

# Summary

In the opinion of the Committee on Tax Base Mobility, there will be sufficient tax revenues to continue to finance a well-functioning social welfare society at current ambition levels. One requirement, however, is that Sweden must continue to maintain and develop its tax system at least as well as it has done during the past 20 years.

Many of the changes that will be necessary will take a long time to implement. While the practice of waiting until the problems grow to be so great and so apparent that everyone understands the necessity for a change may facilitate decision-making on a short-term basis, this is a costly way to proceed. It can impair the welfare of our citizens, and often produces less than satisfactory decisions regarding how to effectuate the changes.

The fact that we have not supplied any dates with our proposed changes, thus, does not mean that we feel these changes can afford to wait. On the contrary, our opinion is that the sooner these adjustments are made, the better it will be for Sweden, the Swedish economy and the Swedish people.

## Demographic trends causing long-term financing problems

Beginning after 2008, there will be a shift in demographic structure. Although the total population will continue to increase, the population in the active ages will decrease. At the same time, there is also a tendency for people to enter the labour force at a later age. As a result, a larger portion of our population will have to be supported by a shrinking one. This presents a challenge to our social welfare policies.

Sweden, however, is not alone in this respect. Between 1999 and 2030 many European countries are facing even more dramatic trends. Because of this, Sweden will most likely not have to endure increasing international pressure to make tax reductions, since

many other countries will need to increase their tax revenues in order to preserve public social welfare programmes.

This long-term demographic trend, however, is not primarily a technical tax problem. In addition, it is almost entirely beyond the time perspective of the Committee. Nevertheless, the support burden issue is not just a question of demography. It also relates to how many of those in their active years choose to work, and how production efficiency develops. In this respect, the tax system is of great significance, and its main structures should also be based on these considerations.

### Three major tax bases

Sweden has three major tax bases. They consist of all the production that takes place within Sweden, all the income received by households residing in Sweden, and everything consumed in Sweden.

All of these three are closely related to the Swedish gross domestic product. Maintaining these tax bases, to a great extent, is synonymous with maintaining the GDP. Therefore, one fundamental consideration is that taxes must not be allowed to excessively reduce the basic financial incentive of households to choose to work on the labour market, rather than engaging in recreation or working at home. A second fundamental consideration is that taxes should not distort household consumption decisions or business production determinations. Without making light of working off the books, and other means of illegal or legal tax avoidance, the main focus must be on how to structure present and future taxes.

The current Swedish tax system has a sensible structure aimed at economic growth. The lower and more uniform decision options are made, the less risk there will be of distorting production and consumption decisions, with the resulting losses in welfare. The way to attain the lowest possible marginal tax rates is to broaden tax bases, and avoid, wherever possible, special tax benefits and exemptions. Broadening tax bases in order to be able to lower marginal tax rates was the major objective of the tax reform of 1990–91. This has also been a major theme in our deliberations, which have included a critical review of various existing deviations from uniform taxation, i.e. tax expenditures and tax sanctions.

## Tax errors

Aggregate tax errors, which means the total tax losses due to incomplete enforcement of present tax rules, constitutes approximately 4 percent of the GDP, or 8 percent of tax revenues. Two thirds of this is attributable to the “black” sector (i.e. unreported income from business and work). One third is connected to different international transactions. Tax errors, measured as a percentage of GDP, has not increased during the past two decades.

### **New types of tax errors**

The Committee’s directive includes instructions to pay special attention to those tax faults arising due to new technology and the internationalisation of the economy. This primarily concerns four types of problems, which have the potential to increase.

1. It is much too easy and profitable today to hide financial assets and their yields outside of Sweden. The National Tax Board estimates that the loss of income, wealth, estate and gift taxes totals at least eight billion SEK a year.
2. There is extensive VAT fraud, including various forms of bogus exports. This can result in a loss of five to ten billion SEK in tax revenues.
3. Tax havens offer primarily companies many different opportunities to avoid paying taxes in their homelands. The National Tax Board estimates that this type of tax fraud costs two to five billion SEK.
4. Losses in taxes due to illegal imports of primarily alcohol, tobacco and fuel may total two to four billion SEK.

These categories represent between one fourth and one third of the total tax errors, as estimated by the National Tax Board.

However, in our opinion, the greatest increase of international related problems will be in relation to areas that currently concern rather small amounts, and do not involve fraud or illegal activities.

- The most serious problems arise when inconsistent taxes create strong incentives for businesses to move their production to some other country. EU’s new tax rules for the taxation of e-commerce and telecom services are examples of this.

- Stronger tax competition due to increased cross-border commerce can lead to losses of tax revenue.
- International regulations, primarily within the EU, may compel tax reductions. EU's current view of Swedish energy taxation is an example of this.

Preventing these new problems (both legal and illegal) from increasing will require intensified international cooperation. This demands greater political efforts, and larger appropriations for the tax administration. Strategic reductions in marginal tax rates should also be considered.

### **Older domestic types of tax errors**

The older types of tax errors, however, represent at least two thirds of aggregate tax errors. Work off the books and unreported business income are the predominant types of illegal activities. Although these types of tax errors are not increasing in terms of the percentage of the GDP they represent, there are new and troubling trends, such as the shift in attitude that has made it socially acceptable to openly discuss one's own criminal conduct in working off the books. This represents the crossing of a boundary, which, as time passes, can mean a serious deterioration of domestic tax bases.

### **Swedish taxes in relation to those of other countries**

The level of taxation in Sweden differs from the level of taxation in other countries. We pay the highest tax proportionally among the OECD countries, calculated on a gross basis. A relatively large portion of the differences in the level of taxation, however, is a result of differences in how different systems are designed. An example of this is the fact that Sweden taxes transfers, while in other countries, transfers are often not taxed, or are even designed as tax deductions rather than open subsidies and grants. Individual social security charges outside the tax system are also common. When tax rates are calculated on a net basis, the differences between countries are not so great. The composition of the population also affects the total tax-to-GDP ratio.

In general, Sweden often is recognised as the country with the highest taxes, in relation to GDP. To a great extent, this reflects a higher level of social welfare objectives. In this context, Sweden is part of a group of northern European countries with similarly high ambitions in the general welfare systems. Sweden also has among the highest levels of taxation of each of the various tax bases. This does not apply, however, to company taxation. The Swedish system contains relatively few tax exemptions, such as standard deductions and tax reliefs. This results in low marginal tax rates in relation to the total level of taxation.

### The general design of taxation of capital

The general design of the Swedish tax system created after the major tax reform contained several important characteristics.

- Both company profits and the income from work are subject to double taxation.
- Interest income is taxed once at the household level.
- Both profits and salaries are taxed at a rate of about 30 percent at the production level.
- At the household level, dividends and capital gains are subject to a proportional 30 percent tax. For a large majority of income earners, the marginal tax on income derived from work is also about 30 percent.
- A minority of income earners, receiving high income, are affected by a special progressive state income tax. There is no corresponding progressiveness, however, for income derived from capital.
- The above mentioned lack of uniformity between marginal taxation of high earned income and income from capital requires special regulations for closely-held companies, in order to determine what is earned income and what is income from capital. These are known as the 3:12 regulations.

In our opinion, the arguments in favour of these principles are even more important in today's internationalised economy than they were ten or fifteen years ago.

## **Company taxation**

In a small open economy, the required returns on corporate capital are internationally determined, which probably makes it difficult for a country such as Sweden to deviate greatly regarding the level of company taxation. Sweden is one of the OECD countries with the lowest company tax.

In our opinion, Sweden should maintain its position as having internationally competitive company taxation. This should be achieved by defining the broadest possible base, and a low tax rate.

However, Sweden should not contribute to making international tax competition in this area into a 'race to the bottom'. In today's situation, there is thus no reason to change the Swedish corporate tax rate. If, in the future, major EU countries should take the initiative of lowering their rates, Sweden should be prepared to go down to a 25 percent rate in corporate taxation.

Furthermore, there is no reason to change the tax rules attributable to the so-called 3:12 firms. Our view is that the tax system facing these firms is marginally more favourable than the regulations concerning other companies. The set of rules is more complicated though.

In the area of company taxation, there are a number of tax deviations that together are expected to result in an estimated tax loss of 15 billion SEK in 2003. Two such deviations are about the same size, and account for approximately 11 billion SEK. The first is the option businesses have of making allocations to tax equalisation funds. The second one is the reduction of social security contributions (including payroll taxes) for total wages up to 850,000 SEK. These two deviations are also those that can most easily be challenged. In our opinion, neither one materially contributes to economic growth.

## **Tax of household income derived from capital**

Sweden has proportional taxation of household income derived from capital. Many other countries combine income from capital and earned income, and tax the combined income according to a progressive scale. This means that Sweden has a significantly lower marginal tax rate for income from capital than do many large European economies. Many countries, however, allow a generous

standard deduction for income from capital. In taxing dividends, several countries allow a deduction for company tax. In Finland, for example, shareholders therefore do not pay any tax on income from capital from Finnish companies. Our proportional taxation of income from capital also means that Sweden applies a higher marginal tax rate to income derived from labour than to income from capital.

In our opinion, the tax rate on household income from capital must be a compromise between international concerns and the requirement of uniformity between capital and labour. Given the present circumstances, the existing 30 percent tax rate is a reasonable solution.

### **Deferred tax**

From a strictly economic perspective, all income should be taxed as it arises. The two main areas where households have an opportunity to defer their tax are appreciation of shares and real estate and group and individual contributions to pension funds. These systems have a number of serious disadvantages.

- They mean large losses of income for the public sector (estimated at 35 billion SEK for 2003).
- They distort economic decisions by companies and households.
- They contribute to increased marginal taxation in other areas.
- They generally have a strongly negative effect on redistribution policy.
- They create tax problems when taxpayers move across national borders.

### **Wealth, estate and gift taxes**

The wealth tax is expected to contribute more than 5 billion SEK to the treasury in 2003. There is no other tax base that is so completely dominated by exemptions and tax breaks. Consequently, it is often easy to use legal tax planning to avoid this tax. Estate and gift taxes contribute 2–3 billion SEK. These taxes are also often avoidable by those who know the applicable tax rules. Sometimes, however, these taxes do create significant

problems for family-owned companies (i.e. *generation change problems*).

Wealth, estate and gift taxes, however, have a significant vertical distributive effect (i.e., they reduce the gap between wealthy households with high incomes and households in a less favourable economic situation). Wealth, estate and gift taxes may be viewed as a progressive complement to the proportional taxation of income from capital. However, their current structure creates great horizontal unfairness. This means that taxes affect various groups of wealthy households arbitrarily and unjustly.

The present structure of these taxes violates some of the most basic principles of our tax system. The narrow bases, high marginal effects and the plethora of exemptions and tax breaks create powerful incentives for households and businesses to make purely tax-based decisions, both legal and illegal. These two extensive and difficult to verify regulatory systems result in less than one percent of total tax revenues collected.

### **A small but important tax reform**

Swedish taxation of capital, along with estate and gift taxation, on one hand, contains tax breaks in the form of exceptions that create large tax losses and negative distributive effects, while on the other hand, from a fiscal perspective, they result in an inefficient increased tax in order to create positive distributive effects. Both of these aspects contribute to irrational economic decisions, and an overall loss of tax revenue. There is certainly an excellent opportunity to make a trade-off here that will benefit all interests.

In light of this background, we are of the opinion that there are good grounds to establish a parliamentary-appointed committee to review this area of taxation. Its main goals should be to use broader bases, lower marginal tax rates and simplification to create an economically more sensible, stronger and fairer tax system. This could be achieved by exchanging tax deviations for an overwhelmingly negative distributive nature for decreases in marginal tax rates that have a positive distributive impact. The best tax deviations to abolish would be:

- Tax deviations for pension contributions.
- Reduction of social security contributions directed especially to smaller companies.



- Tax equalisation funds.

These can be exchanged for:

- The abolition of estate and gift tax for Tax Class 1 (spouses and lineal heirs).
- A broadening of the wealth tax base to include all macro-economically significant assets, and a significant decrease in the tax rate. If this cannot be done, our second alternative would be to completely abolish this tax.
- A significant increase in benefit ceilings for unemployment fund payments, sick benefits and parental leave benefits, in order to lower the marginal tax effects for the relevant income levels.
- In order to ensure satisfactory vertical redistribution, an increase in child benefits and a possible decrease in the VAT should also be included.
- If the trade-off discussed above is sufficiently extensive, it may even yield enough resources to create latitude for a decrease of the national income tax on earned income.

As in the case of the previous major tax reform, one general requirement is that there must be no weakening of vertical income redistribution. High-income earners must pay for their own tax reductions.

### **EU and taxation of household income derived from capital**

Sweden has different rules regarding the collection of taxes on dividends from Swedish and foreign pension insurance funds, respectively. Persons purchasing insurance outside of Sweden are responsible to paying the tax on the dividends, unlike persons purchasing insurance from a Swedish company, where the company pays the tax itself. From a Swedish perspective, these rules are considered neutral. However, there is an obvious risk that the Court of Justice of the European Communities would prohibit Sweden from taxing foreign insurance carriers in this manner. If this occurs, foreign insurance companies would be given a competitive edge. Another important area that can be affected by developments in EU law concerns the difference between the right to deduct contributions to private pension savings in Swedish and

foreign companies, and the difference in treatment of the yield. An increase in the yield tax of private pensions would reduce this problem.

From an economic perspective, the tax on yield is a tax on an individual's income from capital, and not a tax on the insurance companies. We therefore propose that the liability for this tax be transferred from the companies to the individuals involved. The yield-tax would then only be a preliminary tax, deducted at the source, in the same way banks and mutual funds do. A similar problem concerns the taxation of imputed income from mutual funds. Here too, the tax should be transferred to the individual, and standardised income taxation should be replaced by a preliminary tax, deducted at the source.

There are currently efforts within the EU regarding a directive for the taxation of interest (known as the "Savings Directive"). The purpose of the proposed directive is to enable an efficient taxation of interest income in the state of domicile of the depositor. According to the directive, the countries concerned would exchange information with each other regarding income of savings. The Savings Directive, however, will not go into effect fully until 2010. Negotiations are currently being conducted.

At present, Sweden has signed a large number of bilateral agreements regarding information exchange. Efforts to increase these should continue. If the Savings Directive does go into effect as planned, information exchange among countries will be significantly improved.

## Consumption taxation

### **Value Added Taxes**

With at 25 percent, Sweden and Denmark are the EU countries with the highest normal VAT rate. Within the EU, the lowest permissible normal tax rate is 15 percent, with no stated maximum. Countries are entitled to apply up to two rates that are lower than their normal tax rates, to certain categories of goods and services.

In many respects, the Value Added Tax can be viewed as the common tax base of the EU. It is the base for parts of our EU contributions. Like the excise tax, the VAT is the area for which the EU has the most advanced plans for cooperation. From a long-

range perspective, it may be difficult for a single EU Member State to greatly deviate when adopting a VAT rate, due to increased cross-border and Internet commerce. If the EU realizes its objectives of internally adopting the Country of Origin Principle, significant deviations will be even more difficult to maintain. This principle means that goods and services exported and imported within the EU will be taxed at the VAT rate in effect in the country of production, and not, as is presently the case, at the rate of the country of consumption.

Viewed from a longer-range perspective, Sweden should be prepared to reduce the gap between its 25 percent level and the EU minimum level of 15 percent, provided a strong force for convergence develops within the EU. A reasonable objective is to get down to 20 percent. In our opinion, halving the gap would more than halve the problems resulting from the current level.

A rather modest first step, which would also yield additional advantages, would be to eliminate certain lower VAT rates. In our opinion, the deviations from the normal rate constituted by the special VAT rate on food, and certain other lower rates, are not justified by sufficiently strong reasons. We feel that it is possible to increase VAT uniformity to a degree that will make it possible to lower the general rate to 22 percent.

However, the VAT base, in many respects, is one of the truly broad and stable tax bases. Consequently, the first choice would be to go no lower than to 22 percent. Sweden should not go lower unless the political or competitive pressure becomes too strong to withstand. The VAT gap within the EU, however, may be reduced by moves in the other direction. Several large EU Member States already have sizeable budget deficits, and also face difficult demographic trends.

### **The EU and VAT on services**

The Country of Origin Principle already predominates within the EU in the case of services provided to the consumer. This means that, as a general rule, the VAT is collected where the producer has established its business, regardless of where the customers reside. This applies to e-commerce (the sale of music, information, computer software or education, for example, over the Internet). It also applies to web services, telephony services, pay-per-view TV

programmes, legal services, advertising, computer services and gaming.

A country applying a low VAT rate can benefit from this situation, not just by receiving tax income from consumption taking place in other countries, but also by the fact that this type of production will move to that country. For Sweden, this can mean serious problems. Since, according to present EU rules, these services must be taxed at the full VAT rate, Sweden and other countries with high taxes, must lower their normal tax rates if they wish to avoid this type of tax competition.

The above also serves as a typical example of EU's approach that there should be no tax rules that prevent or slow down structural change or trade among EU nations. On the other hand, tax rules that create economically unsound incentives for structural change and cross-border commerce, are not at all as strongly opposed.

We are of the opinion that Sweden should use its best efforts to demand the consent to a special tax level for e-commerce and similar services throughout the entire EU, with the level set at a minimum of 15 percent. Sweden should demand this for all areas exposed to international competition, to which the EU chooses to apply the Country of Origin Principle.

### **Excise taxes**

The requirement that Sweden begin to apply EU's high import allowances for alcohol and tobacco in 2004 will result in tax losses. Sweden has the following two options:

One can keep the high Swedish excise taxes, which will then increase legal imports and decrease purchases in Sweden. This will cost the Swedish treasury an estimated 2–4 billion SEK in tax revenues. The winners will be those consumers who can increase their purchases abroad, and foreign states that will obtain the increased tax revenues.

The second option is for Sweden to decrease its excise taxes to levels that are more normal from an EU perspective. The loss of taxes here will probably be larger – approximately 3–5 billion SEK. The losers will be the Swedish State and those who make money on illegal importing. The only winners will be those making their purchases in Sweden.

The latter model is probably preferable from a limited tax perspective. It means less unfairness between various groups of consumers, and limits illegal activities. However, public health concerns should also be considered, and those are beyond both the scope of our expertise and that of our directive.

### **Energy and environmental taxes**

EU Member States may be subject to limitations in their right to apply exemptions and lower rates of energy taxes for industry. Firstly, Sweden may be forced to apply industrial rates for the CO<sub>2</sub> tax generally for the entire business sector. In that case, this would concern an estimated tax loss of 5–6 billion SEK.

If Sweden were forced to lower these energy taxes, this would not merely result in a loss of tax revenues, would also negatively impact the Swedish and global environments. Consequently, both Swedish political leaders and senior civil servants should try their utmost to convince the EU that its current position is unfortunate, both from an economical and an environmental perspective.

### **Fuel taxes**

There are major differences between how various countries tax petrol and diesel fuel. However, there are strong forces in Europe favouring the financing of the highway network primarily through road fees, instead of by fuel taxes. If this occurs, there will be a great deal of pressure placed on Sweden to fall into line.

There are efforts going on in many places to develop efficient methods of levying these fees. The electronic billing option, especially, appears to be both flexible and environmentally sound. In addition, there are advantages in exchanging a tax for a use-based fee.

### **Non-taxed fuels**

An additional factor that can affect the Swedish taxation of fuel is the import of non-taxed fuels. Peat, firewood and certain other fuels are not taxed in Sweden, and consumption of these fuels has nearly doubled, since the early 1980s. This situation represents a

tax loss of almost eight billion SEK, and is expected to continue. In the future, it may be a good idea to stop this trend. One possibility, in that case, would be to tax these fuels in much the same way as other fuels are taxed.

### Migration

Within the entire EU, there is currently relatively little migration both between the Member States and within each State. At present, migration therefore does not pose any threat to the employment income base in Sweden. Neither are there any significant indications that the mobility of labour across national borders is strongly affected by the differences in the tax systems of the respective countries. The combination of tax and social welfare systems, however, may attract various households. During certain stages in its development, a family may pay more to the system than it receives, and may therefore benefit by moving to a country with low taxes. At other stages of life, however, it can be advantageous to choose a country that offers generous grants and a good social insurance system.

In order to minimise the influence of differences in national tax and benefit systems on migration, the main rule should be that the country providing the benefits should also accorded a corresponding right to tax.

Sweden has demanded the right to tax pensions it pays to pensioners outside of Sweden. This does not always accord with the principle that the country providing the benefits should also be accorded the right to tax. Therefore the taxation of Swedish pensioners abroad should be reviewed. Once a pension is determined as not being tax-exempt, Sweden can recognise the right of another country to tax it. Another problem concerns those who live in one country and work in another. In certain cases, the right to tax a commuter lies with the country of employment. The solution for Sweden is to enter into special cross-border commuter agreements.

### **Taxes on visiting experts**

Sweden currently has a law giving tax relief to foreign experts who work in Sweden for limited periods. We feel that Sweden should not use taxes to compete with other countries for qualified labour. Consequently, tax relief for key persons from abroad should be abolished, or at least radically reduced.

In addition, Sweden should use its efforts to promote the abolition of tax relief for foreign experts, both within the EU and the Nordic countries. This is also an area where there would otherwise be a risk of a race to the bottom. It is a cheap method of attracting key foreign professional categories that require expensive education (e.g. doctors), rather than increasing educational capacity and/or raising salaries.

In principle, we have the same restrictive view regarding other special rules, such as for EU and UN employees, seamen and foreign representatives. Regarding these categories, however, Sweden is often bound by international agreements. Nevertheless, it should be our objective to limit these deviations to the greatest possible extent.

### **Future international cooperation**

In our opinion, a continued harmonisation of the tax systems of the EU Member States is a desirable development. One method of speeding this process would be for the Member States to give up their veto regarding certain areas. In the areas where basic EC rules are in place, one possibility would be to allow decisions to be made by the "committee procedure," with the Commission and the Member States working together in committees to arrive at binding regulatory decisions.

Sweden should use its efforts to promote a harmonisation of tax base definitions and minimum levels for the most mobile tax bases by majority votes and committee procedures within the EU. The harmonisation of tax bases and agreements regarding minimum levels should be conducted in a more orderly manner than as a tax contest in which the low-tax countries set the rules. Taxes on household income from capital, company taxes and VAT in areas where the Country of Origin Principle is applied should be dealt with first.

In the case of the less mobile tax bases (primarily household income of employment and wages paid by companies), EU should adopt the opposite strategy: doing its utmost to protect and facilitate the maintenance of different tax levels by the Member States. Democratic values mandate that citizens should have the opportunity to choose the size of their public sector and the extent objectives to achieve equality shall be realised. In order to do so, the voters must be able to exert control over several broad macroeconomic tax bases.

### **An efficient administration**

In international comparisons, Swedish tax administration appears efficient and economical. In Sweden, administration costs about 50 öre for every one hundred SEK of tax collected. However, there are ways to additionally increase the efficiency of the system in the future. This will be required in order to counteract the forces and tendencies, which tend to erode our tax bases. There are two areas, however, where we feel the National Tax Board must be given more resources.

The National Tax Board must be given quantitatively, qualitatively and organisationally much larger resources to develop and utilise the fruits of international cooperation and international information exchange. Additional resources for these purposes should be equivalent to about one percent of its total resources.

It is also important to begin long-term public opinion efforts. The goal should be to increase the willingness to abide by the law – “the desire to do the right thing” – regarding taxes, and to increase the knowledge of the public regarding taxes and what they are used for. The National Tax Board should also be given an additional appropriation in this area, equivalent to about one percent of its total appropriations.

### **Structural and prioritisation problems when handling tax cases**

The national administration of tax issues is not only the province of the Finance Ministry and the National Tax Board. Many authorities, such as the police and the prosecutors' offices, are involved in tax cases. There is a great deal that needs to be done in



this area. It often takes much too long for cases to result in sanctions, ten years not being an unusual period. There is a crying shortage of expertise. Tax cases are often complicated and require great expertise in tax law and economics. The divided administrative structure, and problems regarding cooperation can lead to varying treatment by the courts.

An unconditional review of how tax cases are handled is required. Its objective should be to improve expertise and rationalise the relevant administrative structures. The changes proposed should make it possible to prioritise the handling of tax cases by prosecutors and the courts. One reasonable goal should be to ensure that administrative courts should complete their handling of a tax case within two years.