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THE NORDIC DUAL INCOME TAX - IN OR OUT?

by

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In this talk I will discuss the Nordic experience with the so-called dual income tax which was introduced in the late 1980s and early 1990s. The dual income tax - which has also been practiced in rudimentary form in countries like Austria and Belgium - is a schedular income tax which combines progressive taxation of labour income with a low proportional tax rate on income from capital. Is this a model for other OECD countries to follow, or is it an unfortunate digression from the fundamental principles of the personal income tax?

As a starting point, it may be useful to ask why countries might want to deviate from the principles of comprehensive income taxation. Under a comprehensive personal income tax - sometimes also referred to as the global income tax - all the taxpayer's various types of income are added together in a single measure of comprehensive income subject to a single tax schedule. Such a tax system would seem to have several virtues. First, if income is considered the correct indicator of the ability to pay, the tax liability should depend only on the taxpayer's *total* income, and not on the *composition* of income. Whether a given amount of income derives from capital, labour, or transfers should be immaterial for tax liability. This is exactly what the comprehensive income tax achieves. Secondly, since the comprehensive income tax treats all sources of income in an identical manner, taxpayers and tax administrators do not have to distinguish between different types of income for tax purposes, and taxpayers have no incentive to transform one type of income into another, since all forms of income are subject to the same marginal tax rate.

Given these virtues, why have so few countries stuck consistently to the principles of the comprehensive income tax? The short answer is that, for technical and political reasons, governments are unable to tax all forms of accrued income in a uniform manner. The longer answer will take some time to explain, but it is worth going patiently through the arguments since they also explain to a large extent why the Nordic countries introduced the dual income tax.

The problems of implementing a comprehensive income tax arise mainly in the taxation of income from capital, because capital income can take so many different forms such as interest, dividends, business income, income from real estate, and all sorts of capital gains. Moreover, capital income can derive from different organizational forms such as proprietorships and partnerships, corporations, pension funds, life insurance companies, and so on. Last, but not least, capital income can become *negative*, as opposed to labour income. Ensuring an equal tax treatment of all the different forms of capital income has turned out to be virtually impossible.

Let me be more specific: in almost all OECD countries, the bulk of private sector saving consists of retained corporate profits, pension savings through pension funds, life insurance companies and banks, and household saving in the equity of owner-occupied housing. Compared to these main forms, other types of private saving are usually of minor quantitative importance. As anyone with a minimum knowledge of real world tax systems will know, no OECD country has ever managed to tax the return to the three main forms of private saving in a uniform manner comparable to the personal tax treatment of labour income. Because corporate capital is internationally mobile, countries eager to attract investment rarely dare to impose a corporate income tax rate at a level approximating the top marginal personal tax rate on labour income. Hence capital income retained in the corporate sector can typically accumulate without being subject to the high marginal tax rate applying to labour income. In theory, this inequity could be eliminated by imposing a tax on accrued capital gains on shares at the shareholder level, but policy makers have shyed away from this for fear of imposing liquidity problems on shareholders, and because of practical problems of measuring non-realised gains on shares in unquoted companies. As a consequence, the return to saving accumulating within the corporate sector is often taxed at a much lower rate than the marginal rate applying to labour income.

This is even more true for pension saving through institutional investors. Such saving is typically subject to so-called expenditure tax treatment: contributions to pension plans are tax deductible, so tax is postponed until the time when the pension is paid out. This implies a savings subsidy if the taxpayer's marginal tax rate is higher at the time of the contribution than at the time when the pension is received. More importantly, in a blatant violation of comprehensive income taxation, the vast majority of OECD countries do not impose any tax on the return to institutionalised pension savings. In principle, a comprehensive income tax would require that the annual return to pension saving be imputed to the individual pension saver and taxed at his personal marginal tax rate of that year. Of course, this might be administratively very cumbersome, but as Australia, Denmark, New Zealand and Sweden have demonstrated, it is at least possible to impose a flat tax on the return to pension saving at the level of the institutions administering the funds. Yet most governments appear unwilling to do so. A frequent motivation for the extreme tax privileges granted to pension saving is that policy makers wish to stimulate private saving. But if this is the basic goal, it would seem to call for a generous tax treatment of the return to *all* forms of private saving rather than a special privilege for a particular type of saving which mainly affects the *composition* rather than the overall *level* of saving.

The third major form of private wealth accumulation is household saving in housing equity. A true comprehensive income tax would tax the imputed rent on owner-occupied housing and allow deductibility for the interest on mortgage debt. It would also include accrued capital gains and losses on the house in taxable income. No country has ever consistently implemented these principles. Only a minority of OECD countries attempt to tax the imputed rent, and those which do typically set the imputed value far below the market rental value. Moreover, capital gains and losses on owner-occupied dwellings are normally tax exempt. Politically it is close to impossible to sell the idea that owner-occupied housing actually yields a return in the form of the value of the housing service and that this return ought to be taxed along with other forms of capital income. There is also widespread political resistance to the property taxes which might serve as an imperfect substitute for the missing tax on the imputed rent. The net result is that investment in housing equity holds a strong tax-preferred status in the typical OECD country.

If technical or political constraints prevent a proper taxation of the returns to the most important forms of private saving, where does that leave us? Obviously it leaves us with a great public revenue loss if we allow full deductibility of interest on the debt incurred in order to finance investment in tax-favoured assets! This was indeed the situation in Scandinavia in the 1970s and 1980s where liberal rules for interest deductibility combined with zero or low taxation of income from the most important asset types to produce large revenue losses. As a consequence of this erosion of the tax base, the marginal tax rates on labour income were considerably higher than they would have had to be if all forms of capital income - positive and negative - had been left out of the income tax base.

To avoid a situation like this, OECD countries have typically reacted by limiting the deductibility of private non-business debt, by lowering the tax rate applicable to interest income, or by allowing negative net interest income to be deducted only against the lowest marginal personal tax rate. Violations of the principles of comprehensive income taxation in some areas such as corporate saving, pension saving and housing investment have thus forced further violations in other areas such as the taxation of interest income, leading to a hybrid system of schedular income taxation which is not known from any textbook and the guiding principles of which are very difficult to understand, presumably because there are no such principles!

A radical solution to the problems of comprehensive income taxation might be to adopt an expenditure tax levied on the net cash flows of individuals and firms. In the late 1980s a Swedish government committee did in fact undertake a thorough study of the expenditure tax. The committee concluded that serious technical problems would arise in the transition from the income tax to an expenditure tax. It also found that expenditure tax principles would be difficult to coordinate with other countries relying on the conventional income tax. For reasons such as these, no OECD government has seriously considered introduction of an expenditure tax, despite its theoretical virtues.

If practical and political constraints stand in the way of comprehensive income taxation and expenditure taxation, the principles of the Nordic dual income tax may offer one route towards a less confused and less inequitable and distorting tax system. To be sure, the Nordic dual income tax is also a form of schedular income tax, like the tax system of so many other OECD countries, but the Nordic system seeks to achieve more consistency by imposing a uniform, proportional tax rate on capital income, including corporate income. In the pure version of the system, the double taxation of corporate source income is fully eliminated, and the proportional capital income tax rate is aligned with the basic marginal tax rate on labour income. Hence the system combines proportional taxation of capital income with progressive taxation of labour income, with a capital income tax rate considerably below the top marginal personal tax rate on labour income.

A basic principle of the dual income tax is neutrality in capital income taxation. This means that capital gains should be taxed, and that taxable business profits should correspond as closely as possible to true economic profits, implying that accelerated depreciation and other special deductions from the business income tax base should be avoided. When the dual income tax was introduced in the Nordic countries, the business income tax base was in fact broadened considerably.

An ideal dual income tax would tax the returns to pension saving and housing investment at the general capital income tax rate. In practice the Nordic countries have not managed to go that far, but Denmark and Sweden impose flat taxes on the return to pension savings at roughly half the level of the ordinary capital income tax rate, and they have tried to make up for missing taxes on imputed rents via a property tax on owner-occupied housing.

The Norwegian tax reform of 1992 was impressive for the consistency with which it implemented the principles of the dual income tax. While the reform did not affect the tax treatment of pension saving, it involved a substantial broadening of the income tax base and introduced a 28 percent corporate income tax rate along with a flat 28 percent tax rate on other forms of capital income such as interest, dividends, realized capital gains on shares and imputed returns to the business assets of small enterprises. The reform involved full elimination of the double taxation of dividends for domestic shareholders via an imputation system. Remarkably, it also abolished the double taxation of retained earnings: when calculating a shareholder's taxable capital gain, the acquisition price of his shares is stepped up by his proportionate amount of the profits retained by the corporation since the time he acquired the shares. In this way the tax falls only capital gains in excess of the retained profits which have already borne corporation tax.

Before discussing some of the practical problems of administering of a dual income tax, let me go through some of the arguments which have been given in favour of the system.

Neutrality: The first argument is that a low proportional tax rate on capital income promotes neutrality in capital income taxation. When the level of taxation is low, it is easier to include all forms of capital income in the tax base. Moreover, if some types of capital income have to be left out of the base for administrative or political reasons, the resulting distortions to the composition of saving and investment are lower when taxes on the other income types are relatively low. Furthermore, a move from progressive to proportional taxation of capital income generates a more efficient allocation of savings across taxpayers since they will all face the same after-tax rate of return on a given form of saving. Proportional taxation also eliminates those forms of tax arbitrage which involve borrowing and lending transactions exploiting differences in marginal tax rates between taxpayers.

Inflation: The second argument in favour of the dual income tax is that a low tax rate on capital income compensates for the fact that the tax falls on the taxpayer's entire *nominal* income from capital. In the presence of inflation, part of the return to nominal assets must be set aside to preserve the real value of the asset. An ideal comprehensive income tax should only tax the remaining *real* asset return. If administrative problems prevent a systematic inflation adjustment of nominal capital income, the imposition of a low tax rate on nominal income may be seen as a rough and pragmatic way of compensating for the missing inflation adjustment. Some might claim that this argument carries little weight in the current climate of low inflation in most OECD countries. However, even with a low average inflation rate of, say, 2 percent and a nominal interest rate of, say, five percent, a desire to impose a 50 percent tax on the 3 percent real return would require that the nominal return be taxed at the much lower rate of 30 percent. Thus the inflation argument still carries force. At the same time the argument seems most relevant for the taxation of interest income. If nominal capital gains on shares, real estate and business assets are not systematically included in the tax base, the case for applying a low tax rate to the taxable income from such assets is obviously weakened.

Capital mobility: I turn now to the so-called capital mobility argument for the dual income tax. For a small open economy the need to avoid capital flight may be a compelling argument for a relatively low tax rate on capital income. Corporation tax is mainly levied in the country of source where the income is generated. A country imposing a high corporate tax rate will therefore find it difficult to attract corporate investment, and multinational companies will be tempted to shift taxable income out of its jurisdiction through transfer pricing. It might be argued that though this may call for a low *corporate* tax rate, the personal tax rate on capital income may easily be set at a higher level, since the personal income tax is based on the residence principle, falling on the taxpayer's income from foreign as well as domestic sources. There are two problems with this line of reasoning. The first one is that the residence principle is very hard to enforce in practice, due to the lack of effective international exchange of information among tax authorities. A country imposing a high personal tax rate on capital income may therefore find that its citizens hide away their wealth in foreign bank accounts outside the reach of the domestic fisc. The second problem is that a personal capital income tax rate significantly above the corporate tax rate provides an incentive to accumulate capital within the corporate sector at the relatively low tax rate applying to retained corporate earnings. To avoid the higher personal tax rate on the return to saving, the corporation may invest its earnings passively in the capital market on the shareholders' behalf, or it may invest retained profits in low-yielding real investment projects. Such a 'locking in' of corporate capital in existing firms is unfortunate since it may prevent profits from being paid out and invested elsewhere in more productive projects yielding a higher pre-tax rate of return. In theory, this locking-in effect could be neutralized through a personal tax on accrued capital gains on shares, but for reasons already mentioned such a tax is very difficult to impose. The bottom line is that capital mobility necessitates a relatively low tax rate on corporate income, and the need to limit opportunities for tax arbitrage and locking-in effects means that the gap between the corporate tax rate and the personal tax rate on capital income cannot be too high. It should be added that this capital mobility argument would lose its force if countries could coordinate their taxes on corporate income and capital income at a higher level than the present one. But to be effective, such coordination would have to involve a large number of countries and might even have to go beyond the OECD. Until such coordination becomes possible, small open economies seeking to protect their tax base will have a natural interest in keeping their capital income taxes below the high marginal tax rates applying to labour income.

Savings and labour supply: Concerns about a low level of national saving may also motivate a low level of capital income taxation. Such concerns have certainly been present in the Nordic countries with historically low private savings rates. It is true that a lower tax rate on capital income may not stimulate saving for a taxpayer with a positive level of net wealth, since the so-called income and substitution effects work in opposite directions. But if important forms of saving such as pension saving and housing investment are subject to special tax rules which must be taken as given, a fall in the ordinary capital income tax rate will apply mainly to the negative net capital income of debtors for whom the income and substitution effects will both work in the direction of higher saving. In this case a lower capital income tax rate may also improve efficiency in the labour market by paving the way for lower marginal tax rates on labour income, since the lower capital tax rate will limit the revenue loss from the deductibility of interest payments. Still, if the goal is to stimulate saving and increase the tax base, the important thing is to have a low tax rate on *negative* capital income, whereas these goals do not necessarily justify a low tax rate on positive net income from capital.

So much for the various arguments in favour of the Nordic dual income tax. Let me turn now to some of the administrative problems raised by this tax system. The main problems arise in the taxation of income from small enterprises. To ensure that investment in business assets is treated in the same manner as other forms of investment, it is necessary to impute a rate of return to the business assets of proprietorships and partnerships and to tax this return as capital income. Otherwise the return to non-corporate business equity would be taxed at the high marginal rates applying to labour income, in contrast to the returns to corporate capital and financial savings. The need to split the income of proprietors into a labour income component and an imputed return to capital poses several technical problems such as separating the proprietor’s business assets from his non-business assets, and choosing a proper imputed rate of return.

The taxation of small corporations with active owners is another problem area of the Nordic dual income tax. A controlling shareholder working as a manager or as a consultant in his corporation can take out his income either as wages and salaries or as dividends or capital gains on his shares. If the two latter forms of income are not subject to double taxation, the controlling shareholder has an obvious incentive to transform highly taxed wage income into low-taxed dividends and capital gains.

Norwegian policy makers faced this problem when they decided to fully eliminate the double taxation of corporate equity income. They therefore decided that an imputed rate of return on the share of corporate assets owned by so-called active owners should be taxed as capital income, whereas the residual part of the owner’s share of corporate profits should be taxed as labour income. In this way the tax liability of active shareholders becomes independent of the way in which they take out income from the corporation. The Norwegian procedure also has the advantage of ensuring equal tax treatment of proprietorships, partnerships and small enterprises organized as corporations. At the same time it raises the difficult issue of determining when a shareholder is ‘active’ in his firm. Obviously, the separation of so-called ‘active’ from ‘passive’ shareholders is bound to involve some arbitrariness, and the complex definitions adopted in Norwegian tax law have created considerable controversy. By comparison, Finnish tax law cut through the problem of separating ‘active’ from ‘passive’ shareholders by requiring that dividends paid by all corporations which are not listed in an official stock exchange be split into a capital income component subject to the flat capital income tax rate, and an earned income component subject to the progressive labour income tax.

While the rules for splitting the income from small business firms certainly complicate the Nordic dual income tax, it is worth bearing in mind that most OECD countries apply special tax rules for small enterprises, and that they often face the problem of defining a labour income component of the selfemployed for the purpose of levying social security tax. The Nordic tax rules may be seen as another attempt to deal with the latter problem.

The recent Italian business tax reform represents an interesting example of dual business income taxation which seems to have been inspired by Nordic tax practice. Under the Italian reform introduced in 1998, firms are taxed at a low, concessionary rate on an imputed normal return to the increase in their net equity since the base year, whereas the remaining residual profits are taxed at the ordinary rate of business income tax. While the Norwegian rules for income splitting apply only to unincorporated firms and to corporations with active owners, the new Italian rules apply to all business firms.

The taxation of ‘normal’ returns at a concessionary rate can be defended on equity grounds as well as efficiency grounds. The equity argument is that the normal return is a reward for the saver’s willingness to postpone consumption which should be taxed at a low or even a zero rate to avoid overtaxation of individuals with relatively high savings propensities. By contrast, pure profits above the normal rate often represent windfall gains which ought to bear a high tax rate. The efficiency argument for the Italian system is that above-normal rates of return can be taxed without distorting investment decisions, whereas taxation of normal returns discourages saving and investment. A laudable feature of the Italian tax system is that the concessionary tax rate applies only to the normal return on *new* equity accumulated *after* the reform. In this way the system stimulates new investment without creating windfall gains and without wasting revenue through a lower tax on pre-existing capital.

Before closing this talk, let me return to the discussion of basic tax principles. Many observers find it inequitable to apply a lower tax rate to capital income than to labour income. For example, calls for higher tax rates on capital have recently prompted the Norwegian government to reconsider the dual income tax. But as I argued earlier, any attempt to tax the returns to the most important forms of saving at the high marginal rates applying to labour income would meet with formidable technical and political barriers. In practice, the call for so-called comprehensive income taxation typically boils down to the demand that interest and dividends earned outside the institutional sector be taxed in line with labour income. Such a procedure exacerbates the inequities and distortions in favour of tax-preferred savings where the returns take a form which is difficult to tax at high rates. If tax policy makers seek to reduce tax discrimination between capital income and labour income by moving toward some rudimentary form of comprehensive income tax, they will end up generating stronger discrimination in the taxation of the many different forms of capital income, so that more savings are channeled into tax-favoured assets. Indeed, there is no doubt that the Nordic tax reforms of the early 1990s were beneficial to labour because the acceptance of a low statutory rate of capital income tax made it technically and politically easier to broaden the capital income tax base, thereby significantly increasing the net revenue from capital income taxation.

I am not arguing that all OECD countries should adopt the dual income tax on this basis. All tax systems have their merits and drawbacks and involve difficult trade-offs between equity, efficiency and administrative feasibility and simplicity. Countries with modest revenue needs and relatively low marginal tax rates on labour income may have legitimate reasons for trying to stick to the ideal of comprehensive income taxation, despite all the difficulties of transforming the ideal into practice. But most of the European welfare states with high revenue needs have found it impossible to systematically tax capital income at the high marginal rates imposed on labour income.

The Nordic tax policy makers of the early 1990s had the political courage to be explicit about the fact that we cannot tax all returns to capital at marginal rates above 50 percent. Turning necessity into virtue, they concluded that if we have to tax the returns to capital at a lower rate, then let us at least try to do so in a transparent, uniform and consistent manner. This philosophy may not appeal to purists in tax theory, but implementing it might still bring substantial improvement to many existing tax systems.

A selective list of literature on the dual income tax

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