-to-date and estimation methods are applied to VTV's satisfaction.

B.3.2. Problems with EU law

TEs can have challenges to comply with EU law, especially in cases where they can be interpreted as competition distorting state aid or aid that affects the trade between

¹ Verotuet - Tilivelvollisuuden toteutuminen. Valtioneuvoston tarkastusviraston tarkastuskertomus 141/2007

member states of the EU. Due to the strict EU provisions this potential discrepancy is usually addressed in the preparatory works of legislation when a new TE is introduced. According to Article 107 in the Treaty on the Functioning of the European Union (TFEU) any aid granted by a member state or through state resources, which favor certain undertakings, or certain goods shall be incompatible with the internal market and thus forbidden. The interpreted aid can be granted in any form whatsoever, including tax exemptions or deductions. The measure, which can potentially be interpreted as state aid must in each individual case be notified to the commission, which can choose to accept or reject the aid. An aid that has been rejected in the notification procedure or originally left unannounced is deemed illegal.

For instance, the national implementation of a support program aimed at promoting the usage of bio fuel on the basis of the Energy Tax Directive (2003/96/EC) always requires a notification procedure and acceptance by the commission. In Finland this procedure has been used for some bio fuels in experimental projects.

As another example, the government proposal HE 151/2011 amending the Tonnage Tax Act (476/2002) was rejected by the EU commission as illicit state aid. Some of the suggested provisions regarding taxation of dividends, concern taxation and deduction off losses were considered in breach of the rules of the internal market. As a result, the proposal was amended and the required changes were included in the new proposal.

Another EU provision that can affect TEs is Article 110 TFEU, which prohibits discriminatory tax treatment. According to the principle domestic products and products from other member states are to be treated equally in taxation and a member state shall not impose, directly or indirectly higher fees or taxes on other products than on similar domestic products. Sometimes the TE is impossible to execute, due to the EU provisions, if it is interpreted as illegal state aid or tax discrimination.

B.3.3. Case law and problems of interpretation

On a conceptual level the TEs have not given rise to any specific case law or problems of interpretation in Finland. Additionally, case law does not have the same prominent role as a source of law in Finland as in Anglo-American legal traditions, which is apt to lessen the importance of case law. However, it is clear that tax subjects want to benefit from lenient tax treatments of TEs and are as such inclined to interpret the provisions expansively or favorably for themselves. In that regard, the TEs have caused problems of interpretation that have lead to some relevant legal cases in this context.

For instance, some cases by the Supreme Administrative Court (*KHO*), notably the decisions KHO:2002:57 and KHO:2007:75 have expanded the realm of TEs through interpretation. Both cases concerned capital transaction tax in a situation where the

proprietary right of the shares of a housing company was to be transferred only once a loan amounting to 35 percent of the purchase price held by the housing company was repaid by the bank. KHO ruled that the payment of the housing company's loan was exempt of capital transaction tax. Thus debt held by the object of purchase could be deducted from the taxable purchase price, thereby marking a deviation from the benchmark tax system.

The legal cases related to TEs merely deal with the substantive law and do not address TE as a concept. It is possible that the TEs can be used for tax circumvention, but far more often cases have concerned the interpretation of the extent or scope of a TE rather than its illicit use.

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