REGERINGSKANSLIET

Memorandum

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Taxation of capital and wage income; towards separated or more integrated personal tax systems? Swedish economic country report

1. Introduction to the personal tax system

Swedish taxation levels are among the highest in the EU. 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). The overall tax burden has decreased slightly after that and the tax-to-GDP ratio is expected to decrease to 47.7 per cent in 2007. Still, the tax-to-GDP ratio is much higher than the EU average (37.7 per cent in 2004). The gap between the Swedish tax quota and the EU average is mainly represented by the higher taxes on labour and social security contributions in Sweden. However, it must be kept in mind that tax-to-GDP ratios between countries are difficult to compare. For example public transfers in Sweden are taxed in contrast to many other EU countries. A transition from gross to net accounts where transfers are not taxed would lower the tax-to-GDP ratio with approximately 4 percentage points.

In international comparison, the Swedish tax system relies to a greater extent on direct taxation, in particular personal income taxation, for raising tax revenues. The tax structure resembles that of Norway and Finland (European Commission, 2006). Table 1 shows the overview of total taxes in Sweden and the expected development of the tax revenues as per cent of GDP. Taxes on labour added up to about 30 per cent of GDP in 2006. 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. Taxes on capital amounted to

6.5 per cent of GDP in 2006. About two thirds of the total tax revenue in Sweden may be regarded as tax on labour (i. e. tax on earned income and social security contributions). Tax on capital covers about 10 per cent of the total tax revenues.

Table 1. Overview of total taxes in Sweden 1996-2006

as % of GDP	Income year						
	1996	2001	2006*	2007*	2008*	2009*	2010*
Taxes on labour	32,5	33,1	30,3	28,9	28,6	28,8	28,8
Taxes on capital[1]	4,9	5,1	6,5	5,8	5,7	5,7	5,8
Taxes on goods and services	14,0	13,1	13,2	13,1	12,9	12,9	12,8
Total taxes	51,4	51,3	49,9	47,7	47,2	47,3	47,3
State budget surplus, BSEK	-21	38,8	18,4	106,8	63,4	101,5	135,1

* forecast, [1] including income tax on company profits.
Source: Ministry of finance and the Swedish Tax Agency.

In 1978 the Nobel price winner in economics, Gunnar Myrdal, launched a tax debate in Sweden. Sweden had during the 1980's reached the end of the road with a global income tax system supposed to finance a welfare state. The tax-to-GDP ratio had increased from 30 per cent in 1950 to 40 percent in 1970 and to 50 per cent in 1980. The tax system consisted of various deductions and tax allowances. The tax bases were narrow and marginal tax rates extremely high. For example the top marginal tax rate on labour income was 85 per cent. Clearly, such tax rate must be very harmful for work incentives. This finally led to the introduction of the dual income tax system in the 1991 tax reform.

The tax reform in 1991 transformed the Swedish tax system into a so-called "dual" income tax system which combines a high progressive taxation of labour income with a lower general flat rate on capital income. One of the goals of the tax reform was the broadening of the tax bases and lowering of the formal tax rates. The principle of uniform taxation, i.e. all income should be taxed uniformly, was the point of departure. The tax reform aimed at making the tax system more robust and less exposed to manipulation, but also making it simpler to administer. The tax system should affect the actions of private individuals as well as companies in a less arbitrary and more economically sound manner.[1]

Local government income taxes are paid at uniform rate of all income above basic allowance. The average local government tax rate in 2007 is 31.6 per cent. State income taxes are only paid of incomes above 106 per cent of full-time average wage earnings. The rate is 20 per cent which rises to 25 per cent for income above 152 per cent of average earnings. The capital tax rate is 30 per cent. (OECD, 2007).

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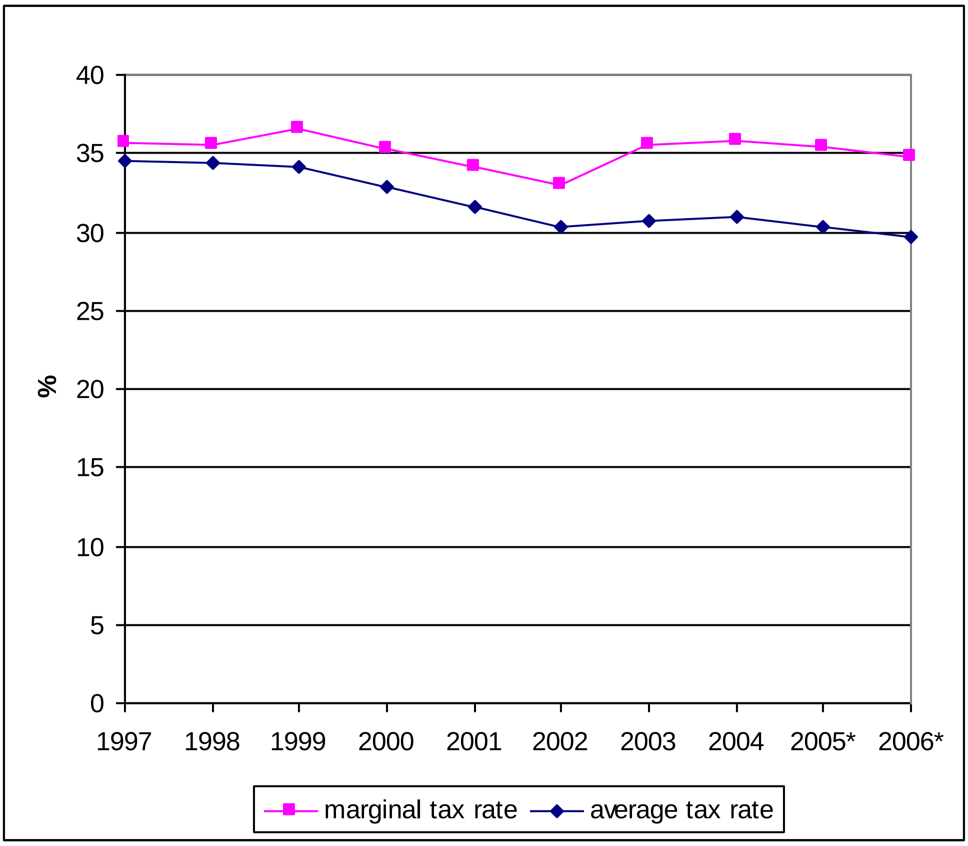
[1] For a further description and an evaluation of the tax reform see Agell et. al. (1998).

Figure 1 shows the marginal and average tax rates for a single person earning 100 per cent of the average production worker's[2] earnings in 1997-2006. The marginal tax rate for the average production worker has varied around 35 per cent during this time period. The slight increase in the marginal tax rate between 2002 and 2004 is due to the green tax reform which increased the basic allowance. After 2004 the marginal tax rate has decreased slightly and is expected to decrease further in the next few years. The average tax rate for the average production worker has decreased from 34.5 to 29.7 per cent. Despite the recent downward trends these are still relatively high tax rates in international comparison.

Figure 1. Marginal and average tax rates for single earning 100 per cent of average production worker's earnings, APW, (covering employees' social security contributions and personal income tax, according to OECD's previous definition of APW), per cent



* forecast. Source: OECD and Ministry of finance.

To get an international comparison, it is useful to look at marginal tax rates including employer's social security contributions. Figure 2 illustrates the marginal tax rates on labour including employer's social security contributions for the Nordic countries as well as for the EU15 and the OECD averages. Sweden has a relatively high marginal tax rate on all wage levels, ranging between about 51 per cent and 67 per cent.

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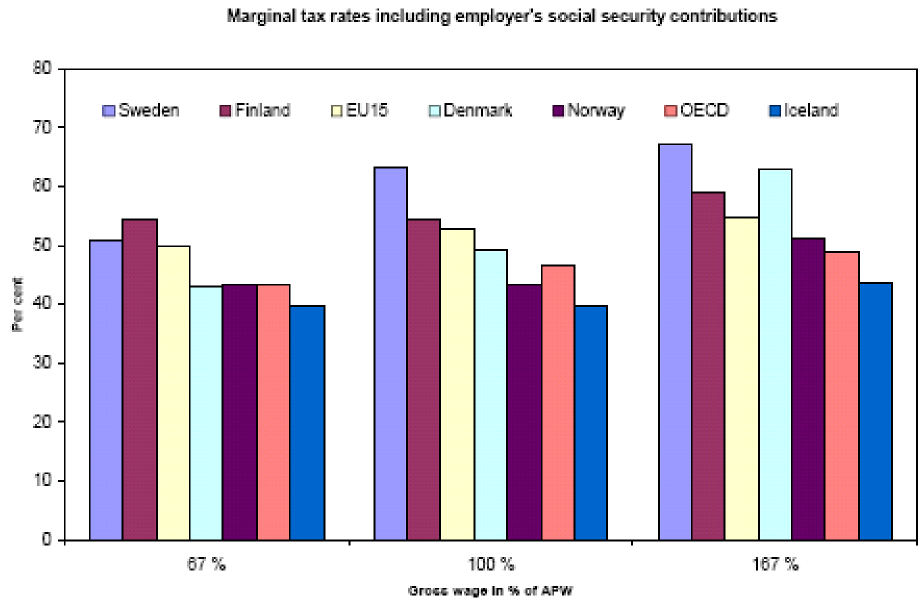
[2] According to the OECD's previous definition of the average production worker.

This is higher than both the EU15 and OECD averages for all wage levels and higher than the marginal tax rates in the other Nordic countries for income levels over 100 per cent of the average production worker's earnings.

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[1], per cent



[1] 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.

2. Taxation of wage and wage-related income

Income from employment is the sum of all earnings deriving from a persons own work, which includes wages, sickness benefits, parental benefits, pensions and fringe benefits (such as company car and food vouchers). Local government income taxes are paid at a uniform rate of all income above a basic allowance of SEK 11 900 – 31 100 in 2007. The tax rate varies between roughly 29 and 34 per cent, depending on the municipality of residence. The average local government income tax is 31.6 per cent. For taxable income over SEK 316 700 there is a state tax bracket with a tax rate of 20 per cent and the top rate for taxable labour income above SEK 476 700 is 25 per cent. Benefits add to the effective taxation of income from work by being contingent on not working (unemployment benefits) or by being withdrawn when income grows (housing benefits and social assistance). The state income tax implies strong progression from just above average full-time earnings. One way of illustrating this is the tax wedge. 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. Thus, there is a strong incentive to work short hours and the individual is left with only little of the economic gain from entrepreneurship and increased effort.

Deductions are only allowed for expenses that are directly associated with work. The most common deductions are travel to and from work. From 2007, an earned income tax credit (described below) is given for labour income but not on social security payments, such as pensions, sickness insurance payments or parental benefit payments.

Recent reforms

Employees and self-employed pay a general pension contribution of 7 per cent, though maximum SEK 25 100 a year. A multi-year programme was completed in 2006 with income tax reductions to compensate for employee pension contributions. 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 reduced by 5 per cent.

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. 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.

The new government, elected in autumn 2006, has launched a number of new measures in order to stimulate both labour supply and labour demand. These measures include tax changes as well as other employment measures, such as changes in the unemployment insurance policy. Tax measures that are expected to affect labour demand include reductions in the employer’s social security contributions for the youth and for certain segments of the service sector. The most important tax change aiming to boost labour supply is the earned income tax credit.

From 2007, an earned income tax credit worth 1.3 per cent of GDP has been introduced with the purpose of making work economically more rewarding relative to unemployment or inactivity. Depending on the municipal tax rate, a person gets up to SEK 12 000 annual tax credit on labour income. For those aged 65 or more, a higher tax credit worth up to SEK 21 000 is given. Earned income tax credit reduces marginal tax rates for low- and middle-income earners. Marginal tax rate decreases considerably for the lowest incomes and about 3 percentage points for annual wage incomes between SEK 100 000 and 300 000. The marginal tax rate for higher income levels is unchanged. The average tax rate is reduced for all income groups. Measured as per cent of income the average tax rate reduces the most for the low-income earners.

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. Some of those already employed earning low and middle incomes are likely to choose somewhat longer hours, for example shifting from part-time to full-time. However, for persons already employed with above-average earnings the credit has no effect on effective marginal taxes and thereby no positive substitution effect. It is simply a lump-sum with a negative income effect making them choose slightly shorter hours. In total, the earned income tax credit is expected to increase the number of hours worked in the economy by 1.34 per cent which is equal to roughly 60 000 jobs.

Tax wedges on work are high in Sweden. 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. 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' 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.

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.

The government finances show surplus despite all the recent tax reforms.

Future tax reforms

The government has announced further tax cuts on labour income in 2008. This will include further development of the earned income tax credit with an emphasis on tax reductions for the low- and middle income earners. This is expected to reduce the marginal tax rate for annual wage incomes between SEK 120 000 and 280 000 by 1.1 percentage points in 2008.

3. Taxation of capital

Taxes on capital paid by individuals include tax on capital income, properties, wealth (announced to be abolished in 2007) and pension fund earnings. In 2005, total taxes on capital paid by individuals amounted to SEK 76 billion. Table 2 shows an overview of taxes on capital paid by individuals in 2005.

Table 2. Overview of taxes on capital paid by individuals in 2005, SEK billion

Income tax on capital income	22,9
Real estate tax	25,1
Wealth tax	5,0
Tax on pension fund earnings	12,0
Stamp duty	7,8
Other taxes on capital	3,0
Total taxes on capital	**75,8**

Source: The Swedish Tax Agency.

The tax rate on capital income is 30 per cent. Taxes on capital income can be divided into two groups: taxation of periodic yield, such as interests, dividends etc., and taxation of realised capital gains, e.g. on corporate shares and real estate. Deductions are allowed for paid interests and capital losses. If capital income is negative, 30 percent of the loss up to SEK 100 000 and 21 percent of the loss exceeding this amount is credited against state- and local government earned income tax. There is a large variation of the total net yield from the individual income tax on capital between different years. Declared income in the form of interest, dividends etc. are completely offset by deductions for debt interest (mainly home mortgage loans). However, capital gains generally exceed capital losses by a large margin. Net capital gains vary widely from year to year. The large variation is expected by varying asset prices. Furthermore, tax planning in anticipation of changes in tax rules the following years give rise to further volatility.

The tax assessment value of a property is established through periodic real estate assessments. The tax assessment value of the property is intended to corresponds to 75 percent of the properties' market value. Before 2006, the real estate tax on private homes was 1.0 per cent of the assessed value. In waiting for abolishing the national real estate tax in 2008 the influence of the land value on the real estate tax charged is limited. In 2007 the real estate tax rate for apartment buildings was lowered from 0.5 to 0.4 per cent. In the same year the standard imputed income for tenant-owner associations was abolished. Between 2006-2008 the basis for the taxation of private homes and apartment buildings is frozen at 2006 levels.

The tax on net wealth may be regarded as complementary to other taxes on capital to make taxation more progressive. The wealth tax is not a purely personal tax like other direct taxes. The wealth tax is levied on the net wealth of the household, each spouse being liable for tax according to his or her share of the net wealth. Wealth tax is levied at the rate of 1.5 per cent on net wealth. The tax threshold is SEK 1.5 million for single taxpayers and SEK 3.0 million for married couples. In computing the taxable base, the general principle used is that assets should be entered at their market values. Properties, however, are included at their taxable value, i.e. 75 per cent of the market value of the property. Assets employed in the owner's trade or business is exempt from tax, as are shares in most non-quoted companies. Shares quoted on a stock exchange are assessed at 80 per cent of their market value, but shares owned by principal shareholders (controlling 25 per cent or more of the votes) are exempt.

Taxes on capital also include tax on pension fund earnings. Up to a maximum limit, taxpayers are allowed deductions for premiums to private pension funds. To establish neutrality with other forms of saving, the tax reform in 1991 introduced a special tax on pension fund earnings. This tax also applies to premiums paid by employers. The tax is paid by insurance companies and other financial institutions that administer such funds. The tax base is the estimated yield of the fund capital. The yield is calculated by multiplying the fund capital by the official State lending rate. The rate applied to this yield is 15 per cent in the case of pension capital funds and 27 per cent for other funds.

A further not negligible tax on capital in Sweden is the stamp duty. Stamp duty is levied on the acquisition of real property and the registration of mortgages. The standard rates are 1.5 per cent of the value of the acquired property. Other tax rates apply in special cases.

Recent reforms

The real estate tax in Sweden has been criticised for being unfair and having no popular support or legitimacy. With its linkage to the market values the real estate tax affects individuals who own their homes unpredictably and they are not able to noticeably affect the situation. It is 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.

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The local government real estate charge will be approved by the Riksdag but be paid to the municipalities from 2008 onwards. The government grant to the municipalities will be adjusted so that the transition will be neutral for both the State and the municipalities while future income changes will go to the municipalities. The Government intends to review the municipality tax equalisation system and in that context consider the issue of the relation between the local government real estate charge and the municipality tax equalization system. The step after the circulation of the proposal is a proposal to the Council on Legislation. After that there will be a Bill in the autumn 2007 to enable a new tax system to come into force on 1 January 2008.

In the Spring Fiscal Policy Bill 2007 the Government also proposes to abolish wealth tax entirely as of 1 January 2007. The main reason for abolishing the wealth tax is the inconsistent valuation rules of the wealth tax and its many exceptions that create loopholes and encourage tax planning. This distorts households' choices of investment and undermines the legitimacy of the tax. At the same time many homeowners have had to pay wealth tax due to rapidly increasing house prices and thereby increasing assessed values. The wealth tax is considered to be arbitrary and unfair and also difficult to administer in terms of control. It is also argued that the wealth tax is an obstacle to encourage establishment of new companies and make it easier for small and medium sized companies, in particular, to expand. Thus, removal of the wealth tax is expected to improve the supply of risk capital, particularly to small companies, and thereby create better conditions for entrepreneurs in Sweden. A proposal has recently been circulated. The next step will be a proposal to the Council on Legislation and a Bill in the autumn 2007.

4. Problems of income transformation and tax evasion

During the last decade policy makers and researchers have to some extend focused on the possibilities of income transformation as one additional concern for the design of the business tax code. Firms may respond to tax incentives not only by changing real investment, but also by changing their form of organization – that is from corporate to non-corporate status – or by altering the form of compensation to shareholders, managers and other key employees. Though tax distortions to real investment may be a concern for all types of businesses, tax avoidance through the shifting of income between the personal and the corporate tax bases, is a practice mostly undertaken by small firms. In Sweden, small firms may be organized as *closely held corporations*, as *partnerships* or as *sole proprietorships*, and apart from the tax treatment these legal forms are to a large extent close substitutes. In fact, neutrality between different organizational forms was one important concern in the tax reform of 1991.

Under the dual income tax system introduced in Sweden in 1991, 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. Indeed, small business firms, where labor and capital income accrue jointly, have been judged to be the "Achilles heel" of the dual income tax, cf. Sorensen (1994).

The tax legislators often face a difficult dilemma in designing tax rules for small businesses, since the more effectively tax motivated income shifting is combated, the greater are the risks of worsened incentives for real investment and business expansion. Ever since the dual income system was introduced in the beginning of the 1990's the Swedish debate has been quite noisy from time to time concerning the balance between combating income transformation on one hand and incentives and expansion matter on the other. In particular, the taxation of closely held corporations (so-called 3:12-bolag) has been of special interest in the debate. For closely held corporations, the Swedish tax code follows a so-called *source model*, where business earnings are divided into income from capital and income from labor. Very simplified, capital income is defined as an imputed rate of return times the own equity, and the residual income is defined as labor income.

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.

Further, the Swedish Tax Agency has made a survey of undeclared work in Sweden[3]. The survey shows that the Swedes have relaxed attitude towards performing or purchasing undeclared work and this is perceived as a minor offence. Undeclared work is relatively common and the tax morale is sinking. There is a discrepancy in the national accounts between income in society and household expenditure, which indicates that undeclared work could amount to SEK 115-120 billion. The Tax Agency's survey could explain SEK 90 billion as undeclared work. The government has announced a number of measures that will contribute to a reduction in fraud and incorrect payments of benefits. An income tax credit has been introduced for private households' purchase of domestic services to reduce incentives to buy undeclared work. The government aims also to reduce the social security contributions in certain segments of the service sector, which are particularly exposed to tax evasion and have a high incidence of undeclared work.

5. Conclusions

The Swedish dual income tax system has been in force since the tax reform in 1991. The tax reform was unique in its scope and it changed the fundaments of the Swedish tax system. The tax system became more robust and less exposed to manipulation as a result of tax avoidance schemes. Also, the reformed tax system treated private individuals and companies in a less arbitrary and more economically sound manner. However, the tax system did not acquire the stability that had been explicitly hoped for. A number of changes in the rules have been made since the reform, but despite all these changes the fundamental features of the reform are still mostly in place. The goal of the tax system is to be simple, comprehensible, efficient and neutral.

The largest reforms recently have been the introduction of the earned income tax credit. Further, a tax credit for the households' purchase of domestic services has been introduced, and changes in the property tax and a abolition of the wealth tax have been notified.

From a technical perspective the earned income tax credit has made the tax system more complicated and less comprehensible. On the other hand, there are gains due to the narrower tax wedges and the increase in the supply of labour. The introduction of the tax credit for the households' purchase of domestic services has meant that all

[3] Swedish Tax Agency (2006)

sectors of the economy are not treated equally in the tax system. This may create welfare losses since the resources in the economy are not used in the optimal way. However, the tax reduction could create efficiency gains if it leads to a considerable reduction in undeclared work and increase in labour supply.

The abolition of the national real estate tax and the introduction of a low local government real estate charge will be fully financed within the housing sector. There will however be a redistribution of the tax. A larger part of the total tax on properties will be levied on capital gains. The periodic tax on properties might thus be too low in relation to the principle of uniform taxation and result in an inefficient allocation of capital.

The future Swedish welfare state and the pressure for reduced taxation

The internationalisation of the Swedish economy involves increasing pressure to reduce taxes. There is a general development among the OECD-countries to lower tax rates on labour income, capital income and company profits. In 2002 the Committee on Tax Base Mobility examined the long run stability of the Swedish tax bases in an internationalised world. It was stated that there is no immediate risk for large tax bases in Sweden to erode. However, the Committee pointed out certain specific taxes, relatively small compared to total tax revenues, where there is a risk for eroding tax bases. Especially within the capital income taxation there is risk for eroding tax bases. For example the inheritance and gift taxes as well as the wealth tax create incentives to hide wealth abroad. The Swedish Tax Agency estimates the amount of capital invested abroad to avoid taxation to approximately SEK 500 billion, which corresponds to about 25 per cent of GDP. The Committee argued, however, that the risk of eroding tax bases could be counteracted by adjusting or abolishing some taxes (e.g. inheritance, gift and wealth tax) and finance this by eliminating certain tax expenditures. For example the deferral of capital gains, the preferential tax treatment of private pension savings and the general reduction on social security contributions. The inheritance and gift taxes were abolished in 2005 and the Swedish Government intends to abolish the wealth tax in 2008.

To conclude, the relatively small problems created by the internationalisation of the Swedish economy could to a large extent be counteracted by adjusting or abolishing harmful taxes by eliminating certain tax expenditures.

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