German Tax Policy in 2008

The new settlement tax on capital incomes and realized capital gains

Effective January 1, 2009, the *Abgeltungsteuer*, a withholding tax on capital incomes, has been introduced. It replaces the old tax on capital incomes, which used to subject capital incomes to the personal marginal tax rate. The new tax, in contrast, works as a settlement tax: With the payment of a flat tax of 25% on taxable capital income, the tax liability on this income is definitely settled. For tax payers whose marginal tax rate is below 25%, however, a reimbursement of overpaid taxes is possible. The downside, from the taxpayer's perspective, is that under the new tax realized capital gains are also subject to taxation, which has not necessarily been the case before. For example, a realized capital gain from selling company shares was not taxed under the old law, provided that the taxpayer had owned the shares for at least one year, but it will be taxed at the 25% flat tax rate under the new law. As already mentioned, the *Abgeltungsteuer* is designed as a withholding tax. The tax payment on interest is, for example, made directly by the bank handling the taxpayer's deposits. The tax on dividends is paid directly by the companies distributing the dividends.

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The effect that the new *Abgeltungssteuer* will have on saving decisions of German taxpayers is not entirely clear. On the one hand, many taxpayers who allocate their savings to simple interest carrying investments will benefit from a lower tax rate under the new regime, which is in part possible due to the tax cut cum base broadening philosophy being pursued. Under standard assumptions, this should encourage saving. On the other hand, this broadening of the base discourages directing savings into investments where capital gains have hitherto been left untaxed. Such was the case of funds investing in corporate stocks that were so far relatively popular instruments for private retirement saving. Another issue is that of tax avoidance. Having a relatively low, flat tax on capital incomes can be expected to reduce incentives to transfer savings abroad, especially given the fact that popular European tax havens now also levy a source tax on interest from accounts of foreign investors. At least in the long run, this may also contribute to broadening the tax base, vis-à-vis the alternative scenario of maintaining progressive taxation of capital incomes.

Issues of equitable taxation do, however, also arise. It is certainly difficult to reconcile the ability-to-pay principle with discriminatory tax rates that, for individuals with sufficiently high overall incomes, apply substantially lower marginal rates to capital income, compared to wage and other incomes. Such equity arguments can, however, not only be made against a flat tax on capital income – they could just as well be turned around to criticize progressive taxation of other incomes, i.e. to advocate a general flat tax on all types of income in order to restore equitable taxation according to the ability-to-pay principle.

From a perspective interested in the efficiency of the tax system, there are other serious problems arising from the fact that the *Abgel-*

tungsteuer is not fine-tuned to the existing system of corporate taxation. In its 2007/2008 annual report, the German Council of Economic Advisors has calculated the costs of capital for different means of financing a marginal investment under the new tax regime. The first result is that, compared to the *status quo ante*, the **new regime substantially increases the costs of capital for investments that are self-financed through retained profits**, both for incorporated and non-incorporated businesses. For incorporated businesses, the combined tax burden on the business-level from the corporate profit tax and the municipal business tax declines from 38,65% to 29,83% For an alternative interest-carrying investment and a taxpayer at the top margin of the income tax progression, however, the *Abgeltungsteuer* reduces the marginal tax rate even more sharply, from 47,48% to 26,38%. This leads to an increase of the opportunity costs of self-financing for corporations. For non-incorporated businesses, the adverse effect on self-financing is even larger. Although there is a special tax facility for retained profits in non-incorporated firms, the overall tax burden on profits that are eventually distributed to the owners of the firm is in general substantially higher than the flat 25 percent tax rate on interest payments.

For incorporated firms, financing additional investments by issuing new shares also becomes much less attractive under the new tax regime. When (even temporarily retained) profits are eventually distributed to shareholders, they have been taxed at an effective rate of 29,83% on the company level. The cash dividend is then, in a second step, subjected to the *Abgeltungsteuer* on the shareholder level. The new tax regime therefore also distorts more heavily against financing through issuing new shares, compared to the old regime.
In sharp contrast to the stated political aims of the corporate tax reform, **the *Abgeltungsteuer* increases the incentives for debt financing for all types of business**. In the long run, German busi-

nesses will operate with lower quotas of equity capital, which is certainly not good news in a broader business environment that is characterized by volatile credit markets. Moreover, the Council of Economic Advisors also points out that under real-world institutional constraints, the tax reform will also have adverse effects on investment activity as a whole. For example, small firms, or young start-up firms, are often credit-constrained, so that increased costs of self-financing as well as issuing new shares will reduce their marginal propensity to invest. A similar effect could be relevant for large corporations, who are now subjected to the so-called *interest barrier*. If a positive difference between paid interest and received interest of a company is larger than €1 million, then net interest payments are allowed to reduce taxable profits only up to an amount of 30% of EBITDA. But increasing the opportunity costs of equity financing, while reducing the tax deductibility of interest payments on a company's debt, will ultimately reduce its propensity to invest.

One might of course hope that the negative effect on marginal investments by existing companies may be overcompensated by a positive effect: **The average tax burden on incorporated companies' profits has declined substantially in 2008**. The corporate tax rate is down to 15%, from 25% the year before. As already alluded to above, if we also take the so-called solidarity surcharge and a typical municipal business tax rate into account, the overall corporate-level tax burden is down to 29,83% from 38,65%. Germany will therefore become more attractive for foreign direct investments. Whether the positive or the negative effect prevails remains to be seen in the coming years.

The reformed German inheritance tax

After a lengthy political debate, a reform of the German inheritance tax has been approved by the legislature in late 2008. The reform had become necessary after the constitutional court had declared the old inheritance tax unconstitutional, as it used different valuation methods for different types of property. For example, shares in companies listed at a stock exchange could be valued at market price, while real estate was regularly taxed at a value substantially below its actual market value. The new regime of inheritance taxation follows the standards set by the constitutional court in a very narrowly interpreted sense. Now, all types of property are to be evaluated at their ongoing market values – in this sense, the demand of the constitutional court has been met. However, now different types of property are eligible for different degrees of tax relief. It will be interesting to see whether this new arrangement survives the scrutiny of constitutional lawyers.

In detail, the reform of the inheritance tax first of all alters the structure of the tax schedule. The tax brackets have been widened for all heirs, and for close relatives of the bequeather, the tax rates remain constant. For example, an inheritance with a taxable value of up to €75,000 is taxed at a rate of 7% if the inheritance is made by a son or daughter, but at 30% if the heir is only a distant relative of the bequeather, or no relative at all. Inheritances above €26 million are subjected to the top marginal rates, 30% for close relatives and 50% for others. Compared to the old regime, tax rates for more distant relatives have been generally increased (in the lower brackets) or held constant (in the higher brackets).

The more interesting changes concern, as already mentioned, the new rules of evaluation and tax relief for specific types of inherited

property. In general, all kinds of property are to be evaluated at their market prices, which implies for example that for businesses not listed at a stock exchange, a capitalized earnings value based on past profits is to be calculated. The important issue, however, is the provision for tax relief: A fraction of 85% of the business value is exempt from taxation, if (i) the heir remains the owner of the business for at least seven years after the inheritance has been made; (ii) the accumulated, overall payroll in these seven years does not decline below 650% of the payroll in the year of the inheritance and (iii) not more than 50% of the business property is so-called administrative property. The third provision is meant to ensure that the tax relief is channeled towards what is perceived as productive capital. At the time of the inheritance, the heir can also irrevocably opt into an even stricter regime. In this case, (i) she remains the owner of the property for ten years, (ii) the payroll threshold increases to 1,000% and (iii) not more than 10% of the business value comes from administrative property. The reward is that under this stricter regime, the inheritance is completely exempt from taxation.

If an heir fails to meet the stated requirements during the relevant time periods, taxation sets in proportionally to the extent of her transgression, i.e. no heir has to fear that the entire tax exemption immediately expires for any small transgression. Nevertheless, these provisions are associated with severe problems from an economic perspective. They are meant to reward prolonged family ownership of businesses, and also to reward a stable level of employment. In fact, however, these provisions increase the costs of restructuring and adjustments within firms in the period after a transfer of ownership through an inheritance has taken place. At the margin, they could also discourage risky, but worthwhile investments with a relatively high probability of job losses. It is also difficult to see the economic rationale behind rewarding sustained family ownership. There

is no clear empirical evidence showing that family ownership increases profitability of a company. And even if this were the case, there should be no need for special provisions: price signals (higher present values of future expected returns) would be sufficient to set private incentives. If policy-makers shun from laying the burden of an inheritance tax onto ongoing businesses, a clear-cut exemption such as the British business property relief would cause fewer distortions, which are clearly entering through the detailed conditions for tax relief set forth in the German tax code.

Other current issues in German tax policy

In a decision eagerly anticipated by taxpayers, the Constitutional Court decided in late 2008 that the current provisions for deducting the costs of commuting to the workplace are unconstitutional. Under these provisions, taxpayers have not been allowed to deduct any costs if they live no further than 20km from their workplace, but a lump-sum deduction could be made for any kilometer commuted beyond this limit. The constitutional court considers this to be an arbitrary limit that violates the basic tenet of equal treatment before the law. Accordingly, all taxpayers are now allowed to make a lump-sum deduction for every kilometer commuted to their workplace. There has been some political discussion on the appropriate reaction to the court's decision. Some politicians suggest that losses in tax revenue ought to be compensated by reducing the deductible lump-sum amount for all taxpayers. Given that we are in an election year, however, all decisions on this issue have been postponed and the status quo will be stable at least until the end of this year.

Finally, as a response towards the current dismal macroeconomic situation, there have been a number of minor, one could also say

cautious, modifications of the income tax schedule. At the lower end of the income tax schedule, the tax rate has been decreased from 15% to 14%, and the general personal tax allowance has been extended from € 7,664 to € 8,004. Furthermore, the threshold income levels for the different tax brackets have been shifted mildly to the right. Overall, it is expected that these measures will merely compensate for bracket creep of recent years, but not be associated with any major relief as far as the income tax burden is concerned.

Report on Italy

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Introduction

Italy remains a heavily taxed economy. The commitments taken by various Italian governments to reduce the tax pressure continue to be postponed due to political incompressibility of public expenditure and, more recently, to more than precarious overall public sector financial conditions. However, after a surge in the most recent years, the annual rate of increase of tax revenues has somewhat slowed down during the first three quarters of 2008 and has become aligned to the rate of growth of GDP in current terms. Thus it appears at the time of writing this report that the overall tax pressure has been kept constant at the level of 42.3%.

Stability of the overall tax pressure is the result of two countervailing forces. Namely, a) the high growth of the personal income tax collections and, b) the negative dynamics of VAT collection.

The growth of the former has to be ascribed to the continuation – until the third quarter of the year 2008 - of the expansion of the total wage bill, which is the main component of the tax base of the personal income tax. The decline in VAT collec-

tions is a more complex phenomenon, partly tied to evasion and partly to the immediate impact of the slowdown of economic activity.

The **Italian government has been quite active in tax policy throughout 2008** and a number of changes have been introduced in taxes at all levels of government. Further changes in tax policy orientations have been widely discussed. Some of them could be introduced in the near future, although the global economic crisis has shifted, the attention from structural changes in the tax system to the immediate impact of fiscal packages on the level of economic activity.

The slimming of the municipal property tax

The main and more widely debated change has been the elimination of the whole burden of the municipal property tax (ICI, or *Imposta Comunale sugli Immobili*) on primary residences.

The process was started by the Centre-Left government in 2007 with the granting of a general tax relief, amounting to €200, to all first homeowners. Then, the Centre-Right coalition made of the complete elimination of the municipal property tax on first homes a salient component of its electoral platform for the national election of April 13, 2008. Once in power the coalition kept its promise. With the elimination of the burden on first home owners, the tax base of the municipal property tax has been reduced to industrial and commercial properties and to secondary residences. The loss in revenue generated by the elimination of the tax on first homes has been estimated to be of the order of 20% of total ICI collections. In turn, ICI provides municipalities with one third of their total recurrent reve-

nues, corresponding to one half of their total tax revenues. Thus in purely financial terms the impact of the elimination is relatively small, amounting to 1/15 of total current revenues. **The government has promised to compensate municipalities with a corresponding increase in transfers**. However, the gravity of the present economic and financial crisis has also impacted on intergovernmental financial relations, bringing in a substantial cut in central transfers to local governments.

In policy terms, the elimination of the property tax burden on primary residences is **a severe blow to the principle of local tax autonomy**, the more so when one considers that Italy is presently trying to implement a huge decentralization process mandated by the constitutional reform of 2001. Clearly, the two governing coalitions that have alternated in power in Italy since 1994 – the Centre Left and the Centre Right coalitions – have betted on the political popularity of a tax measure that impacts on a very large share of the Italian population. In fact, 80% of Italians own their primary residence.

The Robin Hood tax package:
a) lower taxation of overtime work

This is the imaginative title given to a package of tax measures introduced along with the ICI change (government decrees 93 and 112 of 2008). It consists of the "detaxation" of overtime work pay for the second semester of 2008, whose impact on revenue will be **compensated by an increase in the tax burden for the energy, bank, insurance and cooperative sectors**. Part of the additional revenue raised from these sectors will also be used to fund the **introduction of a social card** that will be distributed to poor persons and finance purchases of basic necessities.

Detaxation of overtime pay consists of replacing, for the remuneration of overtime the present progressive tax rates with a flat rate of 10%. The tax allowance is limited to private sector workers and to a ceiling of €30,000 (in other words, the tax benefit will not exceed individually €3,000). The individual and general fiscal **impact of the measure is substantial**, considering that tax rates for the personal income tax (PIT) range from 23% for incomes less than €15,000 euros to 43% for incomes exceeding €75,000. In fact, it has been estimated (by the leading Italian financial daily paper *Il Sole/24ORE*) that a private sector employee with a monthly gross income of €1,300 (at the low end of the salary scale) could gain from the detaxation of his overtime pay up to €580 per month, if he were able to fulfil his entire maximum monthly allocation of 250 hours.

Detaxation of overtime pay has raised a lot of **controversy among experts, politicians and trade unions**. The arguments against are that, by lowering the burden of taxation on overtime pay, it will increase the amount overtime used by firms and thus the number of hours effectively worked. Thus, detaxation of overtime pay will lead to a substitution between hours-worked-per-job and the number of jobs. Since low employment is one of the main problems of the Italian economy, the **perspective reduction in the hiring of new employees** is absolutely not welcome in large sectors of the Italian society. Furthermore, it is feared that detaxation will favour the so-called strong component of the labour force, namely males aged 25 to 40 at the expenses of the weaker components, such as very young and female workers. **Firms will gain** in terms of flexibility in the use of their labour force, while their labour costs will not benefit, at least in the immediate, since according to present agreements overtime is remunerated 50% more, when done in work days and 100% more during holidays. In the longer term the advantages for firms could

become more substantial, since they will start to bargain for lower remuneration of overtime, thus sharing part of the benefit of detaxation. In this case detaxation could reduce the average cost of labour and thus stimulate expansion of employment. Furthermore, the **huge costs of detaxation** are financed, as we will see just below, by taxation of super-profits of firms. This has been presented as a non-distortionary way of raising additional revenue since it taxes rents from monopoly sectors and avoids possible criticisms of detaxation of overtime that could be made if it were financed out of typical distortionary taxes.

The Robin Hood tax package:
b) higher taxes for energy, banks and insurance companies

Revenue lost from ICI and detaxation of overtime work is supposed to be recovered **from higher taxation of sectors enjoying rents due to their market power** and/**or to favourable regulation.** More specifically, firms operating in the electricity, oil and gas sectors—royalties on oil and gas production have also been substantially increased--will be subject to an extra burden on their profits that will **bring the total tax rate on their profits to 33%, compared with the 27.5**% tax rate applying to firms operating in the rest of the economy. For banks and insurance companies the burden of taxation has been increased through an **expansion of their tax base**. More specifically, the full deductibility of interest paid to depositors and of some income put into reserves has been reduced. In fact, the expected increase in collections from banks and insurance companies was estimated at the time the measures were undertaken – the summer of 2008 - to be substantially higher than that deriving from higher taxation of the energy sector. The rapid deterioration of the financial markets and the huge drop in the price of

oil will surely and hugely impact on the revenue potential of these tax changes, whose dynamics looked brilliant at the time of their introduction (see table 1).

Finally, also the cooperative sector has been subject to an increase in taxation by reducing the deductibility of profit put into reserves. The government has not made clear why the taxation of windfall profits and monopoly rents has not been extended to other sectors, such as toll highways and telecommunications that also earn fat returns. Critics of government have pointed to the substantial discrimination inherent in the choice of sectors.

The increase of tax revenue deriving from higher taxation of rents will also be supplemented by a **change of the tax regime of stock options**. More precisely, it has been decided that the income of managers exercising their stock options will be taxed as income from labour, instead of being taxed as income from capital. Since the latter is subject to a flat tax rate, while the former is subject to a progressive tax rate schedule, the change of regime implies a higher taxation of stock options.

Table 1, below, shows the distinct impact of the Robin Hood package combined with the reduction of the municipal property tax. Since detaxation of overtime pay is experimental its impact is limited to 2008 and 2009. The estimated increases in collections deriving from taxation of monopoly rents and windfall profits are clearly dependent on the time they were made. They assume continuation of high oil prices and do not take account of the huge deterioration of conditions in the financial sector.

Table 1. **The revenue impact of 2008 tax changes**
(millions of euros)

	2008	2009	2010	2011
Elimination of ICI on the first residence	-1,700	-1,700	-1,700	- 1,700
Detaxation of overtime	- 649	- 401,5	37	38
Total of tax reductions	- 2,349	- 2,101,5	- 1,663	-1,662
Taxation of extra profits in the energy sector	437	2,282	1,441	1,189
Taxation of extra profits in banks and insurance companies	1,783	2,368	2,908	2,297
Increase of taxes on cooperative	40	45	45	45
Total of tax increases	2,260	4,695	4,394	3,531

A missed reform: financing the new decentralized /quasi-federal system

Italy is very likely to miss a huge opportunity for reforming its tax system provided by the implementation of the reform of inter-governmental financial relations mandated by the Constitution of 2001. A government decree (the so-called "Fiscal Federalism Decree"), providing the new legal framework for financing regional and local government, is currently under discussion in parliament. The decree is the mediation of a long and bitter struggle between the Northern (rich) regions (headed by Lombardy and Veneto) and the front Southern (poor) regions. The former regions have been asking for very high shares of revenue from the personal income tax and for VAT on the ground that most of the collections are generated within their territories. The latter regions have been asking for an intense equalization system of centrally provided transfers that would ensure equality of per capita resources for social expenditure – such as health, education, social assistance and local transport,

where the introduction of nationally determined standards has been mandated by the reformed Constitution of 2001. Homogeneous standards will apply. **No regional front has ever asked, however, for a higher degree of tax autonomy.** One has to remind in this context that opposition by municipalities to the elimination of the municipal tax on primary homes has been very weak.

Also very weak has been the opposition by regional governments to the announced policy of eliminating IRAP, the backbone of regional finances. As mentioned in the previous Report on Italy, IRAP is a tax payable by businesses on the difference between their sales and the sum of their material purchases and depreciation. IRAP is an origin-based income-type VAT, whose payment is determined by the subtraction method. Even with its present relatively low tax rates, revenue from the IRAP is substantial, in the order of almost 2.5% of GDP, providing at countrywide level almost 50% of health care financing - the main regional expenditure responsibility.

The Centre-Right government coalition has long been committed to eliminate IRAP as soon as budget conditions allow it and has renewed this commitment constantly. Elimination has been delayed, up to the present time, by the impossibility of finding an adequate substitute for IRAP collections.

The Fiscal Federalism decree will base the new financing system on sharing revenue of national taxes and on equalization grants, while the role assigned to local taxation will be almost irrelevant, with the still vague exception of the surcharge on the income tax. No region has shown a real interest in expanding local taxation, although the new constitutional text recognizes the power of regional councils to introduce new taxes on tax bases not yet exploited by the central government. Basically, the new system has been

geared to preserve the present redistribution pattern between the various areas of the country, whereby the Southern regions are able to sustain per capita levels of expenditure for their services that are quite close to those of the richest regions, despite the huge disparities in GDP and thus in their financing capacity. Close per capita levels of local expenditure are, however, not synonymous with equal levels of effective service provision, since local politicians have shown a far better ability in bargaining for more financial resources than in the transformation of those resources into services for their constituents.

Lower taxes in the Southern regions for development purposes

Political representatives of the Southern regions have strongly bargained during the preparation of the Fiscal Federalism decree for the **introduction of tax allowances for regional development**. More precisely, for the possibility of lowering tax rates of centrally and locally administered taxes with the aim of fostering local development by **inducing firms and or people to locate new activities in their territories**. Similar regimes are operating in Europe, particularly in the remote islands and have been requested by a number of regions. Since these allowances are potentially a huge factor of distortion of competition, the EU has intervened to strictly regulate the matter. The European Court of Justice has stated- with reference to the regional allowances scheme of the Azores Islands - that local and regional governments can lower the burden of their taxes provided that: a) these governments are effectively autonomous from the central government; b) these governments have the power to take in full autonomy these decisions: and c) that the cost of these allowances in terms of lower tax collection cannot be refunded by the central government, or by other regions.

In theory, the third clause should put an end to the debate in Italy, since it was intended by proponents of regional tax allowances for Italian Southern regions that there would be no costs for these regions and thus that the central grants would provide compensation for lost revenue. However, the Fiscal Federalism decree leaves at article 14 the possibility of lowering tax rates for firms locating in the less developed regions, obviously in accordance with EU legislation. This means that explicitly central transfers will not be able to provide compensation. In practice, however, means are easily found that would allow the central government to compensate.

Tax update Luxembourg 2008

Serge Tabery

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Introduction

The Grand-Duchy of Luxembourg has for several decades endeavoured to increase its overall competitiveness.

These efforts have for many years materialised in an extremely high political and social stability, in a generally coherent legal framework with a yet reasonable production of new laws and decrees as well as a straight forward and favourable tax environment.

In this field, **new regulations have recently extended the scope of "*eligible investors*" in Specialized Investment Funds** (SIF), created—on the 11th of May 2007--the "Private Asset Management Company" (SPF), the successor to the 1929 holding company, and have provided for a **special allowance for families with children**.

Positive measures were adopted in 2008 among which inflation adjustment of progressive tax brackets and a reduction of the capital duty payable upon the incorporation of companies and subsequent capital increases (the reduction is from 1% to 0.5%--decree of the 21st of December 2007 with effect from January 1st 2008).
In 2009 **further improvements for indi-**

vidual tax payers and companies have been introduced in Luxembourg's tax system by the law of the 19th December 2008.

For individual tax payers, the new measures aim at better taking inflation into consideration when introducing new tax credits, smoothing the payment of children benefit, encouraging donations to charitable institutions and abolishing withholding tax on interest paid by some savings institutions.

As to corporate income tax, the changes relate to the abolition of the capital duty upon incorporation or subsequent capital increases, a reduction of the corporate income tax rate, a broadening of the parent-subsidiary dividend withholding tax regime, a special tax regime for intellectual property income, the extension of the tax exemption for shareholders of SICAR's (risk capital investment companies / *société d'investissement en capital à risque*) and a fundamental change in the VAT.

Individual taxpayers

Tax brackets

It was felt that the measures introduced in 2008 were insufficient to compensate the adverse effects of inflation. Tax brackets have therefore been increased as from the 1st of January 2009 by up to 9%. This means that income up to €11,265 remains untaxed (article 118 LIR). The highest tax rate of 38% only applies to income in excess of €39,885. This is however the case for an individual tax payer.

For a married couple with two incomes, the tax benefit will amount to over €1,600 in this tax bracket, without taking into account de-

pendency allowances for children.

Tax credits

Up to now salaried and retired tax payers were entitled to different allowances the effect of which was a reduction of their respective taxable income (article 139 bis and ter LIR).

From the 1st of January 2009 this **allowance system is replaced by tax credits** for both categories amounting to €300 per year. The tax credits are granted by either the employer or the state pension institution (*Caisse de pension*) on a monthly basis. They are therefore directly deducted from the taxes withheld on the P.A.Y.E basis.

That tax credit is refundable: In the event that the tax credits exceed the taxes to be withheld, the difference is paid by the employer or the state pension institution to, respectively, the employee or the retired taxpayer. The employer or the pension institution will have to request the reimbursement of this difference to the tax authorities. It must be noted that this tax credit is only applicable to income on which withholding taxes are due, that is, on annual income exceeding €11,265 per year.

A similar change has been introduced (article 154 ter LIR) with respect to the single parent entitled to child(ren) allowance. This allowance is replaced by a refundable tax credit of €750 per year and is also directly deducted from taxes withheld on salaries or pensions. If there is no withholding tax, or should the tax credit exceed the amount of tax to be withheld on salaries or pensions, the tax payer will benefit from it when filling out his annual tax return or by a direct payment should his income remain non taxable. This tax credit

is available for both resident and non resident taxpayers. The latter must however meet the condition that they are subject to Luxembourg income tax for a minimum of 90% of their professional taxable income.

Children allowances

In 2008 a **new regime of child benefit** "*boni pour enfants*" has been introduced. It abolishes the system of different classes of tax payers according to the number of children composing their family and linking tax reductions to number of children of an individual taxpayer.

The main reason for the change was that, given the overall tax reductions, an increased number of tax payers were no longer in a position to fully take advantage of the full child tax allowance (**some € 922 per child per year**). Under the new children benefit system, the tax reduction is paid directly to the tax payer—up to €922 per child in 2008.

Under 2009 tax reform, the benefit is paid on a monthly basis (€ 76.88 per child).

Various

A change of article 109 LIR has made **donations and gifts to charitable institutions more advantageous from a tax point of view**. The overall deductibility has been doubled and is now set at 20% of the net income of the tax payer or €1,000,000. However donations exceeding these limits can be carried forward on the two

subsequent tax years on the same conditions and limits.

Interest paid by some Luxembourg credit institutions (specialized home saving licensed institutions) was subject to a 10% lump sum withholding tax. From the 1st of January 2009 such interest **will be totally tax exempt**, provided that the savings are exclusively allocated to the financing, the acquisition or the refurbishment of the taxpayer's home.

Finally, further changes have been introduced with respect to deductibility of life insurance premiums and cost deductibility for dependant children, elderly people, nurse etc.

Corporate income tax

Tax reduction - tax incentive

A **general corporate income tax reduction** has been adopted from the 1st of January 2009.

Although the minimum tax rate remains set at 20% and an intermediary income bracket (income between €10,000 and €15,000) has been cancelled, the overall corporate income tax rate has been reduced to 21%.

Companies and businesses are also subject to the "municipal business tax" (*impôt commercial communal*) which varies from municipality (*commune*) to municipality. As a rule, the **lowest municipal business tax rates are found in the less well equipped and furthest out in the country side communes** whereas Luxembourg City charges the highest municipal business tax at the rate of 7.59%. The maxi-

mum corporate income tax payable in Luxembourg on 2009 income therefore amounts to 28.59%. The tax credit of 10% allocated upon the taking on of unemployed workers is increased to 15%.

Dividend withholding taxes exemptions

Article 147 LIR covering income from participations, known as the parent subsidiary privilege, has been extended. As a consequence, the **Luxembourg subsidiary is completely exempted from dividend withholding tax**.

This is the case when dividends are paid by a Luxembourg company to its parent company established in a country which has entered into a double taxation treaty with the Grand Duchy of Luxembourg. The condition set to this exemption is that the parent company must be subject to an income tax comparable to the one applicable in Luxembourg.

More precisely, the parent company's tax rate must amount to at least 50% of the Luxembourg tax rate (that is, to 10.5%). Further well known conditions continue to prevail as to financial importance of the participation (at least 10% of the subsidiary's share capital or a counter value of a minimum of € 1.200.000 and an uninterrupted holding term of 12 months).

The abolition of the capital duty

Until 2009 a capital duty of 0.5% was due on capital contributions at the incorporation or at subsequent capital increases of Luxembourg companies.

From the 1st January 2009 this **capital duty has been replaced by a fixed registration duty amounting to €75**.

This charge is due at the time of incorporation or of capital increases but also at the time of simple changes to companies' articles of incorporation and is also applicable to deeds of transfer to Luxembourg of the registered office or the effective management seat of foreign companies.

Exceptions

Special care must be extended to capital contributions in kind involving immovable properties when such a contribution is made in exchange for "*social rights of a company*" and the buildings are situated within the Grand-Duchy; "*social rights*" meaning here voting rights, dividend rights, liquidation rights and similar rights).

The total duty amounts to 1.1% (registration duty of 0.6% and transcription of 0.5%). A special surcharge is levied by the city of Luxembourg when the building is situated within the limits of the city.

A mixed contribution — that is, when a property located within the country is brought as a capital contribution in kind *together* with the loan or charges attached to it — is regarded as a straight sale and is subject to the ordinary property transfer duties, 6% + 1% + Luxembourg surcharge (3% in the case of a private house and 6% in the other cases).

A contribution in kind in similar circumstances in exchange for rights other than social rights is subject also to the 6% + 1% + Luxembourg surcharge.

A major change has occurred in the sense that the above rules apply irrespectively of the nationality or effective location of the company to which a property is contributed in kind.

Anti abuse rules provide that the registration and transcription taxes remain fully due in the event that buildings are attributed before five years from contribution under a dissolution, liquidation or share capital reduction reorganisation to a shareholder other than the one who contributed it.

Reorganisations

A wider definition now extends capital duty exemption in the case of contribution by one or several companies of their entire assets or of one or several lines of their activities to an existing or to be set up civil or commercial company in exchange for a majority of shares in their share capital.

Thus far, a cash compensation of up to 10% was acceptable. This contribution has been increased to 49.9%, meaning that contributions in kind remain tax exempt even in these circumstances.

The recapture rule has been cancelled as from the 1st January 2009. This rule meant that when the exemption conditions, that is, an uninterrupted holding period of five years of a minimum of 65% of the contributed participation, were not met, the unpaid capital duty became immediately due and payable, also known as the claw back principle.

Under the new regime, the waiting period has been suppressed, and

rights are definitely acquired even if the 5 year period from contribution has not lapsed yet.

Intellectual property income

In 2008, a new article 50 bis LIR had already provided for a major incentive to innovate for both resident and non resident taxpayers whether individuals or companies.

A **80% tax exemption is granted on net income as well as capital gains deriving from acquired or "constituted" rights** such as computer programmes, copyrights, patents, trade marks, designs and models – collectively referred to as I.P. which, as confirmed, include in 2009 domain names.

In 2008, effective tax burden applicable to a company having its registered office in Luxembourg city amounted to 5.93%. It will be reduced to 5.71% in 2009 as a result of the decrease of the overall corporate income tax rate.

SICAR

Venture capital companies (*société d'investissement en capital à risque*) which operate under the law of the 15th of June 2004 can now be set up with multiple compartments. This allows for the split of risks and type of assets in separate compartments which can now be ruled by different investment policies.

Varia

International cooperation

The **enhanced international cooperation between different departments of tax and other public authorities** has been decided in the tax package and should become effective in the near future.

It covers close cooperation between direct tax authorities, the registration administration (*administration de l'enregistrement et des domaines*) which is also competent for VAT supervision, the Customs and Excise administration, the central social security bodies, labour inspection and generally all state services which **will, in the future, exchange information and cross examine the data these services have recorded on every single taxpayer**. An extension of the transfer of relevant information by the tax authorities to courts and public prosecutors is also provided for.

Value added tax

It is anticipated that the 2008/ 8th Directive with respect to VAT will be implemented by the Grand Duchy of Luxembourg on schedule.

The first major change will take place on the 1st January 2010 with respect to reverse charge in transactions between VAT registered parties, VAT charge according to the place of the service provider, reimbursement of paid VAT, etc.

Taxation in the Netherlands: New developments in 2008

Dr. Jan Schnellenbach

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In 2008, the Dutch government has announced plans **to discourage excessive remunerations by means of the income tax system**. These measures are aimed in particular at business executives who receive severance payments or pension entitlements that are perceived – by policy-makers, as well as the general public – to be at unjustified high levels. The first proposal was designed to restrict advantageous treatment of pension claims in the income tax system above a threshold level. This proposal has, however, been rejected by the Dutch parliament. The main tenets of the actual measures approved by the upper chamber of parliament in December 2008 are as follows:

Severance payments above € 500,000 are deemed excessive. Nevertheless, they are in a first step treated as regular wage income in the personal income tax of the employee. As such, they are subjected to personal marginal tax rates which, in the progressive Dutch income tax system, can reach 52%. In a second step, an excessively high severance payment is subjected to a flat tax of 30% to be paid by the employer (not the employee) to the extent that the severance payment exceeds the annual salary of the employee. Payments above the threshold but below an annual salary of the employee are thus not subjected to the addi-

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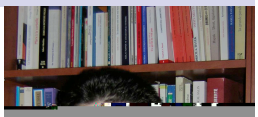
with decisions that seem to be rooted in the politics of populism, such as the novel tax on so-called excessive severance payments.

Taxation in Romania 2008



Romania preserved the ***flat tax rate for personal income (16%), the same corporate income tax (16%) and VAT (19%) during the entire electoral cycle (2005-2008).*** *The new government in charge since end-December 2008 announced its intention to leave the rates unchanged for these main taxes. As a general tendency, tax rates for social contributions were reduced and their tax base was extended. Thanks to the possibility to submit fiscal statements in electronic form,* ***administrative fiscal burden decreased****, at least for some companies. However, the impact of these remarkable improvements is limited because electronic submission is not yet possible for social contributions, responsible for the major part of the administrative burden. The problem of* ***quasi-taxation*** *became a central point in public debate. After about nine month of research, the Minister of Economy and Finances delivered the Register of fiscal and quasi-fiscal taxes. Virtually all political forces declared support for* ***government's commitment to reduce or eliminate about 100 of these taxes*** *— according to the Minister of economy and Finance, there would be 115 quasi-taxes and still counting. Despite that,* ***2008 witnessed few achievements in this filed****. Romania continues to be a country with relatively low tax rates but with high social contributions rates, innumerable quasi-taxes and a huge administrative fiscal burden.*

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General presentation

Local (June) and legislative (December) elections of 2008 increased uncertainty in fiscal affairs. The general political situation was confused, with open conflicts between the President (originally from the Democrat-Liberal Party, DLP) and the Prime Minister (National-Liberal Party, NPL), formers allies in 2004-2006. Social-Democratic Party (SDP) played a double role: it was simultaneously the main opposition party and the indispensable support for a government without a parliamentary majority. The coalition between NPL and the party of the Hungarian minority had together about one quarter of MPs. It remained in power because it faced a weak and uncoordinated opposition from SDP and DLP. Those two parties formed a new government after the elections. New government withdrew the draft budget for 2009 proposed in November by the former government, but it did not submit an alternative proposal until February 2009.

Taxes

Personal Income Tax

During the 2008 electoral year, the **flat tax principle was contested** from an egalitarian point of view, especially by formal and informal SPD leaders and by a well-connected think tank. Moreover, SDP's president claimed publicly his intention to reintroduce a progressive personal income tax, but in the same interview, he admitted the possibility of maintaining the flat tax. The intensity of the flat tax debate was significantly lower than in 2004. Uncertainty in this field continues in 2009.

Despite the fragility of the NPL government and its dependence on SDP parliamentary support, the 16% flat tax on personal income remained unchanged in 2008. Romanian flat tax was associated from the start (2005) with **a complex system of fiscal allowances**. The untaxed income decreases with income level and increases with the number of "dependent persons" (children and/or other family members without income). For example, in 2008, fiscal allowance was zero for a single tax payer earning a gross income over 3,000 lei/month (€850, about 1.6 times the average gross salary). The total maximum fiscal allowance was 650 lei (€185) for a taxpayer with a gross income inferior to 1,000 lei and with four or more "dependent persons" in his household.

Other **fiscally deductible** expenses were:

- The **contributions to voluntary pension schemes** ("third pillar", according to World Bank's classification), up to €200/year;
- Savings in an already subsidized "Savings and Loans" program, meant to encourage house ownership.

Corporate Tax

Corporate tax rate is **still 16%.** The dividends received by a Romanian company from another Romanian company are not submitted to corporate income tax. This is also the case for dividends paid by or to a non-resident from another EU member, under certain conditions (two years of uninterrupted control, at least 15% of capital in 2008 and 10% in 2009). However, at individual level, **distributed profit is taxed once again at 16%** because distributed dividends are considered part of personal income. This means that, from an economic point of view, the tax rate on capital as a production fac-

tor is eventually 29.44%, not 16%.

Micro-enterprises (less than 9 employees and less than €100,000 turnover) **can opt for turnover taxation** as an alternative for profit taxation. For the first time since its introduction in 2004, turnover tax rate remained the same as in the preceding year : 2.5%. In 2009, it will **become 3%**, its initial value. Employers used extensively micro-enterprises as a tax-avoidance device by incorporating highly paid employees. Authorities amended the Fiscal Code in order to close the loophole.

Value Added Tax

Until December 15, VAT rates remained identical to those of 2007 (19% and 9% for books, newspapers, medical prostheses, hotel accommodations, etc.). After this date, the government decided to **introduce a 5% VAT rate for houses sold under certain conditions and to certain categories of customers**. The official reason was to protect the building sector, distressed by the global crisis. However, aside increased red tape, it is likely that this measure will have a very limited impact. Indeed, many contractors were able to avoid legally VAT payment under previous regulation.

Excises

Excise duties on energy, tobacco and alcohol continued to **increase in 2008, in order to achieve conformity with EU regulation**. Tax evasion incentives increased correspondingly.

Custom taxes

After Romania's accession to EU (January 1st, 2007), custom taxes are established at Union level and concern only 30-35% of all imports. In 2008, one of the most debated subjects continued to be the **import of second hand cars from other EU countries**. Existent and potential car producers located in Romania and even importers of brand new cars were concerned about the competition of second hand cars. Common market rules prevented the Romanian government to adopt openly protectionist measures. However, in 2007 the **government introduced a "green" tax with significant protectionist effects.** European Commission criticized this tax and Romanian taxpayers successfully contested it in court. For these reasons, the government changed it repeatedly in 2008. For example, in November-December only, there were two major modifications. It is likely that the process will continue in 2009. It is ironic that, for now, the tax lost its protectionist component: it hurts also new cars, produced either in Romania or in other EU countries. Moreover, its environmentalist effects are questionable because it does not modify the incentives towards buying a new car rather than keeping the old one. Actually, its effects could be exactly the opposite: the tax represents a "sunk cost" paid only once, at the first registration of the car (either new or old) and it does not take into account the car's emissions after one year or ten years later.

Local taxes

Local taxes did not experience radical changes. The most controversial modification concerned their "local" characteristics. Indeed, the **government decided to centralize and then redistribute a large amount of real estate tax from "rich" local jurisdictions to "poor" ones**.

Social contributions

Romanian legislation maintains the conventional distinction between employer's and employee's social contribution. Table 1 outlines the evolution of social contribution rates during 2004-2008 period and the perspectives for 2009. The tax base is usually the gross wage, including bonuses and all work-related income. In February, the government tried to increase the tax base for social contributions to in kind benefits, (car, cell phone, etc.) but renounced it a couple of weeks later. Overall, in 2008, **social contributions and other taxes on labor were decreased by 5.3-6.9%**. However, Romanian social **contributions remain among the highest in EU**, in strong contrast with social benefits. This explains the low social acceptance of these contributions and the efforts made by employers and employees to avoid them.

Pension contributions

In 2008, the second pillar of the pension system became operational. The first pillar continues to function on the principle "pay as you go". The second pillar is based on individual saving accounts and administrated by a dozen private pension funds. The total rate of mandatory pension contributions remained constant (9.5%) but is split between the first (7.5%) and the second (2%) pillar. This reform concerns all employees younger than 35 and, on an optional basis, those aged between 35 and 45 in 2008. The latter category represents 37.3% of the 4 million contributors to the second pillar. Employees who did not want or could not opt out from the first pillar are contributing 9.5% of income to it.

It is debatable if contributions to the second pillar should be assimilated to a tax. Work incentives and tax evasion incentives depend on whether employees perceive their pension contributions as personal savings or as a payment without any effect on future pension value. For now, it is too soon to give a final answer to this important question. Indeed, Romanian employees keep a property right on their pension account and can change their pension fund administrator: these are two major differences from the first pillar. However, the contributions are mandatory and pension funds are subject to many portfolio restrictions (T-bonds are privileged, stocks are subject to ceilings, etc).

The **third pillar** (privately administered voluntary but tax exempt savings) is open to all employees on an optional basis**. Contributions are deductible from taxable income up to €200 /year,** which represents less than 4% of average annual salary. The employer can match employees' contribution and benefit from an equivalent tax emption, up to €200/year.

Health care contributions

The Romanian government decided to reduce employees' contribution rate by 1 percentage point after July 2008. Employers' contribution decreased by 0.5 percentage points since January and by 0.3 percentage points more in December. Overall, at the end 2008, **total health care contributions were 1.8 percentage points lower than their 2007 level**.

Unemployment contributions

The low level of unemployment allowed employees' and employers' contributions to **decrease** by 0.5 percentage points and, respectively, by 1% since January 2008. In December, authorities reduced employers' contribution by 0.5%. End 2008, total unemployment tax rate was only 1%, compared to 3% in 2007.

Contributions for risks and accidents

Their rate depends only on the enterprise's main activity and does not take into account the differences between actual risks faced by each employee. This infringement of insurance principles is supposed to reduce employer's administrative costs. The lowest rate remained unchanged (0.4%) but top rate decreased from 3.6% in 2007 to 2% in 2008.

Table 1. Labor taxation in Romania, 2004-2009 (red numbers indicate changes)

Type of contribution	Fiscal liability	2004	2005	2006	2007
Pension	Employee	9.5	9.5	9.5	9.5
	Employer	22	22	20.5	19.5
		27	27	25.5	24.5
		32	32	30.5	29.5
Health	Employee	6.5	6.5	6.5	6.5
	Employer	7	7	7	6
Unemployment	Employee	1	1	1	1
	Employer	3	3	2.5	2
Risk and accidents	Employer	0.5-4	0.5-4	0.5-4	0.4-3.6
Labor inspection	Employer	0.25-0.75	0.25-0.75	0.25-0.75	0.25-0.75
Salaries' guarantee fund	Employer	-	-	-	0.25
Sick leave and indemnities	Employer	-	-	-	0.85
Total		49.75-53.75	49.75-53.75	47.75-51.75	46.25-49.95
		54.75-58.75	54.75-58.75	52.75-56.75	51.25-54.95
		59.75-63.75	59.75-63.75	57.75-61.75	56.25-59.95

*Employer's contributions are for "normal", "uncommon" and, respectively, "special" conditions of work.
** Since 2008, employee's pension contribution (9.5%) is split between the first pillar ("pay-as-you-go", 7.5%) and the second pillar (capitalization, privately administrated, 2%) of the pension system.

Type of contribution	Fiscal liability	2008 Jan-Jun	2008 Jul-Nov	2008 Dec	2009*** January
Pension*	Employee**	9.5	9.5	9.5	9.5
	Employer	19.5	19.5	18	18.5
		24.5	24.5	23	23.5
		29.5	29.5	28	28.5
Health	Employee	6.5	5.5	5.5	5.5
	Employer	5.5	5.5	5.2	5.2
Unemployment	Employee	0.5	0.5	0.5	0.5
	Employer	1	1	0.5	0.5
Risc and accidents	Employer	0.4-2	0.4-2	0.4-2	0.15-0.85
Labor inspection	Employer	0.25-0.75	0.25-0.75	0.25-0.75	0.25-0.75
Salaries' guarantee fund	Employer	0.25	0.25	0.25	0.25
Sick leave and indemnities	Employer	0.85	0.85	0.85	0.85
Total**		44.25-46.35	43.25-45.35	40.95-43.05	41.20-42.40
		49.25-51.35	48.25-50.35	45.95-48.05	46.20-47.40
		54.25-56.35	53.35-55.35	50.95-53.05	51.20-52.40

** The tax base differs slightly for some contributions and has changed over time, but in most cases, it is gross salaries (payroll) or very close to it. Therefore, the total is not rigorously precise but a useful approximation. Source: Romanian legislation

*** The figures are valid for January 2009. On 2nd February, government announced an increase – effective immediately – in pension contributions from 27.5% in December to 31.3% (10.5% employees' contribution to 1st and 2nd pillar + 20.8% employers' contribution). Government limited the contribution to the second pillar at 2%, although it was scheduled to increase at 2.5% in 2009, according to the 2008 Pensions' reform.

Labor inspection contributions

They are due to finance the Territorial Labor Inspectorate. Its two main missions are field verifications of Labor Code enforcement and the administration of individual registers of employees' labor history ("*carte de muncă*"). This document, inherited from the communist period, serves to establish pension rights and other social entitlements. Employers have the option to keep these registers themselves or to outsource them to TLI. The contribution is 0.25% of the payroll in the former case or 0.75% of the payroll in the latter. Remarkably enough, these rates have not changed since 2004.

Other labor based contributions

Contributions for the salaries' guarantee fund (0.25%) and for sick leave and indemnities (0.85%) remained at their 2007 level.

Quasi-taxes

Quasi-taxes are a controversial topic in Romania. Each year, business associations are reporting unbelievably high numbers of hidden or quasi-taxes and the government contests them. End 2007, the Minister of Finance appointed a commission responsible for identifying all the taxes and mandatory payments that concern Romanian enterprises. After many delays, in August 2008, the list was published on Ministry of Finances' website. According to the authorities, **there are 115 quasi-taxes in Romania**. **However, their definition was rather restrictive**. This official list underestimates the real number of quasi-taxes. For example, a journalist identified 10 environmental taxes absent from that list but present in the budget of

the Environment Fund Administration. Moreover, the official list ignores mandatory payments made by businesses for mandatory "services" delivered by private entities. For example, starting with 2010, a member of the Chamber of Fiscal Consultants must certify any fiscal statement. The signature of an Authorized Accountant or Expert Accountant will still be mandatory, but not sufficient. Facing a strong reaction, the government dropped a similar provision from a draft law in 2007, but reintroduced it discretely in the 2008 Fiscal Code.

Other non-monetary and indirect fiscal burdens

In 2008, there were some improvements in this field. First, all enterprises can pay their fiscal obligations and social contributions in only two accounts. Second, they have the **possibility to submit fiscal statements in electronic form**.

However, despite the possibility of electronic submission, few small enterprises are using it. The reason seems to be the **high cost of the electronic signature** (there are only three certified providers) which is valid one year and only for fiscal statements (social statements are still submitted in paper form).

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Acknowledgements and disclaimers

The necessary research was made during the CNCSIS program 1504/2008.

This work benefited from the professional support of "Mureșan Dragoș Apostol" Ltd, accounting, auditing and financial counseling company (www.mmda.ro). The company is not to be hold responsible for the content of the final version. Any remaining errors are author's responsibility.

Tax system Slovakia 2008

Slovakia has recorded the ***fastest GDP growth among EU countries in 2007*** *and is expected to have the 2nd-fastest growth in 2008. A healthy economy has generated* ***rapid growth in tax revenues****, so that even the leftist government is keeping the tax system as set up by the former rightist government largely unchanged. Another reason to keep the tax system intact was the focus on the adoption of the euro and fulfillment of the Maastricht criteria. The* ***19% flat tax rate*** *– so attractive at its introduction in 2004 – has become* ***less favorable*** *in light of tax cuts adopted in neighboring countries in recent years. The growing tax competition represented by these countries together with the expected slowdown in tax revenue growth brought about by lower GDP growth in 2009 will test the government's willingness to adopt changes to the tax structure. It is possible that there will be a decrease in social contributions to stimulate job creation as well as higher taxation of upper-income people.*

Radovan Ďurana

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Figure of the year
Annual growth in personal income tax revenues reached 14.9%.

Increase in tax revenues

Rapid GDP growth combined with a relatively low tax rate resulted in rapid tax revenue growth, which provided a genuine environment for the government to substantially increase expenditures without changing its share of GDP. **Between 2005 and 2008, consolidated expenditures in the public sector grew by 28.2%, but the GDP share**

of tax and social contribution revenues decreased by 1.8 percentage points during this period to a projected 28.9% in 2008. This ratio ranks Slovakia among the three EU countries with the lowest overall tax burden.

Indirect taxation remains most important for 2009

The largest share of excise taxes is generated by fuel taxes. Despite the low income and price level in Slovakia compared to the EU, **fuel prices are among the EU's highest** due to above-average tax rates. These were set four years ago in Slovak koruna (SKK) per liter, and since then have not been adjusted in relation to currency appreciation. For this reason, Slovakia has the 2nd-highest diesel tax and the 10th-highest petrol tax in the EU (the minimum requirement for diesel is €0.302 per liter, but Slovakia applies a €0.481 per liter rate). In spite of pre-tax fuel prices among the lowest in the EU, the Slovak government regularly calls upon the main producer to decrease its prices. In line with the EU strategy of support for low-CO_2 fuels, the excise tax rate for LPG has been brought to zero, with a tax revenue impact of €3.6m.

New on the list of indirect taxes are so-called energy (or "green") taxes levied on the consumption of electricity, natural gas and coal. As the government was intensively working to meet the Maastricht inflation target for euro adoption in 2008, it chose the minimum possible rates when implementing the EU legislation. Households are exempt, and industrial consumers pay the lowest possible rates (50% of the required minimum rate; only coal is taxed at the minimum rate). The share of green taxes – a new phenomenon on the rise in the world of taxation – still remains low at less than 1% of tax revenues. Although the European Commission has

recommended that national governments decrease taxes or social contributions alongside the introduction of green taxes, the Slovak government has not responded.

Income tax revenues increasingly significant

The decreasing trend in indirect tax revenue share of total tax revenues has been driven by income growth for both individuals and businesses. A rapidly rising general wage level combined with increasing employment led to 14.9% annual growth in personal income tax revenues in 2008, closely followed by 12.8% growth in corporate tax income.

Despite the unchanged 19% tax rate, the tax burden on individuals has been slowly but steadily rising over the last 4 years. The personal tax basis is subject to a €3,435 annual exemption applicable to everyone with a monthly salary below €3,000, which was supposed to reduce the tax burden on low earners. As a result, approximately 15% of employees paid no income tax, and the average earner paid no more than 10%. This exemption is set as a multiple of the living minimum, which has been growing at a pace lower than that of real wages. This "fiscal drag" effect results in a growing tax burden on individuals. It is also worth noting the **rapidly rising minimum wage—36.9% increase between 2006 and 2009,** against cumulative inflation of app. 10%. In Slovakia, the minimum wage is set for 6 skills and qualification levels, from an unqualified worker to manager. It is artificially pushing wage levels up, indirectly influencing the growth of the personal income tax base.

Facing the highest share of long-term unemployment in the EU (over 60% of all unemployed in 2008 were long-term) and in re-

sponse to the high tax wedge (the share of taxes and social contributions as a percentage of total labor costs), the government decided to adopt a measure to ease the burden. An employee bonus which makes minimum-wage earners eligible for a negative tax will be paid annually starting in 2009. As with any other **negative tax**, the employee bonus implies redistribution of tax revenues which must be paid for by earners with higher incomes. Although this effectively decreases the amount of money in the hands of government, it increases income redistribution. The employee bonus is one of the measures proposed by the finance minister in a paper entitled "Modernization Program Slovakia 21", and the only one related to the direct tax burden. The other tax-related measure already approved by the government relates to reducing the costs of tax administration by merging the agencies responsible for collection of taxes and social contributions. Implementation of this measure is not expected before 2011.

Corporate tax revenues almost doubled during the past 6 years, reaching €2bn in 2008. Had the government not provided investors with tax holidays, corporate tax income would have been 6.4% higher in 2008. Although the 19% corporate tax rate may be considered favorable compared to the EU average, if one includes all mandatory payments **a small company must pay then the effective tax rate reaches almost 50%**. According to the "Paying Taxes 2009 The Global Picture," (http://www.pwc.com) a study conducted by PricewaterhouseCoopers and the World Bank, the total tax rate for a company with 60 employees performing general industrial and commercial activities reached 47.4%. As other taxes like property taxes and vehicle taxes are rather low, the main "culprit" for the high tax levy is the indirect cost of labor: payroll taxes. It is worth mentioning that the tax system also has indirect costs related to the time spent complying with tax rules. According to the study, such a firm spends

325 hours per year in Slovakia on compliance, compared to 930 in the Czech Republic or 80 in Hong Kong. Despite a 5% year-over-year decrease, the Slovak government has enormous room to decrease tax costs without touching tax rates.

The dark cloud of payroll taxes

Establishing low tax rates in a developing economy such as Slovakia, with its extensive public social and healthcare systems, was possible only through deficit financing or placing burdens on labor costs. **Total social contributions paid for Slovak labor rank the country among the world's top ten**. Social contributions are paid at the same rate from the first earned cent. Despite upper wage limits (of 3 or 4 times the average wage), total income from social contributions reached as much as 43.7% of total tax revenues in 2008. The tax wedge of 38.5% in 2007 for an employee on an average wage is above average for OECD countries. Due to the low share of income tax in this ratio, it is expected that, if a decrease occurs, it will be in social contributions. 2008 brought no changes to the structure or rates of social contributions. These are expected by economic experts to be implemented due to a sharp drop in economic growth in 2009.

Local taxes

Tax rates for 95% of total tax revenues (including social contributions) are decided at the central government level. Municipalities and regions collected €0.5bn in 2008. Despite the process of fiscal decentralization and the transfer of competences to self-governing units, **options to differentiate through tax rates are limited and there are no signs of tax competition within the country**. The

outlook for progress in this area is negative due to a combination of municipalities' unwillingness to bear greater responsibility and unwillingness of government to lose control over a significant amount of money.

Expected changes in 2009

Parliament has already passed an amendment to the income tax law which **increases the personal income exemption** from €3,435 per annum to €4,026. The government will collect 8% less in personal income tax (about €148m.). As the upper limit on monthly income to which this exemption may be applied has not been changed, this amendment **will increase the progressivity of the personal income tax** (today, less than 10% of taxpayers pay more than 50% of total income tax revenues). Other changes already passed relate mainly to decreasing the indirect costs of the tax system. Examples include cutting the period for VAT refunds from 60 days to 30 days and increased minimum values for tangible and intangible property in the depreciation scheme.

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Spanish Tax policy in 2008

Julio Pomes Ruiz
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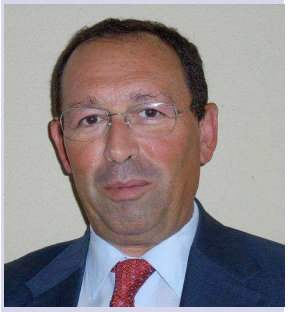

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The most important development of the year is the removal of the Wealth Tax, which has been in force in Spain since 1977.

The year 2008 was not particularly rich in new tax policies. Despite the economic crisis severely hitting businesses and workers, the **Government was slow to react with new tax measures**. In April, the Spanish government stated that "the Spanish economy currently boasts a solid foundation" and that "this solid foundation places the Spanish economy in a favourable position to address the adverse situation arising from international economic shocks" (statement of legal grounds of Royal Decree - Law 2/2008, 21st April, Measures to Boost Economic Activity, published in the Official State Gazette (BOE) on 22nd April 2008, http://www.boe.es). This is probably the reason behind the delayed and weak reaction of tax policy, which did not take place until the **end of December with the introduction of Law 4/2008, 23rd December, which removed the Wealth Tax, generalised the monthly return for Value Added Tax (VAT), and introduced other changes to tax legislation (BOE, 25th December).**

Royal Decree - Law 2/2008 already in-

cluded some tax measures, the most talked about being the **deduction of €400 in personal income tax**, which has benefitted the recipients of income earned through employment and/or financial activities. The deduction ceiling is the result of applying the average rate of income tax to income earned through employment and/or financial activities. It does not take into account the earnings of the taxpayer and thus benefits all recipients of such income, even those who fall into the higher earnings bracket.

This reduction was intended to inject resources into taxpayers' pockets in order to boost the countercyclical effect of personal income tax. This required the impact of the deduction to be reflected immediately in the withholdings and payments on account of income tax and, for this purpose, a reform in tax regulations was announced, and approved a month later in Royal Decree 861/2008, 23rd May, which amended Income Tax Regulations related to payments on account of income earned through employment and/or financial activities. This was published in the Official State Gazette on 24th May. So, as of 1st June 2008 (the date on which the aforementioned Royal Decree came into force), the method of calculating withholdings on employment income changed.

Another measure approved in Royal Decree Law 2/2008 aims to **remove barriers and facilitate the Treasury in capturing savings deposits hidden away in tax havens**. An exemption on income tax has been established for non-residents, which frees from tax obligations all income derived from the Public Debt (interest payments) obtained in countries or territories which are classed as tax havens. This has ironed out the possibility of the State gaining financial resources which may have unfavourable origins.

The third of the relevant tax policy measures adopted in May 2008

was the **extension of the concept of rehabilitation of buildings, in order to reduce the scope of exemption from Value Added Tax** on second and subsequent supply of housing (also in the General Indirect Tax of the Canary Islands). First supply of buildings by constructors is subject to VAT, with 'first supply' being considered to apply to both new and restored buildings. Qualification as a "reforma" requires the cost of the work to be over 25% of the purchase value of the property. The law has been amended to exclude from the total purchase value the proportional value corresponding to land. Thus, certain previously exempt from VAT due to being second supplies (as the work carried out was not considered a "reforma") are now considered first supplies and are thus subject to VAT, resulting in this no longer being a Tax on Property Conveyances and Documented Legal Acts (TPCDLA) required by the Autonomous Communities, and therefore not deductible for constructors, who have to bear the cost of this.

Royal Decree - Law 2/2008 states that this measure is designed **to boost construction activity**, thereby promoting growth and job creation. The reality is that, with this legal reform, the **State has removed a regional tax from the Autonomous Communities**, which they were previously entitled to withhold, as VAT is inconsistent with TPCDLA.

In accordance with the statement of legal grounds of Royal Decree - Law 2/2008, extending the concept of rehabilitation involves a tax rebate in that work related to building reforms intended primarily for housing is subject to a reduced rate of VAT - 7% - instead of the standard rate of 16%. This supposed rebate becomes irrelevant when the developer of the reform is the constructor, as the latter has the right to offset the VAT, and the rate applied is also irrelevant as it will be deducted or returned irrespective of whether the rate is 7%

or 16%.

Other measures approved in Royal Decree - Law 2/2008 are not of sufficient relevance to examine in great detail here. One is an adjustment of the payment by instalments on account, which must be made by constructors during the first quarter of 2008 as a result of the new General Accounting Plan coming into effect. Another is the temporary removal of the tax levied on public deeds documenting the extension of mortgage loans granted for the acquisition, construction and reform of the principal residence (this tax is insignificant – the amount of fifteen cents per sheet of deeds, withheld by the Autonomous Communities).

In December 2008, other tax policy decisions were taken aimed at stimulating the economy, which by this time had entered recession, resulting in widespread job losses.

The most noteworthy measures are those included in Law 4/2008, 23rd December - **removal of the Wealth Tax, generalisation of monthly repayments in Value Added Tax**, and the introduction of other changes to tax law. Law 4/2008 includes measures to make certain criteria of structural and short-term tax policy effective. Others are simple adjustments to the tax legislation already in force, such as those affecting corporate income tax, which are merely the technical tax measures required by the reform of the General Accounting Plan of 2007. We will not discuss these technical adjustments as they are not considered of interest to this report on tax policy.

The most important structural measure is the **removal of the Wealth Tax**, which is a tax collected by the Autonomous Communities. From a practical point of view this has been removed with immediate effect, and was therefore not payable on December 31,

2008. However, it has not been formally removed: Law 19/1991, 6th June, regarding Wealth Tax, is still in effect but a full rebate will apply to taxpayers who have paid the tax due to personal or absolute obligation.

This surprising removal of a tax without repealing the law governing it can be easily explained. The Autonomous Communities are permitted to levy taxes on taxable events unencumbered by the State. If the State repeals the tax, the Autonomous Communities may introduce a similar one in its place. The 100% rebate maintains that ownership of assets continues to be a taxable event of the state and is therefore forbidden ground to the Autonomous Communities. The statement of legal grounds of the law justify the removal of the Wealth Tax, stating that the changing international economic environment and the changes introduced to the tax had rendered it powerless to effectively achieve the objectives for which it had been designed.

The short-term economic policy is reflected in a set of reforms affecting various taxes.

In relation to income tax of non-residents, this once again demonstrates a commitment to facilitate the treasury in its capture of funds. Interest from the Public Debt obtained by non-residents is exempt, although the payee was previously obliged to declare it. This requirement has been removed, as has the obligation up until now to withhold interest on treasury bills in certain exceptional cases. It also provides that no late-payment interest shall be payable during friendly processing procedures to resolve conflicts with Authorities of other States.

Rising oil prices, which reached a peak in July 2008, caused serious

social conflict in the **road transport** sector. In December the situation was very different, but agreements were reached with those affected and consequently Law 4/2008 established **a reduction of 75% during 2008 and 2009 on the tax on insurance premiums** related to urban public transport and road transport of goods or passengers, as well as a reduction of 50% on the Business Activities Tax for road transport for the tax year 2008.

In **Value Added Tax** (VAT), the time needed to elapse in order to consider bad debt against a customer and therefore seek a refund of the tax paid from the Treasury has been reduced from two years to one. This measure aims to alleviate the lack of liquidity plaguing many companies as a result of the crisis in the financial sector. The same objective is attempted in the generalisation of the right to opt for the immediate return of VAT when in the monthly payment the deductible VAT is higher than that due. So far, in general, this return could apply only at the end of the year and only a certain number of companies had access to the immediate return system. The exercise of this option together with the practice of monthly repayment has resulted in the establishment of new regulations, contained in Royal Decree 2126/2008, 26th December (BOE, 27th December). In the General Indirect Tax of the Canary Islands, similar reforms have been made to those of VAT.

Most of the changes introduced in the **Property Transfer and Stamp Duty Tax** are purely technical or interpretative - as is the case with the exemption of Financial Asset Securitization Funds - and the transposing of EU legislation, such as reforming the taxation of corporate operations for adaptation to 7/2008/CE Directive of 12th February 2008 regarding indirect taxes on the raising of capital.

Special mention is given here to the measures affecting the transfer

of residential property, driven by the need to alleviate the serious problems people are facing, and the collapse of the construction industry. In addition to establishing that the tax base of operations related to loan assignment or to rights to acquire property under construction is not the total value of the buildings constructed, but the real value of the property at the time of transfer of the loan or right, the exemption of housing subsidised by the state has also been reformed and systematized.

The main purpose of the other reforms included in Law 4/2008, including those related to **Special Taxes**, is to fulfil the requirement of bringing tax legislation into line with Community Regulations.

Taxation in Switzerland

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International tax competition remained a major issue in Switzerland 2008. The Swiss government continued to reject negotiations with the European Union over special tax regimes for holding and administrative companies and presented new proposals to reform corporate taxation designed to enhance Switzerland's position as a business location while in part taking into account the EU's concerns. Meanwhile, the EU had to dissociate itself from the German finance minister Peer Steinbrück's controversial call to put Switzerland on a "black list" because of its insistence on protecting financial privacy.

At the beginning of the year, a reform alleviating the double taxation of distributed profits was narrowly accepted by a majority of 50.5% of voters in a referendum. The Swiss government also specified its plan to overhaul the value-added tax and implement a single VAT rate of 6.1%. Attempts were also made to clarify the taxation of trusts at cantonal level.

International tax competition and the dispute with the EU

The Swiss government reiterated its refusal to implement internal EU tax rules in Switzerland and established an international tax competition working group to draw up measures in order to improve Switzerland's competitiveness as a business location. Initial re-

sults were presented as a proposal for a new corporate tax reform, including the abolition of stamp duty on financial transactions and the option for the cantons to waive capital tax (see below).

As a reminder, the **European Commission decided in 2007 that certain cantonal tax practices for administrative and holding companies to be forms of state aid incompatible with the 1972 free-trade agreement** between Switzerland and the EU and obtained a negotiating mandate from the Council of Ministers. The Swiss government has so far consistently rejected the EU's interpretation considering it to be unfounded and consequently refused to enter into negotiations. In April 2008, representatives from Switzerland and the EU met a third time to discuss the EU's assessment of the criticized cantonal corporate tax regimes.

The meeting stressed once again the diverging positions of the two parties on the interpretation of the 1972 free-trade agreement. Switzerland sees no reason to adapt or do away with the criticized cantonal tax regulations. Swiss representatives also observed that EU member states apply differentiated tax measures as well and pointed to a future corporate tax reform in Switzerland. It was agreed that **no date would be set for a further meeting at the present time since the positions of both parties had been made clear**. The Swiss government stressed that these meetings were not meant as preparing the ground for negotiations, but to better explain the Swiss tax system and clarify Switzerland's position.

Aside from this disagreement, the European Commission also **seeks to extend the scope of the savings tax agreement**, considered to be too easy to circumvent, although concrete proposals are yet to be made. The savings tax agreement came into force in 2005, whereby an anonymous withholding tax is levied on interest payments to EU

residents in Switzerland, while preserving the financial privacy of account holders. In 2007, tax revenues in excess of **653 million Swiss francs were generated** under the agreement. Germany, Italy and France were by far the largest beneficiaries. The agreement allows the recipients of interest payments to choose between the withholding tax system and a voluntary declaration to the tax authorities. Overall in 2007 approximately 63,000 declarations were received, against 55,000 declarations in 2006. The Swiss government signaled its "openness to a dialogue" on the principle of an extension of the scope of the agreement as long as Swiss banking privacy laws were not affected.

Meanwhile the EU had to dissociate itself from a controversial call by Germany's finance minister, Peer Steinbrück, **to place Switzerland on a "tax haven black list"** and to use "a stick" if "a carrot" did not work. The Swiss government summoned the German ambassador to protest against the minister's remarks, which were widely dubbed as political posturing for a German audience. The German government faces each year new records of emigration of German residents to Switzerland, and the high tax burden in Germany is estimated to have led to an increase in the underground economy and in the relocation of firms outside Germany.

New corporate tax reform

Internally, the Swiss government announced further reforms of corporate taxation in order to alleviate companies doing business in Switzerland of unnecessary tax burdens and to strengthen Switzerland's position as a business location. The government stressed that an attractive tax environment for companies is a key prerequisite for ensuring economic growth and employment and noted that Switzer-

land is facing increasingly intense tax competition. **Against the backdrop of globalized flows of trade and services, corporate taxation is thought to need constant monitoring and improvements.**

The planned reforms contain various measures to eliminate tax barriers to company financing. The main elements of the reforms include the **abolition of stamp duty** and **withholding tax on the issuance of equity and debt capital** to encourage investment and avoid distortion of financing activities. According to the government, groups operating internationally will be more inclined to locate their financing activities in Switzerland as a result of these measures. That in turn should increase tax revenues and support the creation of highly qualified employment.

At the cantonal level, it **should be made possible for the cantons to waive capital tax**. In addition, further measures, such as adjustments to the system of investment deductions, will be examined.

In the short-term the proposed measures will lead to tax reductions of up to 500 million Swiss francs at federal government level. For the cantons, tax reductions will only ensue if the cantons opt voluntarily to waive capital tax.

The cantonal tax regimes of administrative and holding companies criticized by the EU were also examined, and the Swiss government analyzed alternative models of profit taxation, such as a shift to a uniform system. However, the analyses showed that in terms of growth, the existing system proved best placed to produce the desired results. Moreover, a shift to a uniform system of profit taxation would not be feasible in terms of policy, since it would have a serious impact on the cantons, which reject such a step. Targeted meas-

ures could nevertheless take into account the concerns expressed by the EU, whereby the government stresses that its focus is on the enhancement of the tax system for companies which invest and create jobs in Switzerland and that it will push for the swift implementation of these reforms.

Alleviation of dividend taxation

A majority of 50.5% of Swiss voters accepted in a referendum at the beginning of 2008 a reform designed to alleviate the double taxation of dividends at federal government level. The **tax base for distributed profits is reduced to 60% for holdings of at least 10% in the share capital**. Over two-thirds of Swiss cantons have implemented similar measures, whereby the tax rebate varies from 30% to 80% depending on the canton. The federal reform also includes various enhancements for small and medium-sized businesses.

Enhanced taxation of trusts

Following the ratification in 2007 of the Hague Convention on the Law Applicable to Trusts and on Their Recognition, attempts were made by the 26 cantons to clarify the taxation of trusts. Some cantons have longstanding experience in the taxation of trusts, whereby practices can vary significantly depending on the canton. The interministerial conference of the cantonal financial ministers sought to establish a uniform practice in a circular, but tax scholars and trust law practitioners voiced criticism at the proposals and indicated that **the previously used case-by-case method will probably continue in most of the 26 Swiss cantons**, despite the principles laid down in the circular and its intent to harmonize cantonal practices.

VAT reform

In its attempt to overhaul value-added tax, the Swiss government made **a formal proposal in favour of a standard 6.1% VAT** rate and the abolition of most exceptions. This measure is supposed to introduce a more efficient and transparent system while reducing the administrative burden for companies. The plan, which still needs approval by parliament and voters, is expected to make household products, public transport, cars, fuel and electronic equipment cheaper. However, it would probably prompt price hikes for food, the hospitality and health sectors as well as for education, culture and sport. For this reason, the proposed rate, although less than half the minimal VAT rate in the EU, has been criticized by all political parties. Switzerland currently has a standard VAT rate of 7.6%, with lower rates for the hospitality sector and for essential consumer goods such as food.

UK's fiscal 2008 - redistribution and economic fragility

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Editor-in-Chief, openDemocracy

The political timetable

There are two big annual dates for UK fiscal policy: the annual budget in April, in which the Chancellor of the Exchequer (Finance Minister) presents to Parliament tax changes, and the November pre-budget report, instituted in 1997 by Gordon Brown to "help build the foundations of shared understanding and sense of national economic purpose between government, business, and individuals."

April 2008, before the bankruptcy of Lehman Brothers, seems like a relative age of innocence. The financial crisis and its dominance of economic policy might have been foreseen and there might even have been value in earlier responses. Nevertheless, political attention and energies were the usual balance of substantial matters and the micro-politics of competing interests. The November 2008 pre-budget report, on the other hand, was definitely dominated by macro-economic thinking. The pre-occupations of April seem like a luxury from the perspective of November -- oh! for the days when tax policy could once again be about the balancing of social priorities and incentives! By November, the talk is all of stimulus, affordability and possible Ricardian equivalence. Al-

most all the language around fiscal policy is macro-economic.

A review of the year, however, shows that Labour's redistributive instincts were resurgent all year. Small-scale but much discussed policies to increase taxation on the rich, capital gains tax changes aimed at making financiers pay more income tax, as well as a number of changes aimed at the less well off have all marked 2008 as one in which Labour returned to its ideological roots. Part of this is explained by electoral timetables--an election must take place before June 2010--and part by the worsening economy. The New Labour project has always been Rawlsian in its attitude to distribution: inequalities are good if they benefit the worst off. Conversely, as the once vaunted virtues of inequality are tarnished, less inequality can be tolerated.

The run-up to April

Corporate tax migrants

The rate of corporate tax was cut from 30% to 28% in April 2008. The UK's apparently stated goal of having the lowest corporate tax rates in the G7 were achieved by the cut.
As Vanessa Houlder notes in the FT (ft.com, Sept. 08 2008), the decade has been one of intense tax competition:

> "The intensity of international tax competition was underlined by the finding that, for the first time since 1994, no country in the 106-strong sample had raised rates. Competition has been particularly intense in the EU over the past 10 years, moving average corporate tax rates from the highest to the lowest of any group of countries in the OECD."

However, **corporate Britain played the tax competition card**

hard during the year. Attention has focused on complexity, instability and the treatment of foreign subsidiary profits ("Departing companies cite tax instability", ft.com., August 29 2008). Hence, Martin Sorrell, head of the advertising agency WPP was very vocal early in the year about his company's threatened move to Ireland. And, indeed, a fascinating study of actual tax paid by corporations (as opposed to tax rates) confirmed the view that the UK's competitive tax rates hide important differences (visit, http://www.livinginnovation.org/value_added/)

In November 2008, the government announced that it would renounce taxation of foreign subsidiary profits, although it also announced plans to simultaneously tighten rules regarding within-group transfer pricing, for example through the treatment of charging for intellectual property. The plan, together with companies facing tougher problems than head-office location, is forecast to be effective in **stemming the tide of corporate emigrations**.

Non-domiciled tax

The start of the year saw substantial debate over the value to the country of the "non-domiciled" tax regime which allows those for whom the United Kingdom is not their "home" -- however defined -- to avoid paying tax on offshore income and, incidentally, to also avoid paying all forms of capital gains tax.

The **political mood was anyway turning against the luxury lifestyles of the City**. £120m (€130m), while not nothing, was certainly not going to help the fiscal deficit, with public sector borrowing for 2009 estimated to be £118bn. The non-doms were good sacrificial

victims -- symbolic and powerless and not particularly attractive. The mood was well-captured by Professor Willem Buiter in his Maverecon blog:

> The main indirect effect of the proposed increase in taxes on the non-doms (if they were to leave and not spend as occasional or even regular visitors as much as they now spend as residents) is through their consumption of non-traded goods and services, including charitable giving – a form of conspicuous consumption unless it is double-blind. The demand for magnums of 1961 Petrus (at £18,000 a bottle) would suffer. So would a few luxury shops, restaurants and studs. Upper bracket property prices in London and the home counties would fall. With a bit of luck, the fall in property prices would spread more widely (http://blogs.ft.com/maverecon/2008/02/theyd-none-of-thtml/#more-130).

In response to strong lobbying, the **Treasury** (Finance Ministry) **watered down the proposals**, especially with regard to disclosure of foreign assets, which is now not required. Moreover, the charge is to be levied after 7 years' residency, which means that many in the Finance industry, here for just a few years, are exempt.

Simplified Capital Gains Tax

Capital gains taxes were introduced in the UK by the Wilson government in 1965. Until 1998, capital gains were treated as closely as possible to income. Most wealthy people paid the same marginal capital gains tax rate as income tax rate. In a move to encourage entrepreneurialism, Gordon Brown introduced **"Taper relief" whereby the capital gains tax would fall from 40% to 10% over ten years of**

holding an asset. The taper was reduced to four years in 2000 and just 2 years in 2002.

Somewhat strangely, the fees that financial funds — private equity funds and hedge funds especially — levied as a **percentage of profit on managed funds were treated as a capital gain for partners** rather than a corporate income. Thus, **much of the City** (if not already on the non-domiciled tax holiday) **was enjoying tax rates three times lower than their nanny**.

The Chancellor announced **a simplified, single 18% tax rate on capital gains**. Post-announcement lobbying led to the re-introduction of some tapering: a lifetime £1m of capital gains would be taxed at 10% and the rest would be taxed at the flat 18% rate).
The rhetoric was quick to follow from private equity. However, larger trouble in the finance industry soon eclipsed these "good times" arguments. There are capital loss allowances for all to go around for years to come, it seems.

Scottish income tax

The Scottish Nationalist Party (SNP), the ruling party in Scotland, announced a plan to flex its fiscal autonomy by replacing local taxes based on the value of homes (the "Council Tax") with a 3% local income tax. The SNP claimed to have research that showed that 80% of Scots would be better off under the **local income tax proposal**. The SNP tried its fiscal luck even further by asking Westminster **to share excise duties** from (mainly Scottish) North Sea oil directly with Scotland.

London made life difficult for Edinburgh on both fronts. On the matter of oil, the SNP government simply never got a reply to their request. **On the local income tax, the Treasury intimated that Edinburgh might not have automatic access to the computer systems of the tax collection agency** (Her Majesty's Revenues and Customs) for its plan. **The central government went on a strong political campaign against the SNP proposal.** While much of the resistance can be understood in terms of Scottish politics — the ruling Labour party in London would not have a majority without its domination of Scottish representation in the UK parliament, and is very concerned at the loss of its political base to the nationalists in Edinburgh — part of the resistance should also be seen as the political centre protecting its revenues. Alistair Darling, Chancellor of the Exchequer (Finance Minister) and himself a Scottish member of the London parliament, said of the local income tax: "it would be a disaster for the financial services industry. If we are going to attract the best to come to and remain in Scotland, to tell them that you are going to be paying more income tax would be the completely wrong thing to do." (http://thescotsman.scotsman.com/latestnews/Holyrood-and-Westminster-at-war.4135513.jp) Whatever the virtues of the argument (what of the abolition of the home-value based council tax?), this sounds like an objection to a rival for tax revenue.

The abolition of the 10% income tax band

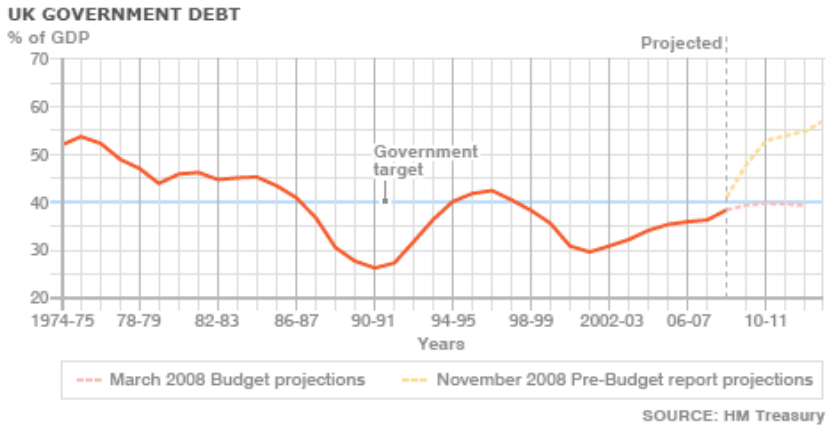
The 2007 budget had announced changes to the marginal rates of income tax bands to be implemented in April 2008. **The 10% rate was to be abolished altogether, while the rate in the next band was to be reduced from 22% to 20%**. This policy, clearly regressive for the lowest paid, had been presented as part of a set of budget proposals that were politically acceptable to Labour at the

time while also striking a real blow to the Conservative's claims to be able to reduce income tax further. The 2007 move had been seen at the time as good political tactics.

However, as the moment for implementation arrived, and with household incomes suffering from high oil and food prices, **Labour members of parliament threatened to vote against** the government unless the regressive policy was changed. It was simply not possible for the UK left to enact regressive income tax policies in the face of a worsening economy. The parliamentary rebellion was successful. Alistair **Darling agreed a series of neutralising measures** — that the zero rate band would be increased by £600 (€666); that low income households would receive a £120 tax rebate; that fuel subsidies for the poor would be increased, and that the minimum wage would be increased.

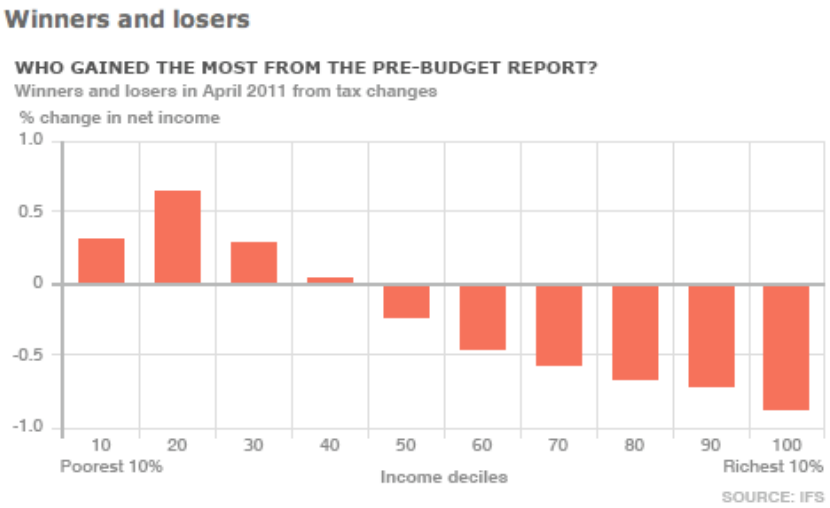
Macroeconomic storms gather

As the macroeconomy worsened, it became clear that the **"Golden Rule"** formulated by the then Chancellor of the Exchequer, Gordon Brown, **to "balance the budget over the course of the economic cycle" would not be honoured**. Tax receipts were forecast to fall well below previous forecasts simply because of the reduced economic activity and climb-downs over various tax increases — especially the 10p tax band, but also fuel and alcohol duties — that can also be attributed to the political difficulty of increasing taxes while the economy worsens. By November, the **government was convinced that the world faced a Keynesian recession** and announced an immediate **2.5 percentage point cut in the value added tax rate**, from 17.5% to 15%.



The November 2008 pre-budget report **tried to present both an expansionary response to immediate crisis and a prudent approach to the future of public finances**. (The practical relevance of commitments beyond 2010 is questionable given that an election, which Labour seems likely to lose, must be held by June 2010.) Together with the cut in VAT from 17.5% to 15%, the government announced its intention to:

- bring forward £3bn of capital spending from 2010/11 to today;
- introduce a £145 tax rebate for low income households;
- increase all National Insurance contributions (a tax levied on income for pension payments) from 2011 by 0.5 ;
- increase pensions and tax-credits for implementation from January 2009 to April 2009;
- increase subsidies on various green measures
- defer an intended rise in small business corporation tax (from 21% to 22%)
- allow struggling firms to develop payment plans for their VAT and payroll tax payments;



- increase the marginal income tax rate from 40% to 45% for income above £150,000;

The re-distributive impact of these measures has been simulated by the Institute for Fiscal Studies (http://www.ifs.org.uk/). Aside from any macroeconomic impacts of the program, it is clear that the economic crisis and the electoral calendar have sent Labour back to their re-distributive roots.

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