

ANNEX A

The 2010 Tax Reform Process in Denmark

In the spring of 2009 the Danish Parliament adopted a major tax reform with the main goal of reducing the relatively high top marginal personal income tax rates. The reform is fully financed by offsetting tax increases and it is expected that both tax cuts and tax increases will have positive structural effects, to a wide extent, on labour supply, savings, the allocation of capital and the environment. It is estimated that the Gini coefficient will increase by 0.45 as a result of the tax reform.

The elements and effects of the Danish tax reform are described in more details in a separate paper presented at the November 2009 meeting of Working Party 2 of the OECD's Committee of Fiscal Affairs. But how did the Danish government succeed in implementing a fully financed major tax reform with the apparent obstacles such a reform faces with regard to distributional effects and increased tax burdens on specific groups of households and businesses?

The main explanations that may be offered are i) that the reform was announced well in advance, ii) that the reform and especially the financing of the reform is phased in gradually so that tax cuts exceed financing during the first years of the reform, iii) that special concessions were made to accommodate distributional issues and iv) that the reform involved a rate reduction and base broadening approach that made it possible to balance tax cuts and financing within broad income groups.

The process towards the tax reform started in late 2007 after the general elections. Until then the government enforced a tax freeze implying that no tax could be increased, thereby preventing a tax reform involving tax increases to finance tax cuts. Until then, tax cuts had also been focused on the bottom and middle income tax brackets to address distributional issues. After the elections the government announced that a Tax Commission was to present a proposal for a tax reform at the beginning of February 2009 with the main goal of reducing the highest marginal income tax rates. After the reform the tax freeze would then again be enforced.

The Tax Commission was appointed in early 2008 with the former social democratic minister for taxation Carsten Koch as chairman and a number of primarily academic tax experts as members. The secretariat was supplied by the Ministry of Finance, the Ministry of Taxation and the Ministry of Economic and Business Affairs.

The appointment of the Tax Commission initiated a broader public and political debate about changing the highest marginal tax rates. At the same time the chairman was able to use his political network to explore some of the different opinions on some of the

tax reform ideas that were considered to be included in the final Tax Commission proposal. Given the short time horizon of the Tax Commission, no interim reports, working papers or intermediate proposals were published. But the Tax Commission met several interested parties during the first 6 months of their work; the commission met other academics, representatives from business and industry, labour unions and the OECD. The Tax Commission's work also seemed to have created some silence within the political arena as parties were waiting for the Tax Commission's report and recommendations.

On 2 February 2009, the Tax Commission's presentation of its report on tax reform was broadcast live on television. Tax cuts and tax measures to finance these cuts were around 36 billion DKK, corresponding to approximately 2% of GDP. On 24 February 2009, the government then put forward proposals based on the Commission's recommendations, and on 1 March, a political agreement on the 2010 tax reform was reached.

The government's tax reform plans either modified or excluded some of the more controversial elements of the Tax Commission's recommendations. The total value of the tax reform was also reduced to around 30 billion DKK. The changes made to the Commission proposals were mainly due to concerns about distributional issues and the tax burden on the business sector.

The most important issue in the public debate was the Tax Commission's proposal to reduce the tax value of the (mortgage and other) interest deduction in personal income taxation by 8 percentage points. This element was included in the Tax Commission's recommendations for a number of reasons; 1) in general, this reform would increase private savings, 2) it would create a better correspondence between the taxation of owner-occupied housing and the deduction of interest rates on mortgages, 3) it would reduce the financing of tax-preferred pension savings through loans and 4) it would provide a substantial amount of tax revenue that could be used to finance tax cuts. However the media, politicians and also the electorate were very critical towards reducing the value of interest deductions. The main argument heard was that such a reform would be very harmful to house owners especially at a time when house prices were falling and because of the substantial financial and economic insecurity as a result of the international economic crisis.

However, excluding this tax reform would imply that government would not be able to finance a substantial part of the tax cuts, thereby foregoing part of the potentially positive structural effects of both the tax cuts and the reduction in the value of the interest deductions. It was therefore crucial to find a way to maintain this element in the tax reform.

The government was able to implement this tax reform measure by building several safeguards into the reduction. First, the reduction of the tax value from 33.5 per cent to 25.5 per cent is to be phased in gradually from 2012 to 2019, while the tax cuts are taking effect from 2010. Secondly, the reduction is only effective for the interest deductions in excess of 50 000 DKK (100 000 DKK for married couples) a year. This threshold is nominally fixed and thus will be gradually reduced in real terms. Finally, a special compensation scheme was introduced whereby individuals are to be compensated if the loss from the reduced value of interest deductions (and other personal deductions) exceeds the gain from the cuts in the personal income tax. These additions made it possible to maintain more than 60 per cent of the revenue effect of the Tax Commission proposal and most of its positive structural effects.

Another important element was the reduction in the top marginal income tax rate. The Tax Commission proposed a cut in the top marginal tax rate of 1.5 percentage points from 15 to 13.5 per cent. During the political process, this reduction was abandoned mainly because it would have directed too much of the total tax cuts towards the very high income households. Instead, the bottom tax rate was reduced by an extra 1 percentage point, thereby shifting some revenue to the lower income groups. The Tax Commission proposed a highest marginal tax rate of 54.7 per cent instead of the 63.0 per cent in the current tax system. The final outcome is a top marginal tax rate on labour income of 56.1 per cent in 2010.

Looking at the entire reform process, it seems that the inclusion of some relatively ambitious and controversial elements in the Tax Commission proposal was important to the end result. It might be argued that the Tax Commission proposal set a new benchmark for the tax system, on the basis of which political negotiations could proceed.

In structuring the tax reform, government tried to balance financing and tax cuts among groups of taxpayers that were, or might be perceived as being, connected. This has much to do with the perception that the reform was fair and acceptable. First, the top marginal PIT rate was cut by 5.5 percentage points, while the tax threshold was increased. These measures were financed by cutting the tax value of interest deductions in excess of 50 000 DKK, by introducing a limit to yearly tax-favoured pension savings and a tax on large pension income, and by reducing tax expenditures for business and industry. Secondly, the government followed a similar strategy by connecting a reduction in the bottom PIT rate and the introduction of “green cheques” (a standard cash transfer) with general increases in energy and environment taxes and reductions in the tax value of deductions of expenses like labour union fees and commuting expenses.

The distributional analysis that underpinned the reform proposals focused not only on the immediate impact of the reform but also on its longer-run distributional impact, which made it possible to take into account the longer-run tax reform efficiency gains. In addition, the timing of the tax cuts and financing was important in light of the international economic crisis. The emphasis on improving fiscal sustainability in light of the crisis therefore worked to implement this fully financed tax reform.



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