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Norwegian Income Tax Reforms

Vidar Christiansen*

In few countries have modern income tax reforms been governed by overall economic principles to the same extent as in Norway. This is primarily due to the influential role of a number of government-appointed committees whose reports have set the agenda for tax reform in Norway during the last two decades. The first was the Report of the Tax Commission in 1984 (NOU 1984) that instigated a series of reform steps during the eighties. The second, and big milestone, was the Report of the Aarbakke Committee in 1989 (NOU 1989) which led to a structural overhaul of the tax system. The overall purpose was to establish a tax system based on sound economic principles that would promote an efficient allocation of capital, while at the same time limiting the distortion of capital accumulation. The resulting introduction of a new income tax system from the beginning of 1992 - to become known as the dual income tax - was seen by many in Norway as the ultimate tax reform that had finally furnished the country with a durable income tax system that would guarantee adherence to major economic principles.

This verdict may seem ill founded, or at least overly optimistic, in view of the fact that only eleven years later a third report, submitted by the Skauge Committee (NOU 2003), proposed further reform steps, partly undoing some of the elements of the previous reform. Two kinds of problems had been underestimated at the time of the Aarbakke report. One was the information and enforcement problems inherent in the system, that were to become increasingly noticeable and urgent as over time the economic agents found ways to adapt to the new system. Another was the lack of political commitment to basic principles beyond the short term. We shall return to these problems and how they have been addressed after reviewing the main features of the 1992 income tax system.

The 1992 reform

Taking a quick look further back in time, we may note that Norway entered the eighties with very high statutory tax rates applied to labour as well as capital income. With full deductibility of interest expenses, while tax favours were granted to a number of assets, there was a strong concern that this asymmetry induced excessive borrowing for socially unprofitable investment. A major contribution of the Tax Commission, was to put an end to a lengthy debate on the deductibility of interest payments in Norway by proposing major cuts in marginal tax rates that contributed considerably to eliminating the harmful (dis)incentive effects on accumulation of debt and assets while still retaining full deductibility. By increasing pay roll taxes and social insurance contributions, levied only on labour income, not on capital income, a step was in fact taken towards the future introduction of a fully-fledged dual income tax differentiating taxes on capital and labour income.

Prior to 1992 there was a wide recognition in Norway that savings were low, the return to investment was low, and the investment allocation was seriously distorted. The overall objective of the 1992 reform was to achieve a moderate taxation of capital income that is neutral in a very broad sense, while maintaining the distributional role of a progressive tax on labour income (see also Sørensen 1994). A linear capital income tax with a tax rate of 28 per cent was introduced. The ideal was that no tax favours should be granted to specific types of investment, certain organisational forms, or particular sources of finance. Marginal tax cuts were combined with base broadening and the elimination of a variety of opportunities for firms to make use of deductions and tax-favoured funds, often to defer tax payments more or less indefinitely. Efforts were

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made to reconcile depreciation allowances with true economic depreciation. The principles laid down by the Aarbakke committee had far-reaching implications for practical tax policy.

Derived from the desirability of neutrality and symmetry in the taxation of capital, the ideal was single taxation of all kinds of capital income at a uniform rate, also applied to negative income such as mortgage interest expenses. To avoid discrimination of corporate income and hence corporate investment it was considered crucial to have no double taxation of profits accruing to shareholders either as dividends or capital gains. Two innovations were essential for this purpose. An imputation system was devised to ensure single taxation. Once profits have been taxed at the corporate level the shareholder is granted full credit against the personal tax on dividends. A further innovation was required to extend single taxation to capital gains that should not be taxed to the extent that they reflect retentions of already-taxed earnings. There was a need to separate the latter from capital gains due to exogenous and random events. The method, called RISK (a Norwegian acronym), implies that the tax value of shares is adjusted for profit retentions. By stepping up the value basis a smaller taxable gain will materialise at the time of realisation. The commitment to single taxation is ambitious, and the RISK scheme has proved administratively costly.

As we have seen, a key premise of the reform was that capital income should be taxed differently and on the whole by a lower marginal tax rate than labour income. It is interesting to observe how the motivation for a lower capital income tax has shifted over time. While the first reforms to that end were justified mainly by the concern with excessive borrowing, the motivation gradually shifted towards the concern with international mobility of capital - an argument virtually non-existent in the early eighties. A particular aspect, often drawn attention to at a time when the inflation rate was much higher than today, was the confiscatory real effect of nominal taxation driving the nominal after-tax interest rate below the inflation rate. Even if the intention of the 1992 reform was to achieve uniform and neutral taxation of all kinds of capital income, realistic, experience-based expectations were probably that in practice certain investments would remain tax favoured. A way to limit the resulting distortion is then to tax ordinary, non-preferential investments relatively mildly, which is a further low-tax argument (see also Nielsen and Sørensen 1997).

Obviously differential taxation of labour and capital makes it necessary to distinguish labour and capital income in practice – in itself a daunting task as for self-employed no such distinction is readily available. As their aggregate income originates from the capital they have invested as well as the labour effort they put in, there is in practice no obvious way to disentangle the two theoretically distinct kinds of income. A method for splitting the income – referred to as the income splitting model – had to be constructed. The purpose is to single out for income splitting those firms whose owners are also working in the firm as managers, or even taking part in primary production activities. These owners are labelled "active owners". Income splitting is mandatory for sole proprietorships, partnerships and corporations with active owners. For the owners to qualify as active owners, they must own at least two thirds of the firm, and each one must work in the firm for a minimum number of hours per year.

With a few qualifications the approach taken in the Norwegian tax system is to define capital income by imputing a return to the stock of business assets and then to calculate the labour income as the residual income. The imputed rate of return is stipulated as the interest rate on five year government bonds plus a risk premium of four percent.[1] The rationale for the imputed return is that it may be interpreted as the return that could be obtained elsewhere and is in this sense an opportunity cost of capital. In other words it is the return that would be required in order to invest in a particular business in the absence of taxes. By taxing the business as if the imputed return were obtained, the tax will not bias the investment decision either way, and neutrality is achieved.

There are two qualifications to the splitting method sketched above, that may be worth mentioning. One is that residual income over and above a certain threshold is considered to be capital income. (Exceptions to this rule apply to certain professions – doctors, brokers, lawyers, etc.). The other qualification is that active owners with employees are entitled to make a "salary deduction" from the residual before arriving at the final

[1] Whether a risk premium should be added is a controversial issue among tax economists.

estimate of labour income. The salary deduction is 20 percent of the wage bill. It has been argued that this deduction may make up for missing inclusion of self-created goodwill in the stock of business assets and that firms with many employees would otherwise be assigned an unreasonably high labour income. It is probably fair to say that the various elements of the splitting model have to some extent been played around with as part of a political game motivated in part by the concern of politicians of various colours with special interest groups. Certain key rules were changed after the principal reform in 1992, detached from its overall perspective, and at odds with the advice of the Aarbakke report. It is thought provoking in this context that a large number of firms subject to the splitting model are in fact assigned a negative labour income.

In line with the splitting rule different kinds of income are taxed differently. If we – as seems natural – interpret the imputed return as a normal rate of return on capital, the residual income will in fact not only be labour income but may also conceivably include monopoly rents, resource rents, remuneration for high risk taking and particularly favourable outcomes of random events. In this sense the dual income tax does not only tax labour income at a higher rate than "normal" capital income but also imposes a surtax on various kinds of rents. This appears to be an attractive feature of the system as such taxes tend to be non-distortionary. Generous salary deductions will however erode this effect as more income is taxed at the low rate. To the extent that risk is involved favourable outcomes will, with the above qualifications, imply a high tax burden as labour income is overestimated, whilst a loss will reduce the estimated labour income and the corresponding tax burden. Hence there is an element of risk-sharing between the private investor and the government.

Beyond the general tax rules surveyed above there are some special tax rules motivated by Norway's position as a resource-rich and sea-faring country. Special surtaxes are imposed in the petroleum and hydro-energy sectors as these are supposed to earn a resource rent beyond the normal return to the invested capital. Ship-owning companies only pay income tax when profits are distributed and not as long as profits are retained within the company. In this sense there is a tax deferral. While the tax rules devised to appropriate part of the resource rents in certain sectors have won the acclaim of most economists, the special tax rule for ship-owning companies has to a large extent been considered as a tax privilege supported by well-resourced lobbying rather than social efficiency arguments.

Taxed-favoured owner-occupied housing

Even though tax reforms in Norway have been guided by economic principles to a large extent, tax economists have never fully succeeded in convincing the politicians of the virtues of neutral capital taxation, and shipping is not a sole example. The most blatant violation of the principles of symmetry and neutrality is due to the low value assessment for tax purposes of selected assets. The most striking example is owner-occupied housing, including houses for leisure use, which has a long-standing history as a tax-favoured asset. The value assessment of houses for tax purposes is far – on average perhaps 80 percent – below market value. In this respect Norway differs significantly from neighbouring Denmark and Sweden that are more successful in equating tax values to market prices.

In addition to the low general valuation, there is in Norway considerable variation across vintages of houses, and there is a systematic bias in favour of expensive houses as measured by the ratio between the tax value and the price actually quoted in the market for houses being traded. As rich people typically own expensive houses, the reported bias introduces an unintentional regressive tax element. The preferential treatment of housing is reinforced by the fact that taxpayers in wealth tax position pay wealth tax on houses based on the tax value.[2] Owner occupied housing is the dominant part of the housing market in Norway, and there is extensive ownership of leisure houses. In view of the size of the housing market and the importance of houses as household assets, there is no doubt that serious tax distortions are implied.

In spite of this economically sad fact, the present government wants to phase out the income taxation of the imputed rent from owner-occupied housing altogether.[3] This step is exactly the oppo-

[2] Two further taxes may be briefly mentioned. Local communities may impose a property tax, which is also based on the tax value, but few do. In principle there is a capital gains tax on houses, but none is imposed if the seller has lived in the house for at least a rather limited period of time.

[3] Politicians will usually refer to the imputed rent tax as an 'obsolete tax', or point to alleged liquidity problems faced by some poor, old widow.

site of the policy recommended by the Skauge committee. As pointed out by many economists, this abolition is paradoxical at a time when there appears to be increasing recognition of the need to tax immobile rather than mobile assets in the face of international tax competition.

The wealth tax

Whereas several countries have abolished their previous wealth tax, it is still retained in Norway with rather high statutory tax rates. As there are often cumulative effects of income and wealth taxes, say, on savings and investment behaviour, the two taxes should be considered in conjunction. Even if the political attitude to the wealth tax in Norway varies along the left-to-right political axis, there is a widespread opinion that the present wealth tax has serious deficiencies.

As it fails to achieve anything near uniform taxation of various, major types of wealth, it strongly violates the cherished principles of neutrality. Whilst some assets such as bank deposits, bonds, and shares of stock listed at the stock exchange are taxed according to their market value, non-quoted shares and quoted shares in small and medium-sized companies are entitled to an explicit 'tax rebate' of 35 percent in terms of undervaluation. Various types of real estate, including owner-occupied housing, are even more tax-favoured assets. There seems to be little political will to tighten the wealth tax. On the contrary the political sentiment seems rather to be in favour of gradually removing it.

Impacts of the 1992 reform

Presumably the 1992 reform induced both transitory and more interesting structural effects. Even bearing in mind the identification problems posed by economic recovery and conceivable after-effects of economic liberalisation in the years subsequent to the reform, observations of after-reform changes and preliminary results from economic analyses of the reform are interesting from the perspective of allocation as well as distribution.[4] There are strong indications that the (pre-tax) return to capital has shifted to a higher level and that the dispersion of rates of return has narrowed. Both results would be consistent with the intentions of the reform since the old tax regime implied larger general tax wedges as well as differential tax treatment that were likely to generate unequal marginal returns to investment in various sectors.

Studies based on computable general equilibrium models have estimated the efficiency gain from more uniform capital taxation at 0.75 percent in terms of the equivalent increase in private consumption. Real investment has shifted to a lower level, while the after-tax real interest rate and the households' savings rate have increased. Subsequent to the reform there has been a sharp rise in distributed profits. This can partly be ascribed to transitory effects having to do with the removal of legal constraints on the scope for distributing funds previously accumulated partly in order to obtain a tax credit. But even apart from such cases, retentions were tax-favoured compared to distribution of dividends, and capital was locked into the companies with potentially harmful allocative effects.

Income inequality has increased somewhat during the nineties, and it has been debated whether the tax reform is to be blamed for this development. The observations that are reported are illustrative of the problems involved in comparing before- and after- reform distribution as the income concepts used do not reflect the same underlying economic reality. Previously some of the true income of shareholders was concealed as profits retained in the corporations, and the corresponding capital gains never, or only much delayed, materialised as shareholder income. Now the more extensive distribution of dividends after the reform is immediately registered as an increase in income. A further question is how the taxes for a given base affect the distribution of after-tax income as compared to pre-tax income. It has been revealed that the tax system is slightly less progressive than it was prior to the reform. However, it turns out that this is mainly due to inadequate adjustment to increases in certain deductions and child benefits. This was never part of the 1992 reform.

Effects for which the reform must take full responsibility are those related to income splitting. Whilst income splitting with its risk sharing property may seem appealing from an ex ante point of view, owners of firms that have already been successful may

[4] A research project is in progress to evaluate the reform as data for a sufficient time span become available.

view things differently. Rather than having a substantial part of their income taxed as labour income they would like to have it taxed leniently at the rate applied to capital income. It follows that if a significant part of the income is taxed at high tax rates there is strong motivation for finding ways to transform labour income into low-taxed capital income. This is indeed what many Norwegian entrepreneurs do. Especially active owners of corporations have escaped the split model. One way to do this is to invite more passive owners into the company to bring the ownership share of active owners below 66 percent. Between 1992 and 2000 the percentage of corporations subject to income splitting fell from 55 to 32. By avoiding mandatory income splitting the owners are free to work for a very low official salary, whilst reaping large dividends. In particular it has caught the public eye how a number of celebrities in show business and TV production manage to acquire most of their income in terms of capital income through corporations.

The extensive circumvention of the income splitting model figures as the major deficiency, some would say the Achilles Heel, of the tax system introduced in 1992. This problem was a major motivation for appointing the Skauge committee that delivered its report in 2003. Below I will concentrate on its proposals addressing the income splitting problem as these are about to win political acceptance.

The road ahead

It is corporations with active owners that have posed the most serious problems for the income splitting scheme. The key element of the proposed solution is to replace the previous income splitting model for active shareholders by a sophisticated income tax model for all personal shareholders (see Sørensen 2003). The previous imputation system as well as the RISK scheme will be removed. A personal shareholder tax will be imposed on share income exceeding a risk-free rate of return. The idea is to approximate the marginal tax on high share income to a somewhat lowered marginal labour tax in order to remove the motivation for income shifting, while preserving the low tax on 'normal' capital income.

For this dual purpose the tax base is defined by deducting a so-called rate-of-return allowance (RRA) from the share income consisting of dividends and any realised net capital gain. The role of the RRA is to shield the imputed risk-free return. The after-tax corporation profit may be distributed as dividends or retained within the corporation presumably generating a capital gain by pushing up the share price. In any given year the shareholder will receive the distributed dividend and keep or sell the share. If the share is kept the income being taxed at the hand of the shareholder is the dividend minus the RRA. To the extent that the dividend falls short of the RRA the difference is defined as unutilised RRA. The RRA is the product of the after-tax interest rate and a basis value of the share. The calculation of the basis takes as its point of departure the acquisition price of the share and then steps up this basis at the beginning of each year by adding any unutilised RRA.

The shareholder income tax can be shown to have a number of appealing neutrality properties with respect to investment allocation, choice of funding between injection of new equity or retained earnings and the timing of realisation of shares. The step-up in the basis for calculating the RRA is crucial for these properties. Beyond leaving the marginal investment unaffected, the shareholder income tax appropriates without distortions some of the above-normal profits on infra-marginal projects. *Ex post* it will tax away some of the returns due to favourable states of the world under uncertainty, but we should observe that *ex ante* this tax is offset in expectation terms by the prospect of tax savings in the event of losses being deductible against contemporary gains on other shares or against future gains after being carried forward with interest to preserve their present value.

For sole proprietors and partnerships the proposal is to apply a revised version of the income splitting model which is close in spirit to the shareholder income tax model. A risk-free imputed return to business assets, called the "shielded return", will be taxed as capital income while income beyond this level will be taxed as labour income. There is to be no cap on profits to be taxed as personal income, no "salary deduction" from taxable profits, and the same rule will apply to the professions such as lawyers, brokers, etc. and other tax subjects.

Concerns with international agreements

Even though not a member of the EU, Norway is in several respects affected by the EU legislation via

the European Economic Area (EEA) and the underlying agreement between the EU and Efta countries. A Finnish case (the Manninen case) on the agenda of the EU Court has caused concern in Norway that the Norwegian tax rules for shares may be found incompatible with the non-discrimination rules of the EEA as Norwegian and Finnish rules have strong similarities. The present imputation system and RISK rules, preventing double taxation of distributed and retained profits, apply only to income from corporations that are Norwegian tax subjects and shareholders who are liable to pay ordinary income tax in Norway. Shareholders of Norwegian corporations who are foreign tax subjects normally have to pay a source tax on top of the corporate tax already paid. Share income from foreign companies accruing to shareholders who are Norwegian tax subjects is taxed as capital income in Norway irrespective of the corporate tax liability abroad. (The only qualification is potential crediting against foreign source taxes.) I believe that these legal aspects of international commitments have affected the political climate in Norway in favour of introducing a shareholder income tax even among those politicians who have a reputation for fiercely opposing high/double taxation of dividends.

Concluding remark

The ambitious Norwegian dual income tax experiment is interesting as it illustrates both the scope for and the limits to a tax policy trying to pursue economic principles in a high tax country, with an open economy and a strong emphasis on the distributional role of taxes. It illuminates how theory meets reality both in the form of political constraints and formidable problems with enforcing universal principles in practice. I would like to conclude that in order to redress important allocation failures, huge reforms have indeed been implemented, admittedly facing problems and set-backs, but certainly not without some measure of success.

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