Challenges for tax policy in Sweden

By Robert Boije
Monetary Policy Department.

The restructuring of the budget in recent years, in combination with a growing economy, has led to a substantial improvement in public sector finances. From the lowest point, in 1994, when the government debt amounted to 76 per cent of GDP, the government debt has fallen to 54 per cent this year, which is below the requirements of the Treaty of Maastricht by a good margin. The substantial improvement in the public finances has contributed to a more stable macroeconomic climate. Nevertheless, fiscal policy now faces a number of challenges in both the short and the long term. The continuing process of internationalisation and its effects on the mobility of tax bases is one example of this.

Challenges for tax policy

This article discusses a number of *tax policy* questions which have arisen, or will necessarily arise in the future. The intention is to add to the debate and contribute to a holistic perspective. The aim is to provide a "gross list" of challenges for tax policy in Sweden from the perspective of which fundamental goals the tax system must or should achieve. A "list" of this type may be of interest in a discussion of tax policy priorities over the next few years.

The article begins with a brief discussion of principle on the configuration of the tax system. Why are taxes necessary? How should the tax system be configured? How is the Swedish tax system configured in practice, and what principles underlie its present configuration? It then discusses a number of long-term tax

The author is Fiscal Policy Adviser at Riksbanken, and was formerly Deputy Director at the Fiscal Affairs Department of the Ministry of Finance.

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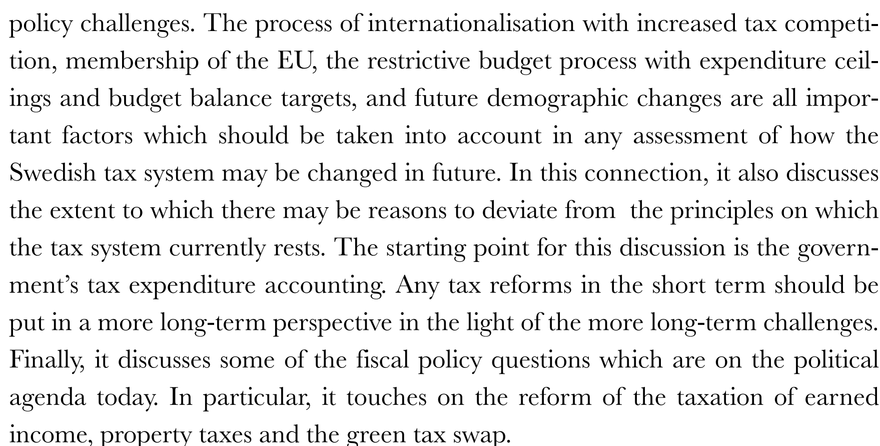

policy challenges. The process of internationalisation with increased tax competition, membership of the EU, the restrictive budget process with expenditure ceilings and budget balance targets, and future demographic changes are all important factors which should be taken into account in any assessment of how the Swedish tax system may be changed in future. In this connection, it also discusses the extent to which there may be reasons to deviate from the principles on which the tax system currently rests. The starting point for this discussion is the government's tax expenditure accounting. Any tax reforms in the short term should be put in a more long-term perspective in the light of the more long-term challenges. Finally, it discusses some of the fiscal policy questions which are on the political agenda today. In particular, it touches on the reform of the taxation of earned income, property taxes and the green tax swap.

Fundamental starting points

Purposes of the tax system

The most important purpose of the tax system is to finance the general government sector's expenditure. Another purpose is to influence the distribution of income and wealth. Taxes can also be used for stabilisation and allocation policy purposes.

Taxes can be used in various ways for distributive purposes. A tax system in which everyone pays the same amount of tax irrespective of income or wealth may still have a redistributive effect if the general government sector's services affect taxpayers to different degrees. A proportional income tax system means that taxpayers pay proportionally the same amount in tax. Even if the tax rate in such a system is independent of the size of income, households with higher incomes pay more tax than households with lower incomes. Accordingly, such a tax system is more redistributive than the first mentioned, unless households with higher incomes utilise or are covered by general government services to a greater extent than households on lower incomes. A progressive income tax system – in which the tax rate increases with rising income – is the result of a political desire to further increase income redistribution in comparison with a system with proportional income tax.

Taxes can be used in a variety of ways for distributive purposes.

Stabilisation policy is intended to achieve economic goals such as full employment and price stability. Taxes can be used for stabilisation purposes by raising taxes in booms and reducing them during recessions. Through this

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approach, the government actively contributes to raising total demand during recessions and moderating total demand during booms, with the aim of evening out economic fluctuations. A tax system with progressive elements, in combination with income-related transfers, acts as an automatic stabiliser. Consequently, the tax system may have a stabilising effect even in the absence of an active stabilisation policy.

Allocation policy is intended to correct market failures.

Allocation policy is intended to correct market failures, such as abuse and environmental pollution. High specific taxes on petrol help limit demand for petrol, and this reduces emissions of substances such as carbon dioxide. High specific taxes on alcohol and tobacco help reduce abuse problems.

How should the tax system be configured?

A universal requirement for a tax system is that it should be general. The tax rules should also be stable over time, to create greater certainty about the economic consequences of various alternative courses of action. Another desideratum is that the tax system must not generate excessive marginal effects. High marginal effects on, for example, the taxation of earned income reduce the incentive for households to work more, change employment or move to locations with more job opportunities.[1]

The actual configuration of the tax system – the 1991 tax reform

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The linchpin of the 1991 tax reform was that the tax system should, as far as possible, be uniform and general. The uniformity rule means that economic activities of the same character must be covered by the same tax rules. Other important elements in the tax reform were substantially widened tax bases, reduced marginal tax rates and the introduction of a dual taxation model in which income from capital is taxed separately from earned income. As part of the tax reform, property taxation was also configured so that, in principle, it would produce a taxation on owner-occupied houses which was equivalent to the

[1] In Appendix 4 to the 2001 Government Spring Bill, the government published estimates of the size of the marginal effects and the effect the tax system has on these.

taxation of other capital assets.[2] The tax reform, accordingly, fulfilled the majority of the fundamental requirements which may be placed on a tax system.

As part of the preservation of the 1991 tax reform, and with the aim of preventing special tax legislation, the government has published calculations of tax expenditures since spring 1996, as an appendix to the annual Government Spring Bill. To identify a tax expenditure, the existing tax system must be related to a selected tax norm. The norm used in the tax expenditure calculations is based on the principle of a uniform taxation of different economic activities in accordance with the fundamental principle underlying the 1991 tax reform. This norm means, for example, that all types of income must be taxed uniformly[3] and that all consumption of goods and services must be liable to the same value added tax rate. Deviations from uniform taxation are perceived as a *tax expenditure* if a group of taxpayers are granted a tax concession in comparison with the norm and as a *tax penalty* if a group of taxpayers are subjected to an excessive imposition of tax in comparison with the norm.[4] So, for example, under the norm, all regular income from capital is to be taxed at the same general rate of tax on income from capital of 30 per cent. The tax rate on the yield of private pension savings, for example, is, however, reduced to 15 per cent. Those who save in private pension plans are, consequently, granted a tax benefit. For the 2001 tax year, this tax expenditure is estimated at SEK 13 billion.[5] The purpose of the deviation is to create an incentive for individuals to save for their own pensions.

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Despite the fact that the tax system has been amended in a number of re-

[2] The fact that property taxes were and are regarded as part of the taxation of income from capital is due to the adoption of a model in which property acquisition is seen as a capital investment. According to this model, the acquisition of property generates a non-monetary housing yield which can be equated with the monetary yield on other capital investments. The housing yield is not directly observable, but it can be taxed through the imputation of a standard income to owner-occupiers, equivalent to a specific percentage of the estimated market value. It is not, however, obvious how the level of the standard income should be determined. Boije and Shahnazarian (2000) noted certain objections to the assessments made in connection with the tax reform and in the report of the Property Taxation Committee "Likformig och neutral fastighetsbeskattning", [Uniform and neutral property taxation] (SOU 2000:34).

[3] In the tax expenditure accounting, the government has chosen to apply the uniformity norm so that the taxation in each tax category should be uniform. Consequently, no analysis is made of whether, for example, the taxation of earned income and income from capital is uniform. In a strict application of the uniformity norm, any such tax expenditures should also be reported.

[4] A more detailed description is given in the report *Förmåner och sanktioner* (SOU 1995:36).

[5] See the 2001 Government Spring Bill, Appendix 3.

spects since the 1991 tax reform – the extent of the amendments is partly shown in the tax expenditure accounting – the fundamental principle is still that the tax system as far as possible should be uniform.

The theory of optimal taxation

According to the theory of optimal taxation, the tax system should be configured to minimise distortions in the economy.

Alongside the universal requirements which may be placed on the tax system, the economic literature provides theoretical models for configuring the tax system on the basis of different balances between efficiency in production and the distribution of consumption opportunities among citizens. From a pure efficiency perspective, optimal taxation theory says that the tax system should be configured so as to minimise distortions in the economy. By this is meant that the tax system should have the smallest possible effect on the alternative courses of action of households and companies. A uniform taxation of goods and services – which was one of the linchpins of the 1991 tax reform – is, under this theoretical approach, optimal, provided that there are no tax-free areas. This assumes, for example, that leisure can be taxed. The practical difficulties inherent in such a tax system are obvious, since it is in practice impossible to tax leisure.

An alternative theory says that distortions are minimised if goods and services with low price elasticity are taxed more severely than goods with high price elasticity.

An alternative theory says that distortions are minimised if goods and services with low price elasticity are taxed more severely than goods with high price elasticity.[6] Such taxes are commonly known as "Ramsey taxes". An obvious problem with such a tax system is that it can be difficult to combine with the goals of distribution policy. The theory says that essential commodities, such as staple foods – which are likely to have a relatively low price elasticity – should be taxed more severely than "luxury items", which are likely to have a relatively high price elasticity.[7] The consumption of essential commodities, measured as a percentage of household disposable income, is greater for low-income earners than for medium and high-income earners. A tax system based on Ramsey taxes would, therefore, have regressive elements, with the effect on disposable income being greater for low-income earners than for medium and high-income earners. Such a tax system also

[6] With low price elasticity, demand for a good is not appreciably affected by price changes.

[7] Atkinson and Stiglitz (1980) describe the theory of optimal taxation. See also Rosen (1999), which gives a less "technical" overview.

assumes that the price elasticity for all goods and services can be determined with an acceptable degree of precision.

Optimal taxation theory has not influenced the configuration of the current tax system to any great extent. Since leisure cannot be taxed, the present tax system, based on the norm of uniform taxation of different economic activities, cannot be optimal from a textbook perspective. A uniform tax system does, however, have other benefits; it fulfils the universal requirements which can be placed on a tax system and is easier to administer than a system of differentiated Ramsey taxes.

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The importance of internationalisation for the Swedish tax system

The effect of internationalisation on the tax bases

The ambitions of welfare policy are reflected in the scope and configuration of the tax system. A common way of measuring the tax burden is to calculate the tax ratio which relates total taxes to GDP. Measured in this way, Sweden, along with Denmark, has the highest tax burden in the world.[8] The conditions for a continued high tax burden in Sweden are not solely dependent on the value placed by citizens on the commitments of the general government sector. The continuing process of internationalisation places certain restrictions on how much tax the general government sector can collect from companies and households within the country's borders. Internationalisation is increasing the mobility of the tax bases. Both the destination principle in the taxation of goods and services, and the domicile principle in the taxation of income, are becoming increasingly more difficult to maintain.[9]

A common way of measuring the tax burden is to relate total taxes to GDP. Measured in this way, Sweden, along with Denmark, has the highest tax burden in the world.

[8] It should be pointed out that two different countries with similar welfare ambitions may have different tax ratios as a result of different technical solutions. In Sweden, the majority of benefits are taxable. In many other countries, benefits are tax-exempt or are given indirectly through subsidies in the tax system. The two latter arrangements give a lower tax ratio. In the Government Spring Bill for 2001, section 5.6, an attempt is made to estimate the tax ratios for several different countries taken these differences into account.

[9] The destination principle means the taxes on goods and services (such as value added tax) are payable in the country in which consumption takes place. The destination principle differs from the origin principle in which the tax is payable in the country in which the seller has established his business. The domicile principle in income taxation means that tax subjects (the household or the company) shall be taxed in their home country.

Global companies have long been able to influence their effective tax rates through a high level of geographical mobility which allows them to choose their tax jurisdiction. Deregulated capital markets and new facilities for moving financial capital electronically, have created global investment options for corporate and household financial saving. Consumers can increasingly shop in other countries – partly as a result of the Internet – and can, therefore, wholly or partially avoid taxation. Increasingly knowledge-intensive production and greater international competition for well-educated staff risks eroding both the earned income tax base and many other tax bases.[10]

The increased mobility of tax bases over national borders is creating an incentive for tax competition.

The increased mobility of tax bases over national borders is also creating an incentive for tax competition. A number of European countries have implemented extensive tax reforms, with tax rates being reduced and tax bases widened. The most extreme form of tax competition is the development of tax havens. The improved facilities for moving financial capital electronically has created completely new opportunities for the operations of tax havens. A number of well-known newly-established IT companies in Sweden have significant participating interests via holding companies in tax havens.[11]

The government has appointed a committee to investigate how the tax structure should be configured in a world of internationalised markets.

In the light of the continuing process of internationalisation, the government has appointed a committee – the Tax Base Committee – with the task of arriving at a collective assessment of how the Swedish tax structure should be configured in a world of internationalised markets. The committee will assess the mobility of tax bases and the time perspective in which increased mobility may emerge. The principal aim of the investigation is to create a better basis for the future prioritising of fiscal policy. It should be pointed out in this connection that government committees currently have the requirement imposed on them that any proposals the committees put forward must be neutral with respect to public finances. Calculations of government finances must also be based on the current year's tax bases, which means that it is not possible to take account of any "dynamic profits". If the Tax Base Committee were to propose that certain tax rates should be lowered in consequence of internationalisation, the financing

[10] See also: *Jakten på den försvinnande skatten* [Eklund (1998)]; *Vår förvaltning år 2010 – i globaliseringens spår* (RSV Rapport 2000:9); the directive for the Tax Base Committee (Dir. 2000:51) and *Den nya ekonomin* – Skatter [Andersson (2000), report, Industriförbundet].

[11] See Andersson (2000).

requirement means that other tax rates would have to be raised or certain expenditures reduced. Since the committee is, first and foremost, a committee of investigation into the tax structure, it is unlikely that it will propose any reductions in expenditure. This means in practice that any tax proposals the committee may put forward will not permit any reduction in the tax ratio. Under the directive, the Tax Base Committee is also bound by the restriction that any tax proposals the committee may put forward must allow welfare policy ambitions to be maintained at their current level. Strictly interpreted, this restriction means that the distribution of income and wealth must not be affected to any appreciable extent by the proposals put forward by the committee. It is, however, hardly possible to redistribute tax impositions to a great extent without substantially affecting the distribution of income and wealth.

Assessing the mobility of the Swedish tax bases is, obviously, a difficult task. In the next section, there is a brief qualitative discussion of the vulnerability of the various tax bases.

Capital taxation. One tax base which has been the subject of a great deal of discussion recently is the capital tax base. Undeclared foreign savings were estimated at SEK 353 billion at the end of 1998.[12] At an assumed average yield of 7 per cent and a domestic tax rate on income from capital of 30 per cent, this amounts to an annual loss on the tax on income from capital of just over SEK 7 billion (approximately 0.3 per cent of GDP). In addition, the state losses wealth tax revenue, since it may be assumed that a substantial proportion of foreign savings would be liable to wealth tax. As long as the Swedish tax authorities do not have the ability to control this, it is reasonable to assume that non-declared foreign saving will continue to increase. If Sweden were to join the single currency, exchange rate risks would be eliminated, which would further increase the incentive for households to move capital abroad.

Another question is the extent to which high capital taxation and the associated increase in saving abroad will affect the accumulation of real capital in Sweden and tax revenue in the long term. At the same time as saving abroad by Swedish households has increased, the proportion of foreign holders of Swedish shares has also risen. The proportion of foreign-owned shares on the Stockholm Stock Exchange

Foreign ownership on the Stockholm Stock Exchange has quintupled over the last nine years.

[12] It should be emphasised that this figure – which is the difference between the measures of saving in the National Accounts and the Financial Accounts – is subject to considerable uncertainty.

increased from 8.3 per cent in 1991 to 39.3 per cent in 2000[13]. Accordingly, foreign shareholdings on the Stockholm Stock exchange have quintupled over the last nine years. One hypothesis is that this phenomenon is a consequence of continuing economic integration. With this approach, it is possible to regard the inflow of foreign capital as wholly or partially compensating for the outflow of Swedish financial capital, in which case the effects on the accumulation of real capital in Sweden should be small. A more negative interpretation is that increased foreign ownership of shares on the Swedish stock market is due to the fact that Swedish holders of Swedish shares are taxed more severely that foreign owners of Swedish shares. From a strict real capital accumulation perspective, however, the circumstances of ownership are of secondary importance.

A substantial reduction in capital taxes would not necessarily jeopardise the public finances to any great extent.

The revenues from the taxation of income from capital and wealth taxes (excluding revenue from property taxes, stamp duty, inheritance taxes and gift tax) is estimated in the Spring Bill at SEK 28 billion for 2001. This is equivalent to 2.5 per cent of the general government sector's total tax revenue. A substantial reduction in capital taxes would not, therefore, necessarily jeopardise the public finances to any great extent.

Swedish corporation tax is – at least today – relatively competitive.

Company taxation. To what extent do international differences in company taxation affect tax revenues? Corporation taxation affects, in the first instance, real investment. A relatively high level of corporation tax in comparison to other countries will tend to reduce real investment in Sweden, and this will ultimately have a negative effect on tax revenue. Swedish corporation tax is, however, – at least today – relatively competitive. This is partly due to the fact that the nominal rate of corporation tax is relatively low, and partly on the opportunities to reduce the effective tax rate through accounting arrangements and tax-related adjustments. A number of European countries – including Germany and Ireland – have introduced or announced substantial reductions in corporation tax. If this trend continues, Swedish corporation taxation will be relatively less competitive.

Sweden currently applies double taxation to shares. The profits of limited companies are taxed first through corporation tax in the company, and then through dividend tax and capital gains tax at the shareholder stage. The debate on the loca-

[13] SIS Ägarservice AB.

tion of major multinational companies' head offices has brought to the fore the question of the effects that Swedish double taxation of corporate profits has on the real economy. In its two most recent reports on Sweden, the OECD recommended that Sweden review the policy of double taxation. In the economic literature there are, however, divided views on whether double taxation is detrimental to real investment in Sweden, and four different theories can be identified. To put it at its simplest, these theories lead to different conclusions depending on the assumptions made about who the marginal investors are (Swedish households, foreign investors or investors for whom the effective tax rate is zero, in particular tax-exempt institutions), and what constitutes the source of the marginal financing (borrowing, new issues or retained profits).[14]

In the economic literature, there are divided views on whether double taxation is detrimental to real investment in Sweden.

One consequence of internationalisation is that companies divide their operations globally, which means in practice that the companies have several physical domiciles. This situation can make it difficult to impute income to a specific country. The international taxation of companies must, therefore, also be taken into account in analysing the importance of tax rules for real investment and for the location of head offices. The fact that a company locates its head office abroad is, in principle, of secondary importance as regards tax revenue, as long as the company's earnings can be taxed in the home country.

Tax revenues from corporate taxation (excluding tax on yields) are estimated in the Spring Bill at SEK 51 billion for 2001, which is equivalent to 4.5 per cent of the general government sector's total tax revenues. Since Swedish corporate taxation can still be considered fairly competitive, no reduction in corporate taxes motivated by the process of internationalisation is to be expected in the near future.

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Given that a substantial proportion of the shares on the Stockholm Stock Exchange are currently owned by foreign residents and tax-exempt institutions, the elimination of double taxation – which can be achieved in a variety of ways[15] – would probably have limited effects on government finances. On the other

[14] See Shahnazarian and Stoltz (1999) for a summary of the various theories. See also Auerbach (forthcoming).

[15] The effects of double taxation can be mitigated or totally eliminated through a system, for example, in which a tax reduction or allowance compensates the investor for corporation tax (the imputation system). One problem with such a system is that it discriminates against investment abroad and foreign shareholders of companies operating in Sweden.

The elimination of double taxation on shares would probably have limited consequences on government finances.

hand, in view of the uncertainty surrounding the effects of double taxation on the real economy, it is difficult to give an unambiguous justification for such a tax reform. A high level of *total* taxation on the income from capital (corporation tax, dividend tax, capital gains tax and wealth tax) at the shareholder level does, however, create an incentive for Swedish investors to move *financial capital* abroad. To the extent that this is regarded as a greater problem for the economy than the double taxation of shares, there would probably be greater positive effects if, instead of abolishing double taxation on shares, the rate of tax on income from capital and wealth tax were reduced. The problem is, however, that there are other prioritised tax cuts on the political agenda. The cost to government finances of halving capital tax revenues[16] from tax on income from capital and wealth tax (approximately SEK 14 billion) is roughly equivalent to the cost of taking the reform of earned income taxation a stage further (including adjusting tax band thresholds).

Any reduction in the general rate of tax on income from capital resulting from the continued process of internationalisation would also give rise to a number of questions related to the "3:12 rules". These rules are intended to prevent the owners of close companies taking out earned income in the form of income from capital in order to benefit from more favourable tax treatment. The rules mean that a standard stipulated portion of income is taxed as income from capital, and the remainder is taxed as earned income. Owners of close companies who pay central government earned income tax of 25 per cent and who have earned incomes exceeding the benefit level of social insurance – in which case the social security contributions at the margin constitute a pure tax – have a marginal tax rate of 68 per cent[17] on the earned income portion. The tax on that part which is taken out as income from capital amounts to 49.6 per cent[17]. Any reduction in the general rate of tax on income from capital would make these differences even greater, in which case it could become necessary to adjust the proportion treated as income from capital. Two more general proposals which would also solve this problem are to reduce central government earned income tax or alternatively not to levy social security contributions on earned income which does not form the basis for benefits. This would, however, mean that two important income redistributing elements in the tax and benefit system would be reduced.

[16] Excluding revenue from property tax, stamp duty, inheritance tax and gift tax.
[17] According to figures provided by the Ministry of Finance.

Indirect taxes. With respect to the value added tax base, there are no reliable estimates of how much tax revenue the government is losing as a result of increased consumption abroad, cross-border shopping and Internet shopping. In relation to the total revenue from value added tax, which was estimated at SEK 189 billion for 2001 in the Spring Bill, the loss of this consumption is probably still relatively small, and there should, therefore, be no need for a general reduction in the tax rate in the short term. One reasonable scenario is that this type of consumption will increase, not least in view of the potential tax advantages enjoyed by foreign companies in the sale of goods and services via the Internet. This allows Swedish consumers to buy goods and services over the Internet at a significantly lower price than if these goods and services had been purchased in the conventional way.

The loss of tax revenue as a result of increased consumption abroad, cross-border shopping and Internet shopping is probably still relatively small.

Tax revenues from specific taxes on alcohol and tobacco – approximately SEK 19 billion – are also exposed to internationalisation. The high levels of specific taxes on tobacco and alcohol in Sweden create an incentive for smuggling. Membership of the EU is also putting pressure on Swedish alcohol taxes. The exemption from the import regulations which Sweden negotiated on joining the EU is being phased out, which means that it will be legal to import substantially larger quantities of wine, beer and spirits than at present. The Budget Bill for 2001 contained a proposal for a gradual increase in the import quotas. On the other hand, there was no proposal to reduce the specific taxes on alcoholic drinks. If the government wishes to maintain the sales volumes of Systembolaget, the Swedish Alcohol Retailing Monopoly, it is expected that alcohol duties will be reduced.

Taxation of earned income. Both the average tax rates and the marginal tax rates on earned income are very high in Sweden in comparison to most other countries. The average local authority income tax rate is about 31 per cent. For incomes over the "lower breakpoint", central government income tax is also payable at a rate of 20 per cent, and for incomes above the "upper breakpoint", central government income tax at 25 per cent is payable. In addition, a national old-age pension contribution is levied at a rate of 7 per cent of income up to a set income limit. With effect from 1 January 2001, there is a tax reduction equal to 50 per cent of the national old-age pension contribution. The remaining 50 per cent of the national old-age pension contribution is deductible in the income taxation on earned

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income.[18] Overall, this means that the marginal tax effect varies from 33.4 to 56 per cent, given a local authority tax rate of 31 per cent. The weighted average marginal tax rate on earned income currently amounts to approximately 42 per cent, according to information from the Ministry of Finance.

The ability to attract foreign workers to Sweden depends on whether the taxation of earned income is competitive.

The question is how the high level of tax on earned income affects the mobility of the earned income tax base. In the literature and the debate, the earned income tax base is usually regarded as relatively immobile. Language barriers, cultural differences and strong links to the mother country are perhaps more important factors than the tax burden. A greater threat is that there is a risk with a high level of taxation on earned income that a number of well-educated Swedes will move abroad. The effect of this emigration on the tax base is presumably marginal in the short term, but for economic growth and future tax revenues it is important both to retain highly-educated Swedes and to attract foreign workers. This latter point is particularly important, since current demographic trends, with an increasing proportion of elderly people in the population, mean that there will be fewer workers to support a larger number of non-working individuals. The Long-term Planning Commission has noted that the need to import labour will increase in such a situation. The ability to attract foreign workers to Sweden will depend, among other things, on whether the taxation of earned income in Sweden is competitive – which is hardly the case today.[19]

The ability to maintain a high tax burden

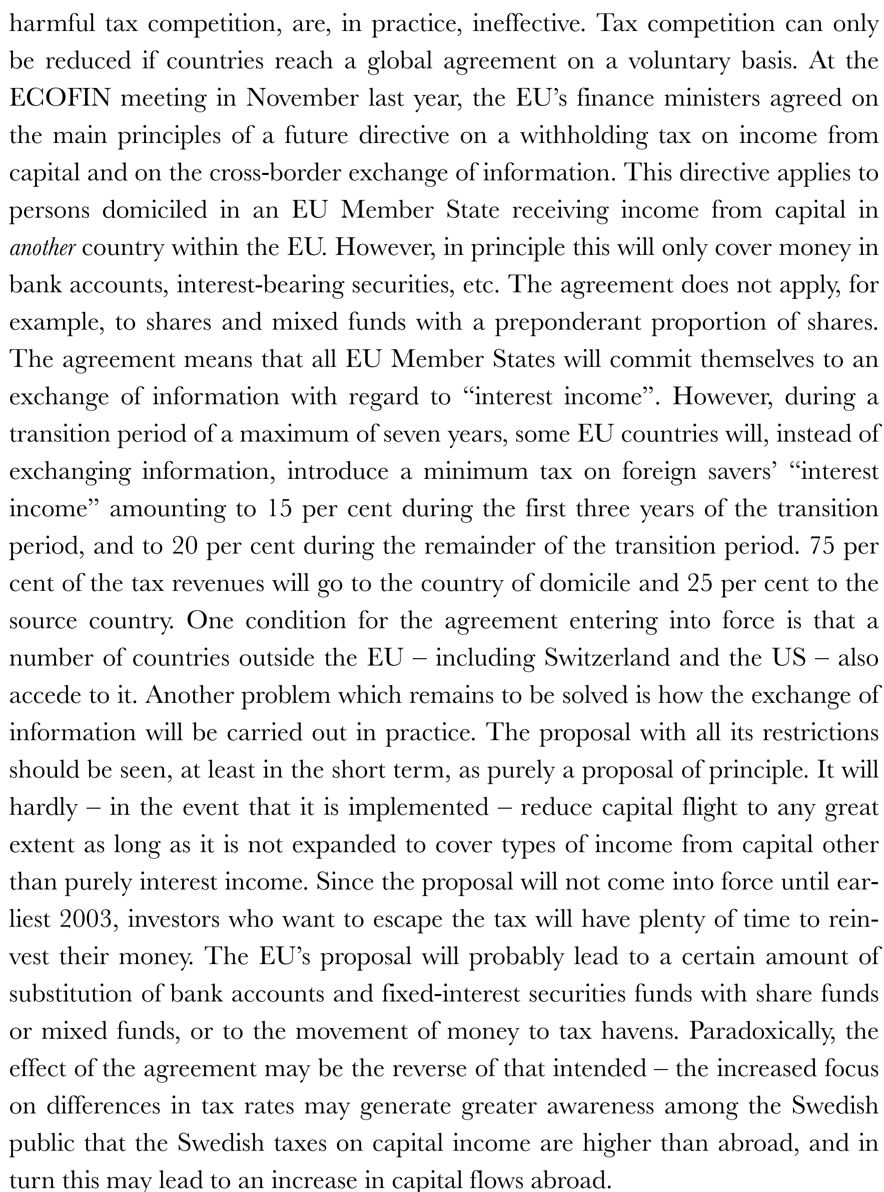
Last year, the EU's finance ministers agreed on the fundamental principles of an agreement on a withholding tax on income from capital.

EU rules on minimum tax rates, disclosure requirements and tax competition. Since every nation state has, in principle, the right to decide for itself how much tax is to be raised from inhabitants and companies within the nation's borders, there is no legal mechanism to counteract either tax competition[20] or the activities of tax havens. The OECD's black list of tax havens, and the EU's campaign against

[18] With a local authority income tax rate of 31 per cent, the effect of this structure is that the marginal tax effect of both local authority tax and the national old-age pension contribution amounts to approximately 33.4 per cent [0.31+0.07-0.5x0.07-0.5x0.07x0.31)=0.334]. For income above SEK 304,200, no national old-age pension contribution is payable, i.e. for income above this level, the national old-age pension contribution does not contribute to raising the marginal tax effect.

[19] On 1 January 2001, however, a tax reduction was introduced for foreign experts.

[20] It is sometimes argued that some degree of tax competition can be beneficial, since it may lead to alternative forms of financing and a more efficient use of tax revenues.



harmful tax competition, are, in practice, ineffective. Tax competition can only be reduced if countries reach a global agreement on a voluntary basis. At the ECOFIN meeting in November last year, the EU's finance ministers agreed on the main principles of a future directive on a withholding tax on income from capital and on the cross-border exchange of information. This directive applies to persons domiciled in an EU Member State receiving income from capital in *another* country within the EU. However, in principle this will only cover money in bank accounts, interest-bearing securities, etc. The agreement does not apply, for example, to shares and mixed funds with a preponderant proportion of shares. The agreement means that all EU Member States will commit themselves to an exchange of information with regard to "interest income". However, during a transition period of a maximum of seven years, some EU countries will, instead of exchanging information, introduce a minimum tax on foreign savers' "interest income" amounting to 15 per cent during the first three years of the transition period, and to 20 per cent during the remainder of the transition period. 75 per cent of the tax revenues will go to the country of domicile and 25 per cent to the source country. One condition for the agreement entering into force is that a number of countries outside the EU – including Switzerland and the US – also accede to it. Another problem which remains to be solved is how the exchange of information will be carried out in practice. The proposal with all its restrictions should be seen, at least in the short term, as purely a proposal of principle. It will hardly – in the event that it is implemented – reduce capital flight to any great extent as long as it is not expanded to cover types of income from capital other than purely interest income. Since the proposal will not come into force until earliest 2003, investors who want to escape the tax will have plenty of time to reinvest their money. The EU's proposal will probably lead to a certain amount of substitution of bank accounts and fixed-interest securities funds with share funds or mixed funds, or to the movement of money to tax havens. Paradoxically, the effect of the agreement may be the reverse of that intended – the increased focus on differences in tax rates may generate greater awareness among the Swedish public that the Swedish taxes on capital income are higher than abroad, and in turn this may lead to an increase in capital flows abroad.

The ECOFIN agreement also includes a timetable for a code of conduct in the corporate taxation area which is intended to limit "harmful" tax competition. An EU working group has identified 66 harmful measures in the company tax area.[21]

[21] See the "Primarolo Report": "Report from the Code of Conduct Group to ECOFIN Council on 29 November 1999".

These are, in principle, to be removed before 2005. The code of conduct means, for example, that countries which aim to attract foreign companies will not be able to apply a lower rate of corporation tax to foreign-owned companies than they do to domestically-owned companies. The proposal will not, however, prevent EU countries competing with each other through a generally low rate of corporation tax.

At the same time as the Swedish government is campaigning for rules which prevent tax competition in capital and corporate taxation, it is contributing to increased competition in other tax areas.

At the same time as the Swedish government is campaigning for rules which prevent tax competition in capital and corporate taxation, it is contributing to increased competition in other tax areas. As from 1 January this year, foreign experts, researchers and other key individuals who are temporarily resident in Sweden have been granted tax privileges in the form of reduced income tax and social security contributions.[22] The government also intends to introduce tax privileges for professional fishermen with the aim of improving their international competitiveness.[23] Tax exemption for the principal shareholders in previously unlisted shares can also be seen as a result of tax competition.[24]

Redistribution of the tax levy with an unchanged total tax burden. The ability to have a tax burden in Sweden which is higher than in other countries will in future be dependent on the political opportunities to redistribute the tax levy from tax bases which are highly exposed to internationalisation to tax bases which are less exposed. A realignment of this type would mean, for example, that real capital – particularly property – would be taxed more severely than financial capital, that earned income would be taxed more severely than income from capital, that "mobile" high earners would be taxed more gently than today, at the expense of continued income tax reductions for "immobile" low earners, and that essential commodities such as staple foods would be taxed more severely than capital goods, luxury items and items which can be bought abroad through

[22] The proposal means that 25 per cent of the salary that key individuals receive is exempted from income tax and social security contributions for a maximum of three years.

[23] See the Budget Bill for 2001 and the 2001 Government Spring Bill.

[24] This asymmetrical taxation of wealth means, for example, that owner-occupiers for whom the home constitutes their only wealth have to pay wealth tax, while far wealthier individuals – who, moreover, have a more liquid form of wealth – wholly escape wealth tax. These asymmetries in wealth taxation may possibly be defended from an internationalisation perspective, but nevertheless they give rise to difficult questions for distribution policy. Nor does the government record these asymmetries as tax expenditures. This is possibly a consequence of the fact that it is difficult to find a theoretical norm for wealth tax. Provided that wealth tax is levied for purely fiscal reasons, a consistently applied uniformity norm would, however, mean that asymmetries in wealth taxation would be recorded as tax expenditures.

Internet or cross-border shopping. A tax system of this kind is, consequently, based on the reasoning of optimal taxation theory. Over and above the fact that it is easier with such a tax system to maintain the tax revenues of the general government sector in a world of internationalised markets, it also reduces efficiency losses in the economy.

It is politically difficult to maintain the levy from property taxes during periods in which tax assessment values are increasing sharply.

Even if it was possible for a taxation system based on optimal taxation theory to maintain a high tax burden in Sweden in a world of internationalised markets, there are a number of other associated problems. A tax system of this type would be a major departure from the intention of the 1991 tax reform of uniform taxation of different economic activities. A greater disparity between the taxation of income from capital and earned income than is found today[25] may lead to further horizontal unfairness, since there is a risk that households in similar financial circumstances would be treated differently.[26] A system of this type also creates new incentives for tax planning and tax evasion. With respect to the taxation of real capital – and in particular of property – the political debate on property taxation on owner-occupied houses shows that it is politically difficult to maintain the levy from property tax during periods in which tax assessment values are increasing sharply. As a result of the pressure of public opinion, the rate of property tax on owner-occupied houses has been cut from 1.7 to 1.2 per cent over the last five years. After such tax cuts, it would require a substantial input of political persuasion to plead for an increase in the property tax rate with the aim of maintaining tax revenues in the face of continued internationalisation. If the general rate of tax on income from capital is reduced, and if the symmetry in the remaining part of the tax system is to be maintained, then the tax relief on interest and the tax reduction for interest expenditure should be cut, with all the problems for distribution policy that would entail. Higher capital taxes on real capital than on mobile financial capital is politically difficult to justify if the intention is to encourage the accumulation of real capital. Taxing essential commodities such as food more severely than capital goods and luxury items is difficult to reconcile with the goals of distribution policy. Reducing income tax for mobile high-earners runs contrary to the government's explicit goal of reducing income tax for low earners.

[25] On average, the taxation of earned income is higher than the taxation of, for example, interest income, which amounts to 30 per cent. For taxpayers who pay only local authority income tax, the average tax is, in principle, equivalent to that on interest income.

[26] The principle of horizontal fairness means that individuals or taxable entities with equal income or financial capacity shall pay the same amount of tax.

One means of maintaining the tax burden is to widen the tax bases.

A further means of maintaining the tax burden is to widen the tax bases. But the tax bases were already widened substantially in the 1991 tax reform, and the question is how much further they can be widened. It ought, however, to be possible to abolish a number of tax expenditures. An inventory of the tax expenditure appendix in the Spring Bill reveals that if tax expenditures which are not directly justified from the perspective of internationalisation are abolished, this would bring in at least SEK 50 million to the exchequer.[27] This option, however, also looks politically complicated. Tax expenditures can be justified for reasons other than maintaining tax revenues in a world of internationalised markets.

It appears to be difficult to redistribute the tax levy to any great extent from mobile to less mobile tax bases.

Consequently, it appears to be difficult to redistribute the tax levy to any great extent from mobile to less mobile tax bases. It should also be pointed out that even if a redistribution of the tax levy at a given total tax burden was possible, it is not an obvious solution to the problem that de facto it is the total tax burden which is the determining factor in tax evasion. The potential effects on the tax bases of the continuing process of internationalisation look even more worrying if the effects of demographic trends on government finances are also taken into account.

Demographic trends

The consequences of demographic trends for both the macroeconomy[28] and public finances have been noted in a number of connections in recent years. In the "Stockholm Report"[29], the Commission and ECOFIN urged member states to take account in good time of the effects of demographic trends on future public finances. In the judgement of the Ministry of Finance[30], the proportion of pen-

[27] Examples of large tax expenditures which are not justified from an internationalisation perspective and the size of these (see the Spring Bill): reduced value added tax on foodstuffs (SEK 15.7 billion), VAT exemption for lotteries (3.6), employer's costs for employees' pensions (3.3), tax benefit for personal computers (1.4), deduction for travel to and from work (4.5), yield on single-family houses (1.7), employment subsidies (1.8), reduction in social security contributions for small companies (5.9) and tax exemption for biofuels (7.6).

[28] See, among others, Lindh (2000).

[29] Report from the Commission and the (ECOFIN) Council to the European Council (Stockholm, 23/24 March, 2001).

[30] See, among others, the Long-term Planning Commission (SOU 2000:7) and Sweden's updated convergence programme.

sioners in the population will increase markedly from 2008, while the proportion of persons of working age will fall. From 2020, it is estimated that the proportion of the population over the age of 80 will increase dramatically. This trend will lead to a situation where tax revenues are increasing more slowly, while at the same time the general government sector's costs for treatment and care are increasing. In Sweden's updated convergence programme, it is emphasised that any tax reforms over the next few years should, therefore, be placed in a long-term perspective. It is, however, remarkable that the process of internationalisation is given only marginal space in both the "Stockholm Report" and in Sweden's updated convergence programme.

Alongside the expenditure ceiling, a net lending target is being applied, which means that the government has as a target that public finances shall, on average, show a surplus of 2 per cent over the business cycle. One aim of this target is to create a stable financial base to meet the effects on public finances of future demographic changes. According to assessments carried out by the Ministry of Finance, provided that the net lending target is achieved until 2015, despite the negative effects of demographic changes on public finances, there will be scope for both some increase in expenditure and some reduction in the tax ratio. It should, however, be emphasised that, in these forecasts, the government has not taken account of any tax losses caused by the continuing process of internationalisation.

The government has announced that it intends to review early retirements resulting from private pension agreements.

In the "Stockholm Report", the Commission and ECOFIN urged member states to review the taxation of earned income, partly in the light of the future negative effects on the supply of labour of demographic trends. The reform of the taxation of earned income which the government initiated in 2000 is a step in this direction. The government has also announced that it intends to review early retirements resulting from private pension agreements signed between employers and employees. Such a review may also include a review of central government tax subsidies on private pension saving. Private pension plans benefiting from tax concessions can mean that many taxpayers choose to retire before reaching the age of 65 (under current rules, a private pension plan can pay out from the age of 55), which contributes to the reduction in the total supply of labour. Seen solely against the background of demographic changes and their future effects on tax revenues and expenditure, this tax incentive is not optimal. Subsidising private pension saving is, moreover, a

departure from the intention of the 1991 tax reform of achieving a uniform taxation of income from capital.[31]

Membership of the EU

Membership of the EU places certain restrictions on the configuration of the tax system and the opportunity to pursue an independent tax policy. The EC's rules on state aid, the convergence criteria, the Stability and Growth Pact, the Broad Economic Policy Guidelines and the exercise by the Commission of "peer pressure" against countries which, in the view of the Commission, are pursuing a procyclical fiscal policy are some examples.

National sovereignty on tax matters versus the EC's rules on state aid. Every member state has, in principle, the right of veto on tax matters. The EC's rules and regulations on state aid are, however, also applicable to certain tax matters. It is the Commission which interprets the state aid rules and approves or prohibits any state aid resulting from either direct transfers or tax reductions. An appropriate example can be found in alcohol taxation. In Sweden wine is taxed relatively more severely than beer, even after allowing for the alcohol content. Indirectly, this means that the Swedish alcohol regulations favour Swedish beer producers and discriminate against wine producers in other EU countries. There are, however, some obscurities in certain cases as to how the rules on state aid are to be interpreted. Should, for example, the various reductions in energy and carbon dioxide tax rates targeted at industry – the aim of which is not to impair the international competitiveness of Swedish companies – be regarded as illegitimate state aid?

It is possible for the EU to interfere in Swedish tax legislation despite the fact that Sweden has, in principle, the right of veto in tax matters.

To the extent that the EC's rules on state aid appear to be applicable in the tax area also, it is possible for the EU to interfere in Swedish tax legislation despite the fact that Sweden has, in principle, the right of veto in tax matters. If, for example, the general reduction of the carbon dioxide tax to industry – which, in the current tax expenditure accounting, the government does not regard as a tax expenditure since the abolition of the reduction would lead to an increase in emissions of carbon dioxide in the surrounding world –

[31] If it is considered that private pension saving should be encouraged through tax benefits without it leading to early retirements, the earliest age at which private pensions may be paid can be raised.

should prove to be covered by the EC's rules on state aid, the government would have two options: either to abolish the reduction completely, which would have a detrimental effect on the international competitiveness of industry and would have negative effects on employment, or to reduce the general carbon dioxide tax, which would have consequences for both public finances and the environment.[32]

The convergence criteria, the Stability and Growth Pact, the Broad Economic Policy Guidelines and peer pressure. At the meeting of the Council of Ministers in Lisbon in March 2000, it was decided that a report should be presented during Sweden's presidency in spring 2001, with the aim of determining the effect of fiscal policy on economic growth and unemployment. The report would pay particular attention to the high level of earned income tax on low-earners, the role of public expenditure in the accumulation of real and human capital, as well as to the question of the long-term sustainability of public finances, partly in the light of demographic trends. In December 2000, the Commission completed a report[33] which later formed the basis for the above-mentioned "Stockholm Report", the conclusions in which will form part of the Broad Economic Policy Guidelines. In the Commission's original report, reference was made to a previous Commission report – *Public Finance in EMU* – in which four criteria were put forward for use in assessing whether a tax reform could lead to a permanent reduction in the tax ratio without breaching the requirement in the Treaty of Maastricht that a budget deficit must not exceed 3 per cent. As a first step, member states should meet the goal set in the *Stability and Growth Pact* that budget restructuring should lead as soon as possible to a budget "close to balance or in surplus" so that the goal[34] established by the European Council of Ministers in Lisbon will be achieved. Secondly, any reforms must not be pro-cyclical. Thirdly, attention should be given to indebtedness and the long-term sustainability of the budget before expensive tax reforms are implemented. And finally, tax reforms must be part of an overall reform package. The first criterion means that tax reductions which are not *compensated for* (through raising other taxes or reduc-

[32] From an economic perspective, the EC's rules on state aid are in parts, remarkable. In some respects they prohibit selective tax reductions to trade and industry even if the tax rates after the reduction are higher than the EU average tax rates.

[33] "The Contribution of Public Finances to Growth and Employment: Improving Quality and Sustainability", COM (2000) 846 final.

[34] At the European Council of Ministers meeting in Lisbon, a new strategic goal was set for the EU: "*to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion*".

tions in expenditure) may only be implemented if the targets of the *Stability and Growth Pact* are met. The second criterion is necessary to avoid any unjustified structural deterioration in the public finances. The third criterion means that member states which have a level of indebtedness which exceeds the reference value of 60 per cent should aim to clear their debts before carrying out expensive tax reforms. The fourth criterion means that tax reforms should be directed at reducing distortions in the economy. Member states have not undertaken to adopt the four tax criteria. The "Stockholm Report" writes in rather vaguer terms …"to meet the short-run challenges, and consistently with the Stability and Growth Pact, the Council and the Commission affirm the need to avoid pro-cyclical fiscal policies, especially by strict expenditure control." Thus, no direct prohibition of pro-cyclical tax policy has been announced. The Commission's "naming" of Ireland shows, however, that peer pressure will be exercised against countries pursuing a pro-cyclical fiscal policy.

The estimated structural budget balance should give an indication of whether the fiscal policy being pursued is sustainable in the medium term.

In the "Stockholm Report", the Commission and ECOFIN also point out that estimates of *structural budget balances* should be used to complement other methods of analysing the structural position of the public finances. The estimated structural budget balance factors out the effects of the business cycle on the actual budget balance and, consequently, show how large the budget surplus/deficit would be if the economy were not in a boom or recession. Even though the estimated budget balance is not free of significant problems in method and measurement, it should give an indication of whether the fiscal policy being pursued is sustainable in the medium term, and whether there is a risk that any tax reductions would be pro-cyclical. As was stated by Lindh and Ohlsson (2000), among others, in recent decades Swedish fiscal policy has had substantial pro-cyclical elements. Even though the Swedish government has not undertaken not to make pro-cyclical tax reductions, the net lending target should be a factor in avoiding such tax cuts.

The expenditure ceiling creates an incentive for new tax expenditures

The Swedish budget process was tightened up in 1997. The Swedish parliament, the Riksdag, now lays down expenditure ceilings every year for the next three-year period. Expenditure on the expenditure side of the budget is, therefore, examined every year. This does not apply to proposals on the income side. Spe-

cialist ministries can, therefore, in principle circumvent the expenditure ceiling by proposing tax reliefs linked to the expenditure area. Even if the tax expenditure accounting to some extent elucidates any special legislation resulting from the circumvention of the expenditure ceiling, this accounting would not constitute a formal obstacle to such a procedure, which would – if it was used to a sufficiently large extent – risk undermining the purpose of the expenditure ceiling. One proposal which has been discussed which would prevent such a procedure is that the tax expenditure calculations should be integrated in allocations in the sense that changes in tax expenditures would always lead to a correction in both the total expenditure ceiling and the allocation to the various specialist ministries. A tax expenditure can in principle be replaced – in the event that it is abolished – by a direct allowance to those liable to pay the tax who were originally covered by the tax expenditure. In contrast to a tax expenditure, such an allowance would be recorded as an expenditure on the expenditure side of the budget, and would, accordingly, be covered by the expenditure ceiling. Such a total integration, however, is associated with significant technical problems[35], and is, therefore, hardly realistic, at least not in a short-term perspective.

Specialist ministries can circumvent the expenditure ceiling by proposing tax relief linked to the expenditure area.

Against the background of the process of internationalisation, it is relevant in this connection to ask whether it is appropriate to have a tax expenditure accounting based on the principle of uniform taxation of different economic activities. An example from the field of energy taxation illustrates the problem. The lower rate of carbon dioxide tax applied to industry is regarded in the current tax expenditure accounting as constituting part of the norm, since any abolition of the reduction would lead to a greater emission of carbon dioxide in the surrounding world. This is already a departure from a consistently applied uniformity norm. Another example of where it should be possible to justify applying different standards is in the taxation of capital. There may be reasons from an internationalisation perspective to tax real capital more severely than financial capital. Against that background,

Does it make sense to have a norm of uniform taxation to the maximum extent possible, but deviating from this norm where internationalisation requires it?

[35] Due to a shortage of relevant data, it is not, for example, possible to quantify all tax expenditures. How should non-quantifiable tax expenditures be handled in the budget process? Should changes in the size of existing tax expenditures caused by nominal changes in the tax bases lead to a correction in allocations and expenditure ceilings, or should only the introduction or abolition of tax expenditures lead to a correction?

does it make sense to have a norm of uniform taxation as far as possible, but deviating from this norm where internationalisation requires it, for example in capital and energy taxation? In the latter case, any departures from uniform taxation would not be regarded as tax expenditures. Even though the application of different norms can be justified from this perspective, it risks undermining the present purpose of tax expenditure accounting. It would also be a major departure from the intention of the 1991 tax reform. Provided that the government holds on to the uniformity norm in establishing subsides and sanctions in the tax system, deviations from the norm can be justified using arguments of efficiency or distribution. With this kind of approach, a relatively high level of taxation on immobile tax bases can be seen as a tax sanction which is justified by the process of internationalisation.

Fiscal policy over the next few years

This concluding section discusses the tax changes which were announced in the Budget Bill for 2001 and the Spring Bill for 2001. The discussion focuses first of all on tax reforms which relate partly to what has been said above about challenges facing fiscal policy in the longer term, and partly to the discussion of the fundamental starting points for the tax system.

From the perspective of the effects of demographic trends on the total supply of labour, the reform of the taxation of earned income is central.

Taxation of earned income. Since the 1991 tax reform, the tax system has been changed in a number of respects, which included raising the marginal tax effects through the introduction of general social security fees.[36] In tax year 2000, however, the government instituted a reform of the taxation of earned income aimed at compensating taxpayers for the general pension fee. The intention was also to reduce the high marginal effects in the tax system. The government announced that the compensation would be phased in gradually, and would take the form of a tax reduction. This year, the second stage of the reform was implemented, which involves giving the taxpayers a tax reduction equivalent to 50 per cent of the general pension fee. Alongside the compensation for the general pension fee, the government's goal, through an adjustment of the tax bands for income taxation, is to reduce the proportion of persons paying central government income tax to 15 per cent. For 2001, the tax bands have been adjusted

[36] The general social security fees were introduced in 1992 as part of the "crisis agreement" but has, since then, been changed on a number of occasions. Since 1998, the general social security fees consist only of a general pension fee, which as of 2000, amounts to 7 per cent of the contribution basis.

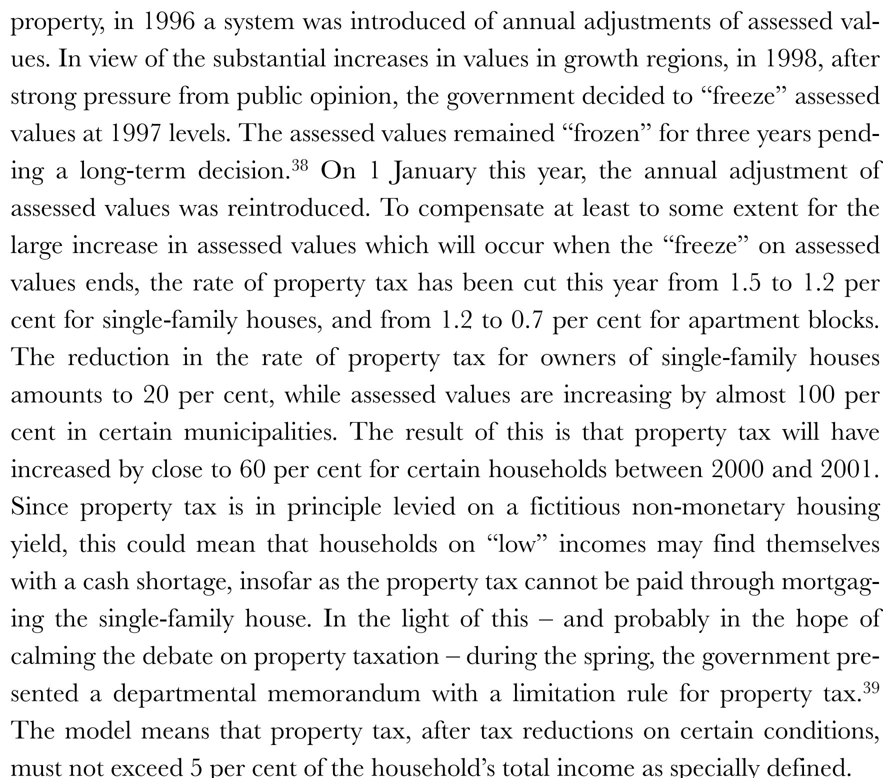
so that 17 per cent of taxpayers are expected to pay central government income tax. The government has announced that any third and fourth stages in the reform of the taxation of earned income during 2002 and 2003 are conditional, among other things, on the outcome of wage negotiations. Another "restriction" the government has to grapple with is the Commission's recommendation to avoid pro-cyclical tax reductions. If the production gap closes or even becomes positive and remains so for the next two years, there is a risk that the final two stages in the reform – in the event that they are implemented during 2002 and 2003 – would become pro-cyclical. The reform is, however, directed partly at the supply side of the economy, since it will hopefully, along with the reform involving a ceiling for daycare fees, produce positive effects on the supply of labour. From the perspective of the effects of demographic trends on the total supply of labour, the reform of the taxation of earned income is, therefore, central.

The "Tax Balance Committee's" view is that there is scope for a "green tax swap" during the period 2001–2010 of around SEK 30 billion.

Green tax swap. On 1 January this year, a budget-neutral green tax swap took place; the specific taxes on electricity and fuel were raised, at the same time as the basic deduction in the earned income taxation was raised and social security contributions were cut. A green tax swap of this nature has the advantage that it increases the environmental relevance of the tax system, and also has the potential to increase the supply of labour. In the Budget Bill for 2001, the government refers to the "Tax Balance Committee's" view that there is scope for a green tax swap during the period 2001–2010 of around SEK 30 billion. A major problem with such an extensive tax swap is that it will probably have significant distribution effects, something which the government also notes in the Budget Bill. Increased energy taxes often have regressive effects, since the consumption of energy measured as a percentage of disposable income is greater for low earners than for high earners. The EC's rules on state aid are also a problem in this connection. These rules may make it difficult to raise general environmentally-related tax rates and, at the same time, grant exemptions to those sections of industry which are exposed to competition.[37]

Property tax. So that the assessed values of properties should more accurately reflect market values in the years between the general assessment for taxes on real

[37] On 19 April this year, the government appointed a parliamentary committee to investigate the framing of rules for reducing energy tax for certain sectors. The committee will analyse and propose suitable criteria for deciding what activities are considered to be exposed to competition and the extent to which this would justify energy tax reductions.



property, in 1996 a system was introduced of annual adjustments of assessed values. In view of the substantial increases in values in growth regions, in 1998, after strong pressure from public opinion, the government decided to "freeze" assessed values at 1997 levels. The assessed values remained "frozen" for three years pending a long-term decision.[38] On 1 January this year, the annual adjustment of assessed values was reintroduced. To compensate at least to some extent for the large increase in assessed values which will occur when the "freeze" on assessed values ends, the rate of property tax has been cut this year from 1.5 to 1.2 per cent for single-family houses, and from 1.2 to 0.7 per cent for apartment blocks. The reduction in the rate of property tax for owners of single-family houses amounts to 20 per cent, while assessed values are increasing by almost 100 per cent in certain municipalities. The result of this is that property tax will have increased by close to 60 per cent for certain households between 2000 and 2001. Since property tax is in principle levied on a fictitious non-monetary housing yield, this could mean that households on "low" incomes may find themselves with a cash shortage, insofar as the property tax cannot be paid through mortgaging the single-family house. In the light of this – and probably in the hope of calming the debate on property taxation – during the spring, the government presented a departmental memorandum with a limitation rule for property tax.[39] The model means that property tax, after tax reductions on certain conditions, must not exceed 5 per cent of the household's total income as specially defined.

The Ministry of Finance's tax reduction model will contribute – in the event that it is introduced – to the already high marginal effects in the tax system being increased further, which is unfortunate from the perspective of the effects of demographic trends on the supply of labour. Furthermore, the tax on income from capital – in this case the property tax – under the Ministry of Finance proposal would be dependent on the size of earned income. This would be a clear departure from the dual income tax model which was introduced with the 1991 tax reform.[40]

From the perspective of internationalisation, it may, as stated above, be important to maintain or even increase the tax revenues from immobile tax bases,

[38] The political debate surrounding property tax has also involved discussion of whether the taxation of the different forms of tenure is uniform. In an article in this issue of the Economic Review, Peter Englund analyses the tax neutrality between leasehold and ownership forms of tenure. The effect of interest subsidies is not, however, discussed in his article. See the report of the Property Taxation Committee, Chapter 11, SOU 2000:34, for an analysis of the influence of the interest subsidy system on the tax neutrality of leasehold and ownership forms of tenure.

[39] En begränsningsregel för fastighetsskatten genom skattereduktion, memorandum, Ministry of Finance, March 2001.

[40] See also Riksbanken's comments on the Ministry of Finance proposals, 01-517-DIR.

such as the property tax base. It is relevant to ask in this connection if a limitation rule of the kind the Ministry of Finance proposes will calm the debate and improve the ability to maintain the property tax levy in the future. A number of factors suggest otherwise. Firstly, the limitation rule is so structured that the majority of households on "normal" incomes, who bought single-family houses on large mortgages a few years ago, and who could not foresee the substantial increase in assessed values, will not benefit from the tax reduction despite the fact that they may have the same type of liquidity problem that the rule solves for households with lower incomes. Secondly, assessed values will increase further in 2002 in certain growth areas as a result of the continued increase in the prices of single-family houses. At the next general assessment for taxes on real property for single-family houses in 2003, there is a risk of assessed values in certain areas increasing further, as price rises in "value areas" feed through into assessed values. In the years between general assessment for taxes on real property it is the price rises in "price trend areas" which feed through into assessed values. These price trend areas contain a number of value areas with varying price trends. Since the price trends within a price trend area can vary substantially, the assessed values on certain properties may rise sharply at the general assessment for taxes on real property in 2003 even though the average price level would not have changed after the valuation in 2002. Thirdly, the limitation rule does not cover wealth tax, which – for households with low or middle range incomes with their own home as their only wealth – may also give rise to a liquidity problem while assessed values are increasing.

The problems with property taxation should be seen in a wider perspective. For the vast majority of wage earners, the increases in property tax in recent years is wholly or partially outweighed by the tax reduction for the general pension fee. From the perspective of the national economy – not least given the negative effects of demographic trends on the supply of labour – a high property tax levy may be justified to allow lower taxes on earned income. It would, however, require a great deal of political persuasion to explain this to owner-occupiers whose current perception is that the property tax is unjust. The problems caused by the property tax in recent years in growing regions and in the archipelago are entirely due to the close link between assessed values and market values. On average for the country as a whole, the property tax levy does not really constitute a major problem. If the most important purpose of the property tax in the future is to safeguard tax revenues in a world of internationalised markets,

From the perspective of the national economy, a high property tax levy may be justified to allow lower taxes on earned income.

it is not necessary to link the property tax to the market values. Nor, from this kind of perspective, is there any obvious reason to justify the property tax on owner-occupied houses as part of a symmetrical taxation of income from capital.

Summary

In this paper, a number of future fiscal policy challenges have been identified and discussed. The process of internationalisation, increased tax competition, membership of the EU, the restrictive budget process with expenditure ceilings and a net lending target along with future demographic trends are all factors which ought to be taken into account in assessing how the Swedish tax system can be configured in the future. The government and the Riksdag are facing an intricate problem of achieving balance between different tax policy goals in both the short and long term. The fact that the public finances are not currently a problem, that Sweden has, periodically, been able to combine high growth with a high tax burden, and that the effects of internationalisation and tax competition are regarded as relatively small today, must not be used to justify the view that nothing needs to be done in the near future. A major effort in political persuasion will be required to implement a tax reform in which immobile tax bases are taxed more severely than less immobile tax bases, not least in the light of the problems with distribution policy and the debate on the configuration of property tax. Further reductions in income tax for low earners are desirable, but there is a risk that they may have to be sacrificed in a world where other tax bases are more exposed to internationalisation – unless the government is prepared in the long run to reduce the total tax burden.

It may not be possible or even desirable, in a world of internationalised markets, to maintain the principle of uniform taxation of economic activities.

Any discussion of tax policy priorities over the next few years must, of necessity, also include a discussion of the principles on which the tax system should be based. It may not be possible or even desirable, in a world of internationalised markets, to maintain the principle of uniform taxation of economic activities. The principles which underlay the "tax reform of the century" in 1991 are, perhaps, now – ten years later – no longer optimal from the perspective of the long-term challenges facing the tax system.

It is possible that it will be difficult in future to maintain the tax burden at today's level. Let us assume, hypothetically, that it is considered necessary in the future to reduce the Swedish tax ratio to the average EU level. Such a reduction

would require that tax revenues be cut by approximately SEK 200 billion. In such a situation, a number of questions arise: Which taxes shall in that case be cut? What alternative sources of finance are available? How will the goals of distribution policy be achieved in such a situation? Which public sector activities will be prioritised?

It is possible that it will be difficult in future to maintain the tax burden at today's level.

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