

Tax Legislation Between Politics and Legal (and Economic) Thinking

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1 Tax Law as Proactive Law

The purpose of tax rules is not primarily to solve legal conflicts but to provide the legal basis for tax collection and to distribute the tax burden in a fair and efficient way. Indeed, more often than not, too little attention is attached to the problem-solving functions of tax rules; at least this is so in Norway. This is due to the fact that legislators normally are very concerned about the overreaching aims of the rules, often having too little time and attention to take care of the more legal aspects of the tax rules.

An illustrative example is the process which led to the tax reform of 1991 in Norway. The expert committee, chaired by then professor of tax law Magnus Aarbakke, was asked by the Ministry to deliver its report earlier than originally planned, and, as a consequence, the committee did not have time to spell out its proposals in statute text and specified comments. This probably had an unfortunate effect on at least one set of rules which was the result of the process: The purpose of the so-called division rules was to separate earned income from capital income, which was essential in view of the different tax rates which applied to those two categories of income. These rules turned out to be the Achilles' heel of the tax reform: They were difficult to handle in practice and were very vulnerable for tax planning and lobbying. Ultimately, they were scrapped in the tax reform process of 2004-06. The reform of 1991 depended to a large extent on the existence of such rules but their ability to solve legal problems was not taken sufficiently care of in the process.

Thus, in a way, tax law has always been proactive law – even if that term has not been used – and sometimes too much so.

However, even if we focus on these overreaching functions of tax rules – tax rules as proactive law – and for a minute forget about problem-solving, there are interesting aspects to be studied. One important aspect is the relationship between the politics of taxation and the legal (and economic) thinking in the field of taxes. To be more specific: To what extent do legal (and economic) thinking influence tax legislation and to what extent are the tax rules a result of purely political considerations and compromises?

Of course, this question cannot be answered once and for all. If an issue is considered to be of high political or ideological importance, then legal and economic arguments will in practice seldom prevail. An illustrating example is the introduction of reduced value added tax rates on food in Norway. Even if an expert committee argued clearly against such differentiating of VAT rates – both on an equity and efficiency basis – and pointed to other more efficient means,¹ such a differentiation was nevertheless introduced in 2001. For issues of a more detailed or technical nature, economic and legal reasoning to a larger extent tends to prevail.

In the following, an attempt is made to study this issue more closely by examining two tax reform processes in Norway: The tax reform of 1991 and the – aborted – reform of the taxation of owner-occupied dwelling houses in 1996-97.² The first process was a success: For some golden minutes, a broad majority in Parliament across the political spectrum agreed to significantly broaden the tax base and lower the tax rates. The second process was a complete failure: The Parliament did not agree on anything.³ The first closely followed recommendations of the expert committee; in the second process, the view of legal and economic experts – even rather elementary points of view – were disregarded.

Of course, such a study is much too limited to provide a basis for any wide-reaching conclusions. However, it may give an indication as to the conditions that must be fulfilled for a tax reform process to succeed and the economic and legal insights to prevail – or, in other words, to produce fair and efficient proactive tax law.

The following account assumes that a dividing line can be drawn between (purely) political arguments on the one side and legal and economic arguments on the other. This, of course, is not easy. By legal and economic arguments I refer to arguments that are based on legal and economic tax theory, which in turn is founded on the basic values and foundations of the tax in question. For the income tax, which is in focus here, these are the principles of (economic) efficiency and of (horizontal and vertical) equity. The typical counterpart is arguments based on sector interests and lobbying and arguments the prime purpose of which is to woo the voters.

2 The Tax Reform of 1991

The tax reform of 1991 is the Norwegian version of the international tax reform trend of those days, going back to the Reagan reform in the US of 1984, the

¹ NOU 1993: 8 *Bør merverdiavgiften differansieres.*

² The following is based on my article *Er rasjonell skattepolitikk mulig?* [Is rational tax policy possible?] printed in David R. Doublet et al. (eds) *Stat, politikk og folkestyre. Festskrift til Per Stavang på 70-årsdagen, 19. februar 1998*, Bergen 1998, s. 207-17.

³ Later, in 2004, the income taxation of owner-occupied dwelling-houses was abolished. However, the process in 1996-97 was focused primarily on the valuation of dwelling houses (on which the benefit of the owner was calculated schematically) and such valuation is still necessary for wealth tax, real estate tax and inheritance tax purposes.

catchword of which was: broader tax base, lower tax rates. On establishing the expert committee in 1988, the Ministry of Finance stated that the yield of real investments in Norway was low in international comparison and that the tax rules were partly to blame. A host of tax credit rules (i.e. rules which anticipates deductions and defers income) had grown into the system, each of them probably supported by good arguments, but in total forming a very complex system and giving investment incentives which often was contrary to what was profitable from a general economic point of view, thus leading to misallocation of resources. Investments might be unprofitable before tax but profitable after tax. Thus, efficiency arguments were in focus.

This gave the tone for the reform process. The expert committee – often referred to as the Aarbakke group, named after its chairman – based its proposal first and foremost on the concept of neutrality in the taxation of capital income.⁴ A lot of tax credit rules should be abolished and consistent taxation of capital gains on shares should be introduced. In addition, the tax rate for capital and company income should be significantly reduced, in order to make the Norway's tax system competitive in an international setting and to significantly reduce the effect of the right to deduct interest. The group anticipated that it would not be possible to reduce the income tax rates for earned income to the same extent – for revenue as well as equity reasons – and therefore favoured what has later been referred to as the Nordic dual tax system: A system in which capital and company income is taxed at a relatively low and proportional tax rate and earned income is taxed at progressive and higher tax rates, though significantly lower than before.⁵

The approach and the main proposals of the group were supported in the following process by Governments of different political colours. In 1989-90, the then conservative Government presented a white paper based on the report from the group, and in april 1991, the then social democratic Government presented its reform proposal for the Parliament, also based on the proposals from the group.⁶ After two months of rather heated debate, the Finance committee in its report to the Parliament in a broad compromise concluded in accordance with the proposals on the essential issues,⁷ which were then adopted by the Parliament in July of 1991.

This was the peak of the influence of economic and legal expertise on this tax reform process, and perhaps on any tax reform of the last decades. The report of the Finance committee to a large extent replicates the view of the expert committee, stressing the need to reform the system in order to increase the yield of investments and to base the new rules on the principles of neutrality, the broadening of the tax base and the reduction of tax rates.

However, this political consensus did not last long. Already some months later, in the autumn of 1991, it broke down. The net wealth tax had only to a limited extent been included in the tax reform process so far, the main reason

⁴ NOU 1989: 14 *Bedrifts- og kapitalbeskatningen – en skisse til reform*.

⁵ This tax rate structure requires rules to separate the two kinds of income. These so-called division rules has already been referred to above as the Achilles' heal of the reform.

⁶ Ot. prp. nr. 35 (1990-91).

⁷ Innst. O. nr. 80 (1990-91).

being that the Aarbakke group did not have time to include it in its main report. The group presented its view on the net wealth tax in a special report which was released in spring 1991.⁸ The group proposed to keep the net wealth tax as part of the tax system (though one member dissented) and proposed that it should be reformed along the same lines as the income tax.

A core issue was the valuation of non-listed shares. Such shares were until then valued very leniently, at half of the share's part of the liquidation value of the company. In accordance with the principles on which the reform was based, the Parliament, in its decision of July 1991, decided that the valuation instead should be based on the taxable values of the company, which meant significantly higher values. However, the conservatives and the right wing Progressive party dissented, and this was an omen of what was to come.

In its white paper on the wealth tax, presented in October of 1991, the Government proposed to reform the net wealth tax according to the proposals by the Aarbakke group and a clear majority in the Parliament endorsed this approach.⁹ However, this proposal was never adopted by the Parliament and in the following process, even the decision of July 1991 on the valuation of non-listed shares were reversed.

To understand this development, it is important to have an eye for the fact that the economic conditions of that time were very difficult. A common understanding emerged, according to which the situation was particularly difficult for the small and medium-sized businesses (SMBs), which was considered to be the backbone of Norway's economy. Every tax rule which was not in favour of SMBs was considered negative. Of course, the new rule on the valuation of non-listed shares was one such rule. Bowing to the pressure, the Government in December instead proposed to reduce the valuation of non-listed shares to only 30 % of the taxable value of the company and this was adopted by the Parliament. The reasoning of the Finance committee was very pragmatic: The proposal was part of a package to secure the conditions for the SMBs in the then difficult economic situation.¹⁰

This new rule, of course, was in blatant contradiction to the principle of neutrality that had prevailed until July of 1991. It led to very low valuations of non-listed shares, and the rule was very favourable not only for SMBs as such but also for all kinds of family wealth that could be put into a company. The rule even spilled over into the inheritance tax, with the effect that, up until this date, family wealth can be transferred to the next generation virtually without inheritance tax. Even worse, the process effectively killed the reform of the net wealth tax which, consequently, has remained unreformed until this day.

In sum, the tax reform of 1991 illustrates, up to a certain point, a unique adherence of the political community to the proposals from economic and legal tax experts. However, it also illustrates how fragile such an alliance is, when confronted with the problems of day-to-day politics.

⁸ NOU 1991: 17 *Bedrifts- og kapitalbeskatningen. Beskatning av formue.*

⁹ St. meld. nr. 12 (1991-92) and Innst. S. nr. 50 (1991-92) respectively.

¹⁰ Innst. O. nr. 35 (1991-92).

3 The “Dwelling-house tax” Debate of 1996-97

The term “dwelling-house tax” in Norwegian debate refers to the income taxation of the benefit of the owner’s use of his dwelling-house. Such income was computed schematically, as a percentage of the taxable value of the house. This taxable value is primarily set for wealth tax purposes. Thus, the core of the debate was the principles of valuation of dwelling-houses.

Norway has never had a consistent system for valuation of dwelling-houses. Therefore, the valuations are generally very low and – worse – varying a lot from municipality to municipality and even within the same municipality. Dwelling-houses of a low and moderate value are probably discriminated against because the undervaluation is believed to be larger for valuable than for less valuable houses.

A proposal to reform the system was presented by an expert committee as early as in 1973.¹¹ A heated debate followed, which gave the tone for the debate the following 30 years or so.

In 1996, the then social-democratic Government presented a white paper in which it proposed to reform the valuation system and also presented its main views on the income taxation on imputed income on dwelling-houses.¹² The paper also contained some examples on the effects of some of the proposals. Again a fierce debate followed.

The Finance committee of the Parliament decided to discuss the “dwelling-house tax” profoundly and this raised the issue as to whether the benefit of the owner should be taxed as income at all. Of course, based on the fundamental principles of equity and efficiency, legal and economic theory concurs in considering such taxation an inherent and logical part of a comprehensive income tax.¹³ However, the report from the Finance committee contains no references to such views.¹⁴ Instead, political rhetoric prevails – as for instance: the dwelling-house is a home and not an object for investment and speculation. More surprisingly, the report neither contains any considerations as to the loss of revenue which would follow from the proposals. This is very rare in a tax document from the Finance committee and it illustrates clearly the heavy impact of the purely ideological and lobby-based arguments: The politicians were moved to propose the reduction or out-right abolition of the tax, regardless of the costs. Put on its edge, the document implies tax reductions which were not calculated, on the basis of arguments which have no basis in economic or legal thinking.

¹¹ NOU 1973: 3 *Skattlegging av boliger*.

¹² St. meld. nr. 45 (1995-96).

¹³ To mention just one example: Messere, Ken: *Tax Policy in OECD Countries. Choices & Conflicts*, Amsterdam 1993, p. 234: “In theory, the owner-occupier should be taxed on the net rental value of his dwelling...”. If not, “...equity is violated and resources are mis-allocated”.

¹⁴ Innst. S nr. 143 (1996-97). The majority proposed to keep the “dwelling-house tax” but with so high tax free amounts that only a small part of the house-owners would pay the tax. The minority proposed to abolish the tax.

4 Significant Differences Between the two Debates

There are striking differences between the two debates. Whereas the legal and economic thinking prevailed in the reform debate of 1991 – at least until July of that year – such thinking had no impact in 1996-97. Which can be the reasons for these differences?

One apparent reason is that the reform of 1991 was based on a common understanding that something had to be done, and it was presented as a package, in which the broadening of the tax base was combined with a significant reduction of the tax rates. The conservatives were very pleased with the reduction of the tax rates; the fact that the top marginal tax rate for earned income would be lower than 50% – for the first time in decades – was considered as an important victory for a core element of their tax policy. The broadening of the tax base was acceptable, not least because it was supported by economic and legal thinking, as a means to encourage economically sound investments. The decreased value of the interest deduction corresponded with the reduction in the tax rates for interest (and other capital) income and, therefore, symmetry in taxation was preserved. – The Labour Party, on the other side, accepted the view that nominal high tax rates would not have the intended redistributive effect if the tax base was narrow and inconsistent, making it easy for well-off people to avoid the high tax rates by tax planning. Thus, the reform – broadening of the tax base – would probably increase the redistributive effects even if the tax rates were significantly reduced. In addition, the Labour Party – as the conservatives – was convinced that something had to be done with the inconsistent tax base. – Thus, across the political landscape there was a common “crisis understanding” and the parties were able to focus mainly on the effects of the reform that was consistent with their program instead of features that was considered as negative.

By contrast, in the “dwelling-house tax” debate, there was no such common understanding and no package with positive and negative features. The proposal was generally considered as negative by the taxpayers, even if it would have resulted in lower taxes for most of them: Even if the value of most houses would increase, the tax free amount was proposed to increase even more; thus, only rather valuable houses would be taxed. One important reason for the negative reactions probably was a fear that once increased values were in place, it would be easy to increase the taxable income. It was even implied by some commentators that inequitable valuations of real estate were a guaranty against tax increases because if a tax is inequitable, there are strict limits as to its possible increase. Admittedly, a similar argument was forwarded in the 1991 as well: The broadening of the tax base would stand but the tax rates may increase (which also to some extent happened after some years) but the argument did not prevail in that debate.

Perhaps an even more basic difference concerns contrasting views on the necessity of a reform at all. As already mentioned, there was a common “crisis understanding” in 1991 – an income tax is necessary and a reform was required; in addition, the economic conditions at that time were difficult. By contrast, there was no common understanding that taxation of owner occupied dwelling-

houses was necessary at all and by 1996-97 the economic outlook was very good. Why increase taxes (which was, in fact, not the issue) when tax revenue is flowing in? The critics instead used the occasion to attack the idea of taxation of income from owner-occupied dwelling-houses at all. In this respect, the debate of 1996-97 had common features with the debate on the net wealth tax of the autumn of 1991. Those critics, at least those of them who were sufficiently cynical, would – also for this reason – prefer a bad tax to a reformed tax.

In the dwelling-house tax debate, the Ministry of Finance had made it difficult for itself by not including the effects of the net wealth tax in several of its examples of the effects of the proposals. Such calculations soon emerged, giving an impression of severe effects. Of course, significantly increasing the valuations of dwelling-houses would have to be combined with a reduction of the wealth tax rates or a significant increase in the tax free amount. By not including this effect, the proposal became more vulnerable to critique than necessary.

Both the reform of 1991 and the proposal of 1996-97 were based on sound economic and legal reasoning. However, this reasoning was far more obvious and easy to explain to taxpayers and politicians in 1991 than in 1996-97. Again, this has to do with the different economic situations in the respective years. However, more basically it also has to do with the fact that understanding the rationale of the taxation of imputed income from the use of dwelling-houses requires a certain degree of abstract economic thinking. Indeed, in a modern media debate the odds are against the dwelling-house tax: It is often said that good taxes are those which the taxpayer cannot see. In the case of the dwelling-house tax, the taxpayers see the tax in their tax returns but they do not see the income. Arguing that they nevertheless have a benefit that should be taxed is an uphill fight.

The tax reform of 1991 was part of an international trend. This trend could be referred as an example of what should be done but it also highlighted the necessity of a reform because of the globalization and the emerging tax competition. On the contrary, the dwelling-house tax was considered as a Norwegian specialty (which it was not). Indeed, taxation of such income had been abolished in many countries (but often combined with introduction of an real estate tax and/or reduction of the interest deduction); thus, the international example gave little support.

It cannot be ruled out that the scope of the reform proposals can have an impact. The 1991 reform was a large one, whereas the 1996-97 proposals were of a more limited nature. In large reform processes, the debate will often focus on some overreaching issues, leaving other parts of the proposals almost out of the debate. These issues can then be adopted, even if an isolated proposal on these issues would not have little chance. Thus, the reform of the taxation of partnerships which was adopted as part of the tax reform of 1991 was very similar to a proposal which had been rejected only a few years earlier. A recent example is the adoption in 2004 of the principle of tax continuity by inheritance and gifts of shares, a reform that had been proposed several times but never adopted by the Parliament.

The principle of neutrality was crucial in both debates. However, it was more consistently carried through in the 1991 reform than in the 1996-97 proposals. In

particular, the proposed increase in the tax free amounts in the dwelling-house tax proposals contradicted the intended neutrality and gave support for the view that the dwelling-house tax in effect would be a tax on houses in cities and that it would lead to a separation of the market for dwelling-houses into two parts.

Discussing general tax policy issues in an election year may be difficult. The dwelling-house tax proposal was presented one year ahead of a general election but the debate continued into the start of the election campaign which obviously increased the heat of the debate. In contrast, the 1991-reform was carried through outside election campaign years.

There may be some lessons to learn from this, even if the examples give only a fragile basis for conclusions:

A common understanding along the political spectrum of the necessity of a reform and its basic principles is particularly important.

Another important factor is the linking together of the good and bad news in a way which clearly shows that there is no such thing as a free lunch: desired reforms have to be financed by less desired changes in other parts of the system. However, as the 1991 reform debate shows, what is desired by some political parties, may be undesired by others, and *visé versa*. This may in fact increase the possibilities of a broad political consensus, in which different political parties focuses on different aspects of the reform.

The timing of a reform proposal may be crucial. It is easier to establish a common “crises understanding” in times of economic difficulties (as in 1991) than when the economy is high (as in 1996-97). And reforms requiring abstract thinking should be kept away from election years.

Sweetening a proposal with exceptions or favorable rules may be tempting but may also backlash, as it probably did in 1997. The proposed high tax free amount, leading to only valuable houses in fact being taxed, weakened the neutrality of the proposal and thus gave support to the critics.