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Nordic tax systems in a global context – A comment

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NTRC 50 years – Nordic tax systems fasing global challenges
Helsinki, May 3 2023

Challenges of tax systems in 1980's and 2020's

- Some challenges in the 1980's
  - How to make tax systems with high MTRs and narrow bases more efficient and equitable
    - On the background was the growth of the welfare state and its high revenue needs; gradual tax refroms led to very high tax rates and badly designed tax bases
    - Improved understanding of distortions caused by taxation helped detecting the weaknesses
  - Adjust the tax sýstem to increased mobility of capital and firms
- New challenges
  - Globalization and environmental challenges
  - Malfunctioning of the tax system, problems with tax avoidance
  - To establish a tax system favorable to employment and growth in the presence of deficits and inequality; search for an "optimal system" which possibly deviates of the old idea of a broad-based system with low rates
- My focus in the following on income tax

Finnish responses to the challenges in 1980's (1)

- Reforms progressed in 2 stages
- Tax reform 1989-1991
  - Followed the pattern of "tax-rate cut cum base broadening" reforms influenced by the US and UK tax reforms in 1986 and 1984 respectively
  - The change in view of what is a good tax system was very important and has influenced the tax policy making up to the present
  - But the TR1989-91 was just modest in its changes; marginal tax rates were cut and tax base broadened by abolishing exemptions and deductions both in PI and CIT; however, no total overhaul occurred
  - NB: a parallel project of starting tax expenditure reporting in Finland; similar ideas and same people working on both projects;
    - the concept of "Comprehensive income taxation" as a model for the tax reform and a tool in tax expenditure analysis

Finnish responses to the challenges in 1980’s (2)

- Introducing dual income tax in 1993
  - At the same time Finland was implementing its TR 1989-91 which based on ideas of the UK and US reform patterns, the Nordic partners were developing the totally new concept of dual income tax (DIT)
  - Finland quickly changed the direction of its reforms and adopted the idea of DIT
    - Minfin working group prepared a blueprint in 1991
    - New center-right government took the plan for a basis of a total overhaul of particularly the PIT on capital income and CIT
  - Personal capital income net of natural deductions became a separate income form
    - PIT rate on both capital income and corporate profits were set at 25 per cent
    - most extra deductions, exemptions and deductible reserves were abolished; personal taxation of earned income was not changed
    - Finland developed its own rules for splitting the income of entrepreneurs into capital income and earned income parts

Finnish responses to the challenges in 1980's (3)

- While clearly a version of DIT, Finland's solution differed in some respects from those of Swe and Nor
  - Capital income was entirely separate from earned income type unlike in e.g. Nor
  - Splitting rules were unique
    - not targeted to active owners of closely held companies but rather to all owners of non-listed companies
    - splitting parameter was not tied to interest rates but fixed
  - Finland kept the full imputation system
  - The tax rate on capital income and profits initially very low 25 %, lower than in Swe and Nor
  - The marginal tax rates on earned income remained high (due to large deficits)

Finnish responses to the challenges in 1980’s (4)

- Finnish DIT was later subject to changes
- 1995 the tax rates were raised from 25 % to 29 %
- In 2005
  - Dividend imputation was dropped and s partial double tax on dividends adopted
  - Tax rates lowered and separated: capital income (28 %) and corporate profits (26 %) and smaller changes to the splitting of income made
- The changes were justified
  - Imputation system not in conformity with EU rules (not necessarily a correct claim)
  - Fairness: full imputation too favorable
  - Income shifting: owners of CHCs able to transform earned income to leniently taxed capital income
    - some saw (I included) that this was due to some problems in the splitting system

Finnish responses to the challenges in 1980's (5)

- In 2010 a working group proposed
  - changes to the splitting system to improve efficiency and curb income shifting
  - reduction to CIT rate to address tax competition and increase to PIT rate on capital income to compensate the revenue loss and keep the balance in PIT
  - The motivation was to improve both efficiency and equity properties of the Finnish DIT
  - Just small changes were implemented
- DIT still seems to be accepted but the problems referred to above have not been addressed

Some responses to later challenges

- PIT-MTRs were lowered gradually over the period 1996-2007 and a tax credit for low-income earners were adopted
  - MTR cuts reduced tax rates by 7 %-points
  - Both reforms motivated by increasing labor supply
- Tax competition and profit shifting were addressed by cuts in CIT rate (=>20 %) and anti avoidance rules
- Search for optimal tax structures can be seen in Finland eg
  - In environmental taxation
  - Using tax instruments as tools in TKI-policy