RIKSREVISIONEN
The Swedish National Audit Office

RiR 2009:3 Summary

Tax deferred accounting of housing deferment and pension savings deductions

Summary

Financial support that the tax system provides to individuals and businesses by means of deductions, exemptions and reductions is referred to as tax expenditure.

The current system has a number of tax expenditures (referred to as tax deferments) that allow the taxpayer to postpone taxation. Among the largest tax deferments are the postponement of capital gains taxation when selling a private residence (housing deferment) and the deduction that individuals may take when making pension contributions (pension contribution deduction). The main purpose of the first deferment is to improve mobility in the housing market, while the main purpose of the second deferment is to encourage private pension savings.

Deferments differ from other tax expenditures in that taxes are eventually payable – ordinarily much later in the case of both the housing deferment and the pension contribution deduction. Many people began to make pension contributions at a young age and cannot withdraw their money until they are much older. That is also true of the housing deferment – homeowners are not liable to pay the capital gains tax until they sell their final residence.

These long deferment periods have led to a growing quantity of tax deferments. Various estimates suggested that housing deferments and pension contribution deductions total SEK 600-700 billion. That represents outstanding taxes of SEK 170-200 billion at current tax rates. Unless the taxes are eventually payable, the government runs the risk of losing major revenues. The risk is growing along with the internationalisation process.

The design of deferments is such that they represent a greater source of uncertainty for individuals than other tax expenditures. The reason is that deferments are not related to a specific tax payment or amount, but rather to a particular income. Amendments to tax regulations during the deferment period can have a heavy financial impact on the taxpayer.

Despite the risks and problems associated with long, indeterminate deferment periods, there are few rules for managing deferments as part of the government budgetary process. Furthermore, very little data and knowledge exist with respect to the effectiveness of deferments and their impact on public finances.

With the above considerations in mind, the Swedish NAO conducted an audit of the government's accounting and assessments of tax deferments. The audit proceeded from the following overall auditing question:

Does the government provide clear and complete accounting and assessments of tax deferments, along with the risks and effects with which they are associated?

Clear and complete accounting and assessments of tax deferments on the part of the government require transparency, as well as comprehensible data and documentation. Of fundamental importance is that the total present

value and future development of the deferments can be determined. In addition, the impact of regulatory amendments that affect the deferments should be assessed. Finally, the length of deferment periods makes it important that the effects of deferments be accounted for and assessed over a longer time horizon than budgetary accounting ordinarily permits.

Conclusions of the Swedish NAO

Unclear calculation and financing principles, as well as short-term focus

Although both deferments involve large amounts of money, finding data about their magnitude and development in the documents that the government submits to the Riksdag is surprisingly difficult. The assessments provided by the government concern primarily the effects on public finances, particularly for the next few budgetary years, occasioned by amended tax regulations. The calculations essentially treat deferments as if they were permanent tax reductions. Given this absence of a long-term view, the government's accounting and assessments of tax deferments are incomplete.

The lack of a sufficiently long time horizon when calculating the impact on public finances of regulatory amendments that affect tax deferments also leads to less transparency in terms of the financing principles that apply when changes in deferments finance other measures.

The frequent use of deferments in order to finance permanent amendments to tax regulations render long-term financing less sustainable. This may be illustrated by examining the way in which the property tax reform and abolition of the wealth tax were financed. Both reforms involve the permanent elimination of two taxes that were largely financed by restrictions on the housing deferment and pension contribution deduction.

However, when expanding tax deferments, the government has sometimes calculated the consequent financing requirement as the additional tax credit generated. The recent expansion of the housing deferment system to include the entire European Economic Area (EEA) was calculated and financed in that manner. Thus, it appears that the government sometimes applies from varying financing principles depending on whether deferments are being restricted or expanded. Besides posing a risk to budgetary discipline, the result may be a lack of clarity about what principles actually pertain, which has a detrimental impact on accounting transparency.

Adaptations to EU regulations and greater international mobility increase the risk of lost tax revenue

Both the housing deferment and pension contribution deduction have been adapted to EU regulations by expanding their area of coverage from Sweden to the entire EEA. The government's preparatory work for the amendments did not investigate or present alternative solutions for expanding the deferment systems.

The expansion has made tax regulations more complex and difficult to monitor. Thus, there is a large risk that the outstanding tax credits stemming from the EEA deferments will become permanent deductions. The risk involves not only new deferments but those that have been accumulating for several decades.

For that reason, the recent restrictions on deferments have also been justified on the basis that they will help ensure future tax revenue. Given the long time horizon involved and the large quantity of outstanding deferments, many years are likely to pass before these or any future restrictions have the intended impact. The government has not submitted an assessment concerning this issue.

Greater mobility might make Swedes more disposed to retire abroad. If so, Sweden's tax treaties with other countries may represent a growing problem. In the treaties, Sweden has largely relinquished the power to tax pension payments in connection with emigration. Although the problem has been known for a long time, its magnitude has not been assessed. Even if it turns out that large amounts are not involved, faith in the tax system may be damaged if an opportunity to avoid taxation arises, regardless of whether the loopholes are in treaties, legislation or supervision.

Impact assessments with a focus on income distribution and reform packages

Generally speaking, the government has not discussed the long-term impact of deferments as a result of regulatory amendments that concern them. The impact assessments provided by the government have focused instead on the effects of its proposals on income distribution. Recently the government has also begun to present equality analyses in connection with its proposals. But the accounting has generally been very scant.

For the most recent restrictions on deferments in connection with the property tax reform and abolition of the wealth tax, the government described the overall effects of the reform packages. As a result, the impact of the restrictions on income distribution cannot be isolated.

In the case of deferred taxation, previous decisions are affected retroactively by regulatory amendments in a way that has no counterpart when it comes to direct taxation. The reason is that deferments are not related to a specific tax amount, but rather to a particular income. Thus, the ability of legislators to amend the regulations that apply to deferments (such as by changing tax rates and bases or adopting ceilings) can have a major impact on individuals. The government has not accounted for or assessed the consequent financial risk that deferred taxation poses to the individual taxpayer. Such a discussion would flesh out our understanding of the socioeconomic costs associated with deferments.

While there is a limit to how exhaustive impact assessments can be, the government's selection process has often generated assessments so brief that they border on insignificance. Most of the analyses would have benefitted from being placed in a larger context.

No evaluation of how effective the deferments are

The government's 2008 spring fiscal policy bill presented a number of tax policy guidelines. The guidelines are based largely on the principle of general and uniform regulations that has governed the Swedish tax system since the 1990-1991 reform. The Riksdag approved the guidelines. The problem with designing guidelines for the tax system is the risk of conflicting objectives when special regulations are used to affect behaviour. The conflict is particularly obvious when it comes to the two deferments, which by definition depart from the principle that tax regulations should be general and uniform. The recent regulatory amendments (both expansion and restriction) have not changed that basic characteristic of deferments. If anything, the amendments have made the regulations to which deferments are subject even more complex. The reason is that deferments must now meet EU requirements that they are not discriminatory in cross-border situations while continuing to serve their original purpose. Nevertheless, the government has not evaluated either the effectiveness of the deferments or how they compare to possible alternative measures. Thus, we do not know how well they are currently working or whether they are worth what they cost.

Recommendations of the Swedish NAO

In view of the observations and conclusions presented above, the Swedish NAO is issuing the following recommendations.

Standardize the accounting of tax deferments

The Swedish NAO would like to bring to the Riksdag's attention that tax deferments are an example of the lack of government standardization. In the opinion of the Swedish NAO, accounting of the deferments should be standardized in the government's annual report. Furthermore, other public documents by the government should present more detailed information about the value of outstanding deferments and estimates of how they will develop in the future. The government's statement of tax expenditure might be used more effectively for this purpose. If more detailed accounting of the public sector's financial position were adopted, including an assessment of tax deferments could be considered.

Establish transparent calculation and financing principles

The government should establish transparent principles for calculating regulatory amendments that affect tax deferments and when such amendments can be used to finance other measures. That is particularly important considering that the government and Riksdag have stated that income tax deferments should ultimately be avoided. Thus, additional restrictions on deferments may be adopted.

Closely monitor tax deferment developments

The geographic expansion of tax deferments poses the risk of tax planning and arbitrage that tax supervision cannot control. Because large revenues may be lost, the government should monitor developments in this area. That includes the risk that Sweden's double tax conventions with other countries pose to the government's ability to recover tax credits associated with the pension contribution deduction when people emigrate. It is important that the government have an overall view and is prepared to implement necessary regulatory amendments or review prevailing double tax conventions.

Evaluate how well tax deferments are meeting their goals

The government has not evaluated whether the housing deferment is improving the mobility of the housing market or the pension contribution deduction is encouraging private pension savings. Given the risks and uncertainties associated with the deferments, it is vital that they are effectively evaluated and weighed against alternative measures that target the same goals. Evaluating and possibly reconsidering the deferments is also important in terms of a upholding the tax system. Due to changed international circumstances, even tax regulations that were once regarded as beneficial can eventually undermine the effectiveness and legitimacy of the tax system.