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THE NON-FISCAL GOALS OF TAXATION

The actual state of tax policy in Finland

Finland introduced the dual income tax system in the beginning of year 1993 which was two years later than Sweden and one year later than Norway. Subsequent to introducing the dual icome tax system, the major tax reforms have been the adoption of VAT in 1994 and the abolishment of the imputation system in 2005.

The core idea of the major tax reforms in 1989 and 1993 was the abolishment of several tax deductions and tax reliefs. The goal of the reforms was to create a broad tax base with low tax rates. The corporate tax and capital income tax rate was lowered to 25 %.

During this decade the idea of broad tax base with low tax rates has became dimmer and has even been forgotten. In theory people generally prefer the idea of a broad tax base with low tax rates, but in practice all the powerful interest organizations are requiring getting special tax advantages and the government often accept these demands. Every year “new holes” are made into the tax base. In other words, new tax deductions or tax free benefits are being granted.

Some kind of rethinking has been done this year. The Ministry of Finance established a taxation working group on September 18, 2008 to evaluate the needs for reforming the tax system. The Ministry’s act of nomination was based on the following:

Taxation Working Group

The Ministry of Finance has today established a taxation working group.

Term
1.10.2008–31.12.2010

Background

Tax system is usually renewed in parts, one tax group at a time. Because of this, the tax system may have undesired effects to companies' and households' decisions. Therefore, it is important from time to time to examine the taxation system as a whole. This is the best way to evaluate system's effects on economy and society in general and to contemplate the focus of different sectors of taxation. It is also easier to optimize the welfare effects of taxation when taxation is considered in its entirety. Adequate career lengths and improvement of productivity are the basis for social security and public sector funding.

The following changes in the operating environment have to be considered when improving the tax system.
-The change in the age structure of people emphasizes the importance of productivity growth in both public and private sectors.
-Productivity growth is based more and more on better know-how and immaterial capital.
-The challenges of sustainable development are growing.
-Economic environment is more open than before.

Mission

The task of the Taxation Working Group is to evaluate the needs for reform in the tax system based on the current tax system and the changes in the operating environment. Fairness of taxation must also be considered. The group will propose guidelines to improve the tax system. The goal is to create a tax system which supports sustainable economic growth and public sector funding better than the current system, and takes ecologic sustainability into account.

The Working Group will especially consider:
-the structure of taxation to promote productivity growth, employment and entrepreneurship
-the desirable and sustainable tax burden within the limits of sustainable public sector
-the improvement of taxation's encouraging effects considering the proposals of the SATA committee, which has contemplated social security renewal
-changes to corporate tax and tax on capital to ensure growth in productivity and employment, taking international trends especially within European Union into account
-international competitiveness of the tax system.

The Working Group may ask for expert briefings and it must hear the spokesmen of organizations and academic institutions. The group can make propositions during its term.

Chairman, Martti Hetemäki, Permanent Under Secretary, Ministry of Finance

Vice-Chairman, Heikki Niskakangas, Professor, Helsinki School of Economics
Secretary General Seppo Kari, Research Director, Government Institution for Economic Research

It is noteworthy, that seven out of the group's ten members are economists and only three are tax law experts. In the previous tax reform groups the tax law experts have had the majority. It may be derived from the act of nomination that the current main problems are on the other hand the international tax competition and on the other hand the aging of the population. Due to the World War II, the age pyramid in Finland is more unfavorable than in other Nordic Countries. In coming years, the baby boomers will be stepping out of the workforce. The economic growth will be based purely on the increasing productivity.

Tax legislation and the Constitution

The constitutionality of laws will be scrutinized by the Constitutional Committee of the Parliament. Finland does not have a constitutional court.

The constitutionality of tax laws has come up sometimes in the context of retroactivity. The Constitution prohibits a tax legislation which in practice means increasing of taxation. The decreasing of taxation can be retroactive. During the past years we have many examples of retroactive tax legislation, when taxes have been reduced.

In June 2008, the question of constitutionality of tax legislation regarding equality of citizens came up for the first time in decades. The government proposed that the transfer of an enterprise or farm to descendants the inheritance and gift tax would be calculated from the value of 20 % of the taxation value. While taxation values are in average one half of the real value, should the tax be only 10 % of the tax that other successors pay. The government justified the proposal so that tax relief is necessary in order to promoting employment and entrepreneurship. The Constitutional Committee began to scrutinize the matter in June. Six out of the seven experts in constitutional law heard by the Committee considered that the proposal violates against the equality among people from the Constitution's point of view.

Section 6 of the Constitution lay down that the people are equal before the law. It is prohibited to put citizens or citizen groups to a more favorable or unfavorable position than the others without a generally acceptable reason. The Constitutional Committee has many times noticed that Section 6 of Constitution can not prohibit a reasonable consideration and policymaking, when the legislator is aiming to some acceptable social target. It is possible to depart from equality due to an acceptable social interest. The departure from equality should anyway be in a right and moderate relation to the aimed interest. Some experts have said that allowed benefit should be focused clearly enough.

The Constitutional Committee left the matter pending in June. In the memorandum draft, the Committee arguably considered the proposal partly violating the constitution. The Ministry of Finance informed on September 10,.2008 that the government will amend change the proposal so that investment property will be left outside the tax relief.. Investment property means portfolio shares, stakes in investment funds and hired real estates.

The goal of redistribution

The goal of redistribution is visible particularly in the sheer progression of the taxation of earned income. Taking into account the social charges of the employees, the highest marginal tax is about 55 %. It varies depending on in which municipality the taxpayer resides and even on that whether the person is a member of a state church. The progression is composed of the scale of state taxation and of the earned income deduction, which is favorable for people with low income.

Finnish Taxpayers' Association researches annually the taxation of earned income in Finland and 17 other European countries. The comparative research contains briefings about earned income taxation, marginal taxes and the tax-like social charges of employers. The wage taxation of low-incomers is competitive, but the gap to the international level increases when the wage becomes higher. Wage taxation in Finland is from 3.2 to 6 percentage points higher than in other European countries on average. The difference to the countries outside Europe is more than 10 percentage points.

Marginal taxation in Finland is very harsh. Marginal tax in all income classes is about 8 percentage points heavier than in other European countries on average. In the income level of 34 700 €/year, the marginal tax in Finland is in fourth place for (45,0%). Denmark's ranking is sixth (42.7 %), Norway's eighth (36.8 %) and Sweden ? eleven (31.7 %). In income level, 113 300 €/year Denmark is number one (63 %), Sweden number three (56.8 %), Finland number four (55 %) and Norway number seven (47.8 %).

The social security charges of the employers are in Finland on the international average level (23.5 % about gross wage). In Sweden social charges of employers are higher, in Norway lower and in Denmark nearly nothing.

The governmental bill for legislating tax scale for the year 2009 has been given to the Parliament. Taxation of low incomers will be reduced a bit more than taxation of higher incomers.

The highest incomes are anyway taxed moderate, because the rate of capital income is 28 %. In the highest decil of income classes 67 % of income is capital income. Inside this decil the highest incomes are capital incomes and the lowest ones are earned incomes. It is remarkable, that dividends as capital income are tax free until 90 000 €/year. They are not included in the statistics.

The steep progression of taxation has not been officially justified. Usually the politicians speak about fairness and justice. The tax experts speak often about the principle of ability to pay tax. The amount of tax free dividend income has been justified by claiming that the tax system should encourage entrepreneurship.

The general VAT rate in Finland is 22 %. VAT of food is 17 % and the government has decided to decrease it to 12 % from 1.10.2009 due to social reasons and distributional goals. The reduction of VAT will decrease the taxation of people with the lowest income – including those who do not pay any income tax. In families with many children the cost of food is proportionate higher than in other families.

Growth policy as a goal of taxation

In tax reform of 1993 tax base was intensified and scale of taxation was lowered. Corporate tax rate was dropped to 25 %. Afterwards the tax rate was raised to 29 %, but was then dropped to 26 % in the beginning of year 2005. The idea is that lower tax units support economical growth in an efficient and neutral manner.

After year 1993 tax reform there has been several small changes to the system of taxation. Mostly those changes have moderated taxation in some way. Moderations have been argued to support employment, economical growth and entrepreneurship.

In the beginning of 1990's, Finland was driven to a deep depression and very high unemployment. Governments, regardless of their political composition, have aimed to improve economy by supporting entrepreneurship. Most significant method has been inexistent or low dividend income taxation. Currently, dividends classified as capital income is tax-free up to 90 000 euro for one receiving the dividend. The dividend is classified as capital income when dividends are paid out less than 9 % of mathematical value of shares (substance value). This has lead e.g. to the situation where self-employed persons, such as doctors and lawyers can transform their professional income into the dividend income coming from a company. In my opinion, there are no longer reasons for such low dividend income taxation. I anticipate that dividend income exemption from taxes will come to an end in Finland in becoming years. If at the same time highest marginal taxes of earned income will be lowered, there will be smaller unbalance between earned and capital income.

Also reduction of taxes in transferring companies' ownership between generations has been reasoned to support entrepreneurship, even though it means practically exemption from taxes. Still, economics theory does not support the idea that transferring the company's ownership to children would be efficient from the perspective of the whole economy. When considering both dividend income exemption from taxes and ownership transferring between generations, which is also basically exempted from taxes, one should bare in mind that industry organisations are very powerful political players in Finland. Peculiar to the Finnish system is that growth policy actions have been targeted to the owners rather than companies.

Gains from selling fixed capital shares have been exempted from tax in Finland since 2004. The tax exemption requires that certain premises are fulfilled. The reason behind was international tax competition. Similar solution had been made earlier in Sweden and Norway.

In Finland machines and equipments are depreciated using cost-remain system on a pooling basis. Depreciation is 25 % per year from cost-remain. The system is basically similar to the Swedish system. In 2006, so called Arvela's tax reform committee suggested taking into use planned depreciations, i.e. same than used in book keeping. Industrial organisations were against of the amendment, because mean of depreciations would have been smaller. The reform would have meant 280 million euro annual bill to the companies. Prime minister Matti Vanhanen's second government stated in its governmental programme in 2007 that the proposed amendment will not be implemented, because over-depreciations act as an incentive to invest. Big investments in turn support economical growth. Over-depreciations and tax exemption of fixed capital shares are the most significant tax measures targeted supporting the companies. Otherwise, Finland's company taxation is some what neutral.

Household tax reduction was implemented in the beginning of year 2001. After that it has been extended. As of 2009, the maximum amount of reduction will be 3000 euro. The reduction is made from the tax. A taxpayer gets a reduction if he/she has employed a worker(s) in his/her home or free time house. According the main rule, a reduction is 60 % from the labour cost. If the taxpayer pays to a cleaning lady 1000 euro in a year, the government will support the cleaning costs for 600 euro. There are two reasons behind the household reduction. First, it supports employment and leads into the creation of small service sector companies. Second, it brings the grey economy within the tax economy.

For over a decade the goals of taxation politics have improved employment and lessen the unemployment. This is partly because to fasten economic growth. Still, the main reason has been balancing the government economics. Better the employment, bigger the tax incomes and lesser the social costs due to unemployment. Especially, taxation of earned income has been reduced every year since 1996. At that time Finland was one of most tightly taxed countries according to the OECD's survey. Currently, taxation of low wages is in the European middle range. Although, annual reductions have been small, cumulative effect is still significant.

The background of the driven politics is the belief that by lowering income taxes supply and demand of workforce can be improved. Economical studies give some support to the idea that tax reductions have positive impacts on employment. Consequently, unemployment has lowered steadily. Currently, the unemployment rate is 6 %, which is lowest rate since 1990. Employment rate has been over 70 % for over a year. There are no clear evidences to what role tax reduction has played in this.

Geographical politicy goals

In Finland companies located in north and east are allowed to do bigger fixed capital depreciations than normal depreciations. In practice, this has very small effect. Otherwise, there are no area politics subventions.

Taxation subventions and housing policy goal

When studying tax subventions one notifies that the biggest subventions are attached to housing. Housing income is exempt from taxes in Finland meaning annually 1 800 million euro in the form of tax subvention. Tax exemption of own house or apartment selling gains means 900 million euro in the form of tax subvention. Mortgage interest deductions of taxes mean 490 millions euro in the form of tax subvention. Housing support exemption from taxes means 280 million euro in the form of tax subvention.

Housing support exemption from taxes is targeted to living on rent. Other tax subventions are targeted to owning a house or apartment. Living in own house or apartment is common in an international comparison. Even though housing space has grown yearly, the Finns still live more crowded than other Scandinavians.

Environmental policy goals

The European Union has introduced major goals for using renewable energy methods before year 2020. This means that the role of environmental taxes is growing. One task given to Hetemäki's working group is to study development possibilities of environmental taxes. During the past years, the aim of using environment friendly energy has been visible mostly in changes of traffic taxation principles.

Car tax is tax paid before first registration or use of a vehicle, and it is enacted in car tax law. The fundamentals of car taxation were changed in the beginning of year 2008 from purely being based on car's value to be based on car's value and car's carbon dioxide waste.

Parcel delivery car taxation is about to become based also to typical carbon dioxide waste, like individuals' cars. This is possible when measurement of their gas consumption is implemented, most likely in year 2009. Gains from car taxes in year 2007 were 1 217 million euro.

Vehicle tax is a collection of taxes based on the registration time of vehicle. It is enacted in vehicle tax law. At the moment, vehicle tax is based on the age of the vehicle. Car taxation on individuals will be based on cars' carbon dioxide waste. This is anticipated to be implemented in the beginning of year 2010, and it will later be extended to parcel delivery cars. Gains from vehicle taxes were 612 million euro in 2007.

Gas tax is the most important of traffic taxes. Gains from it were 2 940 million euro in 2007. A small portion of gas tax is based on carbon usage.

Electricity tax can also be regarded as environmental tax. However, it is not attached to carbon usage.

Waste tax is a tax based on amount of tax delivered to a dumping ground, and it has similarities to excise tax. The aim of the tax is to create an incentive to reduce the amount of waste to be delivered to the dumping ground. Gains from waste tax were 56 million euro in 2007.

Beverage package tax is an excise tax, which aims to create incentive to use environmentally friendly beverage packages. Gains from beverage packing tax were 41 million euro in 2007.

Efficiency of taxation

In economics the efficiency of taxation is primarily connected with the well-being effects of households choices caused by taxation. General rule is that the stronger the behavioural reaction to the tax is, the greater is the loss in well-being and efficiency.

Decreasing the value added tax of food by five percentage points was a political decision. It was a central theme in the Center Party's platform. The economists have criticized this starting-point. Taxation of groceries could be higher since the demand for food reacts only slightly to the tax level. Food is a necessity commodity. High taxes on food do not cause losses in efficiency.

The leading Finnish economists prefer high value added tax rates, because it does not cause significant losses in efficiency and is pretty much protected form international competition. I would not be surprised, if Hetemäki's Working Group would propose tightening the value added tax at the same time it possibly proposes loosening taxes on labour.

Moving away from lollipop politics

Finnish tax politics has in the recent years been lollipop politics. Each year small sweets are given to those who have had the guts to ask for them and have screamed loud enough. The said examples include the tax-free generation turnovers and tax-free dividends in small amounts from the listed companies that is in the governmental programme. Another speciality is the cultural voucher. An employer can give tax-free vouchers of maximum 400 euro to employees. The voucher is valid for cultural events such as admissions to opera or ice hockey matches. It can also be used for exercise fees like gym memberships or green fees on golf courses.

From where I am looking, appointing the Hetemäki Working Group means that government wants to move away from the lollipop politics to drawing greater lines. The tax system shall be regarded as an entity. It is a move towards sustainable taxation. It is an effort to answer to sustainability gap caused by aging. In my opinion, the working group could also abolish the unfounded tax benefits accumulated over the years.