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Local income tax in Sweden: reform and continuity

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Contents

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1. Local authorities and the Swedish model of the welfare state

1.1 Swedish local government structures

The Swedish welfare state has its roots in the 1930s, when the Social Democrats first came to power (at the start of their 50 year period in office). It was after the Second World War, however, that what became known as the “Swedish Model” emerged properly. The main features of this model were:

- high levels of welfare provision paid for through general taxation
- high rates of tax for both individual earners and companies
- uniform standards across the country based on the principles of equity and fairness,
- and an important role for local authorities in the delivery of these services.

Today[1], Sweden has:

- 290 municipalities (*kommuner*)
- 18 county councils (*landsting*) (which, confusingly, are also called “regions” (*län*),
- two regions, Västra Götland and Skåne, and
- the island municipality of Gotland (which is an island region combining the functions of the county council and the municipality).

The municipalities and county councils are protected by constitutional laws, which guarantee their existence and recognize their right to take decisions. The two regional councils are directly elected and have responsibility for the major part of the national government’s regional development resources for the region. They also have

[1] Parishes of the Church of Sweden also carried out certain tasks until the separation of Church and State on 1 January 2000, when they lost these functions.

responsibility for health care, which had previously been a function of the county council.

The setting up the regions meant the amalgamation of previously existing counties as well as municipal boundary changes. Västra Göteland region covers the area around Gothenburg and is really a large metropolitan region. Skåne is close to Denmark and its inhabitants have a long-established regional identity and culture close to Danish.

Another key development in recent years has been the creation of Regional Development Associations (*regionförbund*), inspired by a Finnish experiment along the same lines. The RDA's are indirectly elected, drawing their members from county and municipal councils.

There is no hierarchical relationship between the counties and regions on the one hand, and the municipalities on the other. There are also 21 county administrative boards, each with a governor, who is appointed by the central government, and an administrative board, whose members, since 2003, are nominated by the political parties and appointed by the central government. Previously, they had been appointed by the county councils and municipalities. The county administrative boards are the regional offices of the central state.

1.2 Local government functions in Sweden

The municipalities and the county councils and regions, but mainly the former, are responsible for a wide range of functions. Some of these are exclusive to the municipalities (all primary and secondary education, most social welfare functions, town planning, water and sewage, refuse collection, parks and open spaces). Others are shared with the county councils and the central government (e.g. regional/spatial planning, some culture and leisure activities, environmental and consumer protection). The most important but also financially burdensome of these tasks are education and social welfare but constitutional laws give the local authorities the right to raise sufficient taxes to carry out these duties. The two regional councils have taken over all of the functions of the county councils that existed in these areas but have also taken over the functions of economic development and planning, which had been the responsibility of the RDAs.

1.3 The balance of funding in Sweden

The Swedish system of central-local relations presents something of a paradox. On the one hand, these constitutional guarantees give the local authorities a high degree of political and financial autonomy. On the other hand, the principles of equity and uniformity of service provision across the country means that standards are set by the central government and in this sense the system is highly centralized.

The price that the Swedish citizen has paid for the high level of services has been the very high level of taxes, both individual income tax and corporate tax. In terms of the balance of funding, both municipalities and county councils raise their own revenue almost exclusively by means of a local income tax.

Local authorities are free to set their own rates and, in 2000, the highest combined municipality and county council tax was 33.17 per cent and the lowest was 27.13 per cent, with an average of 30.53 per cent. It must be noted, though, that this local income tax is, for those earning above a certain level of income, added to a national income tax, making for very high levels of taxation for Swedish citizens.

The central state, of course, has a keen interest in overall levels of taxation and, in the 1990s, imposed restrictions on the maximum levels that local authorities were allowed to impose, although, since 2000, these have been lifted. There is thus a potential tension between the local authorities' aspiration to political and fiscal autonomy and the necessity of the central government to supervise overall national fiscal policy. In practice, the political parties play an important role in ensuring that this does not break out into open conflict and the Swedes have developed a pragmatic, consensual way of dealing with the issue.

2. The crisis of the 1980s and the 1991 "tax reform of the century"

By the 1980s, the Swedish model, though still admired by many outside the country, was coming in for severe criticism from within Sweden itself with many influential commentators believing that the system was in crisis (Agell et al., 1996). When the Social Democrats were elected in 1982, they inherited what they and most economists believed to be an economy that was in poor shape (Edlund, 1999). There was low productivity and a large budget deficit. The government therefore devalued the krona in 1982 and deregulated the banking system and financial markets. However, although these measures had some positive economic effects, criticisms continued from both the Left and the Right and began to focus increasingly on the tax system.

The Left's main criticisms were that, despite the high levels of marginal income tax, the system of deductions and exceptions meant that, with skilful tax advisers, high earners could recoup the taxes paid and still remain well-off. This contradicted the social democratic aim of equality and the use of the tax system to redistribute wealth from the wealthy to the less wealthy. As early as 1978, the Nobel Laureate, Gunnar Myrdal, a supporter of the Left, had complained that the high marginal tax rates but with many possibilities of tax avoidance had turned Sweden into a "nation of wanglers".

Other economists, associated with the Right, complained that the high levels of corporate income tax, which were compensated for by a variety of tax allowances were an obstacle to efficient capital allocation (Agell et al., 1996).

Sweden had been experiencing double-digit inflation figures since the late 1970s and unemployment was also rising. The rising level of unemployment placed considerable strains on the social benefit system and, at the same time, eroded the tax-paying base. Inflation exacerbated the problems. The economic and fiscal crisis of these years meant it was difficult to sustain the high levels of welfare provision to which the Swedes were accustomed. At the same time, there were moves to reduce the high levels of individual and corporate taxation, while attempting to maintain the high standards.

These developments had profound implications for local authorities which were responsible for much of welfare service delivery and determined to maintain their own political and fiscal autonomy, which were built on relatively high levels of local taxation.

These developments need to be seen in the broader international context of the more general crisis of welfare states and of traditional forms of economic production. Countries such as the UK in the 1970s and France in the 1980s, both ruled by Left of Centre governments, found it difficult to manage the crisis by using the traditional social democratic armoury of state-driven policy instruments and eventually were forced to adopt monetarist policy approaches. In the UK, the failure of the Labour Party led to the arrival to power of Mrs. Thatcher with a reforming agenda subsequently dubbed neo-liberalism. In France, the attempts by the first Socialist governments, after Mitterrand's victory in the 1981 presidential elections, to adopt Keynesian-type approaches gave way by 1983 to a "swing to the right" by Prime Minister Laurent Fabius. In the US, tax revolts had taken place in California already in the 1980s, which paved the way for the election of Ronald Reagan as president and the 1986 US Tax Reform Act.

All of this amounted to something of a crisis for the ruling Swedish Social Democratic party as the basis of their policy programme seemed to be eroding. Although the party was internally divided, the party leaders decided to embark on a radical reform of the system of taxation, held to be responsible, to some extent, for the fiscal crisis or at least to be hindering a solution to it. They had to convince the main trade union federation, the LO, that the reforms would not be a betrayal of the principles of social democracy and would not be simply tax concessions to the better off. They also had to persuade some of the other parties, particularly the Liberals, more devoted to neo-liberalism, to support them. The result was what they hoped was a balanced package of reforms, the main features of which were:

- a simplification and reduction of the rates of marginal income tax and
- the closing of tax avoidance loopholes

- increases in and uniformization of VAT and other indirect taxes to compensate for the losses produced by the other changes.

The tax bill was passed in 1991 and involved the creation of a dual income tax, separating the tax schedules on earned income tax and on corporate income. The outcome of this was that about 85 per cent of income earners would pay only local income tax, which, in 1991, averaged at 31 per cent. To this was added the national income tax of 20 per cent imposed on incomes above 185,000 SEK. Thus the top marginal tax rate was 51 per cent (as opposed to the previous rate of between 75 and 80 per cent). The rate of corporate income tax was reduced from 57 to 30 per cent. In practice, however, the aspiration to levy a uniform VAT rate was not fulfilled and there were exemptions in several areas, including cultural and social services and housing rents (Agell et al., 1996).

Unfortunately, this so called 'tax reform of the century' was followed by the most severe economic downturn since the 1930s, which, although not the result of the reforms, was certainly exacerbated by them.

One result was the failure of the Social Democrats to win the 1991 general elections and their replacement by a Centre-Right coalition which held power from 1991 to 1994 and was more committed ideologically to a neo-liberal agenda. During their period in government, the coalition imposed severe cutbacks in the country's social security systems (Palme, 2002). When the Social Democrats returned to power, they continued these policies but also increased taxes.

There is debate among policy analysts about the significance of these developments in the early 1990s. Some see them as a radical transformation of the Swedish model. Others believe them to have been little more than tinkering at the margins. Palme (2002) maintains that the basic model remained intact although there were considerable modifications of it. It is true that certain features of the model remained intact and, indeed, the majority of Swedish public opinion wished these to remain (Edlund, 1999). The traditional supporters of the Social Democrats, still the biggest party in the country, remained committed to the ideal of the Welfare State even if they accepted that some changes were necessary. On the other hand, in the 1990s, a clear majority was in favour of reforming the tax system provided that this could both improve the economy while maintaining the principles of fairness and equity (ibid.: Table 1 on p. 341).

Certainly, the decentralized nature of the administration of the welfare state, with the strong role played by the local authorities, remained intact. In fact, in might be argued that the position of local authorities was strengthened as they retained their tax-raising powers which were scarcely modified by the tax reforms except to make the local income tax the main form of taxation for the majority of Swedish citizens.

The tax reforms undoubtedly achieved some of the aims of the reformers, especially the closing off of tax avoidance loopholes. On the other hand, high earners are still better off thanks to the lower marginal income tax rates that they now pay and the expected compensation through increasing other taxes did not completely materialize. Although there is still the aspiration of equalization and uniform standards in the costs and quality of services across the country, there is now also a greater tolerance of inequalities given that there, while there is no minimum level of local taxation (as is the case in Norway), there are minimum standards decided by the central government. Again, like in Norway, there was a restriction on the maximum level if income tax but this was lifted in 2000. This means, in effect, that the richer authorities can levy a higher rate than the poorer and thus provide a higher level of services, although the equalization system whereby those who raise higher taxes receive smaller grants from central government, acts as a disincentive to this. What has changed, however, is the insistence that there should be *uniform* standards across the country. There is also today some resentment by those living in the wealthy south of the country, around Stockholm, who complain that they subsidize the northern, much poorer, regions (similar resentments can be found in the Spain among the Basques and Catalans and in the north of Italy, where it fuels the sense of grievance of Bossi's Northern League).

This new approach, a break from the traditional Swedish model, can also be found in the institutional design of sub-national authorities. The old system of the state, the counties and the local authorities all of which had the same basic design and powers has been replaced by a more complex set of institutions now comprised on the one hand of the central state and its field offices and, on the other, the forms of sub-national representative government: the two new regions, the municipality of Gotland, the counties, and the municipalities. Straddling the top-down system of public administration and the bottom-up organs of subnational political representation are the new regional development agencies whose members and funding come from both sides of the political system. One researcher has identified at least five different policy models, from traditional Social Democracy to Thatcherite neo-liberalism, among the approaches adopted by the municipalities. Thus, it could be argued that there is not just one system of territorial politics and administration in Sweden but several distinct ones, possessing a common Swedish political and administrative culture but expressing this in quite distinct ways quite at variance with the uniformity of the past.

Finally, an important aspect of local government funding in Sweden was the shift away from ear-marked funding – there were about 100 different kinds of ear-marked grants before 1992 – to block grants which gave local authorities almost complete discretion over how spending was distributed and represented a significant increase in the level of local discretion.

3. The current debate on local authorities: background factors

Interestingly, there is currently a lively debate place in Sweden about the allocation of functions between the different levels of government which will have a significant impact on the question of local government finance. A Swedish parliamentary commission recently completed a major report on the question (Ansvarskommittén, 2003) which analyses the major problems in the current allocation of functions although it stopped short of making recommendations for reform of the Swedish system. The next step will be that the Swedish government responds to the report and indicates areas for more in-depth consideration. At the end of that process (probably by the end of 2004), it will then decide whether to pursue further reforms and if so what these might be. The commission's report reached the following key conclusions:

- There is no suggestion that the local income tax system of financing local government should be changed. Both the government and the local authorities are happy with the current arrangements and it enjoys a high level of public support.
- There is also no suggestion that other sources of local government funding e.g. business taxes, sales taxes or property taxes should be introduced. These are national taxes and will remain so.
- The commission does though conclude that there is a significant problem of a lack of transparency in the current system. Because the different levels of government - central, regional/country and local – all use the same tax base it is not easy for citizens to understand how tax revenues are used and which levels of government are spending what.
- The Commission also notes that there is some disquiet on the part of the national administration with regard to the shift towards block grants. The argument here is

that block grants are given for shared functions, e.g. some educational matters or roads, but that both central and local government, are held responsible for the implementation of these functions. Some have advocated returning to more specific earmarked grants as a way of making the system more transparent. It would also mean, however, that local fiscal autonomy would be reduced. For this reason, such a move is opposed by the county councils and the municipalities.

- The commission examined how many levels of sub national government are needed and what form these should take and it has put forward for discussion a number of possible scenarios. It avoids coming down in favour of any scenario but the basic choices are between a centralizing model and a decentralizing model.
- The centralizing model would involve national government taking over many of the functions of local and county government and funding these directly. In effect, this would lead to a situation like that of local government in Ireland (and is therefore unlikely to happen).
- The decentralizing model would strengthen the role of sub-national governments. It could take a number of different forms all of which involve abolition of the counties. One scenario would be to create a small number of larger regions, like the two already existing regions. Another would be to abolish the two existing regions along with the counties and create larger and stronger municipalities taking over their functions. The final approach would be to keep the municipalities but to create intercommunal associations (somewhat like the French system of *intercommunalité*) on a voluntary basis. The commission also recognized that there could be an asymmetrical approach, combining a number of different models in different parts of the country.

4. Conclusions and relevance to the English debate on local taxation

Sweden has undergone major reforms of the welfare state which have in turn had important consequences for local government functions and local government finance. It is striking that the Swedes have been faced with similar challenges to those currently confronting policy makers in England. There are at least three parallels between the local and regional government policy implemented in Sweden in the 1990s and policy options currently being considered in England:

- the creation of a regional level of government combined with restructuring of local government
- an increase in the level of local control over how funding is used, and
- a move away from the imposition of uniform standards across the whole country.

4.1 Introduction of regional government

The Swedish approach to establishing regions has been analogous to the current proposals in England to establish elected regional assemblies in the North East, North West and Yorkshire, subject to the outcome of referendums in October this year. Rather than introducing regions throughout the country, the Swedish set up just two regions in the first instance, on an experimental basis. As in England, where any creation of any regional assemblies will be accompanied by a move to unitary local government throughout the region(s) in question, the introduction of the two Swedish regions also entailed the abolition of the counties and some boundary changes.

4.2 The balance of funding

There are three striking differences between England and Sweden in terms of local government finance and the balance of funding:

- In Sweden, local government services are funded from income tax rather than property tax.
- A much higher proportion of local government spending is funded from locally raised revenues in Sweden – more than 60% of municipal funding and about 80% of county council funding comes from income tax, compared to the 25% of local government funding that is raised locally in England.
- The level of block grants, and therefore local discretion over how funding is used, is much higher in Sweden.

The Swedish experience therefore provides some useful indications of the possible implications and impacts of some of the options currently being considered by the Balance of Funding Review in these three areas.

One striking feature of the Swedish reforms is that the "tax reform of the century" in the 1990s went through relatively smoothly and recent debates about the allocation of functions have not produced any serious challenge to the system that resulted. In fact, in some ways, the current debate in Sweden appears to have strengthened the case for the earlier reforms.

Prior to the tax reforms of the 1990s, many Swedes paid both local and national income tax. Today, the majority (around 85%) only pay the local income tax, national income tax is only paid by the highest earners. This has strengthened the link between the taxpayer and the local authorities except in the case of Stockholm, where there is a feeling that much of the taxes they pay are funding other areas thanks to the equalisation system.

There is little doubt that the direct link between the local income tax and local decision-making over important matters has encouraged a high interest and participation local politics by the Swedish electorate. It is true that Sweden, like other European countries, has experienced some decline in this regard but this has not reached the proportions of the UK, where less than 30% turn out to vote in local elections.

There are important contextual and constitutional differences between Sweden and England which mean that we should not assume that lessons or policies can be imported in a straightforward way from Sweden. The Swedish system is built on a political culture of consensus politics, strong commitment to the values of the welfare state – equality, social inclusion, etc. – even if the Swedes recognize that the institutional expression of these have had to change in recent years. England is, of course, in a rather different situation. There was less commitment to these values during the “neo-liberal” years of the 1990s which also experienced a reduction in the importance and the esteem of local government. Moreover, in Sweden there has been a high level of agreement that sub-national authorities should have a key role in the delivery of welfare services. The constitutional position of local government is also rather different – in Sweden there are constitutional guarantees that local authorities will have the funding to carry out their responsibilities.

On the other hand, it is not easy to distinguish cause and effect and the political system to some extent created the political culture in Sweden and the same might be true for England today. By strengthening local government but in a flexible and variable way, as the Swedes are doing, and by strengthening the link between taxation and decision-making at the local level, it may be that a new political culture would emerge in England and other parts of the UK.

One of the features of the Swedish model that is probably not relevant to the current debate about the balance of funding in England is that it is built on the existence of a single local tax. Although this seems to work in Sweden, the Council of Europe’s Charter on Local Self-government recommends that there be a combination of taxes and this is, in fact, the system in the other Scandinavian countries as well as other countries with a local income tax.

4.3 Greater local diversity

The third key area in which the Swedish experience is instructive is the move away from a very strong tradition of ensuring the same standards of service provision across the whole country in order to ensure equity and fairness.

There are clearly parallels between this trend and current discussions in England of the new localism. As with its tax reforms, the move towards tolerance of a greater degree of local variation in service provision in different parts of the country seems not have provoked any major concerns or opposition in Sweden. This is interesting given the Swedes' previously strong commitment to and assumption of a fairly uniform level of provision.

Further research would be needed to determine exactly what the impacts of a willingness to allow greater local variation have been in Sweden – both in terms of service standards and public opinion. However, the Swedish experience may indicate that it is possible to allow greater flexibility at local level in at least some service areas without major adverse effects. If this is the case, it suggests that policy makers in England might contemplate a reduction in central control and prescription and the introduction of more flexibility and freedom at local level. What the Swedish experience certainly reiterates (as is shown by the current review of local government functions and structures in Sweden) is that consideration of greater local discretion over service provision is almost inevitably bound up with consideration of the level of discretion that local government has over spending – both the overall level of local spending and how available resources are allocated between competing priorities. It seems fairly clear that if there is to be more freedom for authorities in England to address local priorities and develop local tailor-made approaches to service delivery, this would require a reduction in the level of 'ring fenced' grants and perhaps greater freedom for them to determine their overall levels of spending.

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