Summary

Background

The task of the tax system is to collect funds for the financing of public services and income transfers. This should be carried out as efficiently as possible without hampering economic activity. The tax system should also take into account the views prevailing in society on the just distribution of income.

Fundamental changes to the Finland tax system were last made in the late 1980s and early 1990s. Personal and corporate income taxation were reformed and value-added tax adjusted to fulfil European Union regulations. In this context, taxation of earned income and capital income were differentiated in 1993. In addition, withholding tax on interest income and real-estate tax were introduced into the system as new forms of taxation. Since these reforms, many significant changes have taken place in the operating environment of the Finnish economy. Limited changes have been implemented in different segments of taxation. Practical experience indicates, however, that minor changes do not always ensure that the overall effectiveness of the system is maintained. For this reason, the effectiveness of the tax system as an entity must be periodically re-evaluated.

In accordance with its assignment, the working group has evaluated taxation development needs, taking into account, among other things, the following changes in the operating environment: population ageing, sources of economic growth and changes thereto, challenges posed by sustainable development, and increase in economic openness and internationalisation.

In its interim report published in June 2010, the Working Group for Developing the Tax System examined the need to develop corporate and capital income taxation, value-added taxation, and taxation on earned income. In this final report, the working group presents an overall assessment of the development of the tax system, and supplements the present policy outlines, particularly in terms of areas of taxation not included in the interim report, such as housing taxation, municipal taxation, excise duties, and inheritance and gift taxation. The working group also presents an overall assessment of the effects of the proposed measures on income distribution and tax revenue.

Safeguarding tax revenues and supporting economic growth – a challenge for taxation

International integration and the openness of the Finnish economy have increased significantly in recent decades. Increasing openness is evident, for example, in growth of international trade as well as greater mobility of capital and persons and greater cross-border ownership. Deepening globalisation presents challenges, but it also has many positive aspects. For example, it increases competition and improves opportunities to raise productivity.

To date, globalisation does not seem to have affected opportunities to maintain quality welfare services and the relatively high overall tax rate this requires. Economic integration affects some forms of taxation more than others, however. Companies, their investments and profits have become more mobile, and they react sensitively to differences in tax rates. Investment assets and educated labour force are also mobile, and they react to global differences in tax levels.

The mobility of tax bases has led to tax competition in some areas of taxation through tax rates and special tax advantages. This has particularly affected the corporate tax rate, but also to a lesser extent tax rates on capital income, certain corporate tax base rules and taxation of key foreign individuals.

In terms of consumption taxes, excise duties on alcohol and tobacco are most susceptible to tax competition. Generally, goods and services are less susceptible, however, to tax rate differences between countries, although the spread of internet trading and cross-border shopping has increased their mobility, too. Globalisation therefore creates pressure to transfer the balance of taxation from taxation of business income and earned income to consumption taxation and to other immovable taxation objects such as real-estate.

Moreover, climate change and commitments to combat climate change are altering the economic operating environment and giving rise to direct and indirect costs. Sustainable economic growth requires that the adverse effects of climate change and environmental pollution be curbed and also for the costs arising from them to be taken into account through taxation and other control mechanisms.

One of the greatest challenges for the funding of public finances is posed by population ageing and the sustainability problem arising from it. The baby boom generation will retire during the next decade, as a consequence of which the size of the working age population will start to decline. By 2030 the old age dependency ratio, namely the number of over 65 year-olds relative to the working age population, is estimated to rise from its present level of around 25 per cent to nearly 43 per cent. Population ageing will put both the pension system and the funding of public service provision, which is a local government responsibility, to the test. If growth pressures on health and social care expenditure cannot be limited, for example by improving the productivity of public service provision, then with the present service obligations and age-group utilisation of services there will be pressure to increase local government taxation by up to 7 percentage points by 2030. Growth in the number of pensioners relative to the working population will at the same time create pressure to increase earnings-related pension contributions. These together may result in considerable pressure to increase taxation on work. As labour costs increase, higher earnings-related pension contributions and income tax rates would weaken employment and the competitiveness of the Finnish economy.

For the funding of the welfare state, it is essential to aim for as high an employment rate as possible and for strong development of productivity. The taxation structure should as much as possible support employment and economic growth. For this reason, in terms of the funding of public finances and the provision of welfare services, it is important to implement structural reforms that mitigate expenditure pressures arising from population ageing.

In accordance with its assignment, the working group has examined the long-term need to develop the tax structure. The deep economic crisis that began in late 2008 has changed the starting situation substantially by strongly weakening the fiscal position of public finances and thus hampering preparations to meet the expenditure pressures arising from population ageing. Post-recession consolidation needs will also restrict tax-policy room for manoeuvre in the coming years. Recent economic studies indicate that deficit reduction based more on spending cuts has historically resulted both in more permanent results and faster economic growth than adjustment based on tax increases. The working group emphasises, however, the importance of employment and economic growth in meeting the sustainability problem in public finances. The effectiveness of tax and spending adjustments naturally varies case-by-case, depending on, among other things, the way that the adjustment is implemented. When planning tax measures, particular attention must be paid to the tax structure changes by which the tax system can be modified to support the funding of public services and benefits as well as possible. The breadth of the tax base, moreover, must also be maintained and tax subsidies that narrow the tax base critically assessed. In this context, attention must also be paid to combating the shadow economy, on which the working group acquired a separate expert study. Combating the shadow economy will be implemented at a Government level in a separate programme.

As the size of the working age population contracts, improvements in wellbeing in Finland will be increasingly determined by productivity growth. It is therefore important that the tax system encourages both the development of expertise and growth of human capital throughout working careers. At the same time, however, it is important to ensure the fairness of taxation and that social objectives in terms of the distribution of wellbeing are fulfilled. Adjustment to globalisation and the structural changes it brings may increase the need to balance risks and wellbeing in future. On the other hand, the sharing of risks with the aid of the welfare state also increases the acceptability of globalisation and thus helps in utilising the good aspects of globalisation and the opportunities it offers.

Tax structure development

The working group has considered various aspects relating to the development of the tax structure to support employment and economic growth. Research indicates that the various forms of taxation have different impacts on economic growth. Recent studies conclude that earned income taxation and corporate taxation seem to have the most negative impact on growth, whereas real-estate taxation and consumption taxation (expressly value-added tax, VAT) seem to have the least adverse impact. In Sweden, a fundamental quantitative assessment has been made of the welfare losses arising from the Swedish tax system. The largest welfare losses are caused by earned income taxation, corporate taxation and capital income taxation. The welfare loss arising from consumption taxation is clearly lower than these.

Taxation on labour can affect the labour supply by distorting both the decisions of households to participate in the labour market and the number of hours worked. Alongside the level of labour input, taxation on labour can also have a negative impact on labour productivity if, through progression, it weakens incentives to accumulate human capital and further pursue working careers.

Consumption taxation also affects labour supply. Being based on a proportional tax rate, however, it does not reduce returns on education nor weaken incentives to entrepreneurship or the forward pursuit of working careers.

Corporate tax raises the required pre-tax return on investments and therefore reduces incentives to invest. In an international environment, furthermore, it distorts companies' location decisions. A high corporate tax also increases international companies' tax planning, for which ample opportunities exist. For a small open economy, the welfare losses arising from a high corporate tax may be very significant. Taxation directed at the capital income of households, on the other hand, weakens incentives to save and also directs savings away from taxable investments supporting production activity towards owner-occupied housing and other lightly taxed capital

Consumption taxation is considered to have proportionately lower distortionary effects than income taxation and therefore the efficiency loss arising from it is smaller. Consumption taxation is a type of expenditure tax that does not affect the saving and investment decisions of households and business; it falls on labour input but also indirectly on the economic rent from savings and investments. The European Union's value-added tax which is based on the destination principle taxes consumption in the country where the commodities are consumed. This is independent of where the commodities are manufactured and where the manufacturing company is domiciled. It therefore taxes the profits of multinational companies, but does not distort their investment decisions.

A shift of balance towards general consumption taxation (value-added tax) can also be justified by the fact that income taxation burdens domestic factors of production and therefore domestic production and exports but not imports. Consumption taxation, on the other hand, also burdens imports. In terms of exports, the tax is refunded and it therefore does not weaken the competitiveness of domestic production in the international environment.

In addition, the effects of growth in the number of pension recipients and a contraction in the size of the working age population will increase public spending and weaken the financial base of the public sector, which will create significant pressures to increase taxation on labour in terms of both municipal-level taxation and social security contributions. Taking the adverse effects of taxation on labour into consideration, the working group considers that these pressures highlight the need for a change in the tax structure.

Environmental and energy taxes and taxes directed at consumption harmful to health, such as tobacco and alcohol taxes, are included in consumption taxes. In contrast with other forms of taxation, the aim of these taxes is often to influence the behaviour of companies and households. In addition to reducing activity harmful to the environment and health, the welfare loss caused by taxation may diminish if revenue from environmental taxation is used to reduce other, more distorting taxes. On the other hand, as behaviour adjusts, the revenue from these taxes will fall and their significance in funding public expenditure will decline.

Real-estate taxation is considered by many to be the form of taxation that least distorts economic activity and the allocation of resources. Thus increasing the proportion of real-estate tax in the tax system would support the aim of minimising factors harmful to growth in the development of the tax structure.

There are problems relating to income distribution associated with shifting the burden of taxation from earned income taxation to consumption taxation. A change in tax structure justified in terms of economic growth may have, at least in the short term, adverse income distribution effects. Purchasing power may be reduced most among those on the lowest incomes, who consume a greater part of their income and for whom essential commodities make up a large part of their total consumption. As a result, the working group has evaluated as a whole the income distribution effects of its proposals. The income distribution effects of the working group's proposals are discussed in the final section of this summary.

On these grounds, the working group proposes a modest shift of balance in taxation from taxation on labour to taxation on consumption, while not forgetting the income distribution effects of the change. In addition, the working group proposes a shift of balance from corporate taxation to personal-level capital income taxation. The working group proposes a reduction of earned income taxation of EUR 2 billion and a reduction of corporate tax totalling EUR 0.8 billion. The reductions would be funded by increases in value-added taxation and capital *taxation, by raising excise duties and by restricting the deductibility of interest expenses and domestic help credit.* Table 2 shows the tax revenue impacts of the working group's proposals. The proposed change of tax structure aims to support favourable employment and economic development, which also plays a key role in terms of the sustainability of public finances. The projected tax revenue calculations are based on static estimates. Preparing reliable quantitative estimates of the behavioural effects of the proposals as well as their impact on the economy and tax revenues is not, however, possible.

Closing the public finances sustainability gap may require both revenue- and expenditure-side measures as well as structural reforms. The working group has not examined the extent of the role that tax solutions should have in the future balancing of public finances; the working group's proposal is fiscally neutral, i.e. the tax increases and reductions are of equal magnitude on a static basis.

Earned income taxation

Adjustment to population ageing requires rapid measures of sufficient magnitude to strengthen the tax base and strengthen the sustainability of public finances. Changes made to the tax system should above all support employment, the number of working hours in the economy, and productivity development. To fulfil employment and productivity targets, the working group proposes that the emphasis of taxation be shifted from taxation on work to taxation on consumption. Growth of age-related expenditure creates pressure to tighten taxation of earned income in local government earned income taxation and in the pension system. With respect to employment, it is beneficial to examine the taxation of earned income as a whole. Against this background, the reduction of taxation on labour is justified, particularly with respect to central government income taxation.

Earned income taxation should be reduced within the tax system as a whole by EUR 2 billion, while other taxation is correspondingly increased. The aim of the proposals is to ensure that working is economically the most advantageous option at all income levels in comparison with living on benefit income. Taxation of social security benefits and pension income should not be increased.

To boost the efficiency of the tax structure as a whole, earned income taxation should be reduced by EUR 2 billion, estimated on a static basis at the 2010 level. The reduction should be targeted such that marginal tax rates are lowered at all income levels. To improve incentives to participate in work and for income distribution reasons, income taxation should be reduced more than average at low income levels. The average tax rates on earned income should be lowered at all income levels, which would encourage workers to extend their working career at its different stages. It is proposed that the highest 54.6 per cent marginal tax rate (including compulsory employee social insurance contributions), which is *high by international standards, be reduced to around 50 per cent.* By lowering the highest marginal tax rate, the aim is to improve incentives and mitigate the problem of so-called income shifting. Together with changes proposed for capital income taxation, the proposal removes most of the incentives to convert earned income into capital income.

At low income levels, the joint effect of social security and taxation often creates income or incentive traps. More often than not, these traps arise not from marginal taxes but from the lowering of social security benefits as earned income grows. Thus traps cannot be removed by addressing taxation alone. In the social security system, housing support gives rise to significant incentive problems relating to labour participation, particularly through living and housing allowances. The Committee on Social Welfare Reform (SATA Committee) made several proposals by which the worst barriers to employment could be removed, but only some of them have advanced to the implementation stage. In accordance with its remit, the Working Group for Developing the Tax System does not address the social security system other than to take into account the proposals of the SATA Committee to be implemented in 2011.

As the working age population contracts, the proportion of the elderly population grows and international competition in the field of technology intensifies, the significance of productivity growth is highlighted in terms of economic growth and the funding of public finances. The contraction of the working age population will take place in Finland earlier and more strongly than in other Nordic and EU countries. As a result, maintaining the employment rate and productivity growth is a more pressing problem in Finland than in neighbouring countries.

In terms of the significance of the numerous background factors to productivity growth, research does not provide a clear, unambiguous picture. As a consequence of technological change and deepening international division of labour, it is apparent that in a country like Finland the significance of human capital has been emphasised over fixed capital in relation to labour productivity growth. Human capital accumulates not only through formal education but also through skills acquired during a working career. In terms of productivity growth, it is essential that the return on investment in human capital is perceived to be sufficient in all employee groups. Progressive taxation, however, diminishes the benefit received from pay rises and thus reduces the incentive to acquire additional competence or strive forward in one's career. If marginal taxes were lowered at all income levels, the return on efforts aimed at boosting individual productivity would grow in all employee groups.

Furthermore, with respect to the domestic help credit, the deduction system should be reformed such that the tax deductible share of labour costs is reduced from the present 60 per cent to 50 per cent. The maximum amount of the deduction should also be reduced from EUR 3,000 to EUR 2,300.

Indirect taxation

Shifting the balance of taxation from earned income taxation to indirect taxation will be partly achieved by increasing value-added taxation and excise duties.

Raising the *value-added tax* level could be implemented in two different ways. The first option is to implement it by removing the tax subsidy included in the present reduced tax rates, thereby moving towards a uniform value-added tax rate. The second option is to raise tax rates, preserving the current tax rate structure.

In its interim report, the working group has carefully considered the advantages and disadvantages of these two models in terms of their income distribution effects. Many factors support a uniform tax rate. Reduced tax rates create costs both for the tax administration and companies. In addition, a uniform structure contributes to keeping the standard tax rate low, which is an advantage in terms of efficiency. A uniform tax rate also improves the potential tax yield of value-added taxation. This fact might be further highlighted in future if, as a result of the public finances sustainability problem, a situation arises in which there is a need to resort to substantial measures to safeguard tax revenues.

On the other hand, economic theory also supports a differential consumption tax structure. There are justifications for imposing higher taxation on commodities harmful to health and environment (tobacco, alcohol, unhealthy foods, fossil fuels). In principle, differential value-added taxation of foods according to their health value might also be desirable, but this would be difficult to implement in practice.

The recent trend in Finland, furthermore, has taken the value-added tax system more towards differential tax rates, particularly with respect to foods and restaurant services. *The working group proposes that, at this stage, the shift of balance towards consumption taxation should be implemented such that in valued-added taxation both reduced tax rates and the standard tax rate are raised by two percentage points. This is expected, on a static basis, to increase tax revenue by around EUR 1.2 billion.*

In value-added taxation, however, the goal in future should be towards a more uniform structure. This could be implemented gradually. In terms of tax revenue, the most significant question relates to the lighter tax treatment of foods and restaurant services. As part of the move towards a more uniform tax structure, due consideration should be paid to the fact that experience obtained from an experiment with lighter value-added taxation in labour-intensive service sectors suggests that there is no justification for continuing the experiment.

In addition to tightening value-added taxation, it is also proposed that *excise duties* be increased. The working group considers it justified to increase modestly taxation on products harmful to health. The effects of increases on cross-border shopping and the shadow market must be taken into consideration, however, and also the disruption caused by these in the domestic market. This applies particularly to excise duties on alcohol and tobacco, but the effects of the excise duty on sweets and ice cream, which came into force at the beginning of 2011, should also be monitored before the law is changed.

In recent years, a number of environment-based structural reforms have been made. These include, for example, a model based on the carbon dioxide emission and energy content of fuel to be introduced in fuel taxation as well as the introduction of a carbon dioxide-based car registration tax and annual vehicle tax.

The working group has examined the levels of energy and environmental taxes taking into account energy and climate policy targets, the achievement of which can be supported with national-level tax decisions, particularly outside the emissions trading sector, such as in transport. An effort should be made to curb transport emissions by increasing excise duties on transport fuel and by strengthening the steering effect of the motor vehicle tax and car tax.

Significant increases of excise duties on heating fuels and electricity will come into force at the beginning of 2011. Despite the increases, the working group considers that taxes on both household electricity (electricity tax class I) and heating fuels can be increased modestly to support the fulfilment of energy-saving targets. The tax increases in heating and transport fuels would be implemented adhering to the existing tax structure. In addition, the working group considers that a windfall tax similar to the real-estate tax be introduced on electricity production.

The tax increases coming into force at the beginning of 2011 are clearly greater in magnitude, however, than the working group's proposals.

The working group proposes that excise duties be raised by a total of around EUR 1 billion, such that the increases are directed in terms of energy and environmental taxes at the basic tax of the annual vehicle tax, the consumer electricity tax (electricity tax class I) and transport and heating fuel taxes. In addition, a windfall tax on electricity production should be introduced. Health tax increases should be directed at tax on alcohol tax on sweets and ice cream, and tax on soft drinks. In addition, the tax base of the excise tax on sweets and ice cream should be broadened. The introduction of a sugar tax should be explored.

Corporate and capital income taxation

The working group examined the development of corporate and capital income taxation in its interim report, which was published in June 2010. The subject was examined on two levels. The first issue related to the balance of taxation between corporate and capital income taxation at a personal level. In an international operating environment, the corporate income tax rate must be such that internationally operating companies have sufficient incentives to invest and locate in Finland, and to report profits in Finland. Research indicates that in an open, international operating environment, a high corporate income tax reduces domestic capital stock and lowers labour productivity and wage levels. The corporate income tax of international companies is transferred over the long term into a burden on domestic wage earners. Studies show that personal-level capital income taxation does not seem to have a corresponding impact on investment or productivity. The working group considers that it is justified to shift the burden of capital income taxation from corporate-level taxation to personal-level taxation.

The second issue relates to the taxation of dividends distributed by unlisted companies. These dividends are currently divided into earned income and capital income components. The capital income component is considered to be a 9 per cent annual return on the company's net asset value. This income is tax-free up to a limit of EUR 90,000. Of the dividend exceeding this limit, 70 per cent is considered to be the owner's capital income and is taxed at a rate of 28 per cent. Of the dividend exceeding the capital income component (9 per cent threshold), 70 per cent is the recipient's earned income and is taxed on a progressive scale as part of other earned income.

Based on several earlier studies and expert assessments as well as on calculations of the working group, one can deduce that this system strongly directs the behaviour of companies and owners. It particularly creates incentives to increase a company's net asset value. The magnitude of the incentive depends on, among other things, the owner's income and marginal tax rate, and the company's financial position. According to calculations presented in the interim report, the required return on investment of an unlisted company varies from negative to just under 9 per cent, given an assumed return on an alternative investment of 5 per cent. In certain cases, taxation provides a very strong incentive to invest, while in other cases it raises the investment threshold fairly high. The system is therefore decidedly non-neutral.

Present taxation also encourages a company to distribute annually as dividend the maximum amount that the owner can receive tax-free. Studies commissioned by the working group indicate that around 40 per cent of unlisted companies distribute a dividend corresponding precisely to a return of 9 per cent. Taxation might in this way direct a company's internal financing away from productive investments useful for the company's business development.

The present system would also appear to direct owners to invest particularly strongly in non-depreciable assets such as securities and real-estate. When a company invests in these assets, the tax saving obtained from growth of net asset value is maximised. Investing in rapidly depreciating (non-permanent) assets such as machinery and equipment does not bring a corresponding tax advantage. Research and development expenditure recognised in a company’s balance sheet is not included in the company’s net assets. In consequence, it does not produce for the owner the same tax benefit as investment in tangible assets.

Based on the above, it can be inferred that Finland's present dividend taxation of unlisted companies directs resources away from tangible and intangible real investments important for a company's actual business operations towards securities and other permanent investment assets.

The risk premium included in the 9 per cent rate of return applied in calculating the capital income component of the dividend distributed by an unlisted company is sometimes justified by an incentive to risk-taking. This, however, serves to improve the post-tax return of low-risk but low-yielding investments. This perspective also supports the view that the present system favours investments in assets delivering a safe return instead of higher-risk real investments in a company's core business operations.

Proving the above-described incentive effects empirically is rather challenging. Studies commissioned by the working group, however, have produced clear indicative evidence that the taxation of unlisted companies has guided companies' dividend, investment and funding decisions.

The working group has set as a goal of its reform of dividend taxation that taxation be as neutral as possible in relation to investments and their funding. At the same time, the aim will be to remove incentives to income shifting and improve the fairness of taxation. The working group has also deemed it important that the reform does not create for companies and households unreasonable adjustment needs.

The working group proposes a shift of balance in corporate and capital income taxation from corporate taxation towards personal-level capital income taxation. As part of this change, the tax exemptions of dividends received from an unlisted company should be removed and replaced with reduced taxation of the normal return of the dividend. This should be implemented such that the tax rate (company and shareholder) of the normal return of the profit distributed by a company corresponds to the general capital income tax rate. This change is projected to reduce tax revenue, excluding behavioural effects, by around EUR 300 million.

The main aspects of the proposal are as follows:

- The corporate tax rate should be reduced from the present 26 per cent to 22 per cent and the general tax rate on capital income raised from 28 per cent to 30 per cent.
- In contrast with the earlier practice, dividends received from listed companies should be fully included in taxable capital income.
- 35 per cent of the part corresponding to the 'normal return' of dividends received from an unlisted company should be included in taxable capital income, representing a tax rate on dividend income of 10.5 per cent. The overall tax rate of the normal return of profit distributed by a company would accordingly be 30.2 per cent. Dividend exceeding the normal return should be completely taxable capital income.

- The normal rate of return would be confirmed annually and determined as the medium-term interest rate on government loans after corporate tax. The normal return would be calculated on the basis of a company's net asset value per share.

The working group has discussed certain issues relating to the corporate tax base, but has not proposed changes in this respect. The need to develop tax base rules should be assessed in some other instance. The working group does not propose the introduction of an R&D tax subsidy. Justifications for this were presented in the working group's interim report.

In the proposed model, the dividend of an unlisted company should continue to be divided into two parts. The part of the dividend corresponding to the normal return calculated for a company's net asset value, of which 35 per cent is taxable, should be separated from the dividend. The total tax rate of a company's profit accordingly corresponds to the general capital income tax rate:

$$22\% + (1\text{-}0.22) \text{ x } 0.35 \text{ x } 30\% = 30.2\%$$

The part of the dividend of an unlisted company exceeding the normal return should be taxed completely as capital income. In this case, the overall marginal tax rate of the dividend is 45.4 per cent at the tax rates according to the proposal. This marginal tax rate is set very close to the highest marginal tax rates on earned income proposed by the working group, when pension contributions of the insured are excluded. Thus the proposal to a large extent removes incentives to withdraw income based on work input as dividend. The concept of earned income dividend would be removed from tax law, which would simplify taxation.

The normal return component of the dividend would be calculated as the return on the mathematical value of the share. In contrast with the present practice, however, the medium-term interest rate on government loans after corporate tax would be applied as the rate of return. The interest rate would be confirmed annually. Studies show that this way of determining the rate of return is justified from the perspective of the neutral treatment of investments.

Many factors support the lowering of the corporate tax rate to 22 per cent. Lowering the tax rate would strengthen Finland's position as a favourable country for direct investments and improve domestic companies' willingness to keep their headquarter functions in Finland. A low corporate rate also reduces vulnerability to international tax planning, in which companies' internal debt arrangements are used to transfer profits to countries where interest and royalty income are tax-free or lightly taxed.

The increase to 30 per cent of capital income tax on a personal level is connected with the shift of balance in capital income taxation from corporate-level taxation to personal-level taxation. Raising the tax rate higher than proposed might result in harmful behavioural effects. Under inflation, the effective tax rate of capital income clearly rises faster than the nominal tax rate. In addition, the tax rate difference compared with tax-free investment such as owner-occupied housing and long-term savings agreements would become rather large.

In the working group's proposal, the dividend of a listed company would be taxed in full as capital income. This can be justified by the fact that in an open economy, the dividend taxation of listed companies has no significant impact on companies' investment decisions. In an international environment, personal-level dividend tax reliefs are not an effective way of reducing the distorting impact of taxation on investment.

In unlisted companies, the shareholders' equity form of financing provided by domestic private individuals plays a key role. For this reason, it is justified to target reduced taxation of normal return on this group of companies.

The differentiation of the dividend taxation of listed and unlisted companies, moreover, is already applied in present taxation, and no significant adverse effects have been reported to arise from this.

In the working group's dividend tax model, the normal return of profit distributed as dividend from an unlisted company will be taxed at the same 30 per cent tax rate as other capital income. Taxation would accordingly treat an investment in an unlisted company similarly to various taxable investments in the financial markets. The tax treatment of a company's debt and equity financing would also be harmonised. According to calculations presented in the interim report, the required return before taxes on investments funded by a company's retained profits would be slightly lower than the gross return obtained from the financial markets. In addition, it would be lower than the required return on investments funded by external finance. This means that compared with completely neutral taxation, the proposed tax system would slightly favour the retaining of profits for the funding of investments. This can be considered justified from the perspective of the impact of taxation on growth.

Present taxation strongly favours tangible investments that increase a company's net asset value compared with intangible investments. The model proposed by the working group would set tangible and intangible investments largely on an equal footing in taxation. This would encourage the allocation of resources to investments generating the best returns.

In the proposal, the normal return component of the dividend is calculated at the medium-term interest rate on government loans after corporate tax. If, for example, the interest rate on government loans were 5 per cent, the interest rate applied in the calculation of normal return would be

$$(1-0.22) \times 5\% = 3.9\%$$

The interest rate should not incorporate a risk premium included in the required return on investments, because it would encourage tax planning in which net asset value would be increased by investments in low-yielding, safe investment projects. The interest rate after corporate tax should be applied as the normal rate of return of the dividend. In this way, the part of a company's profit corresponding to the return on the company's shareholders' equity according to the interest rate on government loans will be taxed at an overall tax rate (company's and owner's taxes) equivalent to the general capital tax rate.

Studies commissioned by the working group suggest that the proposed changes would shift the burden of taxation from the unlisted company towards the owner's taxation, but would generally not increase the total amount of income taxes paid by the company and the owner. This estimate takes into consideration the changes proposed both to corporate and capital income taxation and to earned income taxation. Studies indicate that the taxation of more than half of entrepreneurs would be reduced and the taxation of around one third would be increased. The largest increases would fall on entrepreneurs who have withdrawn the whole profit or a large part of it as dividends such that the dividends have been tax-free at the shareholder level. The reductions would apply particularly to entrepreneurs who have withdrawn only a small part of profit as dividends. In these cases, lowering the corporate tax rate reduces the total amount of taxes paid by the shareholder and the company.

Housing taxation

For households, homes are both an investment and a consumer durable commodity. For this reason, the tax treatment of housing must be examined both in relation to the tax treatment of other investment objects and in relation to the tax treatment of other consumption. In addition, for most Finnish households a home and a mortgage taken to fund its purchase are overwhelmingly their largest asset items. Both the tenure structure of housing and the financing of owner-occupied housing are strongly influenced by the life cycle of households. Young households are more likely to live in rental housing than older households. More elderly owner-occupiers correspondingly are more likely than other owner-occupiers to have own housing free of debt. A special feature of the housing market, moreover, is that the market is very local and that the price level varies between areas. This is due, on the one hand, to the fact that housing is very long-lasting and, on the other hand, that the services and attractiveness of a residential area have a direct impact on the desirability of housing.

Public authorities influence housing supply and demand in many different ways. In Finland, housing subsidies can be divided into three main groups: direct subsidies (such as housing allowance), financial subsidies and tax subsidies. In general, direct subsidies and financial subsidies are directed at those on low incomes. Most of the tax subsidies, however, are channelled to owner-occupiers, with no means testing.

In terms of the tax treatment of housing, Finland's tax system is in many respects similar to that in many other EU member states or the USA. Finland's current tax system favours owner-occupied housing compared with rental housing and other investment projects. These distortions would be justified if they served to correct positive externalities generated by owner-occupation or managed to balance income distribution. The working group considers that there is no evidence for such positive externalities caused by owner-occupation which could justify the current extensive subsidies for owner-occupied housing. In addition, owner-occupied housing subsidies in Finland appear to be distributed such that most support is directed to those who are relatively well-off. Owner-occupied housing subsidies, therefore, do not appear to support income distribution objectives. The present system may be considered problematic due, among other things, to the fact that most of the tax subsidy goes to those on medium and high incomes while society is striving in other ways to support those on low incomes.

When the tax treatment of housing is compared with the tax treatment of other forms of investment , it is evident that the present system treats the return on rental housing in the same way as the return on other investment. This means that the tax treatment of owner-occupied housing is lighter than that of other investment. *Due to the points presented above, the working group considers that efforts should be made to harmonise the tax treatment of the return on owner-occupied and rental housing and other investment objects.*

In principle, there are many different ways to try to achieve the aforementioned objective. The working group has examined various reform options, which include both tightening the tax treatment of owner-occupied housing and lightening the tax treatment of rental housing. The working group considers that, of the various options, the most appropriate for implementation is limiting the right to deduct interest on mortgage. The right to deduct interest should be limited gradually and the length of the transition period should reflect the fact that the repayment period for mortgage loans is relatively long. The working group has examined various ways of limiting the right to deduct interest and considers that the fairest arrangement is one in which the proportion of deductible interest expenses is limited gradually. Implemented in this way, limiting the right to deduct interest will be directed equitably to all who have a mortgage.

The working group proposes that the proportion of deductible interest expenses be reduced gradually, by five percentage points per year. Thus after four years, 80 per cent of interest expenses on mortgage would be deductible. The working group considers it justified that, in the long term, the right to deduct interest expenses on mortgage be removed.

Local government taxation

The working group has examined the suitability of different types of taxes at local government level. Corporate tax is very cyclically sensitive form of taxation. Most local government services are welfare services that must be provided irrespective of economic cycles, so local government funding, too, should not fluctuate strongly according to economic cycles. In addition, the strong cyclical fluctuation of revenue appears to lead to procyclical local government expenditure. *For this reason, the working group considers that corporate tax is a form of taxation inappropriate for local government, and proposes that the municipalities' share of corporate tax revenue be transferred to central government, which is better able than the municipalities to bear the risks related tax revenue.* The local government income losses arising from this will be compensated primarily via the system of central government transfers to local government. For the same reasons, the working group considers that capital income taxes should not be directed to the municipalities. The working group's proposal to lower the highest marginal tax rate of earned income taxation, together with the changes proposed for capital income taxation, will remove incentives to convert earned income into capital income, which will strengthen the local government tax base.

The removal of earned income dividends will reduce local government tax revenue. On the other hand, in the new tax environment, entrepreneurs will pay themselves more salary from their companies, which will strengthen the local government tax base.

In the terms of giving the municipalities new tax bases, the working group has the following general observations. If municipalities' own tax bases are strengthened, for example by transferring part of the central government tax base to the municipalities, a situation will simultaneously arise in which municipalities' differences in needs and conditions will be balanced less than before. This is due to the fact that the central government will be compelled to cut central government transfers to local government if part of the central government's tax revenue is directed to the municipalities. Taking into consideration the nature of local government services as redistributive welfare services, the working group sees no reason to reduce the emphasis on balancing need and cost differences. Therefore the working group does not propose new tax bases for the municipalities.

Real-estate tax is generally considered to be the tax best suitable for the local level, as it has a number of good features associated with it. The level of real-estate taxation in Finland, however, is low by international standards. *The working group considers that the significance of real-estate tax should be increased in local government funding.* The aim should be to raise real-estate tax revenue by 50 per cent from its present level to EUR 1.2 billion, which would mean an increase of tax revenue of around EUR 600 million.

Over the longer term, efforts should be made to ensure that real-estate tax is linked more than at present to land, because real-estate tax on land is a neutral tax and does not direct landowners' behaviour. Because the aim in raising real-estate tax revenue is to direct taxation at land, changes must be made to the structure of the real-estate tax system. In the present system, general real-estate tax is directed at both land and commercial buildings. *The working group proposes that a tax rate be specified separately for land, and directed at all land uniformly.* Specifying a separate tax on land presents an opportunity for the municipalities to regulate taxation of land without simultaneously changing, for example the taxation of commercial buildings.

Excluding the new land tax, the real-estate tax system should remain mainly as before. *The upper limit of the tax rate should be removed, however, from land, commercial buildings and permanent residential buildings.* The working group, in principle, sees no good justifications for leaving agricultural and forestry land outside real-estate taxation; real-estate tax should be directed to all land without exception. The working group, however, makes no proposal in respect of this, rather it considers that the adding of agricultural and forestry land to the real-estate tax base requires further study.

Increasing real-estate tax may also cause difficulties for households whose income is low relative to the value of their property. The working group considers that real-estate tax relief should be considered for such situations. The working group stresses, however, that such procedures must apply only to housing.

Transferring the corporate tax to central government as well as changes in the real-estate tax system will affect local government tax revenue not only directly but also via the income equalisation system. The reform will affect different municipalities in different ways. The working group also considers that the tax reforms relating to municipalities should be implemented in connection with a comprehensive reform of the system of central government transfers to local government. This would ensure that the position of individual municipalities is not unreasonably weakened.

Inheritance and gift tax

An effort to balance wealth and income differences has traditionally been associated with inheritance and gift tax. Based on research, it also appears that it does not have as adverse behavioural effects as other taxation on saving. Viewed from this perspective, the tax should be progressive. International comparisons show that inheritance and gift tax is also almost without exception clearly progressive in countries comparable to Finland.

Finland's inheritance and gift tax scale is rather special in two ways. Firstly, the highest marginal tax is low and, secondly, the highest tax rate begins to be applied at an exceptionally low level. As, in the first tax class, the 13 per cent highest marginal tax is applied to estates starting at EUR 60,000 and in gift taxation at EUR 50,000, it can be said that after these limits the inheritance and gift tax is a proportional tax.

The level of inheritable wealth has grown significantly over the last two decades. *The working group considers that the tax scale should be adjusted to correspond to present wealth conditions. The limits at which the 10 per cent and 13 per cent tax rates begin to be applied in tax class I should be raised, for example, to EUR 50,000 and EUR 150,000. In addition, a new 16 per cent tax rate could be introduced, directed only at very large inheritances and gifts. The lower limit of the highest tax rate could be, for example, EUR 1,000,000. Corresponding changes would be made to the scale of tax class II of inheritance tax and to gift tax scales.*

The working group considers that tax-favouring of investments in the form of endowment insurance should be removed, thus reinforcing the tax base and strengthening the neutrality of the financial market.

Two difficult to justify aberrations are associated with the valuation of corporate assets. In valuation law, for the reference value of a share, a cut-off rule linked to the now-abolished wealth tax is specified. According to this, the reference value of a share can be at most 50 per cent higher than the reference value of the previous year. If a limited company has been established with the minimum capital (EUR 2,500), the reference value of a share might still be only a fraction of its fair value after decades. This might place different limited companies in very different positions, with no sustainable justifications for such divergence. *For this reason, the cut-off rule should not be applied in inheritance and gift taxation.*

When property received as an inheritance or gift is disposed of, its acquisition cost when capital gains tax is calculated is generally considered to be the value adhered to in inheritance and gift taxation. However, when corporate assets whose inheritance and gift tax has been reduced are sold, the acquisition cost is considered to be the fair value at the time of acquisition. Thus when corporate assets are disposed of, the difference between the fair value and the reduced value applied in inheritance and gift taxation is not taxed as inheritance and gift tax or as capital gains tax. As, in the case of change-of-generation relief, the recipient is encouraged to retain possession of corporate assets received as an inheritance or gift, it is contradictory at the same time also to link tax advantages to the disposal of assets by applying to the capital gains taxation of such assets a significantly more advantageous tax treatment than general capital gains taxation. *For this reason, when corporate assets are disposed of, the acquisition cost should be the amount on which inheritance and gift tax was paid.*

Impact assessments of the working group's proposals

The working group has studied the impact of its proposals on the income distribution of households and on tax revenue. These studies are based on static calculations, which do not take behavioural effects into account. The impact of the proposals on the behaviour of economic units and thereby the economy has been assessed qualitatively in the different sections of the report.

The income distribution effects reflect the impact of the proposed tax changes on the real disposable incomes of households. The impact of changes in personal taxation is assessed with the TUJA micro-simulation model, which is based on Statistics Finland service data on income distribution. The latest data are from 2008, which have been updated for 2010. The income distribution effects of indirect taxation are examined using Statistics Finland consumption survey from 2006.

Calculations concerning income distribution effects are presented in Table 1. The changes proposed for personal income taxation consist of reductions in the earned income taxation scale, increases in capital income taxation, and the limiting of the deductibility of interest expenses and domestic help credit. The changes in personal taxation increase real disposable income in all income deciles. Income growth varies from 0.8 per cent to 2.2 per cent and is on average 1.6 per cent. At the highest income levels, the tightening of capital taxation clearly reduces growth of disposable income, because households at these income levels have most capital income. Similarly, the impact of the limitation of the domestic help credit and the deductibility of interest expenses will be greater at higher income levels, thereby reducing income growth. On the other hand, the effects of earned income taxation are relatively smaller at low income levels and disposable income increases proportionately more the higher the income level. This is mainly due to the fact that the proportion of pension and other benefit income is more significant than at higher income levels in these income classes, and that the earned income taxation of those receiving these forms of income will remain in the reform as before.

The income distribution effects of tightening indirect taxation, namely valued-added tax and excise duties, are similar. The tax increases are directed at all income classes, but proportionately more at those on low incomes. Excise duties, however, have a slightly more regressive effect than value-added taxation has.

The working group has found that the effects of raising excise duties are more regressive than, for example, the effects of raising value-added tax. This regressivity has different effects, in terms of different commodities, depending on whether the commodity is a necessity. For example, health benefits may be achieved through increases in health taxes if the price rise leads to a decline in consumption. The income distribution effect of energy and environmental taxes may, on the other hand, be more permanent, because these taxes are directed more than health taxes at commodities whose consumption cannot be influenced significantly.

The changes proposed for personal taxation and indirect taxation in their entirety reduce real disposable income by on average by 0.1 per cent. The proposed tax changes reduce income in the lowest income deciles and in the highest income deciles. The effects of the tax changes on disposable income vary in the different income deciles between -1.8 per cent and 0.6 per cent. The picture of the income distribution effects of the tax changes alters if the effect of the indirect tax changes on social security benefits via indexation is taken into account. Taking indexation into account alleviates the effect of tax tightening. Overall, however, the taxation of those on low incomes and in the highest income decile is tightened.

In its impact assessment, the working group has taken into consideration the proposals of the SATA Committee to be implemented in 2011. In addition to the indexation of benefits, the guaranteed pension will reduce income differences. The calculations do not include the impact on income distribution of the energy tax decision that comes into force in 2011.

TABLE 1. Effects of changes in direct and indirect taxes on disposable income by decile, per cent

Measure proposal, Income change per decile	Personal taxation	Indirect taxation	Taxes total	Indexation of social benefits	Guaranteed pension	All Total
1.	0.8	-2.6	-1.8	1.0	0.9	0.1
2.	0.9	-2.1	-1.2	0.8	0.4	0.0
3.	1.3	-2.0	-0.7	0.6	0.2	0.1
4.	1.7	-2.0	-0.3	0.5	0.1	0.3
5.	1.9	-1.9	0.0	0.4	0.1	0.5
6.	2.0	-1.8	0.2	0.3	0.1	0.6
7.	2.0	-1.7	0.3	0.2	0.0	0.6
8.	2.1	-1.7	0.5	0.2	0.0	0.7
9.	2.2	-1.6	0.6	0.1	0.0	0.7
10.	0.8	-1.1	-0.3	0.1	0.0	-0.2
ALL	**1.6**	**-1.7**	**-0.1**	**0.3**	**0.1**	**0.3**

From a tax revenue perspective, the proposals of the Working Group for Developing the Tax System are statically neutral, excluding, however, the effects of the proposed real-estate tax and inheritance and gift tax increases. This means that the joint effect of the proposed tax decreases and increases on tax revenue is zero, not taking the behavioural effects of the tax changes into account. Tax revenue calculations for the working group's proposals are presented in Table 2. According to the working group's proposals, the largest tax decreases in euro terms are in earned income taxation and the largest increases are in indirect taxation. With respect to real-estate taxation, the raising of the lower limit of the land tax percentage by 0.2 percentage points proposed by the working group will increase tax revenue by an estimated EUR 15 million. With respect to inheritance and gift taxation, the working group estimates that the tax reform overall will increase tax revenue slightly. It is not possible to make actual tax revenue calculations, however, because this would require an assumption on the development of the value of inheritances and gifts, which is difficult estimate. When estimating the effect of indirect taxes on tax revenue, it is also useful to examine the development of the index-linked social benefits mentioned above, because the tightening of indirect taxes has a direct impact on social benefits through indexation. According to the working group's calculations, the proposed tax increases will raise social security benefits by EUR 300 million.

TABLE 2. Tax revenue effects of the working group's proposals

	Tax changes EUR million	
PERSONAL INCOME TAXATION, TOTAL		-1,400
Capital income taxation	+ 500	
Deductibility of interest expenses	+ 90	
Domestic work credit	+ 70	
Other earned income taxation	- 2,060	
CORPORATE INCOME TAX		- 800
INDIRECT TAXATION, TOTAL		+ 2,200
Value-added taxation	+ 1,200	
Excise duties	+ 1,000	
TAXES, REVENUE		**0**

The table does not include the tax revenue effects of increases in real-estate tax and inheritance and gift tax.

The above calculations do not include possible behavioural effects of the proposed tax reforms. Through taxation, an effort is made to influence companies' investment and location decisions, labour demand and supply decisions, and the structure of consumption. Raising competitiveness, labour productivity and participation rates, for example, are key elements from the perspective of changing the economic environment and the sustainable funding of the public sector. If participation rates can be raised and increasing numbers enter the labour market, income differences will probably also be moderated and poverty risk reduced. Behavioural effects are therefore associated with both revenue and income distribution estimates. Changes in consumption and environmental taxation, on the other hand, aim to alleviate their harmful externalities.

It is often not possible to predict, however, the realisation of behavioural effects. Some of the changes may be realised only over the relatively long term, such as, for example, effects associated with education, energy-saving investments, new dietary habits or possibly labour supply and demand. On the other hand, the effects of tightening capital income taxation may become evident rather quickly.

The working group's proposals in brief

The working group proposes that the balance of taxation be shifted modestly from taxation on labour towards taxation on consumption. The working group proposes a reduction of around EUR 2 billion in earned income taxation on a static basis. The proposed changes to corporate and capital income taxation would reduce tax revenue on a static basis by around EUR 300 million. The reductions should be funded by increasing value-added taxation by EUR 1.2 billion. The remainder, amounting to around EUR 1.2 billion, should be funded by increasing excise duties and by limiting the deductibility of interest expenses and domestic help credit. The effects on behaviour of the tax changes have not been taken into account in these static calculations.

- The working group proposes that the earned income tax reduction be directed at labour income. The reduction should be applied such that marginal tax rates are lowered at all income levels. The reduction should be implemented such that the average tax rate at the lowest and highest income levels falls more than average. At the highest tax levels, the marginal tax rate should fall to around 50 per cent.
- The shift of balance towards consumption taxation should be implemented by increasing valued-added taxation and excise duties.
  - At this stage, value-added taxation should be changed such that the standard tax rate and the two reduced tax rates are increased by two percentage points. In value-added taxation, however, the goal in future should be towards a more uniform structure.
  - With respect to excise duties, both energy and environmental taxation and taxation of products harmful to health (health taxes) should be increased by around EUR 1 billion. The working group proposes that tax increases should be directed in terms of energy and environmental taxes to the basic tax on motor vehicles, the tax on consumer electricity (electricity tax class I), and taxes on transport and heating fuels. In addition, a windfall tax on electricity production should be introduced. Health taxes (excise duty on soft drinks, excise duty on sweets and ice cream, tax on alcohol) should be increased, while monitoring the development of cross-border shopping and the shadow market. The tax base of the excise tax on sweets and ice cream should be broadened. The introduction of a sugar tax should be explored.

- The working group proposes, with respect to corporate and capital income taxation, a shift from corporate income taxation to personal-level capital income taxation. As part of this change, the tax exemptions of dividends received from an unlisted company should be removed and replaced with reduced taxation of the normal return of the dividend. This should be implemented such that the tax rate (company and shareholder) of the normal return of the profit distributed by a company corresponds to the general capital income tax rate.
  - The corporate income tax rate should be reduced from the present 26 per cent to 22 per cent and the general tax rate on capital income raised from 28 per cent to 30 per cent.
  - In contrast with the earlier practice, dividends received from listed companies should be fully included in taxable capital income.
  - 35 per cent of the part corresponding to the 'normal return' of dividends received from an unlisted company should be included in taxable capital income, representing a tax rate on dividend income of 10.5 per cent. The overall tax rate of the normal return of profit distributed by a company would accordingly be 30.2 per cent, which corresponds to the general capital income tax rate. Dividend exceeding the normal return should be fully taxable capital income.
  - The normal rate of return would be confirmed annually and determined as the medium-term interest rate on government loans after corporate tax. The normal return would be calculated on the basis of a company's net asset value per share.
- It is proposed that taxation on housing be changed such that the tax treatment of rental and owner-occupied housing be brought closer together. The working group considers that the most appropriate way of harmonising the tax treatment of owner-occupied and rental housing is to reduce the right to deduct interest paid on mortgage loans. The working group proposes that the proportion of deductible interest expenses be reduced gradually, by five percentage points per year. Thus after four years, 80 per cent of interest expenses on mortgage would be deductible. The working group considers it justified that, in the long term, the right to deduct interest paid on mortgage be removed.
- The working group considers that the structure of local government taxation should be changed such that cyclical fluctuations would affect the tax base of municipalities as little as possible. Corporate income tax is very cyclically sensitive form of taxation, and for this reason the working group considers that the municipalities' share of corporate tax should be transferred to central government. Municipalities should be compensated for revenue losses arising from this primarily via the system of central

government transfers to local government. The working group does not propose new forms of taxation for the municipalities.

- The working group considers that the proportion of local government tax revenue accounted for by real-estate tax should be increased significantly. The working group considers that, in real-estate taxation, the difficulties arising from increasing taxes for households whose income in relation to real-estate value is small should be taken into account.
  - The development of the revenue equalisation system and the system of central government transfers to local government should be reviewed with the goal of improving municipalities' opportunities to use the real-estate tax. The desired objective is to raise real-estate tax revenue by 50 per cent from its present level to EUR 1.2 billion, which would mean an increase of tax revenue of around EUR 600 million.
  - The emphasis of the real-estate tax should be transferred gradually to taxation of land, and tax rates specified for land separately.
  - The lower limit of the tax rate on land should be raised 0.2 percentage points to 0.8 per cent.
  - The upper limits of the real-estate tax rates should be removed in terms of land, commercial buildings and permanent residential buildings, but maintained in the taxation of power plant buildings and other residential buildings.
  - Taxation of undeveloped land (planned for housing) should be maintained in line with the present system at a higher level than the general real-estate tax.
  - With respect to agricultural and forest land, the preconditions for real-estate taxation should be reviewed.
  - It is important that the taxation values of real-estate are consistently close to their market values.
- The working group proposes that inheritance and gift taxation be reformed as follows:
  - The tax scale should be adjusted to correspond to current wealth conditions by raising the limits at which the 10 per cent and 13 per cent tax rates begin to be applied in tax class I, for example to EUR 50,000 and EUR 150,000. In addition, a new 16 per cent tax rate could be introduced, directed only at very large inheritances and gifts. The lower limit of the highest tax rate could be, for example, EUR 1,000,000. Corresponding changes would be made to the scale of tax class II of inheritance tax and to gift tax scales.
  - Tax-favouring of investments in the form of endowment insurance should be removed, thus reinforcing the tax base and strengthening the neutrality of the investment market.

   - When corporate assets are disposed of, the acquisition cost in capital gains taxation should be the amount on which inheritance and gift tax was paid. The 'cut-off rule' for the reference value of a share should not be applied in inheritance and gift taxation.
- Moreover, with respect to the domestic help credit, the allowance system should be reformed such that the deductible share of labour costs is reduced from the present 60 per cent to 50 per cent. The maximum amount of the deduction should also be reduced from EUR 3,000 to EUR 2,300.