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## **The use of taxation for non-fiscal purposes**

In theory, the basic obligation of citizens in a welfare state is to share the burdens of benefits, through both collective and individual, direct and indirect taxes and social contributions. The recognition of citizens' social rights ought to correlate to the obligatory common responsibility to generate the wealth needed. In that way, the obligation of the citizen is based on the legitimate demand to support certain basic needs. In public finance, the concept of generating wealth is centred in the obligation to pay taxes and social contributions, which constitute the main sources of revenue.<sup>1</sup> A tax system can therefore be defined as the most far reaching, multi-faceted government program in a welfare state. Taxation has a huge impact on the citizen's daily lives, as taxes can account for up to fifty percent of the GNP in many western countries. Taxation serves many goals of which a primary objective is to raise revenue from the private to the public sector to be spent on government programs. Increasingly, the welfare state economies have also used the tax systems to achieve other goals than the fiscal purpose.<sup>2</sup>

Although taxation can serve many goals, the discursive terminology of using the taxing power for non-fiscal purposes has been one perspective on tax policies for a long time. Harvey W Peck gave the following definition already in 1936:

“ Taxation for fiscal purposes means taxation for the purpose of raising revenue to defray government expenditures, while taxation for non-fiscal purposes is taxation not to provide revenue to carry on a given

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<sup>1</sup> Sjöberg, Ola (1998) Paying for Social Rights. *Journal Social Policy*, 28, 2, 275-297, Lacey, Nicola (1998), *Unspeakable Subjects. Feminist Essays in Legal and Social Theory*. Oxford: Hart Publishing, 50-52 and Gunnarsson, Åsa (2007) Gender Equality and the Diversity of Rights and Obligations in Swedish Social Citizenship. In Gunnarsson, Åsa, Svensson, Eva-Maria and Margaret, Davies (eds.) (2007), *Exploiting the Limits of Law. Swedish Feminism and the Challenge to Pessimism*. Ashgate Publishing.

<sup>2</sup> See Young, F.L., Claire (2000) *Women, Tax and Social Programs: The Gendered Impact of Funding Social Programs Through the Tax System*. Ottawa: Status of Women Canada, 5 and Barker, B. William (2005) The relevance of a concept of tax. In Peeters, Bruno (ed) *The concept of tax*. 2005 EATLP Congress, Naples (Caserta), IBFD, 21.

program of public expenditures but to produce directly certain economic or social effects irrespective of whether revenue is actually raised or not.”<sup>3</sup>

Tax rules that are designed to technically raise revenue are bench-marked, and tax rules that deviate from this bench-mark are defined as tax expenditures. The distinction between fiscal and non-fiscal purposes has often been made on the basis of the theory of optimal taxation, which bench-mark non-distorting and neutral taxation. In general a neutral tax minimises welfare losses and promote an efficient allocation of resources.<sup>4</sup>

Tax expenditures can serve political redistributive purposes, either to redistribute wealth or to reduce income inequalities. Expenditures that departs from the “normal” tax structure can also serve regulatory and stabilizing functions concerning the economy, like fighting inflation, unemployment, budget deficits and the growth of the shadow economy. Environmental concerns, demographic problems and social programs are other examples of tax expenditures. Some of these tax measures are the result of a political process, while others are imposed as a result of exogenous factors.<sup>5</sup>

Nevertheless, one has to consider that the discursive dichotomy of fiscal and non-fiscal purposes, where the functions of taxation and spending are separated, is a normative assumption. All normative positions can be criticised. Some scholars don’t think it is a valid assumption any more, as the real tax system reflects a complex set of values that promotes different social and economic results that are politically desirable.<sup>6</sup> From this point of view the controversial issue is of course what elements constitutes the benchmark fiscal and non-fiscal.

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<sup>3</sup> Peck W. Harvey (1936) The Use of the Taxing Power for Non-Fiscal Purposes, *Annals of the American Academy of Political and Social Sciences*, Vol. 183, Government Finance in the Modern Economy. Sages Publications, Inc. in association with the American Academy of Political and Social Science.

<sup>4</sup> Konflikten mellan beskattningens fiskala och icke-fiskala ändamål. Rapporter vid Nordiska skattevetenskapliga forskningsrådets seminarium i Saltsjöbaden i oktober 1983. *Nordiska skattevetenskapliga forskningsrådets skriftserie, NSFS 13* .

<sup>5</sup> Messere, Ken, de Kam Flip and Heady Christopher (2003) *Tax Policy. Theory and Practise in OECD Countries*. Oxford University Press.

<sup>6</sup> Baker, B , William (2005), 27-28.

Another controversy is the complexity of the tax system. What is seen as fiscal taxation in one part of the national tax system can be contradictory to what is judged as fiscal in another part of the system.<sup>7</sup> Taxation has many sources such as real estate, capital, consumption, goods, services, production and labour. The Swedish tax system draws, directly or indirectly, on all of these sources. In effect, most economic activities are taxed. One basic problem is that the tax system operates with a very diverse set of distributive principles. How 'tax citizens' come to share a common tax burden is therefore not particularly transparent. When structuring taxation in relation to the economic circulation in society, one can see that the flow of incomes has three main sources. Production is the original source from which income springs, the next step is transfer of the incomes of production to the households, and the third step is the use of incomes for consumption. The circle is then closed as the incomes from consumption return to production.<sup>8</sup>

With these problems in mind I will try to systematise the tax system from the criterion of what is an efficient and neutral tax measure for raising revenue and what is a tax measure based mainly on other objectives. A guiding tax neutrality principle in this analyse will be the principles of equitable and horizontal taxation. In my definition equitable means equal treatment and uniform taxation of income from the same categories of sources (likformighetsprincipen). With horizontal equity I refer to a principle which holds that tax payers who have the same income should pay the same amount in taxes. I will also use the definition of tax expenditures as an exemption or relief from the essential structure of a particular tax, which has been introduced with the specific purpose to be an exemption or a relief for different groups of tax payers, in the assessment of income, for efficiency in the administrative process and similar reasons.<sup>9</sup>

### **The income tax – a choice between economic growth and social justice**

The tax reform from 1990 redesigned the income tax system under the guidance of the principles of tax neutrality and horizontal equity. The idea of neutrality was designed to avoid unwanted welfare losses by adjusting taxation to promote what is understood to be an

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<sup>7</sup> The complexity of fiscal and non-fiscal becomes even more sophisticated in cross-boarder tax situations and in the European tax integration.

<sup>8</sup> SOU 2002:47, 53-56.

<sup>9</sup> Sandford, Cedric (2000), *Why Tax Systems Differ. A Comparative Study o the Political Economy of Taxation*. Fiscal Publications: Bath, 43, 46.

efficient allocation of resources in the market economy. Horizontal equity implies horizontal equality of treatment. Both principles were invoked to justify uniform taxation, with the structural patterns of flattening the income-tax-rate schedule and shifting to broader income and consumption tax bases. As a result of these changes, more incomes, goods and services became taxable and income tax became less progressive. Another result was the shift from global to scheduler income tax, which led to the transformation of the principle of horizontal equity from equality of treatment of tax subjects with equal economic capacity into an equal treatment of equal incomes. Equal treatment of all incomes by broad tax bases has become synonymous with the definition that all incomes constitute an equal ability to pay. In schedular income tax systems each source of income is treated as a separate tax regime, in contrast to a global system where all sources of income are taxed under the same regime.<sup>10</sup>

Some major areas are not income taxed, on the basis of a mixture of general, principal concerns and objectives of more particular character.<sup>11</sup> They are regulated in Chapter 8 of the Income Tax Act.<sup>12</sup> The mixture of objectives is reflected in the multitude of exemptions from the income tax base like; beneficial transfers, lotteries and prizes, scholarships, interests related to taxes, customs, and public fees, social benefits in kind, social assistance, payments for sickness, injury and damage on property in accordance with an private insurance and an tax free amount (SEK 12 500) for the hobby activity of picking and selling wild berries, mushrooms and cones in the wild. Some of these exemptions are enforced simply to avoid double taxation, which are the case for lotteries and prizes. Beneficial transfers and social benefits in kind are outside the definition of income, as they are either the outcome of a work performance or a dividend from capital. These categories of exemptions are not to be seen as non-fiscal. However, others are exemptions from the essential tax structure from the reason of efficiency in the administrative process. The picking of wild berries is such an example.<sup>13</sup>

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<sup>10</sup> Gunnarsson, Åsa (1995), *Skatterättvisa*. Iustus förlag AB: Uppsala.

<sup>11</sup> Lodin, Sven-Olof, et. al. (2007), *Inkomstskatt- en läro- och handbok i skatterätt*. Del. 1, 11th edition, Studentlitteratur, 69.

<sup>12</sup> Inkomstskattelagen (IL).

<sup>13</sup> Lodin, et. al. (2007), 70.

## **Fiscal taxation**

Commonly, the principle of equity has been used to judge the fairness of taxes and holds that taxpayers who have the same income should pay the same amount in taxes.<sup>14</sup> I claim that the Swedish legislators instead has used the principle as a neutrality principle to construct a uniform tax base for fiscal purposes. Neutrality was, in the reform of 1990, constituted as a substantive norm in the income tax system. Before the tax reform it was more commonly used as a formal equality norm, in the meaning of impartiality in treatment. I also claim that the neoliberal tax ideology behind the restructuring of the income tax, inspired by the 1986 US tax reform, draw a line between fiscal purposes and social justice. The benchmark stated that tax regulations with a social purpose were political interventions in the market economy by the government. Economic intervention creates, due especially to the neoliberal economic philosophy of Friedrich A. Hayek, excess burdens or welfare losses, which is a hinder for economic growth.<sup>15</sup> As the distribution of wealth and income are interventions, the tax system has to be distribution neutral as well. This has been the normative standard for fiscal purposes in the income tax system since then.

In conclusion, the following income tax law structures can be regarded as fiscal as they were promoted by the 1990 Swedish tax reform and later, additional tax reforms:

- Reductions of tax rates and equal tax rates on all incomes.
- A dual income tax on labour and capital income.
- A more uniform taxation on different sources of income from capital, like private homes, capital gains and most forms of investments income.
- Taxation of hobby incomes in a hybrid form of business and employment taxation.
- Equal treatment of benefits in kind and wages.
- Not allowing deductions for losses from passive activity against incomes from active economic activity.
- Approximation of the tax treatment of business incomes for small and medium-sized companies and big corporations.

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<sup>14</sup> Cordes, Joseph J. (1999), Horizontal Equity. In Cordes, Joseph, J., Ebel, Rober, D. and Gravelle, Jane, G (eds.), *The Encyclopedia of Taxation and Tax Policy*. Urban Institute Press.

<sup>15</sup> Hayek, Friedrich, A. (1956), Progressive Taxation Reconsidered. In Sennholz, Mary (ed.), *On Freedom and Free Enterprise. Essays in Honour of Ludwig von Mises*. Nostrands Company: Princeton, New Jersey, Toronto, London, 265-284 and Korpi, Walter and Palme, Joakim (1993), *Socialpolitik, kris och reformer: Sverige i internationell belysning*. Institutet för social forskning, Stockholm.

- Income distributive neutrality.<sup>16</sup>

### **Non-fiscal taxation**

All forms of family taxation and social justice objectives were regarded as non-fiscal in the tax reform. Welfare state schemes should be designated to the welfare systems and not to be performed as tax expenditures. With social justice I refer to almost every possible welfare state reform, which can be based on a diversity of objectives in areas like labour market, family<sup>17</sup>, housing and infra-structure policies. However the strategy to avoid unwanted welfare losses, by cutting the effective marginal tax rates and abolishing the non-fiscal, social dimensions in income tax law, did never succeed. Instead, the EMTR-problem has moved into the social welfare law system, as the different welfare systems has to act as a backup for the loss of redistribution incentives in the income tax system. Income-tested social benefits, in combination with the partially income related basic deduction for low income groups and tax reductions for certain categories of tax payers with low ability to pay tax, have lead to an adverse EMTR problem with unemployment and poverty traps.<sup>18</sup>

#### *Tax base of labour*

A part of the essential income tax structure is that the net income constitutes the tax base, not the gross income. However, costs deductible from income should be related to the earnings of the income, which excludes private living expenses.<sup>19</sup> In the tax expenditures report from the government concerning the budget year 2007/08, the deductibility of costs for travels between

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<sup>16</sup> Andersson, Krister och Mutén, Leif (1998), Sweden. In Messere, Ken (ed.) *The Tax System in Industrialized Countries*. Oxford University Press.

<sup>17</sup> In an international comparison, the Swedish case of abandoning family policies in tax law is quite unique. Germany and France are examples of countries with have an extensive family taxation. The family taxation replaces social transfers in certain areas, but also combines support to families as both tax expenditures and social benefits. In Germany marriage and family are protected by the constitution (article 6(1) GG), which governs regulations of maintenance support and joint taxation in tax law (Lang, Joachim, Germany. In Solcher Ross, Maria Teresa (1999), *Family Taxation in Europe*. Kluwer Law and Olsson, Stefan (2006), *Författningsprövning i skatterätten – en studie kring svensk och tysk konstitutionell praxis påverkan på skatterätten*. Iustus förlag: Uppsala, 154-157). In France the family taxation connected to "quotient conjugal" and "quotient familial" has had a very strong position (Gunnarsson, Åsa (2003), 72-82).

<sup>18</sup> Gunnarsson, Åsa (2003), *Fördelningen av familjens skatter och sociala förmåner*. Iustus förlag: Uppsala.

<sup>19</sup> Mattsson, Nils (1983), NSFORS 13, 255.

work and home has been noted as tax expenditures in the income tax base of labour.<sup>20</sup> From a fiscal point of view it has always been regarded as a personal living expense, equivalent to the costs for child care when parents are working. Already the Government committee working with the income tax system, tried to launch an abolition of these deductions, but the political resistance was too strong.<sup>21</sup>

The exclusion of employee's fringe benefits from the income tax base is also tax expenditure from the essential tax structure, and also in this case the exemption from taxation lacks a clear non-fiscal objective. It's just a loophole that has become wider and wider over time. The tax reform stopped the erosion, but the problem still exists. The problem is not only connected to the lucrative business of offering new concepts of fringe benefits to the employers, it is also connected to the extensive right for companies to define their net income.<sup>22</sup> Two examples of exceptions from income taxation are the employee's purchase of shares in the company they work to a lower value than the market value (11 chap 15§ IL), and private health care paid by the employer (11 chap 18§ IL).

### *Tax base of capital*

Another exemption from the essential income tax structure that allows deductions of private consumption is the deductibility of interest. Even if the tax reform, from the normative benchmark of the equal treatment and horizontality perspective, did eliminate many loopholes or tax benefits in the income of capital the possibility of deducting interest from consumption credits remains. This deviation from the bench-mark is closely connected to the taxation of the taxpayer's home (owner-occupied housing). Before the reform, the imputed income of real estates for private housing was income taxed in the form of a standardized percentage of the assessed value of the property and the expenses for mortgage interest were deductible in the sake of reciprocity. After the reform the taxation of private homes were cut out from the income tax base and shifted to a state property tax. However, the deductibility of mortgage interest still remains in the form of a tax credit against income tax. As follows, in the assessment of the interest deficit all loan interests are included.

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<sup>20</sup> Skrivelse 2007/08:123 Redovisning av skatteutgifter 2008.

<sup>21</sup> Pålsson, Robert (1997), *Levnadskostnader. Gränsdragningsproblem vid beskattning av förvärvsinkomster*. Iustus: Uppsala, 50, 53-54 and Prop. 1989/90: 110, 364.

<sup>22</sup> See Pålsson (1997), 83-85 and 90-93.

When Joseph Pechman wrote his interesting article about the future of the income tax, reflected in an evaluation of the 1986 US tax reform, he stated that the tax differential between capital gains tax and ordinary income “should be resisted at all costs”. None or low taxation of capital gains is always an incentive to convert other incomes to capital gains.<sup>23</sup> The tax gap in the Swedish dual income tax is still wide. If one thinks that a comprehensive income tax like the model of Simons and others are the ideal bench-mark, which of course is the ideal taxation on the basis of equal treatment of incomes from different sources, the gap is not in line with fiscal taxation.

Inflation and the timing of taxation are two constant problems for both neutrality and fairness in a direct income tax, irrespectively if the capital income tax is dual or part of a global income tax regime with a flat or progressive tax rate schedule. It is an established opinion that capital gains taxation based on the realization principle generates a lock-in effect, which hampers the allocation of capital for more productive uses. When the realization principle is regulating the timing of tax liability it constitutes an incentive for tax planning. Progressive taxation gives an additional distortion as one has to consider the possibility of being pushed into higher tax brackets in the year of realization as well. The realization of accrued capital gains can be postponed in order to find a possibility for tax arbitrage or transfers of wealth in the “family sphere”.<sup>24</sup> Family sphere should be understood as both members of a nuclear or extended family and family businesses.

#### *The tax base for business*

The bench-mark for business is taxation of all income derived from business activity and the right to deduct all costs from business activity. Tax law should not define costs from business activity, but there are of course several deviations from the bench-mark in this respect. One of them is entertainment (16 chap, 2 § IL). In contrast to the tax exemption for certain categories of fringe benefits in the labour income tax base, this deviation from the bench-mark has a clear fiscal purpose.

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<sup>23</sup> Pechman, Joseph, A. (1990), The Future of the Income Tax. *American Economic Review*, 80 (1), March, 1-20.

<sup>24</sup> Griffith, Rachael, Hines, James, and Sørensen, Birch, Peter (2008), International Capital Taxation. Chapter prepared for, Reforming the Tax System for the 21<sup>st</sup> Century. *The Mirrlees Review*.  
[http://www.ifs.org.uk/mirrleesreview/press\\_docs/international.pdf](http://www.ifs.org.uk/mirrleesreview/press_docs/international.pdf)



## **VAT – the ideal of a fiscal revenue raising machine**

Due to OECD:s calculations, approximately 136 countries (including all the OECD Member countries except the United States) had implemented a Value-Added Tax in 2006, accounting for one-fifth of total tax revenue. The recognised capacity as a robust revenue-raiser is the common explanation to the quite rapid and world-wide spread of the VAT. A common way of presenting the VAT, is to say that it is neutral, transparent and simple. The features of neutrality are that;

- the tax is ultimately paid by the final consumers,
- levied on a broad tax base which treats all forms of commerce equitable, and
- of no burden for the business as the tax are collected in a staged process with the deductibility for input tax on purchases and account for input tax on sales.

This structure also makes the VAT both transparent at simple, which are seen as features for efficiency in both administration and fairness.<sup>25</sup>

The conclusion to be made is that the VAT is supposed to be the most neutral and efficient revenue-raising tax in force in the world at the moment. Nevertheless, there exist non-fiscal exemptions and special arrangements to meet specific policy objectives in the Swedish VAT system, as it does in all other VAT-countries. This distorts neutrality in the value chain and towards international trade, and of course counteracts efficiency in revenue-raising.

### **Non-fiscal purposes**

The central regulation that governs the Swedish tax base for VAT is the EC VAT Directive, which is a recast of the Sixth VAT Directive that regulated the uniform tax bas for assessment for many years.<sup>26</sup> The exemptions made in the former EC Sixth Directive are also reflected in chapter 3 of the Swedish Value-Added Tax Act.<sup>27</sup> Bodies governed by public law or medical and paramedical professions that provides health care are excluded from the tax base (3 chap. 4-5§§ ML). Social care from both public and private bodies is also exempted. The

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<sup>25</sup> OECD (2006), International VAT/GST Guidelines, Centre for Tax Policy and Administration, Kogels, Han (2006), VAT on Internationally Traded Services and Intangibles -- A First Step Toward OECD Guidelines. *Bulletin for International Taxation*, International Bureau of Fiscal Documentation: [www.ibfd.org](http://www.ibfd.org), and Williams, David (1996), Value-Added Tax. In Thuronyi, Victor (ed.), *Tax Law Design and Drafting*. International Monetary Fund: Washington, 164-.

<sup>26</sup> 2006/112/EG.

<sup>27</sup> Mervärdesskattelagen (ML).

consequences of the deviation from a uniform tax base, despite good social policy intentions, are nonetheless to be regarded as non-fiscal taxation. Case law shows how asymmetric the tax base becomes when the uniformity erodes. Acupuncture and general health check-ups become tax exempted, but general dietician advices and massage become taxed. Temporary care for children in private homes provided by corporations is exempted, but summer camp services provided by a private business are taxed.<sup>28</sup>

Other major exemptions are education in the ordinary school system, from pre-school to university, provided by a public body or other educational institution recognised by the public authorities (3 chap. 8 § ML), particular categories of cultural services ( chap, 3 11 § ML) that are of a common value for the society, like public archives, libraries and museums, financial services (3 chap 9§ ML) and the extremely complicated exemption concerning the trade and rental of real estates and rights attached to real estates (3 chap 2 § ML).

There are also other deviations from a uniform VAT in the differentiations of rates. Also here we can find a multitude of objectives, which sometimes is rather obvious, but quite obscure and unclear in other cases. Lower tax rates as incentives for tourism are based on a clear objective<sup>29</sup>, and the same goes for the lower tax rate on victuals/food.<sup>30</sup>

## **Tax reductions**

The manner in which principles of equitable and horizontal taxation have shaped the Swedish tax system allows, in theory, no space for social programs in tax law. However, this attitude has proved to be impossible to uphold. After the 1990s tax reform several changes have been made to adjust the taxation to the individual tax subject's overall collected ability to pay. This has not been done by shifting back to a global taxation, instead tax reductions have been used to adjust the tax burden for certain categories of taxpayers with low incomes. This is the case for the standardized reduction for single parents that was enforced for a period of some years. The reduction was a compensation for the lack of economic means for low income single parents to support their children. It was a perfect example of a tax expenditure.<sup>31</sup> Another

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<sup>28</sup> Alhager, Eleonor, Kleerup, Jan, Melz, Peter and Öberg, Jesper (2007), *Mervärdesskatt i teori och praktik*. Norstedts Juridik: Stockholm, 84-91.

<sup>29</sup> Prop. 1992/93:150, bilaga 6.

<sup>30</sup> Prop. 2005/06:128.

<sup>31</sup> Gunnarsson, Åsa (2003), 62 and 126.

example of distributive policies in the regulations of tax assessment is the tax reduction with the objective to modify the burden of the object tax on real estate.<sup>32</sup> The rapid increase of market values on real estate has also increased the assessed values, particularly in attractive regions. Low income earners<sup>33</sup>, living in owner-occupied houses with high assessed values, cannot afford to pay an object tax, computed on the basis of 1 percentage of the assessed value, when the assessed value can be several millions. The most resent example of a tax reduction based on some sort of distributive objectives is the so called “jobbavdrag” (65 chap. 9 a-d §§ IL).<sup>34</sup>

However, it is not only distributive motives that have used tax reductions as a tax incentive. Labour market policies have been enforced by the use of tax reductions, in order to stimulate certain branches of business, like craftsman services<sup>35</sup> and household/domestic services.<sup>36</sup> An example of infra-structural objectives is the former tax red reduction for the parts of the costs to connect to broadband. Also reductions on pay-roll taxes have been used as a tax incentive for the stimulation of employing new people and for establishing of new business in underdeveloped regions.<sup>37</sup>

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<sup>32</sup> Lag (2001:906) om skattereduktion för fastigheter.

<sup>33</sup> Here we normally imagine an old fisherman widow, still living in the fishing cottage on a picturesque spot, close by the sea.

<sup>34</sup> Prop. 2006/07:1.

<sup>35</sup> The so called ”ROT-avdraget”, which is annulled.

<sup>36</sup> Lag (2007:346) om skattereduktion för utgifter för hushållsarbete.

<sup>37</sup> Lag (2001:1170) om särskilda avdrag i vissa fall vid avgiftsberäkningen enligt lagen (1994:1920) om allmän löneavgift och socialavgiftslagen.