Nosdiska Skattevetenskapliga Forskningsrådet

Taxation of capital and wage income: Towards separated or more integrated personal tax systems?

ECONOMIC GENERAL REPORT

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1 .Introduction

The Nordic states pioneered in a broad implementation of the dual income tax model in the late eighties and early nineties. Also, several steps were taken towards tax rate reductions and a broadering of the tax base, probably more extensively than in other OECD-countries before. On the other hand, the need for tax reductions has also been large since the welfare state model of the Nordic states has lead to high overall tax burdens, and the challenge to maintain the model in a rapidly globalizing world is high. The purpose of this general report is to 1.) produce a survey of the general trends in the taxation of capital and wage income in the Nordic countries, 2.) discuss the potential problems of income transformation and tax evasion which have been encountered, and 3.) also summarize some of the recent debate and plans concerning (the integration of?) capital and wage income taxation.

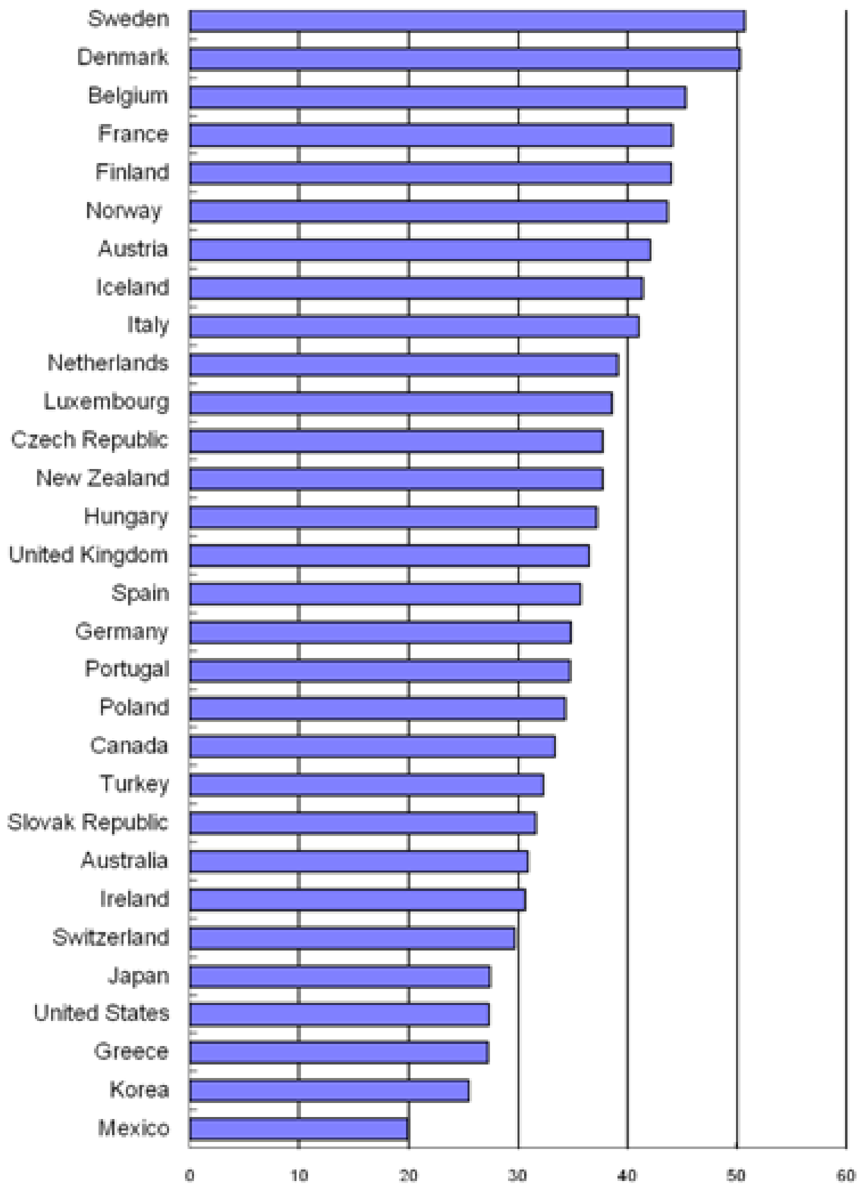
The report is organized as follows. In Section 2, a brief survey of the current systems in the Nordic countries is given. In Section 3, a summary of the main reforms during the last 10-15 years is given. Section 4 discusses problems encountered. Finally, conclusions are given in Section 5.

2. Taxation of wage and capital income in the Nordic countries

The tax systems in Finland, Norway and Sweden are versions of a dual tax system, where wage and capital incomes are separated, and wage income is taxed at a progressive rate whereas a flat tax (lower that that on wage income) is applied on capital income. Also in Denmark, positive and negative income is taxed at lower rates than labour income, and the tax system could be characterized as a hybrid dual / classical system, with several different tax rates on capital. The current taxation systems are the results of major reforms in the 1980's (Denmark 1987, Iceland 1987) and 1990's (Sweden 1991, Norway

1992, and Finland 1993). For all the Nordic countries, taxes as percentage of GDP are among the highest as compared to other OECD countries, as shown in Figure 1.

Figure 1. Total tax ratio as percentage of GDP, 2005, for a selection of countries.



Source: OECD Revenue Statistics 1965-2006, 2007 Edition

A large part of the tax revenues in the Nordic countries are due to taxation of labour income. Table 1 shows the development of the share of labour and capital related taxes as percentage of overall tax revenues in the Nordic countries. Some shift towards relying more on other forms of taxation than taxes on labour income can be seen (in most countries, some form of environmental (green) taxes have obtained a higher weight).

Table 1. Labour and capital related taxes as percentage of total tax revenues in the Nordic countries.

Year	1996*	2001	2006**
Panel A. Labour income (incl. social security contributions)			
Denmark	56%	56%	52%
Finland	62%	59%	58%
Island[1]	44%	56%	57%
Norway[2]	46%	44%	40%
Sweden	63%	65%	61%
Panel B. Capital and wealth income (including tax on corporate profits)			
Denmark	12%	11%	14%
Finland	7%	12%	10%
Island	9%	8%	6%
Norway[3]	6%	7%	6%
Sweden	10%	10%	13%

*) For the year 1995 for Finland. **) Estimate. Actual share in 2005 for Finland.
[1] Includes taxes on profit. [2]Tax on ordinary income persons, and surtax
[3]Tax on ordinary income companies, and wealth tax
Source: the country reports, tax statistics by the Ministry of Finance in Finland.

In Sweden, approximately 61% of total taxes in 2006 are due to taxes on labour, whereas taxes on capital only constitute 13%. Both numbers are somewhat lower in Finland, and for labour income in Denmark, where sales taxes and duties form a larger proportion of overall tax revenues. In Norway, taxes related to petroleum activity increase the overall tax revenues and hence reduce the relative shares of labour and capital taxes.

2.1. Taxation of wage and wage related income in the Nordic countries

Table 2 gives a brief survey of features of the current taxation of wage income in the Nordic countries. Common for all countries is a broad tax base (with few deductions), a heavy progression in the overall taxation of wage income, and high marginal tax rates in the highest tax brackets. However, only a small part of the population falls in these high tax classes (in Finland, only 5% of earners face a marginal tax rate over 50%, while in Denmark, only about 1% of the taxpayers pay 50% or more in effective average tax).

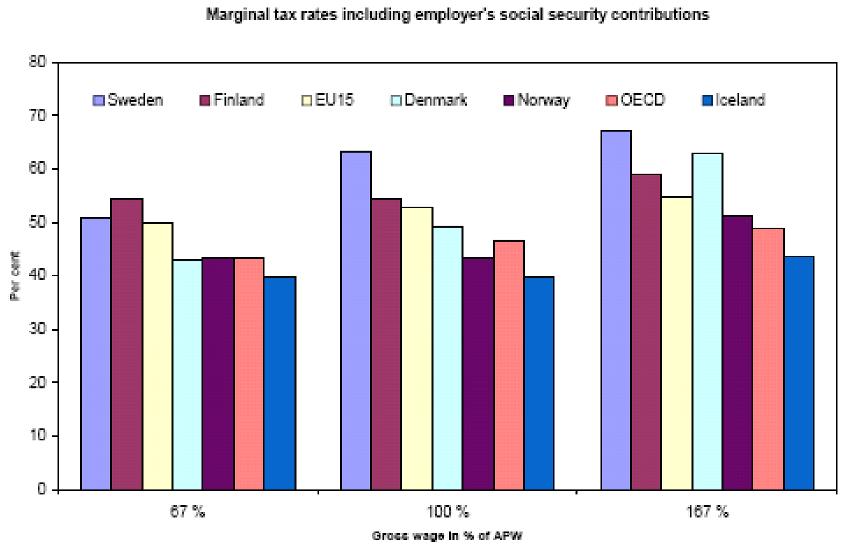
The progression for salary income is generated in different ways in the different countries. In Denmark, Finland and Sweden, state taxes are progressive. In Norway, the progressive element in the personal income tax base is mainly due to social security contributions, and surtax. Figure 2 shows the levels of marginal tax rates, including employer's social security compensations, in 3 different wage income categories, for the 5 Nordic countries as well as for 15 European Union and the OECD countries. As is evident from the figure, Sweden as well as Finland – and in the high income category, Denmark – dominate in terms of highest marginal tax rates, while Island has the lowest marginal tax rates. These have moreover come done since that (since year 2005 in the Figure for Iceland, being less than 36% in 2007). In 2007, Iceland has a fully flat tax for labour income.

Table 2. Summary of the current (2007) taxation of wage income in the Nordic countries

	Denmark	**Finland**	**Island**	**Norway**	**Sweden**
Dual tax system	Hybrid dual / classical system	YES	YES	YES	YES
State income progression	YES	YES	NO	YES for "personal income"	YES
State income tax rates above minimum level	5.48% bottom tax+ 6%+15% for higher wages + labour mkt contr 8%	9% to 32%	Flat, 22.75%	11.8% on "net gen. income" + surtax 0% - 12%+ nat.ins. 7.8%	20%-25%
Lowest taxed wage level	NOK 44.000	<EUR 20.400, tax EUR 8	ISK 1.080.067	Wage minus a deduction of 36% of gross income, or MAX NOK 63.800,-	Tax on >106% of full-time average wage earnings
Local government income tax rate	Flat, about 33.3% incl. church tax	Flat, 16%- 21%	Flat, 11.52%- 13.03%	Flat, 16.2% on "net general income	Flat, 29-34%
Average effective income tax rate	37.3%	26%, av. taxed rate on earned income	24.8% for av. worker		29.7% for av. prod. worker
Marginal tax rate (MRT) for average wage *)	49.2%	50% of taxpayers face MRT≥ 40%.	About 35% for av. worker	47.8% on wage income	About 35% for av. prod. worker
Highest marginal tax rates	63%	Appr. 52%-54%	< 36%	Wage inc. 47.8%	Appr. 51% to 67%
Other wage taxes	Church tax	Church tax 1%- 2.25%			
Health insurance / social security / pension contributions	Yes	Health ins. 2.03%, unemploym.insurance 0.58%, pension contribution 4.3%-5.4%	Pensions funded privately	Social security 10.7% self-employed, 7.8% wage income	Pension contribution 7%, MAX 25.100; from 2006 off-setted by tax credit
Deductions	Earned income credit	Wage related cost, earned income credit, pension etc. premiums, low income credits, household work credit		Travel costs, mortgage interest, trade union fees etc. + standard personal allowance	Few, directly work related costs. In 2007, earned income tax credit.

*) Not including employers' social security contributions.

Figure 2. Marginal tax rates on labour on different wage levels in the Nordic countries, the EU15 and the OECD averages. Single person without children in 2006, per cent



The EU15 and OECD averages and numbers for Iceland are from 2005.
Source: OECD Taxing Wages 2000-2005 and the ministries of finance in the Nordic countries (also: Häkkinen Skans and Sellegren (2007).

Table 2 also shows that the division of taxes between state and local government vary a lot in these five Nordic countries. Analyzing the total tax burden is also made tricky by of the various forms of health insurance / social security payments by the employee. The figures in Table 2 do not include the employer's social security contribution.

2.2. Taxation of capital and capital related income in the Nordic countries

Next, we will take a brief look at the taxation of capital in the five Nordic countries. Table 3 summarizes main features of the systems for taxation of capital in these countries.

Some common trends can be seen from the table. First of all, except for Iceland, corporate taxes are now on rather similar levels. The countries have mostly followed the trend in the OECD countries in somewhat reducing corporate tax rates over time. Secondly, three of the countries have abolished the wealth (property) tax during the last 10 years. Sweden is instead about to abolish the inheritance tax in 2007 (a debate on adjusting the inheritance tax rates down in Finland has also been ongoing). Thirdly, taxation of capital is flat in all of these countries with the exception of Denmark. On Iceland, the capital income tax was only introduced in 1997. Fourth, in all these countries, dividends from corporations are now subject to at least some double taxation. In the next section, we will look more closely at the various major tax reforms in the Nordic countries during the last some ten years.

Table 3. Summary of the taxation of capital income in the Nordic countries

	Denmark	**Finland**	**Island**	**Norway**	**Sweden**
Dual tax system	Hybrid dual / classical syst.	YES	YES	YES	YES
Double taxation of dividends / yields (corporate + income tax)?	28-45% on income from shares	70% of dividends to persons taxed	Yes but only at 10%	Excess distributed profits double-taxed	Full double-taxation of dividends
Progression in taxation of capital income	Many different tax rates, 0-59.7%, 33% for negative cap. income	Flat tax of 28%	Flat tax of 10%	Flat tax of 28%	Flat tax of 30%
Corporate tax rate	Flat 30%	Flat 26%	Flat 18%	Flat 28%	Flat 28%
Real estate tax	1% annually on assessed value if owner-occupied	0.22% - 1% (3%) paid to municipality	0.310% to 0.625%	0.9% of appr. 30% of fair value+ munic. tax 0.2%-0.7%	1%, in 2008, replaced by local gvmt charge
Wealth tax	Abolished in 1997	Abolished in 2006	Abolished in 2006	0.7% to local gvmt + up to 0.4% state tax for wealth > NOK 200 000	1.5% for wealth > SEK 1.5M
Inheritance tax	YES	YES	YES, only 5%	YES	Abolished 2007?
Tax on pension fund earnings	Tax 15% on annual yields, accrual based	No, paid pension are taxed			Yes, 15% to 27%, paid by funds
Stamp duty tax or similar	0.6%-1.5% on purchase of real estate	1.6% or 4% for house, land, stocks (unlisted)		2.5% property transfer tax	1.5%(-3%) of property value on purchase

3. Recent trends and reforms

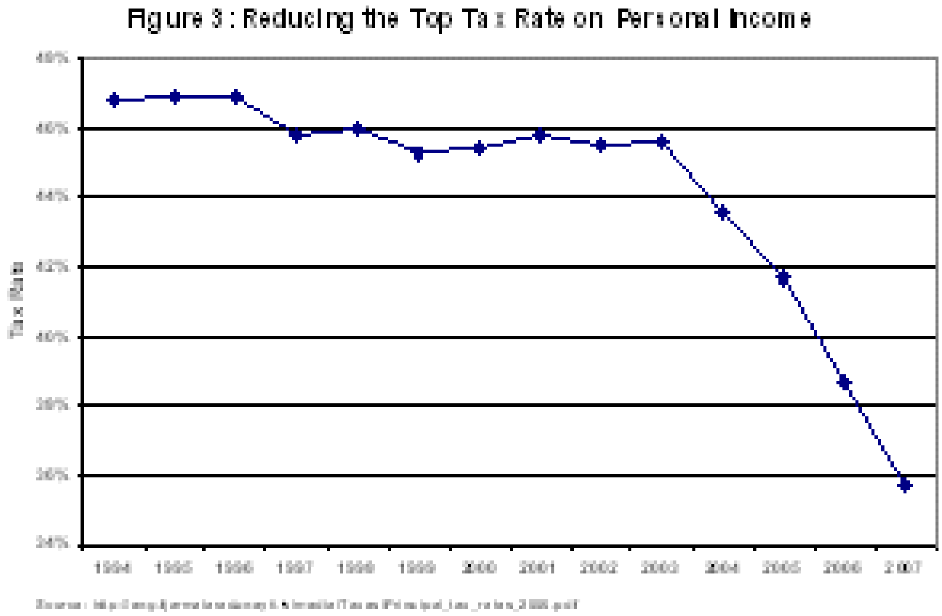
Concerning the taxation of labour income, one recent trend is some reduction in average or marginal tax rates. E.g. in *Sweden*, a multi-year programme was completed in 2006 with income tax reductions to compensate for employee pension contributions.[1] The pension contribution is now fully off-set by a tax credit. As a result, the marginal tax rates for the average income earner have been reduced by 5 percent. More reductions are to be expected due to the new government's actions. Taxes on labour are expected to decrease by about SEK 40 billion between 2006 and 2008, as a result of the introduction of the in-work tax credit. Earned-income credit decreases the marginal tax rate for the lowest income by approximately 3 percentage points, leaving higher marginal income tax rates unchanged. In combination with the reduced income replacement rates in unemployment benefits, earned income tax credit is expected to improve employment rates and lower structural unemployment. Meanwhile, the effect on average hours worked by those already employed is uncertain. Finally, the government has announced further cuts on

[1] Employees and self-employed pay a general pension contribution of 7 per cent, though maximum SEK 25 100 a year.

labour income tax in 2008, with an expected effect of a 1.1 percentage point reduction in marginal tax rates for wage incomes between SEK 120 000 and SEK 280 000. The tax base has in turn been slightly broadened, since e.g. tax deductions for union and unemployment insurance membership fees have been abolished in 2007. This counteracts to some extent the effect of the earned income tax credit, as membership fees are mostly paid by those who work.

In *Finland*, the progressive state tax on earned income has almost annually been slightly reduced. Also in *Denmark*, the tax schedule has become flatter and marginal taxes have decreased over the years (e.g. the average marginal tax rate has come down from 49.3% in 1994, to 44.4% in 2007). At the same time, the tax base has been broadened by the elimination of many deductions. In *Norway*, average tax rates for wage income have been rather stable during the last 10 years, while there is a dramatic reduction in marginal tax rates from top levels in bracket 2 of about 65% as late as in 2004, to today's levels of around 50% for wage income / income for a self-employed. This reduction was performed by decreases in surtax on personal income due to tax cuts in 2005 and 2006, i.e. a reduction of the top tax rates on personal income, in order to close the gap between the top marginal tax rates on labour and capital income.

However, the most dramatic tax reform of labour income has been undertaken by Iceland. Due to cuts in tax rates, and the flat tax for wage income, marginal tax rate have rapidly come down from a level of approximately 47% in 1994, to today's level slightly below 36%. This single-rate tax system is remarkable at least for two reasons. First, it reflects a continued systematic effort to dramatically reduce marginal tax rates on wages, thereby aiming to give higher incentives for work. But second, and perhaps even more important, policy makers in Iceland decided that it was no longer desirable to distinguish between taxpayers with different wage levels.



Source: Gissurarson and Mitchell (2007).

Several major reforms have also touched the taxation of capital income. One category of reforms deals with the introduction of partial dual taxation of corporate dividends in countries which had aimed at a neutral treatment of yields on bonds and stocks, i.e. Finland and Norway. Both countries had earlier tried to avoid double taxation. Finland with the use of an imputation tax credit and equal tax rates for capital income and corporate profits, and Norway, with a split system and equal capital income and corporate tax rates, have made some adjustments.

One reason for the reform in *Finland* was that the old system discriminated between domestic and foreign dividend receivers (the domestic ones obtained the dividend tax-free, while foreigners had to pay the stamp duty tax), as also the European Court of Justice made clear in their decision. The new system from 2005 implies a tax of 28% on 70% of the corporate dividends, with tax exemptions for very low levels of dividend income. The effective tax on 1 euro of corporate profits, distributed out as dividends is thus 0.26+0.7*0.28*(1-0.26) i.e. 40.5%.

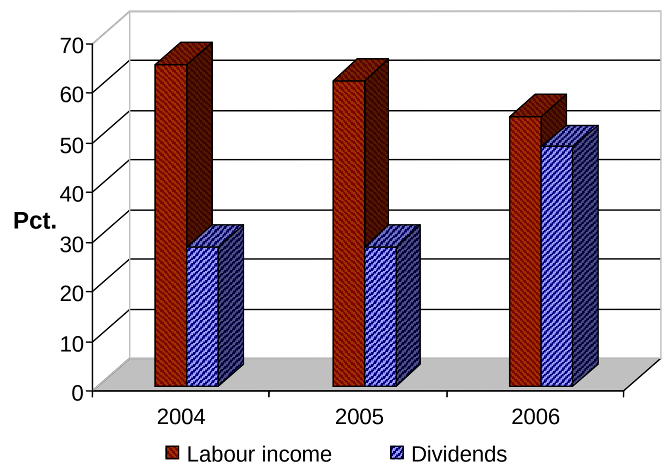
In *Norway*, the tax system was reformed because of tax erosion due to various loopholes / too liberal definitions for capital income. The old dual tax system, with its wide and increasing difference between the marginal tax rate on capital and labour income, had made it necessary to implement *splitting rules* for self employed. Capital income was determined according to an assumed rate of return on capital stock, including a risk premium. The residual business income, in excess of this imputed capital income, was taxed as personal income. This split model applied to all “active owners”, given that at least 2/3 of the owners were classified as active owners. However, with the widening of the gap between tax rates on capital and labour income, and with a too liberal determination of capital income, the split model over time opened up various loopholes for income evasion. The model was put under special investigation by the Office of the

Auditor General of Norway in 2002. Among the findings was that the companies taxes according to the split model to a large extent were only those who gained from it. In the 2006 tax reform, the split model was replaced by the shareholder model.

In the new system (the so-called "shareholder model") from 2006, entrepreneurs can freely decide to get their entrepreneurial income taxed as personal income as self-employed, or to organize their business activity as a stock company and get the income taxed as dividend, or to be employed in their own firm and get it taxes as wage income. This is made possible by tax rates which come close to closing the gap between labour income and dividends; and imply therefore some double taxation of dividends. Figure 4 illustrates the closing of the gap between capital and labour income in Norway.

Other reforms concerning the taxation of capital income include the introduction of capital income taxation in *Iceland* in 1997. The income from it was 2% of total tax receipts in 2000, and has been increasing to 3.8% in 2005. It is notable that the tax rate is only 10%. Changes in the real estate tax in *Sweden* are also expected. It has been criticized for being unfair and having no popular support. With its linkage to the market values, the real estate tax affects unpredictably on individuals who own their homes. It has been argued that individuals after a long life of industrious repayments have reduced their debts in order to be able to stay in their home even when their income falls are affected by the real estate tax. In view of this, the national real estate tax on housing will be abolished as of 1 January 2008. The Government intends to replace the national real estate tax by a low local government charge.

Figure 4: Marginal tax rates on dividends and labour income 2004 - 2006



Source: The Ministry of Finance, Norway. Also: Jacobsen (2007).

Finally, a shift towards environmental taxes as complement to taxation of capital, labour, and regular consumption (through value-added taxes) is seen in most countries. In *Denmark*, changes in environmental taxes were made in the 1994 and 1999 reforms. In total, environmental taxes were increased by approximately 20 billion DKK during the period of 1994 to 2002 (the same magnitude as the personal income tax cuts in those years). In *Sweden,* the green tax reform that began in 2001 increased the environmentally related indirect taxes and reduced the taxes on labour income by increasing the basic allowance. This lead to a slight increase in the marginal tax rate between 2002 and 2004. The aim was to increase the environmentally related indirect taxes by SEK 30 billion and reduce the taxes on labour by the same amount. By 2006, green tax swap worth SEK 15 billion had been put through. The focus of the green tax reform was more on the income distribution effects than increasing the economic efficiency.

4. Some encountered problems and effects

Income shifting, a typical problem for a dual tax system if the wedge between tax rates for labour and capital is high, has been encountered in most Nordic countries. Income shifting in *Norway* under the split-rule has already been discussed in section 3 of this report. The new Shareholder model in Norway, with only a narrow gap between labour and capital income, independent of the organizational form, is expected to work better in this sense. However, there are a few problems also with the new model. For practical reasons, the rate of return allowance (RRA) used to determine the "proper" return on capital, is given to the shareholders at the end of the year, regardless of the actual time the share has been in the taxpayers possession. The idea is that if you sell a share (for instance after six months and thereby loose six months of RRA) this will be reflected in the sales price of the share. It would be practically impossible to keep track of the exact time of ownership for all taxpayers. This gives some obvious incentives to increase the portfolio of shares around the year-end, to increase the RRA. For this form of year-end trading to be profitable, the counterparty of the transaction has to be tax exempt, since otherwise the seller's loss of RRA would have to be compensated by a higher realization price. The risk for year-end trading would be a modest problem if the number of tax exempt sellers would be negligible. However, an important part of the 2006 was that corporate shareholders are exempt from dividend and gains tax. Also, institutional investors such as mutual funds typically are tax-exempt. Hence, the rule would have opened the floor for large year end trading, which would have undermined the dividend tax. The solution implemented by the government was that the shareholder looses any unutilized RRA when the share is realized. This distorts the neutrality properties of the model, since it eliminates the sharing of also downside risk with the government. As a result, the model discriminates against risky projects.[2]

On *Iceland*, where the gap between the flat rates on capital (now 10%) and the marginal tax rate for wage income (now 47.8%) has been even higher than what it now is, following signs of probable income shifting have been observed. By a change in the tax code effective since January 1st, 1995 individuals were allowed to organize their economic activity in a limited liability company. Share(s) of such companies are hold by

[2] Another problem that had to be solved was the opportunity to transform equity to debt, by setting up loan arrangements from the investor to the firm. In this way, the investor would be able to transform double taxed share income to single taxed interests. To avoid this, interests from firms to persons that exceeds a certain rate is taxed in line with ordinary dividends (except interest on ordinary tradable bonds).

only one person. Individuals who wished to reduce the effect of risk associated with their economic activity on their family finances had to establish a full fledged limited liability company, a process made costly and cumbersome by increased formal demands against such companies. Many individuals, specially fishers and farmers have made use of the change. The change was intended to make it easier to draw a line between a person and the economic activity pursued by that person and allocate the risk associated with the economic activity to the personal one shareholder company. The tax-burden associated with either form of organizing economic activity should be similar. The municipalities claim that there has been a shift so that the one man companies have induced a redefinition of personal income from labour income (which is part of the base for the municipality income tax) to capital income. If correct, then the single shareholder companies have induced a reduction in the tax burden as capital income is taxed at a lower rate than personal income. Furthermore, it would also have narrowed the tax base of the municipalities.

Income shifting has also been observed to be a problem in *Sweden.* Under the dual income tax system, capital income is taxed at a lower rate than the top marginal tax rates on labor income, and the preferential tax treatment of capital income is reinforced because of the fact that social security taxes are levied only on labor income. Thus, the taxpayer's total tax bill depends not only on his total income, but also on his income division. This has created new room for tax avoidance, especially for owners of small business firms who are able to lower tax payments by transforming labor income subject to high marginal tax rates into capital income subject to low tax rates. As a result of the ongoing debate, among other things, the Swedish Minister for Finance has ask Professor Peter Birch Sorensen, University of Copenhagen, to examine if the Swedish tax system still fulfills the neutrality conditions that was established in the tax reform of 1991. Sorensen is expected to complete the study at the end of 2007.

Another effect encountered in the Nordic countries is the negative effect on labour supply, caused by the high marginal tax rates on wage income. E.g. in *Sweden*, the overall high taxation of labour income[3] gives strong incentives to work short hours. In combination with employers' contributions, municipal income taxes and consumption taxes, the state income tax means that 35 per cent of the full time employed face marginal taxes above 70 per cent. The negative effects are particularly tangible in the area of domestic services. As a result, these services are either not carried out at all or are performed in the informal sector.[4] This has negative effects on labour supply, specially the labour supply of women, and makes it difficult to reconcile work and family life. Therefore, the government introduced an income tax credit for private households'

[3] In 2004, Sweden was the only EU country where the tax-to-GDP ratio including social security contributions exceeded the 50 per cent mark (European Commission, 2006).

[4] A survey made by the Swedish Tax Agency indeed showed that the Swedes had relaxed attitude towards performing or purchasing undeclared work. There is a discrepancy in the national accounts between income in society and household expenditure, which indicates that undeclared work could amount up to SEK 115-120 billion. The government has announced a number of measures that will contribute to a reduction in fraud and incorrect payments of benefits.

purchase of domestic services in July 2007. The tax reduction amounts to half of the labour cost with an annual ceiling for the tax credit of SEK 50 000 per person. The domestic services include for example cleaning, washing, ironing, gardening, cooking and baby-sitting. In *Finland*, a similar but more modest credit for household services has been in use for a few years (in 2007, the maximum amount for the credit is EUR 2.300; 60% of the actual costs can be deducted against the credit).

5. Conclusions

Several signs indicate that there is some trend in the Nordic countries, towards closing the gap between taxes on labour and capital. Norway has recently gone the full way out with their Shareholder model, together with heavy reductions in marginal tax rates for wage income. In all other Nordic countries, marginal rates for wage income have come down as well, most dramatically on Iceland, while at the same time, taxation of capital income has been increased, especially in Finland and Norway (with partial dual taxation of dividends), and on Iceland (with the introduction of a capital income tax in 1997). However, several countries still report on problems due to income shifting (which would call for further reductions of the tax wedge), and problems with a low supply of labour. Despite these problems, the Nordic welfare model seems however still viable, even allowing for further tax cuts as the economic conditions have been good. Tax reductions for labour income have also been partly financed by a shift towards environmental ("green") taxes.

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