Summary

Sweden would benefit from a tax reform. Since the comprehensive reform of 1990–91, the world has changed substantially. Globalization and digitalization have made tax bases more mobile and international tax competition has become stiffer. Sweden has become a member of the European Union, which means that parts of our tax system must comply with EU rules. Environmental issues have become more urgent. A tax reform needs to tackle all these issues.

On top of these international trends, Sweden faces domestic challenges, such as marginalization, insufficient integration of immigrants and weak productivity growth. The Corona pandemic has taken a toll on lives and weakened public finances. The tax system must therefore both fund the public sector in a sustainable way and stimulate economic transformation and growth. Sweden is in need of a restart – where a tax reform becomes a central tenet.

Shifting the burden of taxation

A starting point is the particular composition of tax revenue in Sweden. Tax on labour is among the highest in the world, whereas tax on property is low. Also, tax on consumption exploits only half of the potential tax base. High taxes on labour distort the economy, create a need for numerous exemptions and deductions and lower the returns to education and skills. Furthermore, while the government imposes high taxes on income from labour it also micromanages consumption patterns and choices of housing by maintaining complex consumption taxes and non-neutral taxes on different types of housing. Condominiums are taxed at lower rates than rental apartments – for reasons that are hard to discern.

Thus, a Swedish tax reform needs to shift some of the burden of taxation from labour to consumption and real estate property. A reform should also simplify the system, make it more transparent and fair. A lower tax on labour with simplified and neutral taxation of consumption and housing will improve citizens' freedom to choose. Furthermore, lower taxes on labour will improve the efficiency of the tax system and benefit the economy as a whole.

A tax reform should not *per se* imply a higher or lower tax ratio. The size of the public sector is of course important for the design of the tax system, but this report aims at fiscal neutrality, and takes the size of the present public sector as given. The task is to improve the tax system, not to debate the optimal size of the government.

Lower tax on labour

The tax on labour should be reduced, across the entire income distribution.

- This report proposes that the marginal tax on high income earners be cut, by raising the threshold above which federal tax is to be paid, and by lowering the tax rate above that point. Most income earners in these brackets will see their marginal tax rates reduced by 15-20 per cent.
- Below the threshold I propose a new "job deduction" (actually a tax reduction, but the term deduction is well established in Sweden) that will lower average taxes for the vast majority of the population. Pensioners will receive the same deduction.

The differential treatment of groups described above is important. According to both economic theory and empirical studies, average taxes are more important when stimulating labour supply at the lower segments of the income distribution, while marginal taxes are more important at the higher end of the distribution. The proposed method of lowering taxes thus maximizes the combined effect on the labour market by causing more effort from those who already have a job (the intensive margin) as well as moving people into employment (the extensive margin).

A lower income tax also reduces the benefits of the RUT deduction on services, which is presently planned to be expanded. Under the proposals in this report, there is no need for such an expansion. Lower taxes are preferable to bigger deductions!

Broaden the VAT and make the capital income tax more homogeneous

The tax cuts on labour will decrease tax revenue. I propose that this decrease is compensated by a broadening of the VAT base and by raising the VAT for those sectors that are presently granted exemptions and face lower taxes. Today's system is administratively cumbersome and unfair. Some reductions are motivated by arguments related to redistribution – most of which are wrong and mainly the result of lobbying rather than fairness. As a result, the system is filled with technical exceptions and logical flaws.

Economically, the most important exception is the lower VAT on food (12 per cent compared to the would-be uniform rate of 25). This exception is supposed to benefit low-income families with children, but numerous studies have shown that the benefits are reaped by everyone, including high-income earners without children. The rich may not eat more. But they eat more expensive food. Indirect taxes are a blunt and inefficient instrument for redistribution. Thus, I propose that the VAT is homogenized across groups, but that families with children are compensated by higher child benefits. Such a change would achieve the intended objectives – at half the cost.

Capital income taxation should be simplified. On paper the capital income tax in Sweden is 30 per cent (higher than the OECD average of 17), but specific tax rates vary depending on type of asset held, who owns it, duration of holdings etc. This complicated system creates distortions and enables tax avoidance.

I propose that most of these taxes be homogenized at 25 per cent, which means a lowering of most capital taxes – but an increase of the lowest tax rate (currently 20 per cent) on so called closely-held corporations, i.e businesses with few owners. Today, owners of such firms may extract lower-taxed dividends rather than salaries, which are taxed at a higher rate. This possibility erodes the tax base and distorts incentives – and triggers resentment from the general public. The proposal of a homogenous capital tax rate of 25 per cent will improve the functioning of the capital market, while the general reduction of the tax level makes the system more internationally competitive.

As the tax rate is lowered, the tax deduction on mortgage interest payments should also be reduced to 25 per cent. This will marginally discourage excessive borrowing.

However, some exceptions to the 25 per cent level are warranted. Individual savings and investments accounts (ISK) are currently subject to standard taxation where the value of the funds is computed following a rule of thumb, irrespective of market price swings. I argue that this system should be maintained, in order to offer a simple alternative to other forms of saving. Also, long-term pension savings should be taxed at a low rate in order to stimulate long-term saving.

Taxes on wealth and property

Property taxation is very low in Sweden, only a fraction of the OECD average. The system is also regressive, since a low nominal tax ceiling is imposed, meaning that the tax-to-market-value ratio declines as real estate becomes more expensive. Many economists advocate a re-introduction of a proportional property tax of around 1 per cent of the tax value. However, introducing a tax rate at that level is politically infeasible. In addition, the low interest rates that prevail at present are grounds for a lower tax rate.

I propose a tax rate of 0.5 per cent, which implies that a majority of households will pay less tax than today, but that owners of expensive homes will pay substantially more. Condominiums should be subject to the same tax as houses (they are taxed at lower rates in the present system) in order to ensure neutrality between types of housing. The tax on rental apartments should be lowered. Consequently, taxes on housing will be more neutral and will have less of an impact on an individual's choice of housing.

I do not deem the re-introduction of wealth and inheritance taxes feasible in a small open economy like Sweden. Even though international cooperation against tax evasion is more extensive now than when these taxes were in place, historical experience shows that it is exceedingly difficult to draw clear lines between what should and should not be taxed. Also, the wealth and inheritance taxes, that were abolished in 2007 and 2005, respectively, made intergenerational transfers of family-owned businesses complicated and expensive. Furthermore, there is some evidence that the abolishment of these taxes has spurred growth of new business.

Corporate taxes

Corporate taxation used to be more competitive, but is now on par with most comparable countries. Internationally, there is a downward trend in corporate taxation and Sweden should follow suit. The nominal corporate tax rate should be gradually lowered, possibilities to deduct interest payments should be reduced and the system should be simplified.

More comprehensive reforms are contingent upon international developments. OECD's work with BEPS (Base Erosion and Profit Shifting) may lead to substantial changes. Some of these, such as the proposed new principles of taxation of digital production and distribution, may affect Swedish tax revenues negatively. The Swedish government has thus opposed such changes. However, if taxes develop in that direction globally, Sweden must comply. This report, however, abstains from analysing measures necessary for adaption to such changes, since the outcome of the international negotiations is uncertain at present.

A contentious issue concerns the tax rules for small business. As mentioned above, these rules have become substantially more generous in recent years. A widening gap between the high tax on labour income and the low tax on capital income has made it increasingly profitable for owners of closely-held businesses to extract dividends rather than to pay salaries to the owners of the firm. This unintended side effect of the high tax on labour has created political strife and is causing a loss in tax revenue.

So far, proposals aimed at rectifying the situation have mainly made the rules for allowing dividends more complex. My view is that this is a second-best solution, or rather no solution. The problem will remain until the underlying discrepancy between tax levels has diminished sufficiently. My proposals – lowering the marginal tax rate on labour income by 20-25 percentage points and increasing the capital income tax on closely-held businesses by 5 percentage points – will remedy much of the problem. But it will probably not be enough. I therefore propose the launch of a new investigation tasked with the difficult mission of abolishing these rules altogether.

Streamlining environmental taxes

Environmental taxes can play an important role in reducing emissions. But the more environmentally efficient such taxes are, the less they will contribute to tax revenue – since successful environmental taxes erode their own tax bases. Furthermore, the system of environmental taxes and regulations in Sweden is often plagued by internal inconsistencies and unclear targets. A tax reform should therefore seek to streamline environmental taxes and focus them on emissions, so that environmental considerations, rather than fiscal ones, become central.

In the Swedish context, this means scrutinizing taxes on road traffic, since this is the main source of carbon dioxide emissions. Some of the features of the present system, such as the deductions for commuting, the existence of company cars and subsidies to environmentally friendly cars all trigger side effects, like stimulating road travel using expensive cars. I thus propose a review and tightening of these taxes.

In the agricultural sector, the consumption of diesel has been exempted from the CO_2 tax. That exemption should be abolished so that the same carbon tax is paid by all. Looking ahead, traditional taxes on emissions will collect less revenue. As electrification and battery technology develops, old patterns will be broken. Taxes on road traffic should be based on the distance driven, and on congestion.

Beneficial effects

In total, the proposed tax cuts summarize to 113 billion SEK and the tax hikes to the same amount. The total sum is about 4 per cent of GDP. The numbers are associated with uncertainty, but the reform proposal is fiscally neutral. The size of the public sector is not affected.

The calculations are based on an econometric model – FASIT – used by Statistics Sweden and most public analysts, including the Ministry of Finance. It is quite conservative in its approach, and, to a large extent, does not take into account dynamic effects. It is my personal belief that the positive long-term effects of my proposals on employment and growth – and consequently tax revenue – are stronger than those suggested by the FASIT computations. But in accepting the FASIT estimates, we can rest assured that we do not exaggerate the impact of the proposals.

The distributional effects of the reform cut both ways. The reductions in marginal taxes for individual in high-income brackets naturally cause a widening of after-tax wage differentials. But this is compensated by tax cuts also for low-income-earners. The new property tax will imply a more neutral taxation of living, which means a lower tax and rising property values for inexpensive housing, but a higher tax and lower property values for expensive housing, meaning a narrowing of income and wealth distributions. The broadening of the VAT tax base will be paid for by all, but since consumption is correlated with income, this means that the new VAT-scheme will complement income taxation. In more general terms, the new tax system will tax labour less and consumption and some property more. Sweden will thus follow the international trend in moving from direct to indirect taxation.

As a result, the tax system will become more efficient. Citizens will be better able to influence their consumption patterns and choices of housing. Employment will increase, courtesy of the lower tax on labour, investment is likely to increase and will be less tax-driven, which should be beneficial for productivity. As a result, both the GDP level and the GDP growth rate will increase. The immediate effect on GDP from the lower tax on labour is estimated at 1.4 percent; however, the broadening of the VAT at the same time cuts into disposable income, which dampens the GDP effect. The potential beneficial effects on GDP growth are essentially impossible to quantify.

A comprehensive reform

The tax system will also become simpler and more transparent, with fewer tax brackets, fewer deductions and – in all likelihood – less tax avoidance. All in all, this should increase the legitimacy of the system. In my own view, it is also fair to reward education and labour efforts more and windfall gains less. Lower taxes on labour should also mean lower thresholds for labour market entry which may help low-skilled labour and newly arrived immigrants.

On a final note, this is a proposal for a comprehensive tax reform. Such a reform presupposes legislation in Parliament – and political discussions and negotiations. A lasting and credible reform should be supported by a convincing majority so that the new system can be sustained regardless of which party is holding office. Obviously, composing a blueprint for how to achieve such consensus is beyond the scope of your humble author.

Debates on taxes tend to focus on small, static effects on the present income distribution. This report takes a much broader view and the proposals have implications also for the wealth distribution, housing, intergenerational distribution, employment, investments, growth and other factors that are crucial in the long run. The debate would benefit greatly from media and different interest groups rising above silo mentalities and vested interests to discuss the tax system as a whole. I can only hope that they do.