

Summary

SNS Economic Policy Council Report 2018. How Should Capital Be Taxed? A Swedish Perspective

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English summary of a report in Swedish with the title "Kapitalbeskattningens förutsättningar"

Almost 30 years have passed since Sweden reformed its tax system in 1991. Since then, both society and the tax system have undergone major changes. Much attention has been paid to labor income taxation, but the changes in capital taxation and the increases in wealth and capital income have been at least as significant. The basic principles of the tax system concerning uniformity and neutrality have been abandoned. Rapid capital growth has created opportunities for investment and growth, but also prompted concerns about growing inequality with social and political repercussions.

The SNS Economic Policy Council Report 2018 analyzes and discusses the state of capital taxation in Sweden. The analysis is based on current theoretical and empirical research in the field of economics of taxation, and on facts relating to the structure of the economy and the tax system.

The report emphasizes that a tax system must be designed to account for both economic

efficiency and distributional outcomes. An efficient tax system encourages people to make an effort and minimizes economic distortions. An equitable tax system takes into account how income from labor and ownership of capital affect the distribution of welfare and the need for redistribution.

An additional aspect is the political economy aspects of capital taxation. Taxes are decided in a political context, and achieving the objectives of efficiency and equity is constrained by political feasibility. The aim of achieving an efficient and equitable tax system must therefore take into account public acceptance of the tax system as a whole.

Our analyses and recommendations aim to provide guidance on how future capital taxes should be designed after taking all the above aspects into account.

Should capital be taxed?

A classical result in the capital taxation literature is that the optimal tax rate on capital income is zero. This result stems from models assuming that capital is saved labor income and, hence, that a tax on savings discourages capital accumulation.

However, recent developments in the theoretical tax literature have emphasized that capital income taxation can in fact play a role in an optimal tax system. Some of the more elaborate theoretical models postulate that taxes on capital can be an effective complement to progressive income taxes, based on the premise that individuals with higher incomes are also often those who have capital income or inherited capital.

Another implication is that all kinds of capital accumulation should be considered, not only physical capital but also human capital, suggesting that the incentive to invest in education and to



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pursue a career should also be taken into account when discussing capital taxation. We conclude that newer contributions to the field of tax theory adduce several arguments for why capital should be taxed.

Capital growth and rising economic inequality

The extent of wealth and capital income has increased around the world. In Sweden, the private wealth-income ratio has more than doubled over the past 20 years. Such growth is historically unprecedented and capital is now far more abundant than in the past. Looking at the growth in different kinds of capital, we observe that financial assets as well as real estate have increased in value.

Sweden is still one of the world's most equal countries, but the dispersion of income and wealth is increasing. The gap between homeowners and renters is widening, but at the same time, the soaring property prices have contributed to counteract the impact in terms of greater inequality of rising financial asset prices. At the top, wealth has grown fastest: the 40 richest families' share of the wealth of the entire population has grown six times faster (from 1 to 6 percent) from 1981 to today. Inherited wealth also plays a major role in Sweden, both in the general population and among the richest.

Experiences of capital taxation

There have been far-reaching changes in the taxation of capital in Sweden since the tax reform of 1991. The principles of uniformity and neutrality, that were central in the reform, have been largely abandoned. Today, capital income is taxed differently depending on where it comes from, a variation in net-of-tax returns that distorts investment and savings decisions and spurs tax planning.

Real estate taxation has been reduced in several steps, by lowering tax rates and eroding the tax base, and it is currently one of the lowest in the OECD. At the same time, the difference in top marginal tax rates on labor and capital income in Sweden is among the highest. Empirical studies on the effect of capital taxes on capital formation and entrepreneurship are not conclusive, but a recurrent finding is that investments are channeled to where the tax rates are the lowest rather than where the capital comes to best use.

The recent rise of international information exchange treaties has limited the scope for

concealing capital in tax havens. It is likely that in the near future, capital owners wishing to avoid taxation will need to move not only their capital, but also themselves.

Attitudes to capital taxation depend on the way capital is taxed

The political dimension of capital taxation is an important aspect, yet it is often overlooked in economic analyses. Taxes are determined in a political context where electoral opinion and interest groups both influence the balance between economically desirable and politically feasible taxes.

With the aid of a large survey of the Swedish population, we examine Swedes' attitudes towards different forms of capital taxation. The responses suggest that Swedes, in general, are skeptical to raising taxes. However, support varies depending on the structure of capital taxes.

The support for a real estate tax is low in response to questions about a general tax on housing, but higher when the tax is linked to a rule that lets low-income households pay less tax or when only taxing expensive homes. Support for an inheritance tax is lower than for a real estate tax, but increases if the inheritance tax is levied only on large legacies. We also study opinions about a wealth tax and different forms of capital income taxation, finding largely similar patterns.

Policy recommendations

Based on our analyses of previous research and economic outcomes, we arrive at a number of recommendations about the taxation of capital in Sweden. The basis for these proposals is that taxes must a) be based on the needs of society at large for financing public expenditures and b) fulfil the politically determined level of economic redistribution. We take the total level of taxation for given, which means that our recommendations do not change the overall tax burden.

1. Increase the uniformity of capital taxation

Capital income taxation has become less uniform over the past years. This leads to distorted investment and savings decisions, tax arbitrage, and political unpredictability, all potentially leading to large negative economic outcomes. We wish to establish uniformity in capital income taxation.

- All forms of capital income should be taxed at the same general tax rate regardless of their source. This would reduce the

risk of adverse economic effects due to distortions of investment, tax arbitrage, and unpredictability.

- In order to achieve uniform taxation on income from capital, a common tax rate is required. We believe that 25 percent is an appropriate level, which is slightly lower than the general tax on capital income, currently at 30 percent, but slightly higher than the tax on, for example, profit from real estate sales and dividends paid by in closely held corporations.
- The imputation-based taxation of certain saving schemes should be changed into a taxation of actual returns, as is currently the basis for most capital income taxes.
- There is a need to investigate new, and simpler, forms of savings for households that do not give rise to distortions and lock-in effects. We discuss a feasible variant, a finance-saving account, where only withdrawals in excess of deposits are taxed, and then as usual it should be capital gains tax.
- Corporate ownership should be taxed for distributional reasons. Today's taxation of corporate profits is preferable to other wealth-based forms of taxation, even though it reduces the uniformity to other forms of capital income taxes.

2. A uniform real estate tax for all housing and lower taxes on sales

All rich countries tax real estate, and for good reason. Real estate does not move when it is taxed, taxing it creates uniformity in relation to other forms of capital tax, and real estate ownership is unequally distributed across the income and wealth distribution. We propose the following:

- All kinds of real estate should be taxed on the basis of their market value. We believe that a tax rate of 1 percent of the tax-assessed value is reasonable when considering how other capital incomes are taxed. This tax rate is lower than the level set in the 1991 tax reform, and lower than in many OECD countries, but higher than the current level in Sweden.
- The lower assessment of condominium apartments, at 30 percent of their market value compared to 75 percent for single-family homes, is unmotivated. We propose that condominium apartment buildings should be assessed at 75 percent of their market value like most other private real estate.

- A rule limiting the real estate tax as a share of household income should be imposed, effectively meaning low-income households would pay a lower real estate tax. This rule is already in place for retirees, but should be extended to the entire population.
- The stamp duty on house purchases reduces mobility on the housing market and creates lock-in effects. We propose an abolition of this stamp duty.
- The taxation of realized capital gains from housing transactions should be milder. We propose that the annual normal return is deducted (as it is subject to the current real estate tax) and only excess capital gains are taxed.

3. Consider a tax on inheritance and gifts, but not on wealth

Inherited wealth has become more predominant in Sweden. Heirs receive transfers worth approximately one-sixth of total household disposable incomes, twice the level 20 years ago. Legacies are not evenly distributed as legatees with the highest incomes also inherit the most. An inheritance tax thus reduces the inequality in opportunity and life chances, especially in the higher end of the distribution.

Sweden abolished its inheritance tax in 2004, but many OECD countries still tax legacies. We find that the Swedish tax deviated in several important ways from that in other countries, in particular by having an extremely low basic deduction, which made more than one third of heirs liable to tax. Practical problems associated with inheritance taxes can be considerable, and we therefore suggest the appointment of a broad committee of enquiry into the taxation of large bequests and gifts.

The wealth tax has some merits, one being that it is broad-based, thus avoiding asset shifting across tax bases to minimize taxes, and another that it taxes the whole wealth distribution. However, there are several practical problems associated with a wealth tax that makes it economically unmotivated. Particularly problematic is the taxation of corporate assets (equity capital): the valuation of unlisted shares is difficult, liquidity problems can arise when the tax has to be paid despite losses in the business, and the mobility of financial assets poses a general problem of avoidance. Problems like these have led many countries to introduce special exemptions and tax breaks, which creates new

problems with uniformity and equity (unlisted shares typically dominate the portfolios of the richest households). In view of the above, we do not recommend the introduction of a wealth tax in Sweden.

4. Shift taxation from labor to capital

Since our proposals are not aimed to change the overall tax burden in society, and our proposals for changes in capital tax in fact imply some increases in taxation, we propose tax cuts in order to maintain the overall tax level without changing the distribution. We believe that a reduction in the taxation of labor income would generate the greatest benefits for society. Exactly how such cuts should be implemented can be discussed.

Since real estate ownership is relatively disperse, and our proposed tax increases are relatively ambitious, a broadly based reduction in income tax would be motivated. On the other hand, the correlation between ownership of wealth, capital incomes, and income from labor are the highest at the top of the distribution of earnings, and that would instead justify a reduction in marginal taxation on higher incomes.

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SNS Economic Policy Council

The SNS Economic Policy Council was initiated in 1974 and has since then brought together leading academic economists to write an annual report with independent recommendations for economic policy.

The SNS Economic Policy Council Report 2018 was launched on January 17, 2018 in Stockholm. Commentators at a public event were Leif Jakobsson, State Secretary with responsibility for taxation at the Ministry of Finance, and Elisabeth Svantesson, spokesperson for economic policy issues for the Moderate Party. And at the SNS Board of Trustees general meeting the same day, Magdalena Andersson, Minister of Finance, commented.

The report has also been presented at SNS local chapters and a number of other arenas. The report has received widespread media coverage.