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Taxation of Financial Claims in Finland

The article reviews and analyses the currentFinnish system of taxing the return on financial claims. The taxation of income from capital has dramatically changed since 1985 due to a series of reforms that tried to establish tax neutrality of the different sources of financing, that is, new share issues, retained earnings and borrowing.

In 1990 a final source tax on interest income was adopted, while 1993 marked the implementation of the so-called dual income tax system where income from capital is taxed at a flat rate separate from the ordinary progressive tax schedule of earned income. In 1990 Finland also adopted the tax credit system in dividend taxation whereby the corporation tax on the distributed profit is fully credited in the shareholders' taxation. Double-taxation of undistributed profit still remained and inflation caused arbitrariness of measured taxable income. It is based totally on a nominal concept of income since many leakages of the tax base were eliminated during the reform process.

The analysis of the system is carried out in terms of the effective tax rates on real income from capital, but the description of legal details cannot be avoided, either. The major argument concerns the effective tax burden of capital income. Firms need to finance their growth. When retained profits are double-taxed by law and nominal interest income is fully taxed without correction for inflation, the benchmark effective tax rate on dividends is set into the range of 50 per cent or more. Therefore, unanimity about the distribution policy requires that the pay-out ratio be determined such that the whole corporate income is double-taxed in equilibrium.

Hence the average tax burden of corporate income tends to be taxed as heavily as the top marginal tax on earned income. Therefore, a non-listed, profitable company's owner-managers have no incentive to transform labour income into capital income. Also, it is warned that in evaluating the Finnish companies one should not apply mechanistically well-known text-book formulae. There is no tax shield from debt because debt interest is deductible at the same rate as it is taxed in the investors' personal taxation. Neither should one apply legal tax rates in capital budgeting techniques. The cash flows are best valuated on their pre-tax basis.