

Taxation of Income from Labour and Capital in Finland - Towards Greater or Lesser Equality?*

Jouko Ylä-Liedenpohja[†]

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Abstract

The structure and reforms of the direct tax system of Finland - the 1990-2004 imputation system (*avoir fiscal*), a simpler effective tax rate schedule on ordinary income since 1991, dual income taxation (DIT) since 1993, the replacement of *avoir fiscal* with double taxation of dividends since 2005 - are reviewed from a perspective of (i) tax-base broadening cum tax-rate reduction with (ii) a scrutiny of the DIT measures that prevent an individual from transforming her labour income into taxable income from capital.

1 Introduction

The core problem would involve a deeper inquiry into the proper economic concept of taxable income from capital in respect of its legal definition in the tax code to draw any firm conclusion about the concurrent tendency in taxation of the two kinds of income. Such a task is far beyond my resources for obvious reasons arising from the economic concept of income. It is well known that Hicks (1946, 172) associated income with the maximum amount which a taxpayer can consume during a year (week in Hicks' terminology) without impoverishing herself and that he had three *ex ante* and three corresponding *ex post* approximations to his concept of income. Economic decisions and conduct are forward looking. Therefore the *ex ante* concept, though not observable, is used in economic theory.

Hicks regarded his *ex post* concept as "almost completely objective" (p. 179), having its place in economic history. He is also clear that realized capital gains are not part of a period's income; "if they occur, they have to be thought of as raising income for future weeks (by the interest on them) rather than as entering into any effective sort of income for the current week" (p. 179). "The calculation of income consists in finding some sort of *standard* stream of

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[†]University of Tampere, e-mail: jouko.yla-liedenpohja@uta.fi

values" with the same present capitalized value as the actual expected receipts (Hicks 1946, 184-185). If some future receipts are expected to rise, the present value of a prospect will be raised. Therefore "it will be necessary to raise the standard stream ... throughout. Income will thus be increased".¹ One hundred years ago Irving Fisher reasoned that if the running yield of an asset already is comprehensively taxed, a realized capital gain is not to be included in taxable income because doing so would break neutrality of a comprehensive income tax with a proportional rate (Ball 1984, Officer 1982). Sefton and Weale (2006) also suggest inappropriate to regard capital gains as income because they reflect changes in the future factor rewards.²

Taxes on realized capital gains are not immensely unpopular,³ far less so than inheritance or property taxes, the latter being taxes on illiquid assets at the time of tax payment. That is why I shall mostly make no difference with the legal and economic concepts of taxable income in what follows. My time span is about two decades to discern the trends in the relative tax burden of labour and capital income.

The calculations in Ylä-Liedenpohja (1987a) resulted in the following conclusions about the Finnish tax system in the mid-1980's:

- the total average tax rate, personal and corporate, on corporate equity income, taking into account the economy-wide shares of distributed and undistributed profits, did not deviate significantly from the tax burden of an average income earner

- the average total tax rate on income from corporate capital, debt and equity, was remarkably less than the average tax rate on ordinary income

- though the average tax rates on both equity and total capital showed a declining trend since 1960, the marginal tax rates on investment⁴ were rapidly increasing due to, among others, the introduction of a partial tax on realized capital gains tax and the rising financing share of taxable money-market loans

- the last conclusion did not disappear even if the corporate sector was thought to be in the state of permanent tax-exhaustion if tax allowances were sold to leasing companies in the financial sector with heavy tax liabilities

Generous capital allowances in business income taxation and an allowance on capital income in personal taxation contributed to relatively modest average rates, but high marginal tax rates on income from capital in the mid-1980's. Ylä-Liedenpohja (1987b) provided additional evidence on the dispersion of the marginal tax rates on investment by asset type, source of finance and ownership category. The King-Fullerton type calculations were redone by Ilvonen (1990) to

¹This in mind, the Hicksian definition of income coincides with *permanent consumption*. That is, income is the maximum amount which a taxpayer can permanently consume during a year without impoverishing herself.

²Neither do international conventions to compile income distribution statistics contain realized capital gains as part of income.

³The public outcry concerns only taxation of purely inflation-induced gains of real estate which is confiscatory in its nature.

⁴This is defined by the total of personal and corporate taxes as a percentage of the pre-tax return on marginal investment, i.e. as a percentage tax wedge of a zero net present value project.

take into account the 1990 reduction of the corporation tax rate, the introduction of the imputation system (*avoir fiscal*) and the source tax on interest income received by the households. He concluded that, compared to the year of 1987, the 1990 reforms did not reduce the dispersion of project specific marginal tax rates, but slightly increased their overall level and more substantially so if a positive effective tax rate on capital gains was assumed.

Finland joined the international wave of tax reforms by broadening the tax base and reducing the tax rates on income from capital in particular. The rate of corporation tax of the 1980's was slashed from 60-62 per cent⁵ to 25 per cent in 1993. It was subsequently raised to 28 (29) per cent in 1996 (2000), but again reduced to 26 per cent in 2005. The revenue from corporation tax varied around 1.5 per cent of the GDP during the 1980's, declined to 0.3 per cent in 1993, the trough of the 1991-1993 deep depression, but thereafter climbed to 5.9 per cent in 2000 along with the recovery of the enterprise sector, retreating to about 3.4 per cent in 2003-2007. Thus the 2005 rate reduction has not affected the tax revenue from corporation tax. Most of the measures to broaden the tax base were carried out in 1990-1993 and consisted of eliminating accelerated tax depreciation charges, transfers to investment funds and making nominal realized gains on all fixed assets fully taxable, including holding gains on controlled companies. Finland has more than halved the statutory rate of the 1980's on undistributed profits,⁶ but more than doubled the revenue from corporation tax as a ratio to the GDP, though from Ylä-Liedenpohja (1987a) the effective corporate tax rate on distributed profits has remained about the same.

(Tax revenues from labour and capital minus tax benefit from deductibility of interest on housing and non-business loans as % of GDP in 1987, 1995, 2000, 2005 will be provided by the seminar)

2 Tax prices of entrepreneurial compensation

Let us investigate the disparity of the tax rates on labour income and on different categories of capital income in 1990 and how they distorted the means of entrepreneurial compensation.

Dividends in 1990 were taxed under the imputation system only if the accounting year had ended after the 1st of January, 1990. Over 92 per cent of dividends received in 1990 by the household sector were taxed according to the previous two-rate system. The distributed dividends were partially deductible from the corporation tax base, the standard fraction being 40 per cent.⁷ In

⁵The rate combines municipal and state income taxes on undistributed profit. Because of partial deductibility of dividends, distributed profits had a lower effective tax rate which Ylä-Liedenpohja (1987a, Table 1) estimated to have been 26 per cent for distributions on newly raised outside equity in the beginning of the 1980's and 24 per cent for 1986.

⁶Taking the transfer to investment funds into account, the effective corporation tax rate on undistributed profits in 1987 was 42-43 per cent by Ilvonen's (1990, appendix) calculations. Thus the effective rate of corporation tax has been cut only by one third.

⁷Distributions on newly-raised outside equity were fully deductible in the year of issue and the subsequent five years.

the owner's taxation they were added to her other income, with the highest marginal tax rate being about 64 per cent. That is why the double-tax rate of dividend income rose considerably above the tax rate on labour income if the same amount were raised as waged or salaried income from the company. Denote

τ_w = average tax rate on labour income = 0.27 of all ordinary income in 1990

τ_{cd} = corporation tax rate on distributed profit = 0.30 in 1989

τ_d = dividend tax rate = marginal tax rate on labour income = 0.64 in 1990

Using the 1989 - 1990 values of the tax rates, the post-tax amount of labour income markka (=0.73) considerably exceeded the post-tax amount (=0.25) of one markka of distributed pre-tax profit:

$$1 - \tau_w > (1 - \tau_{cd})(1 - \tau_d) \quad (1)$$

Thus the necessary income for the living of an entrepreneur's family was taken from the corporation in the form of salary. That is why the tax code includes detailed paragraphs which prevent hidden distributions to the family members in the form of wages. Condition (1) also held true for the last markka of wage income from the corporate to the household sector for which the marginal tax rate = 0.64 = $\tau_w = \tau_d$ applied. Therefore even the wealth tax was paid by the entrepreneurs from taxable labour income and not out of post-tax dividends as in case of passive portfolio investors. In a going concern, all tax incentives in 1990 distorted the means of entrepreneurial compensation in favour of wages and salaries against dividends.

The 1990 tax system also distorted the relative tax price of dividends and income from unincorporated companies and discriminated against the set up of incorporated companies. Partnerships and limited liability partnerships were separate tax entities, but their income was divided in two. One half was allocated to the company and the other half to the partners, and both were taxed at the progressive tax rate schedule of ordinary income. A still lower average tax rate on income from unincorporated companies was attained if an entrepreneur's wife was a limited liability partner because then business income was divided in three parts. The introduction of DIT ended separate taxation of unincorporated companies as well as the set up of such companies.

However, according to *Income and wealth statistics* (Statistics Finland) allocated entrepreneurial incomes, i.e. including the shares of both earned and capital incomes, has grown from 4.3 per cent in 1990 to 5.0 per cent in 2002 in relation to taxable income in state taxation, but declined from 7.4 per cent in 1990 to 6.8 per cent in 2002 if entrepreneurial income also consists of income from farming and forestry.⁸ The decline can be explained by the enormous structural changes in farming and by transferring the taxation of forestry income from

⁸By this statistics, in the top 1 per cent of income earners as measured by taxable income in state taxation entrepreneurial income accounted for 14 per cent in 1990 while in 2002 8.4 per cent within the top 1.1 per cent of income earners.

general income taxation to the sphere of capital income taxation.⁹

The 1990 tax system favoured realized capital gains over dividends and even over labour income as a means of entrepreneurial compensation. The taper relief of realized capital gains on both real estate and corporate share certificates (fixed and movable assets) was made more stringent since 1989 so that 40 per cent of nominal gains were taxable income if the ownership period was at least 8 years. The total effective tax rate on such gains depended then heavily on inflation. Because of accelerated tax depreciations, use of investment funds and special regional allowances the companies could reinvest their profits in machinery and structures paying corporation tax at a much lower effective rate than the statutory rate. Therefore, the total effective corporation and personal tax burden on entrepreneurial compensation was easily the lowest if a company or some one of the same owner's companies was sold.¹⁰ A sale of a company represents mostly quite a sizeable one-off income, exhausting quickly the tax benefits from the lower income bands than the top one. Therefore the relevant tax rate on labour income is $\tau_w = 0.64$. Take Ilvonen's 0.42 for the corporation tax rate on undistributed profits, τ_{cu} . The threshold of effective tax rate on capital gains, τ_g , below which an entrepreneur favoured realization gains over other forms of compensation follows then from the equality

$$1 - \tau_w = (1 - \tau_{cu})(1 - \tau_g) \quad (2)$$

to be $\tau_g = 0.38$.

3 Tax base reforms of income from capital

Two big reforms contributing to the favourable tax revenue development from the base-broadening-cum-rate-reduction policy, outlined in Introduction, were the adoption of the imputation system (*avoir fiscal*) in 1990 and dual income taxation (DIT) in 1993. DIT means taxation of capital and labor income separately. Personal income is divided into capital income and earned income as labor income, pensions and social benefits. Only earned income is taxed at a progressive schedule while income from capital is taxed at a flat rate. Rental income, realization gains on real estate, realized capital gains and dividends from listed companies are always treated as income from capital.

Avoir fiscal contained two base-broadening elements. First, the tax-exempt investors (pension insurance companies, other pension funds, mutual funds, charities and other endowment foundations) were not entitled to the taxman's

⁹The old tax system was based on presumptive growth of forests while today's tax base consists of actual sales proceeds. This has increased the share of total income from forestry by 1.2 percentage points in state income taxation.

¹⁰The "black sheep" of the family could be bought out of the company with its funds. Prior to the 1986 company law the subsidiary could even purchase the owner's shares in the parent company. These operations were limited by the free capital of the companies, i.e. by undistributed taxed profits, and therefore were not so tax efficient as the trade sale of a company.

reimbursement of the imputation credits for their dividends. Second, the imputation system was implemented with an equalization tax, the purpose of which was to guarantee that the distributing company had paid corporate tax in Finland at least equal to the amount of the imputation credits granted to the dividend recipients. At the end of the 1980's this was regarded as a desirable feature because dividends were typically paid out of non-taxed income of the distributing company, realization gains on long-term holdings and tax-exempt repatriated dividends.

The introduction of DIT in 1993 made all kinds of realized nominal holding gains fully taxable income in corporate taxation. The growing importance of foreign ownership of the listed Finnish companies during the 1990's meant that equalization tax penalized through-flow dividends, foreign-source dividends distributed to foreign-destination recipients which were not entitled to the imputation credit granted in Finland. That is why already since 1993, together with the lifting of the restrictions of foreign ownership, there was an attempt to exempt through-flow dividends from equalization tax though that was truly effectively achieved since 2001. But, equalization tax was effective for domestic destination dividends. Therefore its existence may have contributed to the revenue growth from corporation tax during the latter half of the 1990's, in particular, not directly since revenue from equalization tax amounted only to about 150 million euros, but indirectly. Kari and Ylä-Liedenpohja (2005) showed that because of an equalization tax the parent company may transfer price foreign profits to its country of residence, even from a country with a lower rate of corporation tax. In addition, parent companies may have repatriated foreign-source income and invested that in Finland, generating taxable income to avoid directly paying equalization tax on their domestic-destination dividends. *Avoir fiscal* with an equalization tax was lifted in 2004.

Though the introduction of DIT involved a cut of the corporation tax rate to 25 per cent¹¹ it included many measures that broadened the tax base in addition to the mentioned features, all nominal realization gains taxable income and ending the taxation of registered unincorporated companies as separate tax-paying entities. The previous system of taxing corporations was in fact progressive for smaller companies. Because the taxable income of each company was assessed separately even within a group, they were typically made up of tens of separate companies to attain a lower effective rate of corporation tax on group income.

In the household sphere, capital income allowance was eliminated. It had either totally exempted or taxed dividends, rental income and realization gains at a half rate up to a certain limit. Instead, nominal realization gains on all assets were included into the tax base of income from capital.¹² Household

¹¹This was with certainty a reaction to tax competition from Sweden. The structure of the two economies was and still is fairly similar. The Nordic countries have also operated a common labour market since 1954. Therefore Finland as a smaller neighbour has always quickly adopted most of the big changes introduced to the Swedish tax system.

¹²The households could choose to have 50 per cent (40 per cent since 2005) of the realization proceeds as a presumptive acquisition cost if it leads to a lower taxable capital gain.

investors also experienced a change in taxation of interest income. Interest on bank deposits and government bonds was previously non-taxed while interest on money market investments outside the regulated bank intermediation was taxed. Interest income on bank deposits and government bonds has since 1991 been subject to a source tax so that individuals need not declare it in their tax returns. The tax is on nominal interest, in the beginning at the rate of 10 per cent, but it rose in 1994 to correspond the flat rate on capital income.¹³ Similarly, interest expenses on owner-occupied housing and student loans are deductible from capital income. Any surplus carries a tax credit at the capital income tax rate¹⁴ up to a maximum that depends on the number of minor children to foster and no longer at the progressive rate schedule of ordinary income as before DIT. The nominal amount of tax credit has increased less than inflation since 1993. The deductibility of interest expenses was limited also before DIT, but the maximum could contain interest expenses on pure consumption loans.

Finland is also in the process of changing the tax treatment of voluntary pension savings so that in the future their tax credit will be earned at the tax rate on capital income, the deductible savings being maximally only 5000 euros per year, as well as such pensions being taxed as capital income. Previously such savings up to 8500 euros per year could be deducted against earned income if the total final pension did not exceed 60 per cent of pensionable labour income. In some cases the tax rate on such pensions was less than the one against which savings were deducted, offering an intertemporal subsidy.

The base broadening measures eliminated the deductibility of life assurance premia. Life assurance contracts with savings are taxed as other categories of income from capital. Compensations based on death without any savings capital are tax-exempt, but of course subject to inheritance tax.

These kind of measures helped to remove subsidy elements and to raise the average effective tax rate on capital income, increasing progressivity of the whole tax system if we accept that income from capital is mostly earned by individuals in the upper end of income distribution.¹⁵ Simultaneously, marginal tax rates on most categories of capital income were reduced to the flat rate level, improving efficiency, i.e. the reducing the dispersion of marginal tax rates of investment project. This was perhaps most visible in case of private rental housing, the supply of which increased. Rental income was no longer added to other ordinary income and taxed marginally at 64 per cent but at the tax rate on capital income. Of course, the distortions caused by inflation remained,¹⁶ but because rates of inflation have been considerably lower since 1993 than previously, they are not regarded as a problem by most policy watchers. The satisfaction of general public with such a tax may be explained by the fact that

This concerns the assets owned over 10 years. For shorter holding periods the presumptive acquisition cost was 30 per cent (20 per cent since 2005).

¹³Interest income tax has raised 100-200 million euros in revenue during this decade.

¹⁴The first-time buyers enjoy 2 percentage points higher tax credit.

¹⁵Finland has thus implemented the argument of the US "flat tax" supporters that because interest and pension savings are deductible at the flat rate of capital income such schemes no longer benefit high-income earners.

¹⁶The tax rates on real interest income can easily exceed 80 per cent.

it is a tax on liquid proceeds unlike the increasing unpopularity of property tax which taxes implicit return on housing and raised 790 million euros in 2006, 0.5 per cent of the GDP.

4 Double taxation of dividends

Close reading of the memoranda that lead to the 2005 reforms reveals three rationales, (i) to maximize tax revenues and the size of welfare state by (ii) pragmatically responding to toughening tax competition and by (iii) encouraging entrepreneurship. In addition, there clearly was an ideologically motivated aim "to lay a tax on dividends" because the populist media saw them non-taxed and not to have been paid out of pre-corporation tax income.¹⁷

The imputation credits of dividends were lifted since 2005. The tax rate on capital income was lowered to 28 per cent and the corporation tax rate to 26 per cent. That was motivated by the tax systems of the EU enlargement countries, Estonia in particular. As documented in Introduction, revenues from corporation tax have not decreased though politicians clearly sold the reform to the general public as reducing tax revenues. Part of the package was that dividends from listed companies were made partially (70 per cent) taxable at the household level (the case of non-listed companies is analysed in section 6 below) and the rudimentary annual wealth tax was eliminated. The latter was justified by the 110-120 million revenue it was raising, but at the margin its effect was formidable, reminiscent of the 1980's when every single tax was separately progressive and due to specific allowances each category of capital income was separately taxed progressively.

The wealth tax burdened share ownership, but not financial assets subject to the source tax on interest income. Assets of family businesses were also assessed in wealth taxation more leniently¹⁸ than shares of listed companies in the later phase of its life-cycle. Consider a portfolio investment in shares the post-corporation tax real rate of return of which corresponds to that in international financial markets, equal to 6.7 per cent by Dimson, Marsh and Staunton (2002). With a 26 per cent tax rate, the pre-corporation tax rate of return on the physical assets is 9 per cent. The market value of the shares is the equilibrium PE-multiplier times the post-tax return, i.e. the often quoted $15 \times 0.067 = 1$, meaning Tobin's $q = 1$.¹⁹ If the effective rate of wealth tax is 0.9 per cent, it represents a 10 per cent tax on the pre-corporation tax return on the Finnish assets,²⁰ but $0.009/0.067 = 0.134$ tax rate on the post-corporation

¹⁷Neither did the populist view ever recognize that dividends from non-listed companies were partially taxed as earned income at a high average of about 52 per cent.

¹⁸This is justified on the basis that dividend tax has not been paid on undistributed corporate profits, i.e. a wealth tax must burden only household wealth and not pre-income tax household wealth.

¹⁹Tobin's q is defined the ratio of the market value of an asset to its replacement cost.

²⁰Beause the alternative financial asset is not subject to wealth tax, the wealth tax rate must be multiplied with the double-tax rate of undistributed profits to get its effect on the pre-corporation tax cost of capital (Ylä-Liedenpohja 1978). Hence this kind of wealth tax

tax real return the investor earns. In that respect it was quite a sizeable tax on private domestic ownership in a world dominated by tax-exempt collective pension savings.

The new personal tax rate on dividends of listed companies is thus 0.70 times 28 per cent, i.e. 19.6 per cent, and the total tax rate on distributed corporate profits :

$$26\% + (1 - 0.26)19.6\% = 40.5\% \quad (3)$$

While the capital income tax rate was reduced to 28 per cent, the total tax rate on undistributed corporate profits is

$$26\% + (1 - 0.26)28\% = 46.7\% \quad (4)$$

without considering the effects of inflation and taper relief of the holding gains.²¹

The most important change concerning the tax base of corporations was that the realized holding gains of controlled companies (CC) no longer were taxable income in Finland, neither realized holding losses no longer deductible against business income. Most likely Finland was a dumping place of loss-making CC's, an indication of which may be that the stock of deductible tax losses carried forward started to decrease in 2004 when the reform was announced and made immediately an effective rule. In 2000 such carry-forward business losses totalled 22.0 billion euros, 2003 28.3 billion, but at the end of 2005 23.4 billion euros. This is the most likely explanation why the GDP percentage of the revenue from corporation tax has not decreased in 2005. The other important change was to include dividends on long-term investments of insurance companies and banks to the tax base. Similarly, dividends from listed companies received by non-listed companies became taxable in the same effective ratio as dividends received by the household sector if the holding represents less than 10 per cent of the CC, but dividends flowing within the non-listed sector remained non-taxed.

In conclusion, the reduction of the corporation tax rate also reduced the pre-tax cost of capital for investments by listed companies in Finland. Small portfolio investors experienced their tax rate on dividends to increase, but those wealthier owners subject to wealth tax were approximately compensated for by its elimination. Hence, in the aggregate tax incentives for savings and share ownership were diminished but the relative attractiveness of Finland as a residence of wealthy did not change.

5 Taxation of earned income

The reforms to broaden the tax base took place in 1989-1991 and in connection with DIT. The principles and details of the first phase are described in

represents tax upon tax.

²¹Applying the approach of Ylä-Liedenpohja (2002, Appendix) to calculate the effective rate of capital gains tax, the effects of the rate of inflation of 2 per cent and the stricter taper relief of capital gains for ownership periods of 10-20 years roughly cancel each others for real returns around the mean real rate of return of 7 per cent.

Ylä-Liedenpohja (1991). The broadening measures included the elimination of "unwarranted deductions" with a "compensation principle" in the tax rate schedule so that the reform would contain no distributional consequences.²² To a large extent, the reformers regarded "unwarranted" not only deductions as medical expenses and life assurance premia, but also allowances that either differentiated the ability to pay among different kinds of households. These were then compensated by raising the income threshold at which the progressive tax schedule started. But, all tax payers benefit equally from such a universal threshold. Thus the changes were against the modern version of the principle of horizontal equity - "equal treatment of equals, unequals accordingly" (King 1982). In the end, the government recognized the force of the latter half of horizontal equity and therefore reintroduced some of the old allowances, with a new name, of course. The most important is an allowance for earned income which encourages to participate in the labour force and is most generous in 2007 for those earning about 14000 euros per year. Another is a deduction for work expenses paid by a household to outsiders. It has encouraged to establish all kinds of small enterprises in renovation, cleaning and old people's care business, increased employment and reduced tax evasion.

The republic's most carefully guarded tax secret no. 1 is that on average earned income has been less heavily taxed as income from capital. In 2000 (2005) the statutory capital income tax rate was 29 (28) per cent while according to *Income and wealth statistics* the average tax rate on earned income, including dividends and interest receipts taxed as earned income, was 26.5 (26.0) per cent.

Combining the municipal and state income taxes and taking into account the introduction and phasing-out ranges of all allowances, including allowance for earned income, the effective tax rate schedule on earned income contains 16 different income brackets and in the lower income bands the marginal tax rate (MTR) is not always monotonically increasing in respect of taxable income (Ylä-Liedenpohja 2007). In 2007 about 50 per cent of taxpayers face a MTR ≥ 40 per cent on earned income (annual earnings exceeding 21000 euros), but the average of taxable earned income will be about 25000 euros. Today only 5 per cent of earners face a MTR over 50 per cent.²³

Regarding the 2007 statutory capital income tax rate of 28 per cent as the reference, the following thresholds of earned income follow from the effective tax rate schedule (Ylä-Liedenpohja 2007, Taulukko 3):

- the marginal tax rate (MTR) on earned income exceeds 28 per cent at the annual income of 13600 euros
- the average tax rate (ATR) on earned income exceeds 28 (26) per cent for individuals earning annually over 37000 euros (33000)

²²Using a small static general equilibrium model, Heinonen and Ylä-Liedenpohja (1992) calculated that the 1989-1990 phase of reforming personal income taxation, including the imputation system, was redistributive because the tax base was broadened relatively more in the higher income deciles and that the reform of the corporate tax base added to the welfare gain.

²³For income exceeding 61400 euros, MTR = 53.7%, over 78000 euros 52.8%, but over 102300 euros 52%.

Similarly, the average tax rate of 40.5 (46.7) per cent on annual earned income, i.e. that of dividends (capital gains) from listed companies, is attained at 83600 (177900) euros.

6 Prevention of income shifting

In case of entrepreneurs, taxation of earned and capital income are integrated to prevent transformation of taxable income. The income of entrepreneurs represents partly return on capital invested and partly compensation for their entrepreneurial effort and ability. Therefore income from unincorporated businesses and dividends from unlisted companies, with no distinction between active and passive owners, are split into income from capital and earned income. Using a presumptive rate of return on net business assets, the split rule defines the maximum that is capital income for tax purposes. The current presumptive rate of return is 9 per cent for unlisted companies and it is applied to the year-end value of net assets. Because it is a nominal post-corporation tax concept, it corresponds to the Dimson-Marsh-Staunton average real rate of return on international equities plus the equilibrium rate of inflation and guarantees that on the average the reward for an entrepreneur's risk-taking will be taxed similarly as households' passive investments in listed companies. 70 per cent of any dividends exceeding the 9 per cent maximum of capital income is taxed as earned income.

In case of unincorporated businesses (sole proprietors and partnership members), the presumptive rate of return is 20 per cent (or 10 per cent if so demanded), but it is applied to the year-opening value of net business assets. No deductibility of debt interest in unincorporated businesses is allowed on that part of debt which accounts for negative net worth because it reflects personal borrowing from the business sphere.

In case of dividends from non-listed companies classified as income from capital, the first 90000 euros of will be non-taxed. This upper limit is individual specific. Any exceeding amount will be taxed as dividend income from listed companies. Therefore dividends from listed companies received by non-listed companies were made partially taxable income to effectuate an identical tax rate on dividends as if the share were directly owned by individuals. However 42.4 per cent of dividend receipts from non-listed companies (and 21.9 per cent of total dividends) were classified as earned income in 2005 because those dividends were distributed on the basis of the year 2004 accounting profits, the last year when the companies could utilize their tax surpluses, i.e. past corporation taxes on undistributed profits without paying equalization tax. Earlier about 15-18 per cent of all dividend receipts by households were taxed as earned income and taxed at an average tax rate of about 52 per cent (own calculations on the basis of *Income and wealth statistics*).

Two deductions from the net assets of a non-listed company²⁴ are made before the split: (i) any loans made to the shareholders or their family members

²⁴Identical rules apply for the net assets of unincorporated businesses.

as well as (ii) the value of any houses or apartments which are used by the shareholders or their family members. Borrowing from the company is taxable income from capital (collateral must be pledged) and must be paid back within five years. Thereafter repayment of such loans will no longer be deductible from capital income, i.e. double taxation of such undistributed profits.

The republic's most carefully guarded tax secret no. 2 is that an entrepreneur cannot transform her labour income into more leniently taxed income from capital. The populist view contrasts the top marginal tax rate on earned income to the lower flat tax rate on income from capital and asserts that entrepreneurs can label their income into a more leniently taxed category without recognizing the legal constraints and that it is the taxman who does the split, not the entrepreneur.

To understand the impossibility of transforming "heavily" taxed labour income into "leniently" taxed income from capital one needs to understand the intertemporal aspect of the problem, how slowly the maximum dividend that will be taxed as income from capital will grow when an entrepreneur leaves her post-corporation tax wage as undistributed profits in her company, how high is the opportunity cost in international financial markets of the funds left in the company in comparison to the presumptive rate of return on net assets in the split, and how high is the realistic opportunity wage of an entrepreneur who works for her company.²⁵ Ylä-Liedenpohja (2002, Table 1) provides an example of such an impossibility with associated argumentation.

Its core is the following. In 2007 an entrepreneur pays herself a wage so that the tax rate of the last euro does not exceed the corporation tax rate of 26 per cent. It is 13611 euros in a year, 1134 euros per month; see Taulukko 3 in Ylä-Liedenpohja (2007, 92). The rest of the reward for her labour is taxed in the corporation so that each pre-tax euro adds to the net assets of her company with 74 eurocents, 9 per cent of which, 6.67 cents, is the next year's additional dividend taxed as income from capital so that the company invests the remaining 67.33 cents. The same thing will be repeated in the subsequent year. But, the long-term opportunity return in financial markets of the funds in the company tills is the presumptive post-corporation tax rate of return 9 per cent so that the past undistributed wages do not help to increase this year's maximum dividend taxed as income.

If the owner borrows in her personal account to invest into equity of her company to increase the fraction of dividends taxed as capital income, such interest expenses are deducted against her capital income. Any surplus of interest expenses is credited at the tax rate of capital income against her tax liability of earned income. Prior to 2005 such interest expenses were deducted from her dividend receipts before the split was done as well as such loans were deducted from the net asset value of her equity stake. Let us study the implications for tax planning from the lifting of these restrictions.

Because the borrowing rate of interest has been very low during recent years

²⁵In the imputation system an equalization tax and an additional legal constraint that the distributing company lost its tax surpluses (corporation taxes on past undistributed profits) after 10 years made income transformation even more difficult.

in respect of the presumptive rate of return on net assets, there is second-order evidence of the following kind of tax behaviour. Suppose an entrepreneur borrows one million euros at 5 per cent to invest in equity (a higher equity stake would trigger personal dividend tax) which her company keeps in its checking account at zero interest. Our entrepreneur can now raise 90000 euros in dividends taxed as income from capital. She has 50000 euros to pay her interest expense leaving 40000 euros for her living. In addition, she has 14000 euros of tax credit (at 28 per cent on the interest deduction) to shelter personal income tax. Because dividend is non-taxed, tax credit will be reimbursed only if she has at least the same tax liability for earned income. Therefore she raises an additional dividend of 44785 euros, 70 per cent of which is taxed as earned income and 30 per cent is non-taxed. Together with her wage this additional dividend creates the required 14000 euros of tax liability. In the end, our entrepreneur pockets 84785 euros from the dividends plus her annual wage 13611 euros, i.e. 98396 euros, without her paying any personal taxes. The total dividends (134785) must be paid out of pre-corporation tax income of 182142 euros, but the wage is deductible and therefore she need to additionally invoice only for 10072 euros in her company. Her wage is thus subsidized and the society collects revenue from corporation tax only on the pre-tax distributions.

But, the above example contains a very poor piece of investment advice which makes the tax advice worth not paying. To earn each year a tax benefit of 14000 euros from interest deductibility, her company loses 90000 euros of post-corporation tax income by not having utilized the full set of investment opportunities from diversification across all asset categories that would guarantee her company the true expected long-term return in international financial markets. When her company invests its equity of one million in this way and earns 90000 euros post-tax on the average each year, it fills an individual's non-taxed quota of dividends as capital income. The role of her company with one million of equity is totally redundant. The same tax benefit from interest deductibility can be directly obtained by borrowing on her personal account and investing the funds in international financial markets (the true problem is the collateral required by the lender) without paying any corporation tax in the process. The lender certifies to the taxman that the loan is for investment purposes.

7 Incentive effects in non-listed companies

So let us continue the previous example to deduce the remuneration strategy that truly is tax minimizing. She sets up her company with the minimum required equity stake of 2500 euros (neglect its investment return), pays herself a wage up to the amount in which its marginal tax rate (MTR) rises to the equality of the MTR of dividends taxed as earned income

$$MTR = 0.26 + (0.74)(0.7)MTR \quad (5)$$

Solving (5) for MTR (=0.539) she finds three things. First, the right hand side of (5), the MTR of dividends taxed as earned income, lies above the MTR of

earned income in each income band of the 2007 effective rate schedule, even the top MTR of 53.7 per cent. Hence it is no longer optimal to distribute dividends taxed as earned income which are dominated by wages and salaries as a form of entrepreneurial compensation. Second, because the benchmark double-tax rate of capital gains is 46.7 per cent in (4),²⁶ the MTR of wages must not exceed it. Therefore our entrepreneur's tax minimizing remuneration strategy is to pay herself a wage, if she is productive enough, up to 61420 euros a year at which threshold of earned income the MTR jumps from 45.7 per cent to 53.7 per cent. If her earning capacity is higher, the consequent post-corporation tax income adds the net asset of her company. The tax minimizing strategy involves to distribute the maximum dividend taxed as capital income, to retain the rest of post-corporation tax income and at the end of her earning career to sell her company and to pocket the post-capital gains tax proceeds.²⁷

Third, this conjecture crucially assumes that her company has value as going concern. If the market value of her customer contacts will be tiny in respect of the market value of the financial and business assets of her company, the realistic alternative is to wind up the company at the end her earning career. In that case the owner gets the assets of the company at their market value without any personal tax, but the company pays corporation tax (reports a tax loss), if the market value of the corporate assets exceeds (is less than) their book value. Hence the correct benchmark MTR for wages in this piggy-bank strategy is again 26 per cent, the corporation tax rate, because the unlisted companies are taxed on their dividend receipts effectively at the same rate as wage-earners.²⁸ No professional lives with such a low annual salary of 13611 euros, so any higher consumption will be covered from higher annual net wages.²⁹ Hence it is the winding up of incorporated companies that represents tax avoidance; in the current tax system the assets of such companies will be saved out of a post 26 per cent tax on income.

Thus the predictions of this thought experiment are that we should experience

²⁶Borrowing from her company, but not paying back such loans leads to the same benchmark rate of double taxation.

²⁷This only updates the detailed tax rules since 2005 of the argument presented in Ylä-Liedenpohja (2002) where I even considered the possibility that the owner lends to her company. Because of taxation of nominal interest income, this distribution channel has an effective average tax rate of similar size as that on capital gains.

²⁸Three quarters of dividend receipts from the listed companies is added to taxable income if the ownership share is less than 10 per cent, but the taper relief of capital gains after 10 years is not available to incorporated companies.

²⁹Individual preferences for current and future consumption differ which explains the observed structure of companies selling professional services. The professionals own such a company via their personally owned companies within which they can arrange their own personal remuneration practices. In fact, if our entrepreneur operates as a sole proprietor, she faces a lower effective MTR (EMTR) than the MTR of wages because the presumptive taxable income from capital is 20 per cent, implying

$$EMTR = 0.2(0.28) + 0.8MTR$$

- dividends taxed as earned income to end because of lifting *avoir fiscal* and see more wages paid to the owners, and perhaps
- an increased winding-up activity of incorporated companies and
- an increased fraction of new enterprises choosing to operate as unincorporated businesses if the top MTR will further decline³⁰

A fair amount of research on behavioural effects of unlisted companies has been carried out. Kari (1999) showed that the split of dividends in the Finnish dual income tax system creates an incentive for overinvestment, if the company expects permanently to be in the regime of paying dividends taxed as earned income. The finding was replicated by Lindhe, Södersten and Öberg (2002). Overinvestment is however eliminated when financial investments are an alternative way of padding the net assets on the basis of which the presumptive taxable income from capital is calculated (Kari 1999). He also analysed the increased tax price of start-up equity in such a dividend regime for which Lindhe, Södersten and Öberg (2002) also provided numerical simulations. Their conclusion was that the set-up cost of capital is three to five times higher than the steady cost of capital for such unlisted companies. Kanniainen, Kari and Ylä-Liedenpohja (2007) showed that if the presumptive rate of return corresponds to the market rate of interest long-run investment of unlisted companies is not affected by the split rule.

The Kari-Lindhe-Södersten-Öberg model assumed the pre-1999 base of net assets that did not include the distributed dividends. When they are included, Kanniainen, Kari and Ylä-Liedenpohja (2005) showed that the overinvestment incentive disappears without modelling financial investments. As part of net assets in the split, dividends raise the value of the undistributed corporate profits to the owners. Kari (1999) also showed that the split rule causes an incentive to artificially inflate asset values and book equity by not using full economic depreciation charges.

- Kari and Karikallio (2007)

Lindhe, Södersten and Öberg (2002) also analysed the work incentive of an entrepreneur in her company and showed that the more generous the presumptive rate of return on capital, *ceteris paribus*, the less the owner works for her company (income effect), i.e. the less is the scope for the potential income transformation problem.

Kanniainen, Kari and Ylä-Liedenpohja (2007) suggested that the Finnish dual tax promotes entrepreneurship via start-ups of high expected profitability, confirmed by *Income and wealth statistics*.

8 Conclusion

An enormous shift in the balance of direct taxation has occurred in Finland since 1990 from labour income towards heavier taxation of capital income. Corporate tax revenue was 9.2 per cent of all tax revenue in 1990, but 21.0 per cent in

³⁰These have an additional tax benefit, 30 per cent of their wage bill being added to their net assets in the split.

2000. Dividends and capital gains in 1990 were 1.8 per cent of taxable personal income, but 5.2 per cent in 2002. Dual income tax has also spurred people to earn income by saving and entrepreneurship. With all its details, it has been a laudable means to raise tax revenue and the size of the public sector. Finland has only used this additional tax revenue mostly to increase social transfers for working-age people, though marginal tax rates of earned income have been reduced, too. The fraction of aged 15-64 in the labour force has come down from 73 per cent in 1990 to 66 per cent in 2002 from where it has risen to the current 70 per cent. In 2002 there were about 300000 people who were either outside the labour force or effectively employed by the Ministry of Labour in its activities in contrast to the year 1990 circumstances. Their living is financed from heavier taxes on income from capital.

It is well known that, with labour less internationally mobile resource than capital, economics predicts the effective burden from heavier taxation of capital income to lie on labour in such a country in the form of lower wages or loss of jobs (Mintz 1996, for example). Social benefits and transfers financed from heavier taxes on income from capital have maintained or increased the reservation wages and the pricing power of wage cartels in jobs requiring lower skill in particular. Such kind of job destruction has occurred because real wage level has increased most rapidly in Finland among Western European countries.

The definitely more complex tax system of Finland since 2005 was analysed with a special scrutiny of the rules that aim at preventing the transformation of labour income into taxable income from capital. This is only a problem for entrepreneurs in professional services (lawyers and MDs are the prime examples) who have a clearly much higher opportunity wage than an average entrepreneur and therefore would face a top or near top marginal tax rate on labour income. According to the analysis of this paper, the rules prevent all other attempts to avoid taxes except for the piggy-bank behaviour, using an unlisted company to accumulate savings from post-corporation tax income at the tax rate of 26 per cent. After winding up her company, the owner will access to those savings at their market value. To offer equal opportunities for saving for all households,

launch a tax incentive for savings out of earned income by deducting any positive net purchase of assets from earned income, but by adding the deduction to taxable capital income.

The transfer problem of taxable income is not special to Finland nor to the Nordic dual. It is discussed and tackled in every income tax system in one way or another. The United Kingdom has solved the problem so that the total effective tax rate on distributed profits, taking into account the company tax (at the rate of 19 per cent for small companies with taxable profits less than £300000 or 450000 euros) and the personal dividend tax after dividend relief (a partial imputation credit for individuals) approximately follows the rate schedule of wages and salaries. A similar situation concerns undistributed profits, after taking the taper relief of capital gains into account.

Ylä-Liedenpohja (2007) considered the possibility to eliminate totally the split of dividends or entrepreneurial income into taxable income from capital and earned income, after implementing a reform of the tax rate schedule on

earned income so that the range of all realistic opportunity wages would be taxed at the rate on capital income. The reform would be self-financing because it would transfer a number of deductions from earned income into a tax credit on earned income which would be differentiated by the household characteristics. There is also a need for such a reform because this year's tax revenue been more bounteous from what was assumed in those calculations.

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