2022 Research report summary

A Swedish Tax System for the 21st Century

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SNS

Summary

IT IS POSSIBLE TO IMPROVE the Swedish tax system, thereby increasing our productivity, competitiveness, welfare, and GDP. Sweden has a relatively large public sector with a high ambition to provide publicly financed welfare to the population; subsequently, Sweden also has a relatively high tax ratio. Despite a high tax ratio, Sweden uses less harmful taxes, such as taxes on consumption and property, to a lesser extent compared to other countries with lower tax ratios. Instead of increasing its reliance on property taxes, as done by other countries, Sweden has decreased its reliance on property taxes. However, taxes on labor are among the highest in the world. High taxes on labor have a negative impact on individuals' incentives to strive and work, while at the same time increasing firms' labor costs and, subsequently, reducing their incentives to hire. The corporate income tax in Sweden was well below the international average in the 1990s. Today, however, the rate more or less corresponds to the average rate in the EU and the OECD. Sweden is a small country, located on the outskirts of Europe. To compensate for the drawback of being small and not in close proximity to large markets, we need a lower tax rate than the rates in countries with access to large markets. The taxation of capital income, which involves several different rates, encourages investments in property and other passive forms of investments rather than in innovations, entrepreneurship, and research and development (R&D).

To increase our competitiveness, the tax system needs to be adjusted and designed in a way that to the least extent possible discourages effort and work, welfare, and economic growth, while at the same time also encouraging social and environmental sustainability. A tax system that encourages growth and welfare generates tax revenues and, consequently, increases the means available to finance public welfare, as well as to redistribute and reduce differences in income.

The aim of this report is to summarize and report existing knowledge from tax research and to use this to suggest reforms for improving the Swedish tax system. A large part of the report summarizes and draws on reports written in the SNS project "Taxes in a Globalized World" carried out by well-established Swedish tax scholars in economics and law. Furthermore, additional research results and reports are also included to provide a more complete picture of existing research. The ambition of this report is to collect knowledge – economic as well as legal – that may offer guidance when reforming the Swedish tax system in order to make it correspond to the world we live in, while also leading to a more sustainable society and sound public finances. The world has changed drastically since the last great overall tax reform in 1990–91. We now live in a more open and globalized world in which changes in technology and business models have been dramatic, not least with regard to digitalization and automatization processes. Not only has the world changed since the early 1990s, so has our knowledge on how taxes affect individual and firm behaviors. As a result, the tax system needs to be updated to correspond with a more open and competitive world characterized by new technologies and business models. In addition, international organizations such as the EU and the OECD are moving ahead with tax agreements that individual countries must relate and adjust to in order to ensure that their tax systems comply with these agreements.

An important conclusion of the report is the importance of a competitive business climate and the role taxation of firms plays for firm behavior, innovation, entrepreneurship, and R&D. Economic growth and the basis of welfare are created by firms, where new firms are created, investments are made and innovations take place. Sweden is a small country, and to be attractive for firms, we need competitive tax rules. Corporate tax revenues make up a small fraction of total tax revenues. However, firms create jobs and economic activities and thus the tax base for tax revenues from labor and consumption, which is why it is crucial that the tax system does not discourage firms from being launched, growing, making innovations, and investing in R&D. Many countries have attractive tax rules with regard to R&D. The Swedish industry is R&D-intensive, and for this industry to stay competitive, it is important that it does not face a harsher tax environment compared to its competitors. To compensate for our small home market and our geographically unattractive location, Sweden should have a lower corporate tax rate than larger countries, and we should also give tax relief to R&D and productive entrepreneurship.

The aim of the report is not primarily to give concrete and specific suggestions on taxation but rather to present overall principles and guidelines on how the tax system should be reformed to increase Swedish competitiveness, welfare, and

GDP as well as to encourage social, environmental, and fiscal sustainability. As different parts of the tax system are interconnected – a change in one part of the tax system affects other parts of the same system – it is important to evaluate and reform the entire tax system. This is also needed in order to shift from one tax base to another. Moreover, an overall tax reform makes it easier to compensate the losers of one tax change with a change in a different part of the tax system, thereby achieving a more evenly distributed impact of the entire tax reform. Consequently, it is desirable to overhaul the entire tax system. If, for various reasons, that is not possible, it is important to reform the most harmful taxes and adjust the tax system to economic developments in Sweden and the rest of the world. It is also crucial that the tax system is seen as legitimate, transparent, and understandable for taxpayers so that they know what they pay in taxes.

Roughly, the suggested reforms imply a shift from using more harmful taxes to using less harmful taxes; that is, away from taxing labor towards taxing consumption and property. A more uniform taxation of consumption and capital income is desirable and would increase revenues and enable lowering the taxation of labor. It would also reduce distortions in consumption and investment decisions and increase efficiency. It is here proposed that labor taxation is lowered at both the lower and the upper end of the income distribution. At the bottom end, this is done by a more generous general deduction replacing current deductions, tax credits, tax expenditures, and reduced social security contributions. This would lower the marginal and average tax rate at the lower end of the income distribution and increase people's incentives to work and strive. A more generous general deduction would simplify the tax system, make it more transparent, and offer a strong signal. At the top of the income distribution, the central government tax rate is suggested to be cut and/or apply to higher incomes than today. The reduction in labor taxation is suggested to be financed by a uniform and broadened VAT. A 25-percent uniform VAT is proposed, together with base broadening when possible according to the EU's VAT directive. Sweden should actively work within the EU to broaden the VAT tax base and for all types of consumption to be included. A uniform VAT not only reduces distortions in consumption and production but also reduces administrative costs for firms. In addition, consumption is a broader tax base than labor income, as the former is financed by sources other than labor income (e.g., capital incomes and wealth or even untaxed income), which makes taxing consumption relatively efficient.

Taxation of capital incomes would also benefit from being more uniform and, consequently, involve fewer distortions. Taxing capital income discourages investments, and, further-

more, capital income is a mobile tax base. Taken together, these arguments favor a lower tax rate on capital than labor income as well as a rate not higher than in the rest of the world. Hence, we should safeguard our dual income tax system that allows us to tax capital and labor at different rates. In the report, a 25-percent capital income tax rate is suggested. A uniform capital income tax rate at 25 percent incorporates a recurrent property tax of approximately 0.81 percent of the assessed value. This rate includes a capital gain tax on a fictitious increase in value and would thus lead to lower or no capital gains taxation at realization, thereby reducing the lock-in effect of the current capital gains tax.

To combat climate change, a more efficient environmental taxation is proposed that would target the actual externality rather than the activity causing the externality. This implies that several inefficient environmental taxes, such as the tax on plastic bags, air travel, and chemicals, should be abolished. In the long run, energy taxes should also be abolished, as they do not target emissions but rather the use of energy. Today, environmental and energy taxes are discussed intensely at the EU level, which means that it is wise to await the results of this process before reforming the Swedish environmental and energy taxes.

The report presents more detailed budget-neutral tax reform proposals to illustrate how the Swedish tax system may be improved. These primarily focus on how to improve the taxation of labor income. The Swedish National Financial Management Authority (ESV) has estimated the effect of these proposals on public finances and distributional effects in the simulation model FASIT and in a dynamic labor supply model. The results should be interpreted with caution as the models suffer from shortcomings. The resulting estimates likely underestimate the full effects of the proposed tax reforms on productivity, labor supply, and GDP. Several effects are not incorporated in the model, such as the positive effect of a more uniform taxation of consumption and capital income, the improved resource allocation resulting from a sounder tax system, or the higher level of productivity and GDP resulting from lower taxes on entrepreneurship and R&D tax incentives. Nevertheless, the estimates show that the Swedish tax system may be improved without adverse effects on the public finances or the income distribution.

The report also focuses on the extensive international collaboration on tax matters within the OECD and the EU regarding corporate taxation in particular. The aim of this collaboration is to mitigate tax competition and the erosion of tax bases, but also to distribute taxation rights fairly in a globalized world. The principle that tax should be levied in the jurisdiction where value is created is not as straightforward to apply in a global and digitalized economy as in a more closed

and traditional mortar and pestle economy. It is likely that taxation rights will partially move from the place of production to where the consumption takes place. For Sweden, this means a loss of tax base.

Regarding tax bases other than the corporate tax, the EU is taking a more active role. This will influence Sweden's ability to independently decide on these taxes. For example, the EU is in the future expected to implement a carbon border adjustment mechanism (CBAM) and propose a common consolidated corporate tax base and a financial transaction tax. Beyond this, there is a need to finance extensive EU recovery programs (Next Generation EU) due to the pandemic. The fact that tax rights are currently discussed in international organizations makes it even more important for Sweden to design the taxes it is able to decide on independently in a way that strengthens its competitiveness. The proposals presented in this report do not violate EU law and are thus possible to implement. If implemented, Sweden's productivity, competitiveness, welfare, and GDP are likely to increase.

About the author

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