



Tax Policy Reforms in Denmark

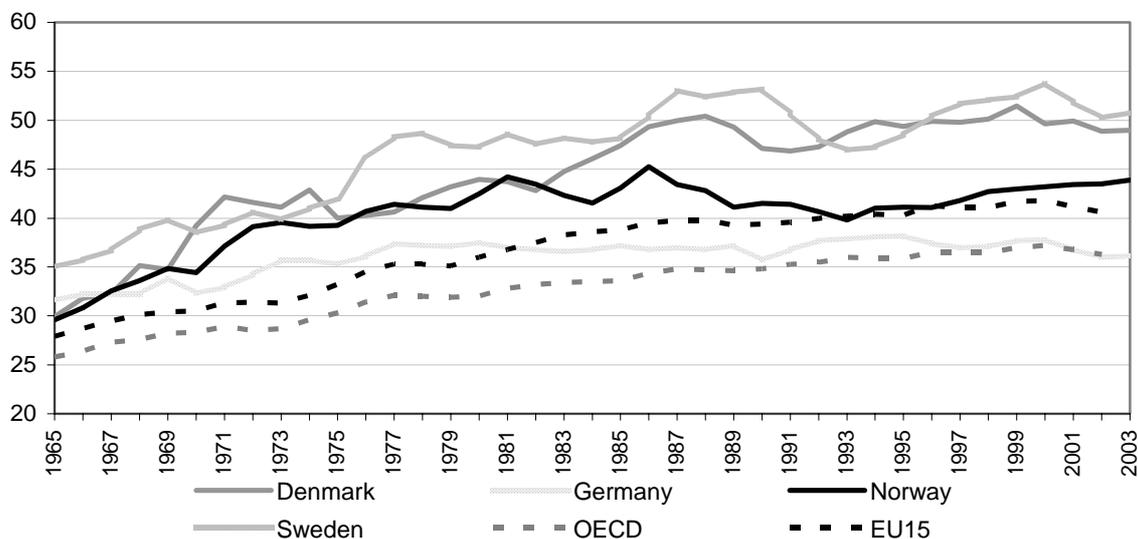
1. TAX POLICY REFORMS IN DENMARK

1.1 Tax structure and trends

The tax-to-GDP ratio of Denmark has been relatively constant during the last 15 to 20 years fluctuating around 48-50 per cent, as can be seen from figure 1.1. In 2004 the tax burden increased to 49.7 per cent of GDP (it was 49.0 per cent in 2003) as economic performance was better than expected. Since the second half of the 1980s, the tax burden in Denmark has been relatively constant while it increased sharply in the period from 1965 to 1988. During the latter period the tax burden increased from around 30 to 50.4 per cent of GDP or approximately 0.8 percentage points per year on average. Only Sweden with a tax-to-GDP ratio of 50.8 per cent has a higher tax burden than Denmark. In 2002, the EU-average is 40.6 per cent while the OECD-average is 36.3 per cent.

As illustrated in table 1.1, not only the overall tax burden but also the tax structure in Denmark differs from the EU- and OECD-average. More than half of the total tax revenue in Denmark comes from personal income taxation. On the other hand, social security contributions are not widely used in Denmark. Most OECD countries put a more equal weight on personal income taxes and social security contributions. In most countries, including Denmark, the sum of personal income taxes and social security contributions make up 50 to 60 per cent of total taxes.

Figure 1.1: Tax/GDP ratio in Denmark and certain OECD countries 1965-2003
Per cent of GDP



Source: OECD Revenue Statistics 1965-2003.

Table 1.1: Tax structure in Denmark compared to some other OECD countries and the average OECD and EU15 (unweighted). Revenue of major taxes as a percentage of total tax revenue 2003

	Denmark	Germany	Norway	Sweden	OECD (2003)	EU15 (2003)
Personal income taxes	51.3	23.9	24.8	31.3	24.9	25
Corporate income taxes	5.9	3.5	18.6	5.0	9.3	8.1
Social sec. and other payroll	2.9	40.5	22.9	34.0	27.0	29.8
Property taxes	3.8	2.4	2.5	3.1	5.6	5.2
Goods and services taxes	33	29.4	31.2	26.3	32.1	30.4

Source: OECD Revenue Statistics 1965-2004.

1.2 Recent tax reform trends

1.2.1 Current tax development in Denmark

Fiscal sustainability

Currently, the medium term fiscal policy in Denmark aims at consolidating the public sector budget surplus and at reducing the public debt to 20-25 per cent of GDP in 2010. A continuous decrease in public sector debt will improve the possibilities for financing public expenditure in the future and reduces the pressure for future tax increases or cuts in public spending.

The so-called tax freeze plays a key role in obtaining fiscal sustainability (for more details, see section 1.2.2). Also the reduction of resources that are currently used in the public sector is a major part of the government's plans to secure fiscal sustainability.

Increasing employment

Although Danish employment is at a relatively high level, policies to increase employment are discussed by politicians as well as by the public. The discussions are the result of, on the one hand, the demographic changes and, on the other hand, concerns about outsourcing and globalisation.

First steps are taken to increase labour supply through cuts in marginal tax rates at the low and medium range income level. Seen over a period of 15-20 years, the top marginal tax rate has been reduced substantially. Current policy questions focus on whether earned income tax credits and additional marginal tax rate cuts might be desirable.

Inducing education

Labour market participation rates and employment rates at different levels of education demonstrate that especially non-skilled jobs are under pressure on the Danish labour market. However, the number of high-skilled jobs is increasing. At the same time, there is a general consensus that Danish companies need to compete internationally in products produced by high-skilled labour. Low wage dispersion and high marginal tax rates might reduce the incentives to take higher education and might distort the choice of education away from professions with a high social value.

Attracting investment, inducing entrepreneurship and stimulating innovation

In light of the increasing globalisation and the continuing decline in total employment in the manufacturing sector, there is a growing concern about how to attract investment, induce entrepreneurship and stimulate innovation. That is: how to replace lost jobs with new jobs in more profitable sectors?

Recent steps that have been undertaken to improve the investment climate, induce entrepreneurship and stimulate innovation are a cut in the corporate income tax rate by 2 percentage points, the improved possibilities for pension funds to invest in unlisted shares and a 150 per cent tax deduction of costs for research in small businesses. Additional measures to increase innovation and entrepreneurship through the tax system are being considered.

Other considerations

In recent years, cross-border shopping has received much attention and has led to a considerable reduction in rates of excise duties.

1.2.2 The tax freeze

The Danish Liberal-Conservative Government has (upon its election in the autumn of 2001) implemented a “tax freeze”, which means that taxes cannot be increased. The tax freeze applies to both direct and indirect taxes. For taxes that are stated in percentages, the rates cannot be increased and for taxes that are stated as nominal amounts, the amounts in DKR cannot be increased. The tax on real property is based on a percentage rate of the assessed property value, but under the tax freeze the valuation cannot exceed the 2001-valuation plus 5 per cent. Furthermore, the tax freeze has abolished the yearly indexation of taxes on car ownership – i.e. circulation taxes.

However, the tax freeze does not completely exclude the necessity to restructure the tax system. If there are compelling reasons to introduce a new tax or raise an existing one, the revenue resulting from this rise in taxation will have to be used fully to reduce another tax. The same principle will be applied if it becomes desirable, for environmental reasons, to introduce a new environmental tax or raise an existing environmental tax.

If Denmark is forced to lower a particular tax as a result of an EU decision or an international agreement, there may be compensation through the increase of another direct or indirect tax. Such changes will be required to leave the net tax revenue unchanged. Changes in taxes already adopted fall outside the tax freeze.

The tax freeze also applies to local governments. The tax freeze does not prevent individual municipalities and counties from adjusting tax rates on income and land, but tax rates set either by municipalities or counties cannot (on average) exceed the level in 2002. The tax freeze is not established directly by law, but it *commits* the government to abstain from raising any tax.

The tax freeze forms *part* of the fiscal policy and can as such be seen as an instrument to control public spending. The cornerstone in the medium-term strategy is fiscal sustainability. This implies that the general government surplus must be large enough to finance the expected future increase in net public spending, without triggering a need for fiscal tightening at some later point. The tax freeze determines future tax-revenue and therefore disciplines public spending, as this sustainable fiscal policy must insure that public spending does not exceed public income.

Compared to the situation without tax freeze, the Danish tax authorities has estimated that households have reduced their taxes with approximately 5.4 billion DKR (725 million Euro) or 0.7 percentage of total tax revenue in 2005. The tax freeze reduces the tax burden with approximately 0.4 percentage point of GDP in the period 2003-2010.

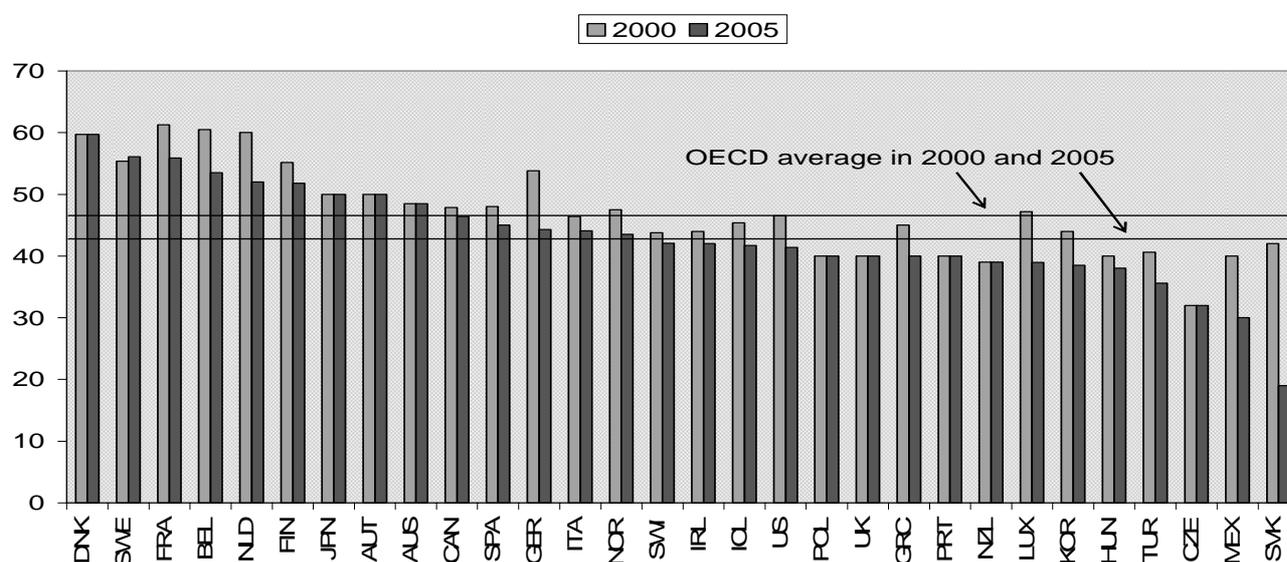
The academic criticism of the tax freeze is that it locks in certain inefficiencies in the tax structure. It therefore would be better to implement revenue neutral tax reforms, which would create the opportunity to reduce marginal income taxes and shift the tax burden towards other tax bases.

1.3 Tax reforms in detail

1.3.1 Personal income tax

Figure 1.2 shows that the marginal statutory personal income tax rates for individuals with high wage income were eased in the OECD-countries between 2000 and 2005. The rates were reduced by more than 1 percentage point in more than half of the member countries. Sweden is the only country where this rate (slightly) increased. In Denmark, the rate has been stable. Denmark had in 2005 the highest statutory rate in the OECD.

Figure 1. 2: Top Statutory Personal Income Tax Rates on Wage Income 2000 and 2005



Source: OECD Tax Database.

Lowering of the marginal tax rates and broadening the base – the reforms 1986-2005

The tax reform of 1987 was the beginning of a series of significant changes in the Danish tax system. Prior to this reform, the tax system was characterised by very high marginal tax rates and narrow bases. The large tax reforms in 1987, 1994, 1999 and 2004 have altogether created a less distortionary tax system.

The reforms in 1987, 1994 and 1999 involved both tax reductions and tax increases. The tax reform in 2004 was relatively simple; it consisted of only two tax reductions, due to the tax freeze.

As shown in figure 1.3, the tax rates have been reduced within all tax brackets. The top tax rate has been lowered from 73 per cent in 1986 to 63 per cent in 2005. The medium tax rate has been lowered from above 62 per cent to about 49 per cent and the lowest rate has been reduced from 48 per cent to about 44 per cent. At the same time, tax bases have been broadened substantially.

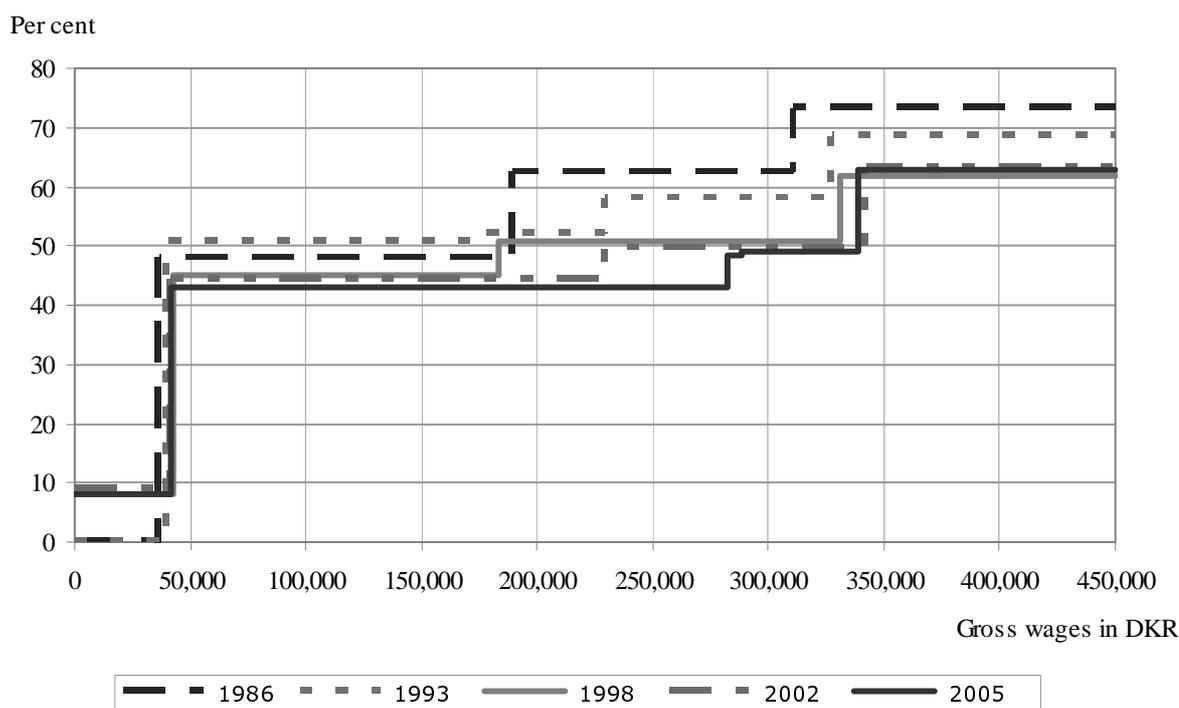
From 1986 to 2002, the average tax burden on personal income has increased, partly reflecting increases in the local tax rates. The average tax for the fully employed increased nearly 4 percentage points. From 2003 to 2004, the average tax was reduced by the tax reform of 2004, as will be discussed below.

The latest cut in labour taxation

In the spring of 2003, a tax package was implemented, that aimed at reducing the distortions in the labour market and at improving incentives to work. The package contained two main elements: an increase of the threshold of the medium tax bracket of nearly DKR 50,000 (6,700 Euro) and the introduction of a tax allowance scheme whereby the taxpayer can deduct 2.5 per cent of earned income to a maximum of DKR 7,200 (965 Euro) in 2005 in the calculation of taxable income.

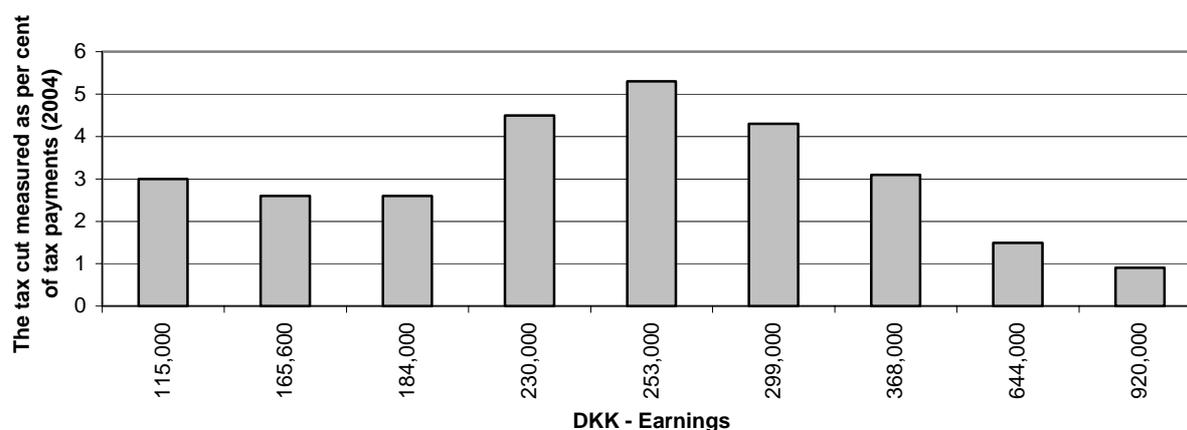
Nearly 90 per cent of the fulltime-employed taxpayers in Denmark in 2003 paid either the medium or the top personal income tax rate. With the tax cuts of 2004, the number of taxpayers in the medium tax bracket will be reduced by about 40 per cent, i.e. around 745,000 persons (from 1.8 millions to around 1 million.)

Figure 1.3: Effective marginal tax rates on labour income in Denmark in 1986, 1993, 1998, 2002 and 2005 as per cent of gross wages.



The distributional effects of the tax cut are shown in figure 1.4. The figure measures the tax cut in per cent of existing tax payments. For comparison, the APW earnings were DKK 327,200 (43,900 Euro) in 2004.

Figure 1.4: The tax cut of 2004 in per cent of existing tax payments.



One of the main goals of the tax cuts was to increase labour supply. The total effect is estimated to be in the area of 10-12,000 fulltime-employees – that is 0.4 per cent of the workforce. Approximately $\frac{2}{3}$ of this increase is due to an increase in working time and approximately $\frac{1}{3}$ is due to an increase in employment.

1.3.2 Corporate taxation

Significant tax cuts since 1989

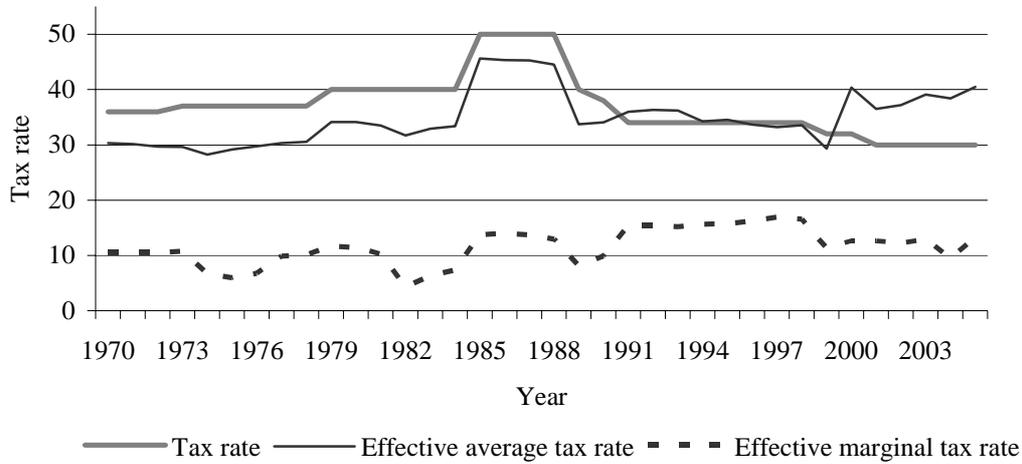
Historically, the statutory corporate tax rate has been relatively high; up to the 1990s, it was 50 per cent. The increased globalisation has however put a downward pressure on the rate, which has resulted in a series of reductions of the formal tax rate combined with a broadening of the tax base. In 1990, the corporate tax rate was lowered from 50 to 40 per cent and in 1991, the rate was lowered with an additional 2 percentage points. These reductions were followed by a reduction of certain indirect investments subsidies, which broadened the tax base.

During the 1990s the tax rate was reduced several times and the tax base was broadened, for instance by abolishing the existing tax relief for foreign income. Until this change in 1994, half of a company's foreign income was exempted from corporate taxation in Denmark.

In 2001, the corporate tax rate was lowered to 30 per cent in order to approximate the level in the other Nordic countries. In addition, the declining-balance depreciation rate of machinery and plants was reduced from 30 per cent to 25 per cent. This was done primarily in order to align the economic and fiscal depreciation.

The latest tax reform reduced the corporate tax rate to 28 per cent as from 1 January 2005. The development over time of the statutory, average and marginal effective corporate tax rates is presented in figure 1.5.

Figure 1.5: Effective corporate tax rates 1970 – 2004.

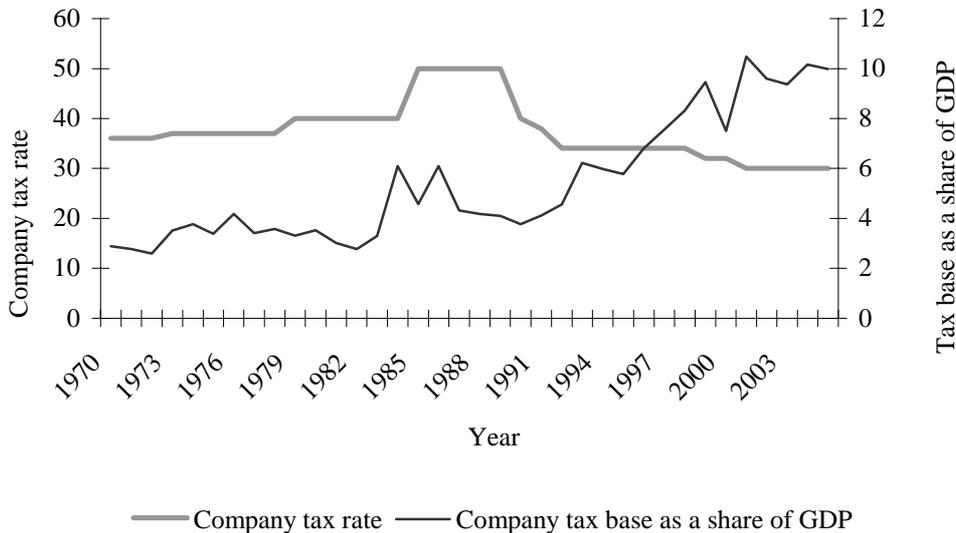


Source: Danish Ministry of Taxation.

Development in revenue and tax base

The development over time of the statutory corporate tax rate and of the tax base measured as a proportion of GDP is shown in figure 1.6. The figure shows a large increase the tax base (as measured implicitly by tax revenue) from 3 per cent to 10 per cent of GDP from 1970 to 2001. The increase in the tax revenue as a share of GDP shows that the effect of the base broadening has had a larger impact than the rate reduction.

Figure 1.6: Development of statutory corporation tax rate and corporation tax base, 1970-2004.



Source: Danish Ministry of taxation

The broadening of the tax base in the 1980s and 1990s can partly explain the rise in tax revenue. However, large structural changes have been important for tax revenue as well. First, there has been a large increase

in the degree of incorporation of businesses. Second, a number of public companies have been privatised and the revenue from those corporations are now included in the corporate tax base. In addition, improvements in the general economic conditions and less distortions due to the lower corporate tax rate might have had a positive effect on tax revenue.

Joint taxation

Since the Danish Income Tax Law of 1903 the Danish tax regime allows joint taxation of Danish companies with Danish *and foreign* subsidiaries. This possibility enables corporations to offset losses generated by one group member against profits generated by another group member. These loss offsets reduce corporate tax revenue in Denmark.

Very few countries allow joint taxation with foreign subsidiaries – and those few countries that do allow joint taxation, allow it in a less liberal way than Denmark. In Denmark the parent company has been free to choose which subsidiaries it wanted to include in the joint taxation. In practice, this possibility of cherry-picking means, that the corporations have chosen to exclude profit-yielding foreign subsidiaries from joint taxation with the Danish parent company (especially when the subsidiaries are located in countries with lower corporate income tax rates than in Denmark) and has chosen to include the loss-making foreign subsidiaries in joint taxation with the Danish parent company. In this way, the Danish tax regime has so to speak “collected” losses from around the world.

This possibility of cherry-picking gives incentives to foreign instead of domestic investment. Through the 1990s and in 2003, several anti-avoidance rules have been implemented that attempt to tax the revenue if a loss-making foreign company starts making profits but decides to leave the joint taxation. However, it has been possible to get around some of these anti-avoidance rules.

As of 2005, the joint taxation rules are amended, and the resulting revenue gain was used to lower the corporate income tax rate from 30 per cent to 28 per cent. The new legislation still gives a possibility for joint taxation of Danish *and foreign* companies, but it is no longer voluntary. The global pooling principle means that all entities of the group will be jointly taxed if the company wishes to use the possibility of joint taxation with foreign subsidiaries. The definition of affiliated companies corresponds to the definition in the international accounting standards (i.e. votes and influence).

But it remains possible for the corporation to exclude income from foreign subsidiaries from Danish corporate income tax. In that case, foreign income will be taxed in Denmark by the territorial principle.

1.3.3 Indirect taxes

Harmonization of indirect taxes

Recent changes in indirect taxes have been mainly driven by EU tax harmonization rules. Since 1993, excise taxes on alcohol, tobacco and mineral oil for road transport are harmonised in EU according to the minimum tax principle. However, market forces in the form of cross-border shopping have increased the distortionary costs of raising revenue through these taxes in relation to the benefits (reduction in external effects). Increasing cross-border shopping and reduction of tax rates have contributed to a reduction of revenue from excises on alcohol, tobacco, soft drinks and sweets from 3.1 per cent of GDP in 1973 to now around 1 per cent.

The Danish excise taxes on alcohol and tobacco have been much higher than the taxes in the EU in general. This has given incentives for cross-border shopping, especially into Germany where the tax rates are lower. Cross-border shopping has been restricted by special rules for traveller allowances in Denmark. These rules set maximum amounts of taxable products that travellers can bring back without paying Danish tax

(after being abroad for more than 24 hours - *24-hour-rule*). The rules have been gradually liberalised. Since 1993, they only applied for spirits and tobacco. From 1 January 2004 the special rules have been abolished. This liberalization has put the tax rates in Denmark under pressure. As a consequence, the tax rates in Denmark have been reduced compared to the rates in Germany. In 1992 the rates on beer and table wine were reduced by 45 per cent. This reduction came shortly before cross-border shopping was liberalised.

The rates on spirits were reduced by on average 6 per cent in the middle of the 1990s and the rates were further reduced by 45 per cent from 1 October 2003 before the abolishment of the *24-hour-rule*. At the same time the tax on cigarettes was reduced by approximately 1/6.

The consequences of the abolishment of the *24-hour-rule* and of the rate reductions have been evaluated in *Rapport om grænsehandel 2004*¹. The report shows that because the liberalization of the special *24-hour-rule* was combined with considerable cut in tax rates, Denmark has managed to sustain the taxable domestic sales and has even increased the domestic taxable sales of spirits. As shown in tables 1.2 and 1.3, the tax rate reductions on spirits even contributed to an increase in revenue. Even though these changes have increased the estimated health externality costs, the net Danish welfare has increased mainly because of considerable increases in consumer welfare.

Table 1.2: Economic effects of the reduction in the taxation of spirits

Millions DKR ¹	Revenue	Danish Consumers	Health cost (externality)	Net welfare Denmark
Abolishing restrictions	-630	+325	-110	-415
Reduced rates	+240	+805	-50	+995
Net	-390	+1.130	-160	+580

¹: In prices including taxes.

Table 1.3: The economic effects of the reduction in the taxation of cigarettes

Million DKR ¹	Revenue	Danish Consumers	Health cost (externality)	Net welfare Denmark
Abolishing restrictions	-970	+170	-0	-800
Reduced rates	-265	+1.415	-95	+1.055
Net	-1.235	+1.585	-95	+255

¹: In prices including taxes.

1.3.4 Environmentally related taxes

Denmark has increased the environmental tax burden rapidly during the 1990s. As a result, tax rates on environmentally related taxes now seem to have reached their limit. In many cases, the rates actually exceed the externalities. At the same time, the introduction of the EU scheme for tradable carbon dioxide permits undermines the economic and political reasons for the Danish carbon dioxide tax. Future possibilities to increase the use of environmentally related taxes in Denmark could be for instance taxes on NO_x and nitrogen fertilizers. The possibility of introducing road pricing for both lorries and cars is increasingly debated. The overall level environmental taxes will not increase in the years to come.

¹ Report on cross-border shopping 2004. The report is only available in Danish.

1.3.5 Tax administration

A unity tax administration

From 1 November 2005, the formerly divided Danish tax administration became a unity administration joint in the Ministry of Taxation. The tax administration now consists of a state tax administration with regional offices and a municipal tax administration. The state tax administration – The Ministry of Taxation – includes The Central Customs and Tax Administration and 26 regional offices. The local tax administration is operated by the 271 municipalities, of which 165 municipalities cooperate in 45 joint municipal tax centres leaving the total number of municipal tax administrations at 151. From November 2005, the regional and local tax administrations are merged into 30 Tax Centres under The Central Customs and Tax Administration. In the medium term the merger of the state and municipal tax administrations will enable reductions in the costs of the tax administration.

Introducing the standard-cost method

The Danish government aims at reducing the administrative burden imposed on businesses by up to 25 per cent before 2010 (as compared to 2002). To reach this ambitious goal the central government has measured the total administrative burden on business. A standard cost method is used which tries to estimate the costs by business connected with supplying the information requirements of different legislations. When compliance costs of different elements of tax legislations are measured, it will provide a tool for considering what legislative changes to make to efficiently reduce compliance costs.

From August 2004 to March 2005, the Ministry of Taxation has carried out a complete standard-cost analysis of the Danish tax legislation. The main finding is that total administrative costs to private businesses and industries are just above DKR 8,000 million (1,082 million Euro) in 2004, as shown in table 1.4. Of total costs, 54 per cent comes from the rules to determine taxable income. Almost 26 per cent comes from rules about indirect taxes and almost 14 per cent comes from the taxation of wage income at the source.

Table 1.4: Total private administrative costs of tax legislation in 2004

	Costs in million DKR	Costs in per cent of total costs	EU and other international obligations %	National implementation of EU and other international obligations %	National obligations %
Taxable income	4.366	54.1	0.0	0.1	99.9
Taxes on wages	1.110	13.8	0.0	0.0	100.0
Indirect taxes	2.153	26.7	35.4	47.9	14.1
Other	435	5.4	0.0	0.2	99.8
Total	8.064	100.0	9.5	12.9	77.6

In many cases, it is difficult to align costs to specific parts of the legislation. The above table should therefore be interpreted with caution. However, the main sources of private administrative costs are presented in the table 1.5. The most costly legislation is the corporate income tax and the rules concerning personal businesses: 38 per cent of total private costs. This is followed by the legislation about tax control: just above 16 per cent of total costs. Worth noting is also that the VAT-legislation costs around DKR 1,000 million (134 million Euro) while customs duties cost around DKR 650 million (87 million Euro). Receipts from VAT were DKR 140,000 million (18,800 million Euro) in 2004, while receipts from customs duties were DKR 2,400 million (322 million Euro).

Table 1.5: Administrative costs for different legislations

Tax law	Costs in million DKR	Costs in per cent of total costs	EU and other international obligations	National implementation of EU and other international obligations	National obligations
Corporation tax and self employed	3,066	38.0	0.0	0.0	100.0
Law on tax control	1,316	16.3	0.0	0.1	99.9
VAT	1,065	13.2	13.0	85.9	1.2
Customs duties	643	8.0	97.5	2.5	0.0
The pay as you earn tax system	503	6.2	0.0	0.0	100.0
Pensions schemes taxation	204	2.5	0.0	0.0	100.0
Motor vehicle registration tax	78	1.0	0.0	0.0	100.0
Top 7 – total	6,879	85.2	11.2	13.5	75.3