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

GENERAL LEGAL REPORT

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1. Introduction

In a drive to encourage entrepreneurship and competitive fiscal advantage, many European countries have reformed their personal income tax system fundamentally over the last two decades. At the same time, governments are aware that they must maintain taxpayer's faith in the integrity of their tax systems to fund public spending. Fairness and simplicity have become the byword of reformers, but the double challenge has meant that no clear consensus has emerged on an ideal personal income tax. These problems are also emerging on the surface of tax reforms in the Nordic countries. Although there are large differences in tax policies between European countries, almost all the reforms of personal income tax in the last two decades can be characterised as

a) rate reducing and

b) base broadening.

The NSFR autumn seminar in Helsinki aims to examine the general trends in the taxation of capital

income and of wage income in the Nordic countries, and the most significant changes that have taken place. It looks closely at the main points of latest country specific reforms, the trade-offs between policy objectives, and design features of personal tax systems. The principal theoretical systems of taxes on personal capital income and wage income are

1) *comprehensive tax,*

2) dual tax and,

3) flat tax.

The Nordic systems will be assessed in country reports in terms of the fundamental principles of tax policy: simplification, efficiency, equity, tax compliance and tax revenue, and their main advantages and disadvantages should be discussed. The purpose of this general report is to produce a short survey of the general trends in the taxation of capital and wage income in the Nordic countries, discuss some of the potential problems of income transformation and tax evasion which have been encountered, and summarize some of the recent reform plans concerning the capital and wage income taxation.

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

2.1 Background

The tax systems in Finland, Norway and Sweden are all versions of a dual tax system, where wage and capital incomes are separated, and wage income 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 and 1990's.

Table 1 summarizes the main features of the systems for taxation of earned income and capital income in these countries. The countries have mostly followed the trend in the OECD countries in somewhat reducing corporate tax rates over time. 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). Taxation of capital is flat in all of these countries with the exception of Denmark. In all countries, major dividends from corporations are now subject to at least some level of double taxation.

Table 1. Summary of the taxation of earned and capital income in the Nordic countries

	Denmark	Finland	Island	Norway	Sweden
Tax system	Hybrid dual / classical syst.	Duaö	Dual	Dual	Dual
Double taxation of dividends?	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% for capital income	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, but only 5%	Yes	Will be abolished
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
Highest marginal tax rate	63%	Appr. 52%-54%	< 36%	Wage inc. 47.8%	Appr. 51% to 67%

2.2 Denmark: some developments

In Denmark, the wage income 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. During the decade from 1992 to 2002 Denmark made a shift in the tax structure from income taxes to green taxes that received much attention. The idea was to tax environmentally harmful behaviour and the use of resources while using revenue from the green taxes to reduces taxes on labour income. The most persevering proponents of such tax shifts claimed that this would create a double dividend both increasing labour supply and improving environment. The green tax shift involved an increase in environmental taxes in the order of 1-1.5% of GDP. This implied the increase and introduction of a number of taxes on petrol, diesel, heating, electricity, waste, water, motor vehicles etc. In many cases tax rates actually came to exceed externalities connected with the taxed behaviour.

The nominal capital income tax rates vary from 0% on capital gains on owner-occupied housing to 59.7% on interests from bonds and bank deposits in case of a taxpayer with positive net capital income paying the top marginal tax rate. Between these extremities nominal tax rates are 15% on annual yields from pension savings but on an accrual base, 1% annually on the assessed value of owner-occupied housing, 28-45% on income from shares, 33.3% on negative net capital income and between 38.8% to 59.7% on interests from bonds and bank deposits.

2.3 Finland: some developments

Since 1993 Finland has applied a dual income tax (DIT) system according to which an individual taxpayer can have two categories of income: capital income and earned income. Each type of income can further consist of three different sources, namely: business income, personal income and agricultural income. Typical forms of capital income, also known as investment income, are dividends received from companies listed on the stock exchange, interest, rental income, income derived from processing land and soil, yield on property or assets, capital gains from selling assets etc. Capital income is taxed at a flat rate of 28 per cent. Earned income could in simplified terms be defined as every form of income that does not qualify as capital income, consequently earned income mainly consists of wages, salaries and pensions. Earned income is subject to a progressive state income tax and a proportional municipal income tax. The separation into two categories of income and three sources of income is also applied to deductions and losses.

The most significant recent reform concerned the taxation of dividends. In 2005 Finland abolished the old imputation-based model of dividend taxation, mainly because it was discriminatory towards foreign source dividend in comparison to domestic dividends. The imputation system eliminated economic double taxation with respect to domestic dividend by providing a full credit of the corporate income tax paid by the distributing corporation at the shareholders level. Economic double taxation was, however, not eliminated with respect to foreign source dividend. This system obviously favored investments in domestic stock. Since 2005 a partial double taxation system is applied, under which corporate income is primarily taxed at the company and dividends are subsequently taxed at the shareholder. Domestic and foreign source dividends are treated alike. The new dividend taxation model can, however, not be categorized as a simplification of the tax system due to its complicated construction.

The progressive state tax rate on earned income has almost yearly been slightly reduced and the capital income tax has in 2005 decreased from 29 per cent to 28 per cent. The wealth tax was abolished in 2005. Since 2006 capital gains are tax exempt if the value of the sold assets during the tax year does not exceed 1,000 EUR. Likewise capital losses are not deductible if the total acquisition cost of the assets does not exceed 1,000 EUR. The main purpose of this amendment was to facilitate the administrative work-load of the tax authorities.

2.4 Iceland: some developments

Income taxation of individuals in Iceland can broadly be divided into two categories, taxation of wages and taxation of capital income. The latter refers to dividends, interests, capital gains and a few other items of income not derived from the employment or the conduct of business. Wages are subject to general income tax and municipal tax, resulting in an average combined tax rate of 36,72%. The rate is flat, i.e. there are no brackets, but the effective tax rate increases due to an annual personal allowance of ISK 385.800.- In general employees cannot deduct expenses, the significant available deduction is pension contribution. Capital income of individuals is subject to a flat tax rate of 10%. The 10% capital tax is a gross based tax, i.e. no deductions are permitted with the exception of the possibility of offsetting capital gains from the sale of shares with losses from the sale of shares within the same calendar year.

There are no clear indications on how the Icelandic tax system will be changed in the future. The exception to this is a declaration by the Icelandic government on the wage tax rate being lowered in the next few years.

2.5 Norway: some developments

The Norwegian tax system was recently reformed because of tax erosion due to various loopholes in the capital income taxation. 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.

The basic principle of the shareholder model is that the ordinary yield on investments is taxed only once (at the company level), whereas distributed profits exceeding the ordinary yield are also taxed at the shareholder level as general income at a flat rate of 28 per cent. In order to achieve the goal of such limited double taxation, the receiving individual is granted a so-called "computed risk-free return"/ "shielding deduction" (*skjermingsfradrag*), which reduces the taxable dividend/capital gain

In the new system 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. The effect of the individual shareholder model is that dividends and capital gains exceeding a risk-free return on the investment is subject to economic double taxation and taxed at a total marginal rate which is roughly in line with the top marginal rate on labour income. There is no longer any taxation at source (only upon distribution/sale of shares), no part of the income is deemed to be personal income and the taxation of dividends and capital gains apply irrespective of whether the shareholders are active or passive.

2.6 Sweden:recent developments

Some major reforms regarding both taxation of capital and employment have taken place during the last few years in Sweden. The tax on gifts and inheritance was abolished in 2004. The reasons stated for the abolishment were the burden of inheritance taxes due increased tax values of real estate, differences in taxation of different types of shares, difficulties in transfer of SMEs to the next generation within families and problems due to advanced tax planning. The tax was also perceived to be inequitable. The tax was of minor importance to the government budget (2,6 billion SEK in 2004) but at the same time rather costly to administrate.

Also, in 2007 the net wealth *tax* was taken away. The existence of this tax had been debated for many years. The newly elected government decided to abolish the tax, as part of the "new" tax policy. The wealth tax was perceived to be detrimental to the creation of risk capital in Sweden and is believed to have driven capital abroad. The Swedish Tax Agency (Skatteverket) has estimated that financial assets worth around 500 billion SEK are placed outside Sweden. At least part of this outflow is believed to be caused by the wealth tax. Due to its construction the wealth tax also has encouraged tax planning and tax evasion. Certain shareholdings were exempted from tax while real estate was taxed at full value. The tax has been viewed as inequitable and arbitrary, especially for "common people" compared to wealthy individuals. Increases in housing prices have raised the wealth tax burden significantly for some real estate owners. Some of them have had to pay both state real estate tax and net wealth tax for their houses. To finance the reform, the proposal is to lower the limit for deduction for private pension premium payments.

One very important feature in the Swedish tax system is that some parts of dividends paid out to active owners in closely held private companies are taxed as income from employment instead of capital income. Also, some parts of capital gains for active owners from the disposal of shares in those companies are taxed as income of employment. The objective of these rules is to prevent income transformation of what is viewed as "real" income from employment (that is subject to progressive taxation) in those companies to low taxed capital income. The model for calculating what parts of dividends and capital gains should be taxed as income from employment are technically very complex. The tax rules have been changed a great number of times since they were introduced in 1991. Due to the complexity and design of legislation, a great number of court cases have been decided over the years regarding the interpretation and the application of the rules, which in turn has led to reactions from the legislator. This part of legislation has been the target of a significant amount of tax planning.

3. Looking to the future

It seems that the most important tax policy trend is the tendency towards closing the gap between taxes on labour and capital. The large tax rate gap has been the basic tax evasion problem of the Nordic dual income tax system. Norway has recently shown the way 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, Iceland and Norway.

The remaining ”big question” obviously is the future of the current Nordic dual income tax model. Should we move towards an unified flat tax rate (or rate schedule) for capital *and* earned income? Or should we abolish the duality and move towards the European comprehensive income tax system with progressive tax rates?

The late Professor *Kari S. Tikka* was one of the most prominent advocates of the flat rate tax system. He pointed out the many disadvantages of the current dual income tax systems. The vast majority of taxpayers receive mainly progressively taxed earned income. Since medium-sized earned income generally is taxed at a higher rate than capital income, it leads to the fact that employees pay more tax in proportion to their income than individuals with considerable capital income. The progressive taxation of earned income might also discourage foreign labour from coming to the Nordic countries. The system based on a steep progression doesn't either encourage individuals to increase their total earned income by further work. Professor *Tikka* saw a general flat-rate tax system, according to which earned income and capital income is taxed with the same rate, as the solution to many problems and he even predicted that such taxation will be introduced in a not so distant future.

The ongoing globalization is another issue. Taxation in a small open economy is under constant pressure. EU law has an increasing impact on national taxation of individuals in Member States. Tax harmonization continues, although slowly. A common tax base for all European firms may become a reality in the near future.