Problems of Equity in Modern Income Taxation

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Revenue Driven Taxation

The proposition in this article is that the Norwegian tax system is basically revenue driven. Much inequity is accepted because that is the only way such a large proportion of GDP may be extracted in taxes.

The political arguments offered in legislative preparatory works may not reflect the importance of the revenue motive for the tax legislators. Tax measures are often justified by emphasizing the need for more equity in the tax system. It is, however, when looking at the basic structure of the tax system, rather easy to argue that the overriding concern is revenue. If one looks too much for the justice and fairness of the modern Norwegian welfare state tax system, one may simply overlook its most basic rationale.

Taxes as Part of – what – GDP

Taxes are a very political subject. In Norwegian debate, it has even become politicized how taxes should be measured as part of GDP. OECD appears to have accepted that the petroleum sector should be included when measuring taxes as part of the GDP. For 2000, taxes amounted to 43.4 per cent as part of the Norwegian GDP when the petroleum sector is included. This proportion of taxes to GDP is fairly high in an international context, but not near the absolute top. The numbers have been fairly stable, with a slightly increasing trend from 42.5 per cent in 1995.

When one excludes the petroleum sector, Norway is much closer to the absolute world top in taxes as part of GDP totalling 49.4 per cent in 2000, up from 46.3 per cent in 1995. That is slightly lower than Sweden and Denmark, but clearly above the average for the EU member states. In Norwegian debate, the Treasury also has introduced a new tax to GDP-ratio called the Oil Adjusted

Ratio (oljekorrigert).[1] Taxes to GDP are 45.4 per cent under this new concept. In the view of this author, the Oil Adjusted Ratio does not add much of interest to the debate. It is probably best seen as an acceptance by the Treasury that Norway has to make some adjustments for the petroleum sector, but that it is politically sensitive to accept a tax to GDP ratio as high as 49.4 per cent.

Some readers may ask why the tax to GDP ratio goes down when one includes the petroleum sector where it may be known the tax burden is extra high (the normal 28 per cent business tax plus a surtax of 50 per cent). One of the reasons is that the investments on the Norwegian Continental Shelf are so heavy that even a high tax rate on net profits does not increase the tax burden compared to mainland Norway.

User Fees and the "Interest Tax"

Since 2001 Norway has been having a centre-right government pledged both to lowering taxes, but, at the same time, not really reducing public expenditure. It remains to be seen how much taxes may be reduced as a percentage of GDP.

To a certain extent, a policy of reducing taxes, but not public expenditure, represents a kind of double bind or blind alley.

One aspect of this policy may be the increasing reliance on user fees in Norway, especially road user fees. These fees are not regarded as taxes when calculating taxes as part of GDP. Another aspect of this paradoxical policy may be the Norwegian interest rate (real interest rate adjusted for inflation) that for some time has been much higher than within the EU and much of the OECD area. High interest rates may be regarded as a way of withdrawing purchasing power from the private sector in much the same way as taxes do. Not wanting to increase ordinary taxes, and wishing to avoid cutting public expenditure and mounting inflation rates, higher interest rates be may the only option left.

Connecting to the main theme of this article, both user fees and interest rates may be regarded as a kind of regressive taxes. They illustrate that when there is a competition between the purchasing power of the public purse and the private sector, it is the purchasing power of ordinary people it may be important to reduce.

The Dual Norwegian Income Tax System

The Norwegian income tax is modelled according to what has been labelled the Nordic Dual Income Tax. There are clear similarities between the Norwegian income tax system and the income tax systems of Sweden and Finland. All income, both for personal taxpayers and corporations, is taxed at a flat rate of 28 per cent (with certain thresholds and exemptions for personal taxpayers).

Salaried income and income in small corporations where at least two thirds of the shareholders take an active part in the running of the enterprise are taxed at

1 *See* report to Parliament No 1 2001-2002 at 114 (St meld nr 1 2001-2002 Nasjonalbudsjettet 2002 s 114).

an additional 7.8 (10.7) per cent social security contribution and a top tax of 13.5 and 19.5 %. (A more correct way of stating the point is that two thirds of the equity should be held by such shareholders; the number of shareholders in itself does not matter.) The top tax rate on salaried income adds up to 55,3 %, from an income of NOK 830,000 (euro 115,000). The rate reaches 49,3 % from NOK 320,000 (euro 45,000). In addition, there is the payroll tax of 14.1 per cent (in most towns and populated areas, down to 0 per cent in some desolate and northern regions. The national average of the payroll tax is approx. 12 per cent). For salaries of NOK 830,000 from the same employer (or affiliated employers) there is an extra 12.5 per cent pay roll tax, called the "kakseskatt" ("richie tax") increasing the marginal payroll tax to 26.6 per cent. If one takes the payroll tax into account, the top marginal tax rate on salaried income adds up to 64.7 per cent [100 % x (55.3 + 26.6)/(100 + 26.6)] = 64.7 %.

The differences in tax rates are substantial. A considerable part of Norwegian tax planning consists in converting salaried income into capital income that may be taxed at the rate of 28 per cent. If the operation succeeds, an employee may end up with an increase in after tax income of 72 per cent (100 – 28) instead of 33,3 per cent (100 – 64.7), an increase of more than 116 per cent in after tax income.

The tax statistics state quite clearly that high levels of salaried income do not really mean that one is really rich. For the income tax year of 1996 the 204 persons with the highest taxable income (average of NOK 28,439,585) had an average of salaried income of NOK 840,473).[2] In other words, of the really rich only a small fraction of their income was subject to the high marginal tax rates. The clearly substantial part of their income was taxed at 28 per cent, a marginal tax rate ordinary salaried persons may only dream of. There is no reason to believe that these basic facts have changed.

One may ask why politicians who clearly state that they want an equitable tax system accept such a tax system. The answer is quite simply revenue – and tax competition. If the politicians want a large tax take, ordinary people must be taxed heavily. The money is where the numbers are high – and that means the numbers of taxpayers. The relatively few taxpayers who possess large sums of money are much more fluid. The politicians obviously fear, and with reason, that if the high tax rates are made to bite the really rich, some of them simply go away – to tax jurisdictions with more comfortable tax rates.

The People's Taxes

The Norwegian tax statistics are quite clear in confirming this basic point about the effects of the modern Norwegian welfare state tax system. The government's large tax take is where there are a great number of people. There are four kinds of taxes that might be called the people's taxes. They may all be regarded as taxes on salaried income: The tax on general income paid by personal taxpayers,

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2 *See* NOU 1999:7 Flatere skatt (Norwegian Governmental Report Flatter Tax), Appendix 6, Gjems-Onstad, Ole, *Toppskatt, kakseskatt, formuesskatt – og omfordeling*.

the social security contribution tax, the payroll tax and the valued added tax.[3] As these taxes are proportional and basically levied on the same tax base, salaried income, it should come as no surprise that the tax revenue per percentage point is about the same – an average of 5-7 billion NOK for the tax year 2001.

With the estimated numbers for the tax year 2001, the tax on general income at a proportional rate of 28 per cent totals NOK 144.6 billion (NOK 5.1 billion per percentage point), the social security contribution NOK 53.8 billion (average of approx NOK 6 billion), value added tax NOK 126.3 billion (average of NOK 5.3 billion) and the payroll tax NOK 75.2 billion (average of NOK 6.3 billion).

Norway levies a net wealth tax. The tax rate is not high at a maximum of 1.1 per cent and the tax assessments of real estate etc often moderate. The exclusions from the net wealth tax are numerous, e g goodwill and immaterial assets developed by the owner. The threshold is, however, very low at NOK 120,000 (euro 16,000). Out of a population of 4.4 million people, approx 1 million are due to pay the net wealth tax. The name of the tax should indicate that it was supposed to be a tax on wealthy people. In practice, it is rather a tax on pensioners and other persons who hold their wealth in financial assets, especially bank accounts, where there is little difference between the market value of the assets and the assessed values.

During recent years, based on anecdotic evidence, tax advisors often refer that more wealthy clients consider emigrating from Norway due to the net wealth tax. Of the revenue from the tax, estimated at NOK 7.5 billion (euro 1 billion) for the fiscal year 2001, a large proportion comes from taxpayers not owning much more than the threshold (which could hardly buy one a toilet seat in a one-room studio in Oslo). The present government has declared that it would like to abolish the net wealth tax due to its many inequities, accidental assessments etc. Revenue considerations may make this very hard. It may also prove difficult, due to revenue considerations, to increase the paradoxically low threshold of the net wealth tax. The simple fact that the net wealth tax has turned into a tax on the assets of ordinary people has made it into a not insignificant revenue instrument.

The net wealth tax may have been introduced due to considerations attending equity and redistribution of wealth. The main reason why it is continued may be revenue. And the reason why it renders revenue not to be overseen is due to the fact that it has turned into another people’s tax.

The Top Tax – Redistribution Among Salaried Employees

The Norwegian top tax is a surtax on salaried income (and on active shareholders in small corporations where at least two thirds of the equity is held by persons, or their relatives etc, taking an active part in the business). The general income tax at 28 per cent and the social security contribution at 7.8 per cent are proportional taxes, apart from the basic threshold and some exemptions making the general income tax progressive for small incomes. The top tax

3 NOU 1999:7 Flatere skatt at 60 included the Norwegian VAT of 24 per cent when calculating marginal tax rates on salaried income.

starting at 13.5 % from an income of NOK 320,000 (euro 45,000), increasing to 19.5 % at NOK 830,000 (euro 115,000) is normally looked upon as the clearly progressive element in the Norwegian income tax system.

There may be little doubt that the top tax redistributes income. The question is among whom.

Analysing the income tax data for the 10,000 persons with the highest gross general income for the income tax year 1996, one finds that the average gross income for this group was NOK 2,693,064.[4] Only 22,21 per cent of this income, however, was salaried income subject to the top tax. If one looks at the proportion of top tax income to net general income, the percentage increases somewhat, but not much, to 25.79 per cent. The point is quite simply that persons with really high income (according to Norwegian standards) do not generate this income as salaried income. Therefore, under the Norwegian dual income tax system, where capital income is taxed at much lower rates than salaried income, one risks developing a tax structure where the high tax rates do not concern much of the income of the really rich.

If one looks at the very top of the income pyramid, the 204 taxpayers with the highest general gross income (averaging NOK 28,439,585), the part of the income subject to top tax, and not only the general income tax rate of 28 per cent, was, on average, 3.22 per cent.

The conclusion appears quite clear. At the top of the income scale where the largest part of the income is capital income taxable at 28 per cent, the top tax does not add any significant progressive element to the tax burden. To taxpayers who mostly earn salaried income, the top tax adds to the tax burden in a highly noticeable way. The marginal tax rate for an ordinary employee with a salaried income below NOK 320,000 is 35.8 per cent (pluss up to 14.1 per cent payroll tax). For a CEO or somebody else with a salaried income above NOK 830,000 the marginal tax rate is 55.3 % (plus 26.6 per cent payroll tax). There is no doubt that the tax burden varies substantially between different income levels for taxpayers with mostly salaried income.

The question still remains, is this an important kind of redistribution of income? It may appear as some kind of redistribution effect among the masses, admittedly the upper part of the 'masses' – leaving the really rich out.

In the Norwegian tax debate in the popular media, the top tax has attained significance as an instrument for the redistribution of income. If there is put forward a proposal to mitigate the top income tax rates to lessen the difference between the tax rates for employees and for the owners of the enterprises, the media will often apply headlines talking about tax packages for the rich. One overlooks that the really rich are not subject to the top tax for any substantial part of their income.

The labour unions have been strongly in favour of the top tax. As long as most voters and union members think the top tax works as a redistribution device, the unions will at least appear to do something about the income gap between the really rich and more ordinary people, an income gap many taxpayers perceive as widening.

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4 *See* NOU 1999:7 Flatere skatt (Norwegian Governmental Report Flatter Tax), Appendix 6, Gjems-Onstad, Ole, *Toppskatt, kakseskatt, formuesskatt – og omfordeling*.

The top tax has also got its own revenue catch. When the top tax was first introduced, the intention was to catch only the really high salaried incomes. As the thresholds were not increased in pace with the annual wage increases, the number of persons paying the top tax steadily increased. During the recent years, around 800,000 taxpayers have been subject to the top tax. As the revenue for the Treasury is where the masses are, the revenue from the top tax has also increased. The estimate for the tax year 2001 is NOK 16.4 billion. This is far less than the really broad ranging "people's taxes", e g the tax on general income, the social security contribution, the payroll tax and the VAT. But the sum is still so substantial, that even though one might realise that the top tax does not fulfil its goals, it would create a not insignificant revenue gap to do away with it.

One might also wonder whether the top tax is necessary as some kind of justification device to make the tax system appear as progressive. If most Norwegian taxpayers really understood how regressive the tax system is for the really rich, it might be asked whether it would be possible for the government to levy such a high tax burden on most ordinary people.

Inheritance Tax

The tensions in the Norwegian tax system between the formal justification of a tax and its actual effects may never be so evident as regarding the inheritance tax. As late as in 2000 a Norwegian Governmental Commission recommended that the inheritance tax be upheld as it served important functions in the Norwegian tax system adjusting for some of the inequities and deficiencies of the net wealth tax.[5]

The inheritance tax is not important from a revenue point of view. The estimated revenue for the fiscal year 2002 is NOK 1.4 billion, which is approx 0.1 per cent of GDP. The Norwegian inheritance tax is levied on the heirs, and recipients of some gifts rendered during the donator's lifetime. The rates are 20 per cent for children and 30 per cent for grandchildren and other taxable recipients. Spouses are not subject to the inheritance tax. There is a tax free threshold of NOK 200,000 and another bracket of NOK 300,000 where the tax rates are only 8 per cent (children) and 10 per cent (grandchildren and others).

The substantial part of the inheritance tax revenue is paid by ordinary people.[6] To avoid interfering with intergenerational transfers of enterprises, the Norwegian Parliament has put some very special assessment rules into the Inheritance Tax Act 1964 art 11 A. For bank accounts and financial assets, the taxable base will be the nominal and factual value. The same applies to real estate owned directly by the deceased or donor, even though the assessments for inheritance tax rates may be somewhat lower reducing the effective rates somewhat from the nominal 20/30 per cent.

5 NOU (Norwegian Governmental Commission) 2000:8 *Arveavgift* (Inheritance Tax).

6 *See* the statistics offered in NOU 2000:8 para 5.4 at 83-88.

If the property is held indirectly through non-listed companies, the tax base is adjusted grossly downwards. Firstly, one is to reduce the assessed values by 70 per cent. The effective tax rates will then be either 6 per cent (20 per cent x 0.3) or 9 per cent (30 per cent x 0.3). Secondly, one is to use the assessment values applied for net wealth tax purposes. Real estate held by an unlisted corporation may then end up with an assessed value of 10-15 per cent of real value. Added on to the reduction of 70 per cent, the effective inheritance tax rates may, in some instances, especially relating to corporations holding real estate, amount to less than 1 per cent (20 % x 0.15 x 0.3 = 0.9 %). As most corporations may have some debt, the assessed values may often be zero or negative, even though the factual values may reach into the hundreds of millions.

The Inheritance Tax Commission in its report published in 2000, proposed that the assessed values in future be more clearly linked to sales values. Representatives of political parties with a majority in the Norwegian Parliament within hours had laid this proposal “dead”.

The reasons behind the very favourable assessments for unlisted companies are obviously not to favour the rich. The politicians have wanted to shield ordinary businesses from the potentially devastating liquidity and equity effects of an inheritance tax using real sales values as its base. Nevertheless, as most rich people own their assets through unlisted companies, or may easily do so, the effect of the Norwegian assessment rules is that rich people do not need to pay inheritance tax – unless they for some reason would like to do so.

There may be no doubt that the inheritance tax results in redistribution effects between ordinary people receiving ordinary gifts or bequests by the way of some hundred thousand or a million NOK in bank deposits, personal real estates, mutual funds or listed equities. Those receiving less than NOK 500,000 will pay up to 8/10 per cent. If one receives more, the rates are 20 and 30 per cent. When one considers what one might call the very rich, there is hardly any or none redistribution effects. On the contrary, the redistribution effects are probably negative. The relative differences between ordinary people and the rich are more likely to be increased by the Norwegian inheritance tax.

Equity in Taxation – Costing too Much?

Norway underwent a far-reaching tax reform in 1992. This reform laid the foundation for the Norwegian version of the Nordic Dual Income Tax System under which capital income, and thereby the income of the rich, may be taxed at substantially lower tax rates than the salaried income of more ordinary people. There have been calls for a more equitable tax system applying a flat tax or at least more proportional tax rates.

In 1999 a Norwegian Governmental Commission submitted a proposal for a flatter tax[7]. The basic proposals were unanimous, and the commission had representatives from the Treasury.

Nothing came out of the proposals of the flat tax commission. To the contrary, not long after the report was submitted, the majority in Parliament

7 NOU 1999:7 *Flatere skatt*.

increased the differences between the taxation of salaried income and capital income by adding an extra 6 per cent bracket to the top tax ending up with a marginal top tax rate of 19.5 per cent instead of the previously 13.5 per cent.

In 2001, another commission has been appointed to put forward proposals to put more equity into the tax system. One may wonder how much will come of it. The dilemma appears not to be that one does not know what one might do. The problem is that the obvious solutions cost too much. The tax dilemma of the welfare state, as evidenced by Norway, is that one has come to rely upon such a heavy tax burden that one has to apply inequitable tax instruments to extract sufficient income from the taxpayers.

Tax competition does not appear to be a serious threat inducing any significant number of ordinary employees to leave a country's tax base. Capital, and its owners, the truly rich, are by most countries perceived as more subject to the attractiveness of lower tax rates in other jurisdictions. In Norway, the general income tax rate of 28 per cent – which is the same as the tax rate on capital income – has been unchanged since the Tax Reform 1992. The tax on salaried income has been increased through the extra top brackets in the top tax and the payroll tax.

The period since 1992, during which the Norwegian tax on capital income has been frozen, has witnessed increasing tax competition between countries. This tax competition has been perceived as potentially more dangerous due to the ever increasing cross border movements of capital. Tax competition may explain why Norway has not increased its capital income tax rate. The constant need for more revenue to enable more public expenditures offers the reason why Norway during the same period has increased the tax rates for salaried income.

Paying for Justice with Inequity

In an ever more global business environment, the harder the tax burden, the more inequitable the taxation may become. It may be fairly illustrative that in Norway small businesses may end up with a marginal tax rate of 55.3 per cent if there are a sufficient number of active shareholders. Probably very few, if any, members of the Norwegian Parliament would even dream of taxing multinational corporations at such rates. It may appear as self evident that even though the rates might be high, the tax base would easily shrink, if not to close to zero, then at least by substantial amounts.

Still, there may be no doubt as to the many redistribution effects of the numerous welfare schemes financed by the large tax take. Maybe there is an implicit understanding among many politicians and parts of the public, that an inequitable tax system is the price a modern welfare state may have to pay for well-developed social systems with all kinds of services and payments and support systems.

As the tax system is often talked about as highly complex and close to impossible to understand, it may also be that the system is accepted much due to the fact that it is not understood. But no modern politician, neither in Norway nor in any other country, has ever given the electorate the choice between an inherently inequitable tax system *or* an extensive welfare state. Consequently, one may only guess about the answer.