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Nordic Tax Systems Facing Global Challenges[1]

A jubilee provides an opportunity to look back in time and into the future as well: How have the Nordic countries handled global tax challenges in the past and how will they meet them in the future?

Challenges can be of different kinds. Two types stand out: Firstly, foreign rules can have a direct impact on domestic tax policy; examples are the challenges of tax havens and international tax competition more generally. It may for instance be necessary to change domestic rules in order for a state to be competitive for investments. Secondly, foreign rules may act as models: Ideas and experiences in other countries on how rules can be formulated and how they may effectively work, can be useful as a basis for tax reform. Both aspects are included in the following.

The title assumes that the Nordic countries are in the same or similar position as far as tax policy is concerned. These countries are certainly similar in being small and open welfare states and relatively high tax economies, which means they are highly exposed to international trends. From a bird's eye view tax systems in the Nordics are also rather similar: The development of the income tax during the 20th century with the reforms around 1990 and the introduction of the value added tax around 1970.

However, a closer look reveals differences. The basic concepts of the income tax were different in Sweden and Finland on the one side, relying on a source based and originally rather narrow income concept, whereas Denmark and Norway on the other, relied on an integrated and broad concept of income. Over the years, these differences have diminished, in particular because the rules in all Nordic countries have moved in the direction of a wider concept of income. Nevertheless, the historical points of departure are still to be observed in several rules.

However, other differences have emerged: Wealth taxes have been abolished in all the Nordic countries (including Iceland, which joined the research council in 2002) except Norway (where the wealth tax is even a cornerstone in the ruling Labour Party's tax policy). Inheritance tax still exists in Denmark and Finland but has been abolished in Norway and Sweden. The surge for increased revenue has renewed the international interest for both these taxes. In addition, equity and distributional considerations can support the reintroduction of the inheritance tax, as recently argued by a tax committee

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1 Keynote speech at Nordic Tax Research Council's 50 years jubilee conference in Helsinki 3rd May 2023. Footnotes are added.

in Norway.[2] The current Norwegian wealth tax illustrates difficulties connected with that tax (mainly as regards including intangibles in the tax base and providing equality in the valuation of the various assets); therefore, the current Norwegian wealth tax should not, I my view, be recommended as a model for other countries.

Also, the Nordics countries' different attachment to the EU leads to differences. Tax policy is not part of the EEA agreement, which means that directives and regulations in the tax field are not binding for Iceland and Norway. For instance, the Norwegian VAT is not harmonized with the EU VAT. However, in many respects the EU VAT functions as a model for the Norwegian VAT and from a business perspective as few differences as possible are preferable.

However, the four freedoms and the state aid rules in the EU treaties have their parallels in the EEA agreement and it is now clear that the EEA agreement rules on the four freedoms and state aid should be interpreted in line with the parallel rules in the EU treaties. This means that most of the so-called passive harmonization of income tax rules through the CJEU case law applies also in Iceland and Norway. Nevertheless, the development in the EU is of course a more immediate challenge for the EU member states than for those outside.

Talking about the EU or the European Community at that time: The EU value added tax was certainly a model for the introduction of VAT in the Nordic countries around 1970. For the countries that aspired for membership in the EU/EC at that time, it was something more: A prerequisite to become a member.

Taking a closer look at the development of the income tax, the increased tax rates after the Second World War and the belief that tax rules should be used as a vehicle in economic policy lead to a great increase in tax credit rules[3] during the 1960s and 1970s. The deduction for reservations to investment funds was promoted by Sweden in particular. In hindsight, it is easy to see that tax policy at that time underestimated the downsides of this policy: It undermined the tax base and thereby hampered both economic efficiency and equity and created great incentives to tax planning. Also, other considerations had produced special rules, for capital gains in particular, in the form of lower tax rates (not least because of the effects of inflation) and favorable timing rules in order to avoid lock-in effects in connection with reinvestments.

The turning point came with the Nordic tax reforms around 1990 – first in Denmark (although in smaller scale) in 1986, a few years later in Sweden, Norway and

[2] NOU 2022: 20.

[3] Tax credit rules: Rules that postpones the payment of taxes either by deferring the taxability of gross income items or by anticipating the deductibility of costs (for instance through accelerated depreciation rules), compared to a normative system.

Finland (with a prelude a few years earlier), in that order.[4] These reforms certainly had international models – mainly the Reagan and Thatcher reforms in the US and the UK respectively. The US and UK reforms were in turn, at least partially, based on the economic thinking of tax expenditures.[5] Even if this thinking did not play the same role in the Nordic countries as in some other countries the thinking certainly supported the reform.[6] More generally, the idea of neutrality prevailed over using tax rules as incentives. More neutral capital taxation would lead to increased economic efficiency.

As in other countries, the reforms were launched under the slogan: broader tax base, lower tax rates.

This strategy turned out to have a great potential. The company tax rate was reduced very considerably, more than 20 percentage points in Sweden, Finland and Norway,[7] without any reduction of the revenue. In fact, company tax revenue increased in the following years. It is reported that for one large Norwegian company the effective tax rate before the reform was between 10 and 16 per cent and afterwards close to 28 per cent.[8]

In hindsight, it is worth noting that this reduction of the company tax rate was not primarily a result of international tax competition but was rather based on tax efficiency considerations in the form of a more neutral tax base, which in turn made reductions of the company tax rate possible. Only later did tax competition lead to further reductions of the company tax rate – in Norway from 28 to 22 per cent from 2014 to 2019 and in Finland from 24,5 per cent to 20 per cent in 2014.

The reforms around 1990 also covered capital income taxation of individuals, also for neutrality reasons, introducing the flat and rather low tax rate on capital income. One important positive effect was that most special rules on capital gains could be repealed. However, for both equity and revenue reasons earned income should still be taxed progressively, though the tax rates were somewhat reduced in some of the countries.

[4] At an earlier jubilee – the 20 year's jubilee in 1993 – the Nordic Tax Research Council published a book focused on those reforms: Nordic Council for Tax Research (publ.): Tax Reform in the Nordic Countries. 1973–1993 Jubilee Publication, Uppsala 1993 (referred to below as NTRC 1993). The book provides interesting insights in the process and the tax reform thinking, almost "in real times". A rather unique and lively inside account of the reform process in Sweden is provided in Johan Salsbäck: The Tax Reform Process in Sweden, in NTRC 1993 pp. 199–212.

[5] Tax expenditures: Deviations from a normative tax system to the benefit of taxpayers, which in effect provides state expenditures through the reduction of tax revenue instead of, as usual, through the distribution of collected taxes.

[6] See Nils Mattsson: Tax Expenditures in the Swedish Income Tax, in NTRC 1993 pp. 173–197.

[7] The largest reduction obviously took place in Finland where the company tax rate was reduced in steps from 60 pst. to 25 pst. from 1985 to 1993, Edward Andersson: The Finnish Business Income Tax Reform of 1992, in NTRC 1993 pp. 63–76 at p. 75.

[8] Harald Espeli: Norway, in: Peter Essers (ed.): History and Taxation. EATLP international Tax Series Volum 20, Amsterdam 2022, pp. 491–511 at p. 502.

This created the so-called Nordic dual tax model, under which we to a large extent still live, perhaps except in Denmark.[9] Two things characterize the model: firstly, progressive tax on earned income and a flat tax rate on capital income and, secondly, a significant difference between this flat tax rate and the top tax rate on earned income. This feature of the Nordic reforms did not have the same international models as the reform of the company tax and the tax base for capital income.

The evaluation of this model has been generally positive, not least among economists (in particular because the model provided a much more neutral taxation of capital income) but also among lawyers.[10] Academic colleagues at the time hailed the reform as a major step forward in the fight against tax avoidance first and foremost by taxing different kinds of capital income (including capital gains) much more equally.[11] However, the dual tax rate structure admittedly created new tax planning options. This is illustrated by the fact that a significant part of the Supreme Court cases on income tax law in Norway in later decades has its background in the dual tax rate structure.[12] The dual tax rate structure also raised issues from an equity point of view.[13] The thinking was, however, that the tax rate difference compensated for the effects of the wealth tax and inflation, which both affected the capital base negatively from the taxpayer's point of view. Observers at that time prophesized that the model would be an important Nordic export article in international tax policy, but, interestingly, this has not happened.

Other observers were more critical, pointing to the fact that the tax rate difference was not tied to the effect of the wealth taxes and inflation and that inflation affects

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[9] In fact, also Iceland ended up with a kind of dual model, see Jón Elvar Gudmundsson: Icelandic Legal National Report, in Robert Påhlsson (ed.): Yearbook for Nordic Tax Research 2008. Taxation of Capital and Wage Income: Towards Separated or More Integrated Personal Tax Systems? Copenhagen 2008, pp. 103–115.

[10] See for instance Sven-Olof Lodin: The Nordic Model of Capital Income Taxation – 15 Years of Swedish Experience, in Påhlsson (ed.) op.cit. footnote 9 pp. 207–216. With a few reservations, Lodin concluded on p. 215 that "the experience shows that the dual system has been very successful". More specifically Tikka pointed out that the challenge of tax evasion (mainly in the form of rich taxpayers concealing assets and income in tax havens) was more effectively met with a low capital tax rate, see Kari S. Tikka: A 25 % Flat Rate Tax on Capital Income. The Finnish Reaction to International Tax Competition, in NTRC 1993 pp. 91–108 at p. 95. However, generally Tikka was rather skeptical (op.cit. p. 91): "The reform was not enacted as a result of a convincing innovation of the tax theory, but was instead a more defensive than offensive reaction to international tax competition."

[11] See Gustaf Lindencrona: The Taxation of Financial Capital and the Prevention of Tax Avoidance, in NTRC 1993 pp. 157–171.

[12] See also Tikka op.cit. footnote 10 at p. 105: "It is to be feared that a new profession will emerge in the society: alchemists who perform magic by transforming earned income into capital income."

[13] Lodin op.cit. footnote 9 p. 210 argued that the former system was much worse also from an equity point of view: "The main reason behind this [the dual tax rate] was the complete failure of the old comprehensive tax system, because of its inability to achieve fairness, efficiency and growth."

capital assets differently.[14] The significance of this critical argument has increased over the years with low inflation and the abolition of the wealth tax (except in Norway). Nevertheless, and perhaps surprisingly, there has been very little debate in the later years on the dual model from an equity point of view.

At approximately the same time as these tax reforms, and as part of their context, we witnessed the deregulation of financial markets. This triggered the globalization of the world economy with huge impacts on tax systems, not least in countries with a small open economy. It became much more important to defend the national tax base. A rather immediate effect was the introduction of controlled foreign company rules (cfc rules)[15] which had obvious international models going back to the US rules introduced already under the Kennedy administration in the US. Other restrictions followed – exit taxes,[16] restrictions on interest deductions, increased importance of and stricter rules on pricing of transactions between companies belonging to a multilateral group of companies (normally referred to as transfer pricing). Such rules, in turn, triggered the issue of their relationship to the EU four freedoms because many of them were obviously restrictions on cross border transactions. As we know, this has resulted in several important CJEU cases. However, it is fair to say that most rules of this kind have subsequently been accepted in the EU and several of them have even been included in directives, although often with modifications. Defending the national tax base and at the same time respect the four freedoms has become a delicate balancing act for governments in EEA countries.

In the last two or three decades the globalization has accelerated the focus on international tax questions. The OECD initiative in the late 1990s on harmful tax competition ultimately lead to a surprisingly successful proliferation of information exchange treaties (including amendments to older treaties). In this process the Nordic countries negotiated treaties together, including treaties with tax havens, which was probably a onetime experience even if it was in a way successful. (But sceptics

[14] See Tikka op.cit. footnote 10 at p. 105: The reform "gives up the goal of redistributing income and causes an equity problem between capital owners and receivers of earned income. … it is very hard to see what the fundamental justification is for the proportional taxation of capital income, while earned income is taxed progressively." And p. 106: "The flat rate tax treats all kinds of assets in the same way, notwithstanding the fact that different types of investment are not equally exposed to inflation". See also Frederik Zimmer: Capital Income and Earned Income Following the Norwegian Income Tax Reform: Is the Dual Income Tax Fair? In NTRC 1993 pp. 141–156, and Zimmer: A Critical Assessment of the Nordic Dual Income Tax Model, in Påhlsson (ed.) op.cit. footnote 9 pp. 217–224.

[15] The most significant feature of cfc rules is that domestic shareholders are taxed currently for their part of the income of the company even if income is not distributed to the shareholders. Such rules normally requires that the domestic shareholders in a way controls the company and that the company is a resident of a country with a relatively low company tax rate or no company tax at all.

[16] Taxes triggered by the taxpayer (company or individual) moving or assets being moved out of the tax jurisdiction.

say the main result was that tax havens managed to negotiate seven treaties at a time (including treaties with the Faroes and Greenland), helping them to be removed more quickly from blacklists of tax havens.)

Later came the BEPS[17] process focusing on the substantial issues raised by globalization and digitalization, a process which is still not finished. That process, as well as the development of information exchange treaties, has been strongly supported by the Nordic countries. They have all resisted the pressure to introduce a digital service tax[18] so far.

An unexpected challenge emerged in the late 1990s from the international human rights, the European Human Rights Convention (EHRC) in particular. However, the impact of these rules was restricted due to the fact that Article 6 in the Convention concerning the right to a fair trial is interpreted as not including substantial tax questions. Therefore, only penal taxes are covered by this rule (as a form of "criminal charges"). In addition, cases on so-called double jeopardy – in practice the parallel imposition of criminal and administrative reactions to the same offence – are covered (EHRC Protocol 7 Article 4). In sum, the human rights Convention has had an important impact on penal taxes and other reactions to tax evasion in the Nordic countries[19] but so far not for substantial tax issues.

What is around the corner for tax policy in the Nordic countries? On short notice, much will depend on the finishing of the BEPS process concerning the so-called pillars. Even if they have been decided in principle, there are obviously still devils in the details. Without pillar 1,[20] digital service taxes may proliferate and non-tax rebuttals may occur, not least from the US. Without pillar 2[21] the race to the bottom of company tax rates may go on. However, that will not necessarily be the case. The relative distance in tax rates to the tax havens is already smaller than before, and if deglobalization materializes, the pressure for a further reduction in company tax rates may ease. Without a minimum tax, cfc rules will be more important.

However, international tax planning will not disappear and the combat against international tax avoidance is probably a never-ending story. International cooperation

[17] BEPS is an acronym for Base Erosion and Profit Shifting; a project initiated by the G20-meeting and carried out under the leadership the OECD from 2013. The main objective is to introduce rules – domestic and international – to counter aggressive international tax planning.

[18] A turnover tax considered as a substitute for the income taxation of profits from sales in market countries, which is easily avoided in the digital economy. Pressure groups and businesses feeling the competition that they consider unfair have lobbied for such a tax.

[19] Denmark does not have administratively levied penal taxes and therefore has been much less affected by this development.

[20] A proposal for providing market states a larger right to tax international income.

[21] A proposal for an international minimum company tax.

will still be necessary. It remains to be seen whether the rules produced by the BEPS project will suffice to reduce the international tax avoidance activity to an acceptable level or whether stronger measures are needed.

The BEPS Pillar 1 rules introduce elements of so-called unitary taxation[22] into the OECD model. In my view, however, this is not a first step to a full conversion to the unitary taxation method in international tax law. The big questions for that to happen are still unanswered. For illustration, look to the struggle over more than two decades within the EU on introducing a system of this kind.

Further down the road one may ask what will happen if the initiatives to make the UN the center of development of international taxation (instead of the OECD) get traction. This may mean that developing countries, and more generally non-OECD countries, get a bigger influence. Regardless of such a development, the increasing significance of developing countries will probably set a larger print on the development of international tax rules in the future. This may for instance challenge the widespread view in the Nordic countries that capital export neutrality should be favored over capital import neutrality.[23]

Climate taxes will probably increase in significance, not only in the form of special climate taxes, but perhaps also in the form of climate-based rules in other taxes, for instance in order to stimulate a circular economy.

The Nordic dual tax system will probably survive for the foreseeable future but the gap between tax rates on capital income and high earned income will perhaps narrow both by increasing tax rates on capital income and by lowering of the progressive tax rates on earned income.[24]

One may also ask to what extent the Nordic countries have been challenges and/or models to each other. In the reform process around 1990 our countries certainly were

[22] Unitary taxation is an alternative to the arm's length method to allocate profits between companies in multinational groups, and thereby dividing the tax base between countries. While the arm's length method endeavors to find a market price on each and every transaction between the companies in the group, the unitary taxation method takes a schematic approach: The profits of the companies in the group is pooled together and then divided between the companies (and by extension: the countries involved) according to a formula. This formula may be based on investments, salaries paid and sales in the various companies.

[23] Capital export neutrality: Domestic and foreign investments should be taxed in the same way in the investor's home country (often favored by industrialized countries). Capital import neutrality: investors resident in different countries should be taxed in the same way in the country of investment (often favored by developing countries).

[24] Tikka ended his article in the jubilee book of 1993 by asking: "Will the dominating structural model for income taxation be a uniform progressive tax on earned and capital income, or a dual system with a flat rate on capital income, or will the income tax system split into final withholding taxes on earned income, interest income and dividend income? Will the income tax system to a great extent lose its characteristics as a personal tax designed to allow for the particular household's ability to pay?" Tikka in NTRC 1993 pp. 91–108 on pp. 107–108. Thirty years later the dual income tax in general still prevails and the alternatives sketched by Tikka have not emerged.

a model for each other. The Danes paved the way, the Swedish reform was in many respects a model for the Norwegian, and the Swedish and Norwegian again for the Finnish. On more specific questions there are often references in Norwegian documents to Swedish and Danish experiences in particular. And my impression is that Finland often looks to Sweden. In general, taking into account foreign rules and experiences as a basis for proposing new rules, is common, and the most near-by countries are often given most space.

There is also an element of tax competition between the Nordic countries. In the recent discussion about the company tax rate in Norway, and whether it should be somewhat increased (from 22 to 24 per cent as proposed by a minority in the recent tax committee proposal) an argument against is that the tax rate is already lower in Sweden and Denmark than in Norway. Therefore, there is a fear that investors will prefer those countries over Norway. Another example: When Norway introduced a tonnage tax regime for shipping companies in the late 1990s, other Nordic countries followed suite.

Lastly, at a jubilee conference for the Nordic Tax Research Council one may ask if and to what extent the research council itself has had an impact on tax legislation in the Nordic countries. It is difficult to point to any direct impact. Seldom if ever do preparatory works refer to the council's conference reports or yearbooks but that could not be expected anyway. However, though it is difficult to measure, in my view the indirect impact has been considerable. It is reasonable to believe that the yearly discussions in seminars with people close to the law reform processes have had an impact over the years. The tax departments of the Ministries of Finance have always been well represented at conferences and in the council itself, often by heads of tax departments. Even more indirectly, the activities of the council have had an important impact on the academic activities within tax, at least in tax law, which in turn certainly have had an impact on the tax policy discussions. It is possible that the founding fathers of the Nordic Tax Research Council had even higher expectations as to the actual impact of the council; however, overall I think we can be proud of its activities through the past 50 years.