

# **Taxation in Europe 2013**

The yearly report on the evolution of European tax systems

a publication from the

Institute for Research on Economic and Fiscal Issues

Edited by Pierre Garelo



## About IREF

IREF is a private institute founded in 2002 by representatives of the civil society coming from the academic as well as business worlds. It is designed to be an efficient platform for the investigation of fiscal and taxation policies. Taxation is a many-faceted issue and existing studies are mostly incomplete if not biased. It is the aim of IREF to explore systematically and completely questions related to taxation and public finance.

IREF has a strong European dimension. Tax studies can no longer ignore the process of globalisation and its consequences in terms of tax competition. In particular, tax authorities are currently under the strain of two opposing forces: centralisation and harmonization on one hand, devolution and competition on the other. It is IREF's intention to reintroduce in this debate the essential links between tax competition and individual freedom.

In order to achieve its goals, IREF relies on a network of specialists. Today, a team of over 25 scholars or professionals--economists and lawyers--report regularly on the quantitative as well as qualitative evolution of the fiscal systems of their respective countries or regions.

Besides its Yearbook on Taxation in Europe, IREF is editing books, reports, briefs and academic studies on topics related to taxation and public finance. Those studies together with general information on taxation in Europe can be found on IREF website at: <http://www.irefeurope.org>



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## A short presentation of IREF 'Yearbook on Taxation in Europe' Series

Among the many ways to understand the climate of opinion and the culture of a country, looking at its fiscal system is one of the most rewarding. Sure, fiscal systems almost always rhyme with complexity; each system bearing the weight of its history. But the attempts to change the system, to give it a new direction, are highly instructive.

To observe changes, debates and new directions in tax systems is precisely what IREF yearbook is all about. In that sense, the yearbook is not in direct competition with other yearly reports on taxation that typically focus on numbers rather than on the philosophy behind them.

Another unique trait of this yearbook is to provide the latest information on the topic. What is presented here are the last known figures (this year, data for 2012) and the on-going debates. This approach allows the reader to judge whether public decision makers have been keeping their promises or have been victims of inter-temporal inconsistency; drawing plans that they are later unable or unwilling to maintain.

The yearbook is conceived for all those who look for a dynamic understanding of tax and budgetary policies. This includes scholars and students, of course, but also journalists, businessmen and public decision makers. While avoiding technical jargon, authors do not hesitate to enter the details of a mechanism whenever it is necessary. For we all know that there is sometimes a world between notional and real taxation.

Those reports can be used all along the year for quick reference whenever mention is made of one of the twenty countries presented here. As a useful complement to this yearbook, country profile cards summarizing the main budgetary, fiscal and macroeconomic data for each country can be found on the website of the institute at <http://www.irefeurope.org/en>.





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Country profile cards (main macroeconomic, budgetary and fiscal data for 2012) available at <http://www.irefeurope.org/en>

# Struggling with or against the welfare state?

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What comes out from the reading of the contributions to this new edition of the Yearbook on taxation in Europe is, as usual, that European *countries vary greatly in their fiscal and budgetary policies*. Some states are nearing bankruptcy while others can display rather healthy financial statements. But all of them, surely to various extents, are struggling with the welfare state.

The battle is a tough one because the danger is not well identified: no government in Europe openly makes the claim that we went too far in developing a welfare state, that it is time to roll it back and to return to private initiative much of what has been entrusted to the State during the past decades. Instead, most countries are trying to get out of financial troubles with a *subtle balance between spending cuts and tax hikes*, and whenever a tax cut is voted it almost inevitably comes with “compensations” for the State's budget in the forms of reduced tax exemptions or other tax base broadening. In short, governments still behave as *if the current difficulties were a byproduct of some external shock* such as the financial crisis. Not a problem with previous political choices. The bad news is that this will not be sufficient as the recent experience of Italy shows: the “technical government” of Mister Monti was not successful, neither on the political front nor on the economic front.

In this rather moribund environment, the healthiest countries, those who do better than average, do not appreciate *outside pressures* coming from the EU, the OECD or the US. Reports from Luxembourg, Switzerland, and Ireland or, to a certain extent, Estonia, Bulgaria or Sweden speak in that sense. Sweden, for instance, rejects a European tax on financial transaction that it has implemented in the past and quickly abolished due to disastrous effects. Switzerland continues painful negotiations with its European trade partners with a feeling of exasperation and worries about its future. The same exasperation is found in Luxembourg's report: Luxembourg, often pointed out as “a tax haven” while its average tax burden is at 37.2% and that pay a high price to comply with the US imposed FATCA (Foreign Account Tax Compliance Act). Bulgaria is very satisfied with its 10% flat tax and worried that this will be judged unbearable by powerful member states with huge fiscal burden.

If one looks now for *some common trends* in taxation throughout Europe we find confirmation of an old tendency to substitute consumption taxes for direct income tax. In many places, VAT rates and excise duties (gas, alcohol, tobacco...) have been increased in 2012 while income tax rates (both personal and corporate) were rather on the decline. With the exception, however, of a few countries such as France, where the actual government was elected with the promise to “make

the rich pay for the crisis". But even there, the move is more ideological than substantial. Another common feature of taxation in Europe is that times of crisis are bad news for pension reforms. Indeed, in some countries the second pillar of the pension system has been weakened, often to rescue the first, pay-as-you-go State pillar.

Still another lesson we can draw from those reports is that tax rates give only a poor idea of the fiscal policies followed by the respective governments. As a matter of fact, most tax reforms involve both, a change in rate *and* a change in base. If the changes in rates are summarized in the country profile cards to be found at [www.irefeurope.org/en](http://www.irefeurope.org/en), the reading of the full report brings a much better perception of what actually changed in those 29 countries in 2012 and beginning of 2013.

The overall impression is that in most European countries the battle is still directed towards saving the Welfare State. This results in high fiscal pressure, ailing public finance and low or now growth. And it will still be that way as long as the welfare state as we know it will not be perceived as the source of the problem.



Austria today faces a double challenge: to consolidate the country's fiscal position through effective fiscal and structural policies aimed at reducing the budget deficit and lowering the public debt to GDP ratio. In 2012, Austria managed to narrow its public deficit below 3 percent according to European Union's Maastricht criteria. In 2012 the public deficit was 2.5% and is estimated to fall to 2.2% in 2013, below the European criteria. State debt is set to peak at 74.7 percent of GDP in 2012 and 75.4 in 2013, above the EU norm of 60 percent. Regarding taxation, most of the taxes rates remained unchanged with the exception of flight tax; however tax increases should be expected within 2013 due to the Austrian Consolidation Program 2012-2016. With that program the Austrian federal government is setting the course for a structural and sustainable consolidation of the federal budget, aiming to balance the budget in 2016 and reducing the public debt to 71 percent of GDP in 2016.

## A budget deficit lower than expected

The government had projected a budget deficit of 3.1% but eventually the country ran a deficit of only 2.5%, below government's forecast and below the EU target. A 4.4% increase of total government revenues (€6.4 bn) played a significant role for this achievement, while total government expenditure showed a similar increase of 4.4% (€6.8 bn). According to the statistics department, 91% of State incomes came from taxes and social contribution in 2012 totaling € 136.9bn. In comparison with 2011 this revenues from taxes and social contributions show an increase of 4.7% or € 6.1bn. To be more specific, revenues from taxes on production income amounted to 44.8bn in 2012, the current taxes on income, wealth etc. were at 41.1bn and social contributions reaches 50.8bn. As far as revenues are concerned, the largest annual increases were observed in taxes on capital transfers 18.38%, in taxes on income and wealth 5.2% and in social contributions 4.3%.

National revenues and expenditure grew both at the same level at around 4.2 %. Revenues increased from € 144.48bn to € 150.84bn, expenditures grew from € 151.59bn to € 158.57bn, which makes a deficit of € 7.73bn representing 2.5 % of GDP. Most of the expenditures went in social protection almost 41% or 64.7bn, in public health 15.3% or 23.7bn, and in general public services 13.2% or 20.5bn. Comparing 2011 expenditures with 2012, the intention of government to reduce spending is far from evident, as far as the public expenditures have grown. However, for 2013 the Austrian federal government is pursuing its strategy of implementing "structural consolidation and reforms."



## Tax Policy

Austria is one of the countries with high tax burdens. The number of taxes and their rates have been largely left unchanged from the previous years. Austria's overall tax burden amounts to 43% of the total domestic income in 2012 slightly higher than the 42.8% of 2011. Most of the taxes remained at their previous levels except the flight tax and the imposition of a capital gain tax of 25%. Due to the Austrian Consolidation Program 2012-2016, however, further tax increases are expected to take place in 2013.

### *Income tax*

All ordinarily residents in Austria are subject to a 25% tax on their worldwide income. The so-called "13th and 14th salaries" below €2,100 are tax-free. In general, all kinds of income are taxed at the same rate. There are some tax exemptions and lower tax rates available for interest payments and other kinds of income for the foreigners and the non-Austrian companies. For income over € 11,000 the marginal tax rate is 36.5% per year. The marginal rate of 43.21% concerns an income of €25,000 and more. Finally, for income over € 60,000 the imposed tax rate is 50%.

### *Value Added Tax*

The standard VAT rate remained at 20%. Food, agricultural products, rents, tourism and entertainment are tax at the lower rate of 10%.

### *Fuel Tax*

The tax rate for the fuel consumption is € 397 per 1,000 litres. The increase of the fuel tax rate from January 2011 on led to a decreased fuel consumption by tourists in Austria who probably fill their tanks in the neighbouring countries at a lower price, except for Italy. The transport department of the Austrian Economic Chambers (WKÖ) warned the government against any plan to further increase fuel tax in Austria. From 1<sup>st</sup> July 2012 the price for off-road activities, also, has been increased.

### *Corporate Income Tax*

In Austria, companies are subject to corporate income tax on their profits at a standard tax rate of 25%. This contrasts with personal income that is taxed, as explained above, at a progressive tax rate from 0 up to 50%.

### *Capital Gains Tax*

The Capital Gains Tax in Austria is 25%. On 1 April 2012 the new Austrian withholding tax and capital gains tax regime came into effect. Generally, the new taxation became effective for profits derived from the sale of shares / investment fund units purchased from 1 January 2011 and for the sale of bonds and derivatives purchased as of 1 April 2012.



### *Bank Tax*

The bank tax has remained the same. The bank levy depends on the total amount of the bank's assets. When the latter exceed the amount of €1 bn, they are taxed at a rate of 0.04% and once total assets pass the threshold of €20 bn a higher tax rate of 0.08% applies. The expected € 500 mil. tax revenues that levy generates have not been poured to a bank rescue fund but to the general budget.

### *Flight Tax*

From 1 January of 2013 the flight tax rates for short and medium-haul routes have been reduced. In 2013, the passengers pay €7 instead of €8 in 2012 for continental flights and €15 instead of €20 for medium-haul routes. The tax for international flights remains at €35. The high level of the international tax flight penalizes the whole Austrian economy by making the country an expensive touristic destination for the foreign visitors. The reduced incoming traffic (see <http://www.breakingtravelnews.com/news/article/austrians-call-for-abolishing-airline-ticket-tax/>) has a negative impact on the tourism industry, damaging every sector from hotels to museums. In addition, some regional airports in Austria have been affected by the drops in passengers. Consequently, the high international flight tax undermines the tourism industry's stability and exposes it to unnecessary risks.

### *Tobacco Tax*

The tobacco taxation remains at a high level during 2013 putting an average packet of cigarettes at around €4.3. Cigarettes in Austria became more expensive since 2012 in order to push smokers to reduce or quit smoking. This taxation policy did not meet its goal (see Manfred Neuberger's report: "Failure of tobacco control in central Europe") but it turned smokers towards other, more economic ways, of smoking or forced them to cut on other consumptions in order to maintain their cigarette consumption at its previous level.

### **Looking for new taxes to balance the budget**

Taking strong measures and doing reforms doesn't seem to be where the Austrian federal government is at its best. Instead, the government is permanently and desperately looking for new taxes that would generate more revenues. Within the new consolidation program, revenue increasing measures consist in social contributions, taxation of realized capital gains from the sale of real estate, closing tax loopholes related to VAT and two sizeable one-off measures (tax agreement with Switzerland, frontloaded taxation of certain pension fund benefits). From the above measures the government expects to gather some €9 bn, the largest part of those extra revenues (table 1) coming from tax on income from real estate and property sales (almost 22.6% or €2bn), followed by VAT - closure of tax loopholes which will account for 20.3% of the revenues (€1.8bn) to which must be added 12.6% (€1.15bn) from withholding tax on capital gains in Switzerland.



The Austrian Social Democrats (SPO) has suggested the reintroduction of inheritance and gift taxation, the People's Party (ÖVP) disagreed with a comeback of the measure which was abolished four years ago, however SPO is still looking for the opportunity to make it happen. Moreover, the current government is looking for a mandatory contribution of the state's richest residents with wages more than 168.000€.

**Table 1: Finding new sources of revenues (million €)**

Measures to increase State revenues	2012	2013	2014	2015	2016	Sum 2012-2016
Taxing income from real estate and property sales	10	350	450	500	750	2060
Group taxation - restriction on deduction of foreign losses	0	50	75	75	75	275
VAT - closure of tax loopholes	40	370	480	480	480	1850
Solidarity fee on high incomes		110	110	110	110	440
Financial transaction tax			500	500	500	1500
Withholding tax on capital gains in Switzerland		1000	50	50	50	1150
Cut in premium on housing savings scheme and private pension provision		70	100	100	100	370
Extension of corporate income tax duty	30	40	50	50	50	220
Special contribution to stability levy	128	128	128	128	128	640
Ex-ante income tax on private pension insurance	890	-75	-75	-75	-75	590
<b>Total</b>	<b>1098</b>	<b>2043</b>	<b>1868</b>	<b>1918</b>	<b>2168</b>	<b>9095</b>

Source: OENB, STATISTIK Austria

### Budgetary Policy: 2013 Budget

The main goal of 2013 Austria's budget is to push forward a strategy of "structural consolidation and reforms". Structural reforms are indeed necessary in the areas of pensions, healthcare policy, public administration, public funding as well as on the labour market. This is a precondition to meet Maastricht criteria keeping its deficit below 3% and, at the 2016 horizon, to achieve a balanced budget. For 2013 public deficit is expected at 2.1% of GDP, while debt ratio will rise slightly, mainly due to the additional measures being taken in the context of the European governments' debt crisis. Public debt will peak at 75.4% of GDP, but from 2014 onwards it will start to gradually fall again. Public expenditure is estimated to fall





by 1% to 51% of GDP, down from 51.7% in 2012, while total revenues is expected to raise slightly from 48.7% of GDP in 2012 to 48.9% in 2013. The Austrian Federal government will try to balance the budget, focusing more, as we saw, on new taxes. As a result, the tax ratio will rise in 2013 to 43% of GDP, up from 42.7% in 2012. The 2013 budget has been prepared in the larger context of the stabilization and growth package decided in spring 2012; a package that imposes structural reforms to be implemented from 2013 onwards.

### Budgetary policy: The Austrian Consolidation Program 2012-2016

Early 2012 the Austrian federal government passed a second package of fiscal consolidation measures in order to correct its deficit, to put it on a sustainable basis by 2013 at the latest, and to achieve a structurally almost balanced budget by 2017. That comprehensive consolidation package amounts to a total volume of €26.5 bn : € 19.9 bn contributed by the federal government, € 1.4 bn by the social insurance system, and € 5.2 bn by states and municipalities. The federal government should hence attempt to balance the budget partly with revenue-increasing measures and partly from spending-restraint measures.

On the expenditure side, the package includes reforms in the areas of pensions, health care, subsidies, and public administration. As a matter of fact, the program relies more on expenditure cut (¾ of the package) than on revenue increases (the remaining ¼). Looking more closely at the measures on the expenditure side related to public administration one finds a pay freeze in 2012, moderate pay increases in 2014, hiring freeze (with an exemption for educational, police and judiciary services), cutting of running costs and merger of administrative entities. Some €2bn should be saved through those reforms.

**Table 2: Cutting on expense (million €)**

Measures on the expenditure side	2012	2013	2014	2015	2016	Sum 2012-2016
Pension and unemployment insurance system	11	919	1483	2059	2491	6963
Public companies/subsidies	291	438	573	1061	1124	3487
Administration and public services law	55	391	536	772	790	2544
Health care	19	0	0	0	0	19
Interest expenditure (due to lower net lending)	12	122	272	486	742	1634
State and local governments	85	-68	594	791	1278	2681
Social security funds	60	144	256	392	520	1372
Total	533	1945	3715	5560	6945	18699

Source: OENB, STATISTIK Austria



Another € 7.3bn will come from reforming pension and unemployment insurance system. The details of that part of the package are: moderate increases for pensions in 2013 and 2014, measures to increase factual retirement age (for instance by increasing the eligibility criteria for early retirements), measures to reduce disability pensions, no early retirement below the age of 50, measures to re-integrate employable people into the job market, stricter rules for allowances for part-time workers before retirement and increase of social insurance contributions.

Regarding health care (with a total contribution of € 3.4bn to the package) the main reforms will impact on the compulsory social insurance system and the hospital sector. Finally, reforming public companies will include cutting on costs (both infrastructure and operational costs) at the Austrian Federal Railway and a decrease of early retirement in that same company.

## Conclusion

In 2012 Austria managed to narrow its public deficit below 3 percent according to European Union's Maastricht criteria. State debt is set to peak at 75.4% of GDP in 2013. However, a necessary precondition for economic growth, for new jobs, and for social stability is to balance its budget and bring down its public debt below 60 percent. There is no doubt that the Austrian Consolidation Program 2012-2016 is a positive step in that direction to the extent that ¾ of the effort is on expenditure, including cuts in payroll (in particular, a public-sector wage freeze in 2013), smaller pension increases in 2013 and 2014 (adjustment factor reduced by 1 percentage point and 0.8 percentage points respectively), together with measures to raise the effective retirement age, as well as reductions in various government grants (subsidies for Federal Railways of Austria). This explains that according to the Heritage foundation freedom index, Austria is 1.5 points better than last year due to improved scores for government spending, business freedom, and investment freedom.

However, there is much doubt regarding Austria tax policy and the imposition of new taxes, such as the capital gains tax and the flight tax which will make the country an expensive touristic destination for foreign visitors. Moreover, the willingness of SPO to reintroduce inheritance and gift taxation will raise further tax burden in Austria, which is already one of the highest in Europe.



## General outlook

An almost continuous wave of laws implementing an important number of “miscellaneous measures”, or “containing tax and financial matters” has struck Belgium in 2012. The present climate of crisis has led Belgian authorities to seek new sources of financing or to enforce old ones, sometimes at any cost, thus regardless of several important rights of the taxpayers.

As a result, the situation of Belgian taxpayers worsened: by reference to OECD's numbers, natural persons are taxed in Belgium at 55% of his revenue (total taxation), that means at least 10 points above its neighbors (independent audits state a number of 57%).

In the field of corporate taxation, following OECD's numbers, Belgium ranks among the 5 most taxed countries in the world.

Unfortunately, one has to be pessimist for the future—at least the near future—considering that growth is blocked to 0% for 2013 but also that the future measures for 2013 that have been announced or discussed will most probably have a negative impact on the situation.

2012 was thus rich in tax measures. The reader will find below those measures that present an interest, whether direct or indirect, on shaping the future.

## Withholding tax on movable income

Movable income has been subject to two reforms in 2012. A first reform was applicable to income allocated as from 1 January 2012. For those income, the principle of the withholding tax considered as a final tax had been abandoned and, consequently, to report income became mandatory. Also, the rate has been increased from 15% to 21% and an additional levy had been introduced, that was an addition of 4%, thus 21+4%, on “important” movable income (exceeding € 20,020).

- (a) Latter, following the law of December 28, 2012, the government tried to simplify the situation. The nominal withholding tax for interest and dividends was raised from 21% to 25%; the 4% additional rate has thus been abolished.

*More precisely:*

- a. Interest: Withholding tax of 25%, except:
  - a. Revenue of savings not exceeding €1,250 (indexed to € 1,880 for the tax year 2014): exempted
  - b. Revenue of savings exceeding the aforesaid threshold: withholding tax of 15%



- c. Revenue of State bonds issued between November 24 and December 2, 2011: withholding tax of 15%
- b. Dividends withholding tax will be paid at a 25% rate (except on the revenue of some very specific products)
- c. Liquidation surplus: the withholding tax has been maintained at a 10% rate.
- d. Resident SICAFI: withholding tax is raised from 0% to 15%

Furthermore, the obligation to declare movable income has been repealed; thus, the withholding tax becomes final again (exception: income from royalties has still to be declared, even if this income has been subject to withholding tax at the source.)

Finally, the same act provides that the rate of the withholding tax on royalties (income from the cession or concession of copyright and related rights, as well as legal or compulsory licenses) will be of 25% as from January 1<sup>st</sup>, 2013.

Nevertheless, income from author's rights up to an amount of € 56,450 (tax year 2014) is regarded as moveable income and remains taxed at 15%.

### Implementation of the *Una Via* principle

By a Law of September 20, 2012, the UNA VIA principle has been introduced into the Belgian tax law (for direct taxation frauds only). Hence, as soon as the law enters into force, a tax fraud case will be handled either by the tax administration or by the public (King's) prosecutor authorities but not by both of these administrations simultaneously as was the case before. This rule is therefore an application of the "*non bis in idem*" principle.

Under the new regime, the Public Prosecutor's office and the tax administration will consult, case by case, in order to decide whether such case will be subject to criminal prosecution or just handled by the tax administration. If the "rule" is that important frauds will be prosecuted; nevertheless, the law does not provide any criteria in order to distinguish the important from the "less important" frauds (in an October 2012 Circular, the tax administration considers that criminal procedures will take place only if the case requires special investigations that could only be ordered and enforced).

In any case, if the prosecution path is chosen, administrative fines of any kind will be suspended.

One must note that a motion of annulment of these provisions has been filed against this law - the case is pending before the Constitutional court.

Finally, the maximum fine for tax offenses, in the criminal procedure frame, has been raised from € 125,000 to € 500,000 (in some cases where certain special provisions apply the amount can be much higher).



## Company cars

The Law of December 13, 2012, modifying a Law of December 28, 2011, has changed the regime of disallowed expenses related to company cars.

Accordingly, the benefit in kind resulting from the use of a company car will from now on be calculated following the basis of a new lump sum calculation method. The new calculation is made as follows: 6/7th of the catalogue value of the car multiplied by a percentage linked to the car's CO2 emission rat: Benefit in kind = catalogue value \* % (CO2 coefficient) \* 6/7

## Allowance for corporate equity

Starting with tax year 2013, the possible carry-over for lack or insufficiency of profits will be abolished; therefore, the allowance for corporate equity can only be set off against profits of the taxable period linked to the deduction.

In the same time, transitional measures have been put in place for the companies who still had remaining allowances for corporate equity that could be carried over on December 31, 2011. For these companies, the carry-out remains possible. Nevertheless, above € 1,000,000 the carry-over is limited to 60% of the remaining profits but, in the same time, an extension of the carry-over period is accepted for the amounts which could not be deducted because of the aforesaid limit of 60%.

## Capital gains on shares

The Law of December 13, 2012, modifying a law of March 29 of the same year, amended the provisions of Belgian tax law related to capital gains on shares; the former version provided that capital gains realized by Belgian companies were totally exempted from taxes.

Under the new law, the tax exemption is maintained but, as from tax year 2013 (related to gains realized from November 28, 2011), will be submitted to a condition: the company must hold the shares for an uninterrupted period of one year. If this delay is not respected (certain operations, neutral from a tax point of view, are not considered as interrupting the one year delay), the company will be taxed at a rate of 25% (global rate after surcharges: 25,75%).

## Thin-capitalization

The law of March 29, 2013 (modified by a law of June 22, 2013) modified the Belgian corporate tax law provisions on thin-capitalization. The provisions concern interest payments or attributions to (real) beneficiaries.

Under the new laws, the 7:1 debt/equity ratio formerly existing has been brought to 5:1.

In accordance with the new provisions, the tax-deduction of interest payments or attributions exceeding the 5:1 will not be accepted.



This rule does not apply to the loans contracted

- by leasing companies to companies whose main activity consists of factoring or immovable leasing within the financial sector and to the extent the funds are effectively used for leasing and factoring activities
- by companies which are primarily active in the field of public-private co-operation.

**When the rule is applicable, and for the purposes of its application,**

- **equity** is the sum of the taxed reserves at the beginning of the taxable period and the paid-up capital at the end of the taxable period (in certain cases, certain non-taxed reserves are deemed to be taxed reserves)
- **debt is**
  - loans where the beneficial owner is not subject to income tax or is subject to a substantially more advantageous tax regime (interest taxation) than the Belgian one;
  - intra-group loans

The law also provides that when the loans are guaranteed or funded by a third party which bears, partly or wholly, the risk, the aforesaid third party is deemed to be the beneficial owner of the interest, if the guarantee or the funding have tax avoidance as their main target. Similarly, third party in this context would also mean group companies, even if the loan has formally been granted by a non-group member.

- **debt is NOT:**
  - bonds and other publicly issued securities
  - loans granted by financial institutions.

### **Tax abuse**

The Law of March 29, 2012 has introduced a new “anti-abuse rule” concerning direct taxation and registration rights (and, indirectly, estate rights). Hence, the concept of tax abuse has been instituted; when such a tax abuse will be established, the operation or series of operations forming a global transaction will not be considered as opposable to the tax administration.

Following (new) article 344, §1 of the Belgian Code of taxes on revenue, the tax abuse will be presumed in two cases:

- if the tax payer places himself, in violation of the **purpose** of a provision of the Code, outside the scope of the aforesaid provision;
- or
- if the taxpayer tries to obtain (or actually obtains) a tax benefit when the grant of such tax benefit would be in violation of the purpose of said provision and the taxpayer's primary purpose is to obtain the tax benefit in question.

Therefore, under the new rule, if the tax administration manages to demonstrate a tax abuse, the taxpayer will have to demonstrate that the operation is justified by motives which are not related to tax evasion. If the taxpayer fails to do so, he



will be taxed as if the operation had not taken place.

The annulment of the provisions of the law of March 29, 2013, related to the tax abuse measures is pursued in a case pending before the Constitutional court.

### **Big Brother law: a breach of the right to privacy**

By the law of August 24, 2012 *on the collection of tax information by the tax administration*, the Belgian legislator has authorized the tax administration to gather information on the taxpayers (creating in this way a giant personal data base) in order to accomplish its missions in a more effective way. This database will gather all the data available from the different branches of the tax administration, which is authorized to draw all information necessary within the strict framework of its missions.

This law has raised a wave of criticisms (and has been challenged before the Constitutional court), especially concerning two points:

- a. The Control commission who will have to ensure the monitoring of the activities of the tax administration and the good application of the law will be a part of the Ministry of finances; a fact that obviously raises the question of its independence.
- b. In case of tax control or acts preparatory to a tax control (and provided that the aforesaid commission approves the suspension), the right of the taxpayer to consult his personal data, or to have it corrected, will be suspended till the end of control.

Given the fact that Belgian law does not define “preparatory acts to a tax control”, nor provides any maximum duration of the tax control, in many cases, the length of the suspension of the rights deriving from the right to privacy will be indefinite.

### **Miscellaneous**

#### **a. Payments in cash**

Payments in cash for the purchase of goods (between professionals or to a professional but not between private persons, or deposits on bank accounts) were limited, since the law of 1993, to € 15,000. The law of March 29, 2013 has reduced this threshold, to € 3,000 and extended the limitation to payments for services. In both cases, the limit is determined on the basis of the service or good; therefore, it is useless to try to avoid the application of the law by making multiple payments.

People who violate the law are punished with a fine (which cannot exceed 10% of the amount paid in violation of this provision).

#### **b. Gifts**

Tax payers who make gifts to recognized institutions, for an amount of € 40 or more will be granted a 45 percent tax credit. Of course, limits have been provided: the total amount of the gifts cannot exceed 10% of the net income of the



couple (if the taxpayer is married) nor, in any case, € 365,950 per spouse.

### **c. Energy tax credits**

Tax credits for work aimed at energy saving have been abolished as from tax year 2013, with the exception of roof insulation. This abolishment has been accompanied with transitional measures for expenses incurred in 2012 under an agreement signed before 28 November 2011.

### **d. VAT for notaries and bailiffs**

Notaries and bailiffs are subject to VAT as from January 1<sup>st</sup>, 2012 (law of December 28, 2011). The Belgian government just announced that lawyers will also be subject to VAT as from January 1<sup>st</sup>, 2014.





# Bosnia and Herzegovina

Miroslav Tomic, IREF

Fiscal adjustment continued during 2012 despite the fact that real GDP fell by 0.7%. The rates of major taxes remained unchanged. Fiscal cooperation between different levels of governments substantially improved during 2012, resulting in an early December 2012 adoption of the state (Institutions of BiH) and two entities central government budgets for 2013. Actions by Council of Ministers (CoM) of Bosnia and Herzegovina (BiH), formed at the beginning of the year 2012 after long delay following October 2010 elections, signaled strong determination to reverse the trend in quality of public expenditures. Faced with substantial increase in debt servicing in 2013 and 2014, authorities adopted unpopular measures such as nominal wage and allowance reduction, already in 2012. The adjustment measures are expected to bring fiscal system in primary surplus territory in 2013 and first stabilize, and subsequently, reverse the increasing trend in debt to GDP ratio. IMF program approved in September 2012 provided needed financing and focused policy making to the actions that target structural weaknesses.

## **Should government increase tax rates if overall public expenditures are too high and of inadequate quality?**

Year 2012 didn't bring major changes in the structure of public revenues. The most important taxes were left unchanged, despite the increasing need for financing, as debt servicing (interest plus principal) had increased by more than 50% in 2012 compared to 2011. The size of government as measured by overall revenue stands close to 47% of gross domestic product and further increase in taxes would hardly be justified. Excises on tobacco have been increased, following the need to reduce discrepancy between tobacco taxation in Europe and potential candidate countries in a smooth manner.

The key challenge with respect to the taxation policy in BiH is related to labour taxation, including mandatory social contributions, given that unemployment at almost 28% (labour force survey definition) is exceptionally high. In that respect, year 2012 didn't bring any improvement in the incentives for increasing labour force participation and reducing grey economy. Pension and health funds remain under fiscal pressure, making social contribution rate reduction impossible without offsetting pension revenue or expenditure measures.

## **Wages in Institution of BiH were reduced by 4.5% and hiring of new employees was frozen.**

Real GDP is projected to have fallen around 0.7% in 2012, after two years of only modest recovery. Fiscal adjustment continued, partly under the IMF supported program. Authorities decreased wages for the employees in the public sector, and commit to refrain from hiring, tackling the long recognized structural weak-



-ness. These measures were needed as public wage bill stands at around 13% of GDP, and wages in public sector are higher than comparable wages in the private sector.

Fiscal cooperation improved and by the end of the year, in early December 2012, budget of the Institutions of BiH, Republika Srpska and Federation BiH Central Government were adopted for year 2013. In addition, fiscal adjustment reflected in the fact that entity budgets are projected to book primary surpluses due to the higher debt servicing, will continue in 2013.

Once politics was removed from budget negotiation process, authorities at different levels started with measures that should ultimately improve the structure of expenditures.

First, the law allowing retirement of the decommissioned soldiers (some as young as at the age of 40!) who took part in the war was annulled at the national level. In spite of several weeks protest by war veterans and demobilized soldiers in front of the government building, and notwithstanding political costs, CoM insisted that privileged pensions must be dealt with in a systematic manner at the entity level. This not only helped to reduce future burden on the budget of Institutions of BiH but also forced preparation of the law on privileged pension that will not jeopardize functioning of the pension system (which operates under PAYG principle.) The Law in Federation BiH is about to be adopted, as precondition for the IMF disbursement.

### Politics against policy

Full picture of the positive developments in 2012, however, can only be understood once political events in 2011 are explained. After October 2010 general elections, CoM was not formed until January 2012 (and confirmed in Parliament in February 2012). Budget for 2011 was not adopted and Institutions of Bosnia and Herzegovina had to operate for the whole 2011 on temporary financing. Once the CoM was formed, the two budgets of Institutions of BiH entered into force, namely for 2011 at the level of execution, in January February 2012, and for 2012 in May 2012. During the political blockage of the adoption of the 2011 budget of the Institutions of BiH, different interpretations of the legal mechanisms for foreign debt servicing led to a bizarre situation that, in spite of the fact that two entities from whose revenues debt is serviced provided enough funds, CBBH couldn't make the transfer to creditors because of Minister of Finance reluctance to sign the payment order. This damaged country's reputation, although subsequent actions by government, including through the changes in legislation, minimized the incident (see Moody's report, July 2012).

Fiscal federalism in BiH is very simple to explain: more than 80% of the total tax revenues come from the indirect taxes. Indirect tax revenues are collected centrally to the single account, from which the Institutions of BiH have the first drawing right, in the amount adopted in the annual budget for Institutions of BiH. The remaining is shared by Brcko District (fix share of 3.55%) and the entities



based on the registered consumption on their territory. Funds for servicing foreign debt obligations are automatically earmarked at the single account, before disbursement to the entities. Neither Institutions of BiH nor Brcko District participates in the risk stemming from fluctuation in indirect tax collection. Essentially, it is zero sum game with entities taking the burden of fall in revenue as well as taking the increase in indirect tax revenues booked in their territory. Direct taxes as well as social contributions, policy decisions and revenue collection, are under the control of subnational governments. Roughly, Institutions of BiH budget gets between 13-15% of total indirect taxes, whereas, total expenditures at the state level are around 8% of total public expenditures. The key spending decisions are made at the entity level.

### **Is coordination better than centralization in terms of securing fiscal sustainability?**

Fiscal and budget policy coordination is done through the Fiscal Council—an intergovernmental body established in 2008 whose voting members are the Chairman of the CoM, the Minister of Finance and Treasury of BiH, and the prime minister and minister of finance of each entity. The Governing Board of the Indirect Taxation Authority, whose voting members include state and entities' ministers of finance, makes policy decisions regarding indirect taxes. Fiscal council, according to the Fiscal council law, set up primary fiscal targets.

The essence of political disagreement over 2011 budget was the size of the indirect tax share that should be spent through the budget of Institutions. In the past, Institutions of BiH were regularly taking more from the single account than they could spend, leaving less for the entities who had to borrow to finance mandatory expenditures assigned to them. Once realistic revenue figure for the budget of Institutions of BiH was agreed at the Fiscal council, the budget adoption at the Parliament was secured.

When looked from a non-political point of view, the budget of Institutions of BiH is mostly used to fund foreign affairs, defence spending, and indirect tax authority—exclusive competencies that are assigned at the national level. A majority of functions of government and public expenditures (police, education, social spending, subsidies, judicial system etc.) are therefore assigned to subnational governments. The ideology of state building, partly supported by a still strong presence of international community in BiH, insisted that the more money will be allocated at the state level—the level of Institutions of BiH, the stronger the BiH will be. This approach follows the logic “functions would follow funds”, which is non-implementable since at least one subnational government, with de facto veto mechanism in the BiH Parliamentary assembly, is strongly opposing it.



### Beauty of federalism: can't err fast

Reasonably low level of direct tax rates (10%) and the fact that single VAT rate of 17% was left unchanged since its introduction in 2006 are direct consequence of the fiscal architecture and decision making process with several actors. Faced with lower economic activity Republika Srpska government introduced changes to the corporate income tax, exempting the interest paid to loans for financing assets, machinery and buildings used for production. Similarly, Federation BiH Corporate income tax law envisages tax exemption of the corporate income tax if the company exports 30% of its sales. If, despite those decisions, BiH scores poorly on different indexes that measure quality of institutions, and private sector associations frequently complain on the high cost and expensive tax compliance, this is imputable to the poor quality of the bureaucratic apparatus, not to poor policy choice or inadequate fiscal architecture.

There are implicit checks and balances between subnational governments (entities and Brcko District) with respect to the potential attempts to increase direct taxes. Indeed, the entity government that would try to increase direct taxes would look bad in comparison to the entity that leaves its rates unchanged. That would create incentives for businesses to register in the lower tax jurisdiction. Although tax system sometimes may seem overly complicated, or may be presented in such a manner by those who would prefer more centralized organization of the country, it did not trigger any irresponsible behaviour during the crisis. As explained, during 2012 governments opted to remove the most obvious weaknesses in the structure of expenditures.

### Are existing fiscal rules sufficient?

The uncertainty with respect to economic recovery in a wider regional context, a possible fall in revenues, or the arrangement with the IMF going off track, may trigger different policy behaviour, namely, re-examination of the spending side measures.

Since major spending decisions are made at the entity level, as well as debt servicing, it is worth mentioning here what existing fiscal rules are. In Republika Srpska, there is a total consolidated debt limit of 60% of GDP. In addition, short term debt is limited at 8% of the consolidated revenues from previous year, whereas guarantees (exposure) are limited at 15% of GDP in given year. Local units (municipalities) may contract additional debt, if and only if future repayments are not exceeding 18% of revenues from the previous fiscal year. Short term debt of local units can't exceed 5% of total revenues from the previous year whereas guarantees are limited to 30% of previous year revenues.

In Federation, there is a similar rule fixing a maximum of debt servicing at 18% of previous year revenue, consolidated for Federation Central Government and Cantonal governments. Cantons and local government can borrow if the debt servicing in future period doesn't exceed 10% of the revenues collected in the previous year.



### EU accession, or plan B?

BiH, still without formal application submission, lags behind neighbouring countries in the EU accession process. Resolution of the major political issue is still uncertain: implementing the decision of the European Court of Human rights that requires removing the obstacles for citizens which do not declare themselves as members of one of three major nationalities (Bosniaks, Croats, Serbs) to be elected in Presidency. The social and political consensus necessary to find a solution to suppress the discrimination is missing. In the meantime, it is said that corruption in public tenders takes away almost 800 millions KM annually, or more than 80% of the size of the budget of Institutions of BiH! (see more details on [www.tender.ba](http://www.tender.ba)) Assuming this information even only half correct, who could still argue for more taxation when the public sector is so much abused for private interests?

EU accession process could help to establish rule of law, but plan B, prolonged non-accession, should not be ruled out. In any case, although growth is expected to return to positive territory in 2013, the need for further reductions in public expenditures will be present in years to come.





## General assessment

2012 was rather good fiscal year for Bulgaria – while the economy is still underperforming, tax revenues almost fully recovered to their pre-crisis (2008) record high levels and the budget position was close to balanced, with deficit being far less than 1% for 2012. There were no big moves in tax policy, except for the introduction of 10% tax on interest payments from bank deposits – thus widening the base of the flat tax.

2013 already proved to be a challenging year for Bulgaria, with protests throughout the country and a caretaker government being appointed by the president. The social unrest in Bulgaria was fundamentally driven by the depressed labour market and the high electricity bills in the winter. While there are serious challenges ahead and a political uncertainty prior to the elections, one should note that there is no “fiscal fire” in Bulgaria. There are of course long term fiscal challenges – pressure of social systems (pensions, health), low fiscal reserve, the quality of public spending – but there are no immediate pitfalls that should be addressed in an urgent manner.

## Fiscal Policy & Economic Recovery

Bulgarian economy is still struggling to recover from the crisis. While there is some anemic growth in the recent years, the labour market is still depressed – the bottom of the employment rate was hit late in 2012 and is one of the lowest in Europe (12.3% unemployment). The budget consolidated gradually, with revenues from taxes on consumption, traditionally dominating the budget, catching up in 2011-2012. Revenues from corporate taxation are still heavily depressed, meaning that the economy cannot generate profits, while the income taxation proved to be resilient to the economic downturn and the revenues stayed stable in the bad years and even increased a bit.

Bulgaria has faced budget deficits in four consecutive years (2009 – 2012) to the total amount of around BGN 5,4 billion (€ 2,7 billion) – with excessive deficits in 2009 and 2010. Those budget shortfalls were mainly financed from the fiscal reserve of the country allowing the public debt to stay relatively stable below 20% of GDP. Consequently, the fiscal reserve, mainly accumulated from budget surpluses prior to the crisis, is now down from more than BGN 10 billion (€ 5 billion) in 2008 to less than BGN 5 billion (€ 2.5 billion) in 2012, which puts it to the so-called “critical minimum”. Furthermore, most of these reserves can't be used to cover budget shortfalls as they are part of separate funds with special purposes – for instance, almost BGN 2 billion (€ 1 billion) from the fiscal reserve



are part of the pension “Silver Fund”, which shall be used (as written in the law) to cover future pension obligations and not current budget deficits. As the fiscal reserve is being used as a buffer throughout the year to finance immediate shortfalls in the budget – like payments in the beginning of each month prior to the actual revenues being collected – the lack of enough “free” financial resources in the fiscal reserve is a matter for concern.

The political crisis in the beginning of 2013 was not directly caused by fiscal policy and is not imposing any immediate threat to the financial stability of the country. The crisis was fueled by the lack of jobs and the higher electricity bills, which is quite a different story from the other European countries that experienced social tension, mainly due to fiscal policy and the so called “austerity”. While in other countries there was a need for a quick solutions to the political uncertainty, as immediate fiscal measures were to be adopted, **in Bulgaria there is no “fiscal fire”**, thus the caretaker government, which cannot vote any legislative texts, is perfectly capable of carrying out the budget as voted by the Parliament and keeping the sound fiscal position.

### Direct Taxation (Corporate Tax & Income Tax)

Bulgaria has probably the lowest level of direct taxation (excluding social contributions) in EU with 10% flat tax for both corporate profits (introduced in 2007 – down from 15%) and income (introduced in 2008 – down from progressive scale in the range 20-24%). Moreover, the 10% flat tax on income in Bulgaria has no minimum non-taxed threshold, meaning that every lev (or euro) earned as a salary is being taxed at the same rate of 10%. Recently the flat tax is being debated, mainly due to the elections coming in 2013, but mostly regarding the income taxation and not so much the corporate tax.

When discussing direct taxation in Bulgaria, one should always note that most of the tax revenues in the country come from indirect taxation – that is VAT and excise duties, while the direct taxes are far from dominant. The main reason for that is the fact that Bulgaria is still a developing country, meaning that there is not enough capital or wealth to tax – the only way to fill up the budget is through taxation of consumption. Moreover, there is low employment and significant undeclared work, meaning that revenues from income taxation are in a way limited – that also explains the problems with social security contributions and the huge deficits in the pension system.

The revenues from direct taxation on income and profits are performing differently during the crisis. While revenues from taxing profits are still depressed, revenues from taxation of income proved to be the only tax that performed well during the crisis – they have risen even in the period of recession. The revenues from taxes on income are projected to reach BGN 2,5 billion (€ 1,25 billion), which is more than 3% of GDP, thus highest since the introduction of the flat tax. **The 10% flat tax on income is performing well since it was introduced**, meaning that the recent debate is driven mainly by social and ideological factors – even if it is not a dominant issue for the budget revenues, the flat tax is far more debated than the taxes on consumption for instance.





At the end of 2012 one of the main tax issues in Bulgaria was the proposal for introducing a 10% tax on interest payments from bank deposits – in practice widening the base for the flat tax. The arguments were mainly balancing between the effects for the budget – more revenues — and the implications for the banking sector – probably discouraging savings to some extent. At the end of the day the proposition was adopted and since the beginning of 2013 the new tax on interest payments is in place. The first few months of the year show that there is no serious impact on savings, but also, that the revenues for the budget are not significant. There is some talk against the new tax within the election debate, but most probably the tax will stay – fiscal authorities in Bulgaria have proven that a new source for revenues is not easily given away.

### Indirect Taxation (VAT & Excise Duties)

Indirect taxes include VAT and excise duties on special goods such as fuels, cigarettes and alcohol beverages. Bulgarian tax regime is mainly oriented towards indirect taxation, meaning that the State prefers to tax consumption, rather than income and profits. To put that into perspective, **revenues from income and corporate taxation combined are slightly less than those from excise duties only** and almost twice less than those from VAT.

VAT in Bulgaria is set at 20% and despite the various discussions that took place in the recent years it is supposed to stay at that level for the years to come. Revenues from VAT are expected to recover and to reach almost BGN 8 billion (€ 4 billion) or close to 10% of GDP in 2013. This is above their record high 2008 level, meaning that revenues from taxing consumption are fully recovered. Some changes in the preferential VAT for tourism were introduced in April 2011 – a single reduced VAT rate of 9% now apply to hotel accommodation services regardless of whether they are a part of a tourist package or bought individually. Before that the preferential rate was 7%, applying only to tourist package services. While the rate was increased by 2 percentage points, the preference was in effect widen for more services (individual tourists included) – the data shows that the budget is losing more money from the new regime, as the tax base of the preferential VAT rate increased substantially.

Meanwhile, Bulgaria has to harmonize its tax regime with that of the European Union by introducing the minimum excise duties of the European Community on tobacco, alcoholic beverages, and fuels. Started in 2002, the harmonization process should be completed by the end of 2013. As a result, excise duties are the only taxes that are continuously increasing year after year generating some clearly negative effects. One example is the increased excise duties on cigarettes in 2010, which resulted in a collapse of the (official) consumption, while smuggling went up. Excise duties on motor fuels are also proving to be problematic, as the prices are increasing and EU obligations are seen as a burden to consumers. Nevertheless, excise duties are highly important for the budget, as the revenues are expected to reach above BGN 4 billion (€ 2 billion), which is more than 5% of GDP.



Additionally a new indirect tax was recently (2011) introduced in Bulgaria – a 2% tax is due on insurance premiums for insurance contracts covering risks on the territory of Bulgaria. The tax is to be collected by insurance companies but it is practically a burden for the insured – nevertheless the revenues are limited at around BGN 30 million (€ 15 million).

### Social Security Contributions

Social security (including health) contributions are traditionally highly disputable in Bulgaria. In 2005 the contributions were above 40% of the gross wage, but following some consecutive cuts (mainly pension and unemployment contributions) prior to the crisis they went down to around 30% of gross wage. Since then, they stayed relatively stable (slightly up and down) and in 2013 the social contributions will be at around 31% of the gross wage, paid by both the employer and the employee in a certain ratio (as shown in the table). In addition, the contribution base was capped in the last years at BGN 2000 (€ 1000) monthly and any income above that level was not subject to any obligatory social security contributions. However, in 2013 the bar was put higher at BGN 2200 (€ 1100), meaning that **those with higher income will pay the same obligatory social insurance rates, but at a higher base** (up with 10%). The official data shows that around 100 thousand people will be subject to the higher cap – these are around 3-4% of the workers in the country.

In the last few years the so-called minimum social security thresholds for the main economic activities and professions were increased several times – regardless of the big drop in employment after 2009. These thresholds are being used as a minimum tax base for social security contributions and are playing important role in Bulgarian tax policy – official data shows that 1 out of every 4 workers is insured on administratively levied minimum thresholds. There are strong indications that this policy is hurting job creation, especially in less developed regions in the country.



## Social Security Contributions in Bulgaria

### (% of gross wage, capped at BGN 2200)

Social Contributions (2013)		State Fund		Private Fund	
		Employer	Employee	Employer	Employee
Pension	17.80%	7.10%	5.70%	2.80%	2.20%
Illness & Maternity	3.50%	2.10%	1.40%	X	X
Unemployment	1.00%	0.60%	0.40%	X	X
Labour Accidents & Professional Illness*	0.50%	0.50%	0.00%	X	X
Health	8.00%	4.80%	3.20%	X	X
Overall	30.80%	15.10%	10.70%	2.80%	2.20%

(\*) The rate for Labour Accidents and Professional Illness is averaged – there are several rates depending on the labour category – varying from 0.4 to 1.1 percent

From 2009 on, along with social contributions paid by the employee and the employer (as in most European countries), the State itself started to pay social (pension) contributions for every worker – 12% of the gross wage. Those “new” State contributions, however, are more of an accountant's trick than a real reform. Actually, the State had always made payments from the budget to the Pension Fund – the difference is that those payments used be called transfers (or subsidies) and are now called contributions. More importantly, even with these “State contributions”, the state pension fund is far from balanced and needs further government subsidies (transfers) to cover the deficits. The data shows that **the sole pensions contributions** – by employers, employees and self-employed – **are not sufficient to cover even half of all the pension payments**.

In recent years the crisis put additional pressure on the pension system, which resulted in a long-term pension reform drafted at the end of 2010, but by being too soft and inadequate, amended in 2011. One the most debated measures in the plan is the increase of the retirement age starting from the beginning of 2012 – by 4 months a year until it reaches 65 for men (63 before the amendments) and 63 for women (60 before the amendments). While the “official” retirement age is being increased, there are still challenges concerning the so-called early retirement – **the effective retirement age in Bulgaria is actually less than 60**, because of the wide opportunities for early retirement.

One of the most heated controversies in the crisis years has been the partial nationalization of the private professional pension funds (2010) – those are actually early retirement accounts in private funds. Around BGN 100 million (€ 50



million) were transferred from the private funds to the State fund, with the idea to support the early retirement obligations for the next 3-4 years. Nevertheless, in 2011 the Constitutional Court ruled this as unconstitutional and the argumentation was astonishingly strong in favour of the personal accounts and against any right for a politician to make such decisions.

The recent years have seen the healthcare system in Bulgaria hit by a deep crisis; with ministers being replaced every year or two. The state of the system is still best describe as chaos – bad organization and artificial pricing, inefficient spending, perverse incentives and fraud, not to mention the absence of agreement on an expected reform. The health contributions are still at 8% of gross wage, which now go entirely and directly into the system. The so called “health reserve”, which used to be held at the Bulgarian National Bank (around BGN 1.5 billion or € 750 million) is no longer available, as it was “transformed” at the end of 2010 and actually used to cover budget deficits. Whether the health contributions should be split in some way and partly directed towards a chosen private health fund is still the object of debates. While accepted as one the biggest challenges in Bulgaria, the healthcare system is not at the centre of the election debate.

Further changes in the social security contributions are to be expected in the forthcoming years – not so much because of the election debate, but mainly because of the growing pressure for the budget. The long-term plan for pension reform is in place, but subject to minor or major changes – as we saw with retirement age in late 2011. The healthcare system has proven to be highly vulnerable in the recent years and it is expected to remain so in the years to come.

## Conclusions

Fiscal policy in Bulgaria proved to be rather resilient in the recent years. The excessive budget deficits in 2009 and 2010 were overcome with no serious tax hikes – 10% flat tax on income and profits, and 20% VAT are still in place. Excise duties are going up, due to the EU policy, which has some negative implications and is **driving a strong opposition against any attempts for tax harmonization within the EU**. The political uncertainty in the country was not driven by fiscal policy and while there is a caretaker government in place with no legislative powers, there is no “fiscal fire” and the budget shall be conducted as written in the law – with deficit of around 1% of GDP. There are strong fiscal rules in place and the election debate shows that these rules are generally supported by most of the political parties. The biggest challenge is not so much the fiscal policy, but the anaemic economic growth and the depressed labour market. The social systems (pensions, healthcare) will be the long-term challenges and a more policy measures are to be expected in the years to come.



## Abstract

On July 01 2013, Croatia will become 28th member of the European Union, but the timing could be better both in the EU and in Croatia. Negative growth continued for the fourth consecutive year: in 2012 real gdp has shrink by 1.8%. Government applied fiscal devaluation type measures during 2012-increased general VAT rate by 2 percentage points to 25% and reduced social contributions to the health insurance fund from 15% to 13%- that did result in overall increased revenue collection and lower deficit compared to 2011. Nevertheless, public debt to gdp increased by 6.4 percentage points, to 53.1% of gdp, partly also because government overtook the debt of the shipyards (2.8% of gdp). Looking ahead, it appears that fine tuning of the tax system measures can't be used as substitution for bold structural reforms and further reduction in the current expenditures, yet to be specified.

## Are there limits to VAT rate increase?

Despite several changes in rates and base of major taxes in previous years, the structure of the revenue side of the Croatian public finances has been relatively stable over past years: tax revenue collection amounted to approximately 22% of gdp, social sector contributions 12% of gdp and other revenues around 4% of gdp. With respect to the structure of the tax revenue, VAT provides near 55% of the whole revenue (see Table1).

**Table 1: Structure of Tax Revenue in Croatia, 2011, 2012 (in 000 of kunas)**

			2011 % in	2012 % in	2011	2012
Tax	2011	2012*	tax revenue	tax revenue	% in gdp	% in gdp
Personal Income tax	9,272,770	9,876,169	13.20	13.32	2.78	2.95
Profit tax	7,288,030	7,697,342	10.38	10.39	2.18	2.30
Property tax	886,046	802,663	1.26	1.08	0.27	0.24
VAT	37,718,154	40,652,023	53.71	54.85	11.29	12.14
Sales tax	181,077	182,220	0.26	0.25	0.05	0.05
Excises	11,215,054	11,206,489	15.97	15.12	3.36	3.35
Taxes on international trade	1,766,356	1,754,364	2.52	2.37	0.53	0.52
Other	1,900,557	1,946,486	2.71	2.63	0.57	0.58
Total tax revenue	70,228,042	74,117,755	100	100	21.03	22.14

Source: Ministry of Finance of Croatia and own calculations \*2012 data are projections



The most important measure taken in 2012 was to increase the general VAT rate from 23% to 25%, beginning March 01 2012. Further changes in VAT system, motivated by the EU accession, have started at the beginning of 2013, namely abolishment of 0% rate -for bread, milk, scientific magazines, and certain medical supplies. These products will be taxed at 5%, in line with lowest possible rate for new member states under EU rules. In addition, since beginning of 2013 services in tourism will be taxed at the rate of 10%. These different changes make judgment on the future VAT revenues difficult. As a reminder, in 2009 general VAT rate was increased from 22% to 23%.

Second major change was related to the decrease in health fund contribution rate by 2 percentage points, from 15% to 13%. Furthermore, under personal income tax changes, personal exemption was increased from 1800 to 2200 kunas (1 EURO =7.5 HRK, from approximately € 240 to € 293), measure expected to benefit low wage workers. However, in order to increase labor force participation, government would likely need to consider further reduction of the rate of social contributions.

In addition, 12% tax rate on dividends and profits distribution was also introduced, whereas reinvested profits reduce taxable base.

Preliminary data suggest that consolidated revenues in 2012 have been higher by 2.2% compared to the previous year (Informacija o gospodarskim kretanjima, Hrvatska Narodna banka, april 2013).

### **From taxation of labor to taxation of property**

Debate on new Property tax law, a subject long present in the public, continued during 2012. Faced with the need to reduce the deficit, government was working on a draft Property tax law that would increase burden on the property owners. While uncertainty about final draft version of the Law clouded public discussion, general public as well as leading experts in the country opposed the law questioning whether the necessary precondition for its enforcement existed or whether expected outcome would actually be realized (Institut za Javne Finansije, Newsletter no 66). Nevertheless, the unintended consequences of this government activity – searching for additional revenue sources – contributed to raising public awareness of the expensive public sector. The Government reasoning behind the promotion of a tax on property is easy to grasp and lies behind other measures implemented: social contributions, which are essentially burden on legal labor contribute around 12% of gdp to the consolidated revenues whereas tax on property contributes around 0.25% (see Table 1). If revenues from taxing property would be higher, there would be a space to reduce burden on labor. The Minister of Finance publicly stated that reduction on health contribution could go from 13% to 7% if property tax law reform is successful. At the end of the year, the government presented a draft law proposing a rate of 1.5%, tax base to be 70% of the value of property, envisaging plenty of exemptions (depending on whether the property is used for permanent residency



only occasionally, etc). Different views among coalition partners delayed adoption of the law for the moment, but the issue is expected to come back on the agenda.

### **Strengthening Fiscal discipline could also help**

Apart from changes in the tax system, there were several important steps in strengthening the fiscal discipline. One that was well received in public certainly was publishing of the list of persons that owed taxes. Second, not that well received because of increasing costs of business, was adoption of The Cash Transactions Fiscalization Act in November 2012. This law targets grey economy and requires introduction of the specific IT system that registers cash transactions through the communication system centrally. The law is enforced since January 01 2013, and apparently, registered turnover in restaurants, and hotels, the group covered in the first stage of fiscalization did increase in comparison to the previous year. Fiscalization will be mandatory for all business subjects as of July 01 2013. If successful, it will contribute to level playing field between business who operate in full compliance with the positive legislation and those in the grey area.

### **Fiscal consolidation on expenditure side continued in 2012, in spite of negative growth.**

Apart from the tax measures described above, resulting in revenues around 0.6% of GDP, the 2012 budget envisaged also a reduction in public wages and of subsidies and social benefits for an amount of 0.6% of GDP (IMF Country paper 2012, page 5). Overall, revenues were higher by 2,4 billion kunas, whereas expenses were lower by 2.3 billion kunas, contributing to the overall reduction of the headline deficit from 5.4% of GDP in 2011 to 3.9% of GDP in 2012.

The consolidation booked in 2012 was in line with fiscal rules envisaged in the Fiscal responsibility law adopted in 2010. The rule states that total expenditures of general government will be reduced by 1 percentage point each year, until the primary balance of the general government reaches either zero or switches into the surplus territory.

Government has also initiated an all encompassing project "Clean Start" with a view to take stock of situation in government bodies and prepare analyses that can be used to improve the efficiency in public management. Although the project could have been seen as blaming the previous government for current economic and fiscal problems, it helped portrait a better picture not only of the arrears found in different agencies. Findings could be used for substantial overhaul of the public sector's management. (More details on Clean start project available in Anto Bajo, Institut za javne finansije, Aktualni osvrt, br 46 available at <http://www.ijf.hr/upload/files/file/osvrti/46.pdf> )



### **Public debt increase: reason to concern or business as usual?**

Sustainability of public debt can be secured if and only if economy grows at higher rates than the rates at which country is borrowing. Recently, Croatia issued 10 year bond at yield of 5.625%. While EU accession offers new opportunities over the long run, in the short term companies from Croatia may lose some benefits of the membership in the CEFTA (Central European Free Trade Association): specifically, goods made in Croatia will not be import duties exempt in Albania, Bosnia and Herzegovina, Serbia, Macedonia, Montenegro, Moldova, Kosovo. This could cause some problems to the companies that are still unable to compete on the European market that will lose privileged position in CEFTA market. It is not ruled out that some of these companies actually decide to relocate production altogether in neighboring CEFTA member countries. Creativity of the government to enhance, and revitalize growth will be tested, particularly in light of the rapid increase in public debt since the onset of the crisis, from 32% in 2007 to 53.1% in 2012. The fact that public indebtedness was increased by 6.4 percentage points from 2011 to 2012, as well as the fact that tax increase measures have already been relied upon extensively in the past, signals that more bold actions on reducing expenditure side of the budget are awaiting. According to preliminary data, payments for interest amounted to close to 7% in total expenditures, or almost 5 times money spend for child allowance. This very basic assessment of the fiscal and budget developments therefore suggests that government will have to examine non essential current expenditures, identify those with low relevance, and get ready to reduce them. For the revival of the economy, fiscal consolidation, likely including unpopular measures such as limiting the wage bill in public sector or extending the retirement age, will have to continue in years to come.

### **Bold measures need credible government**

It is much easier to implement unpopular measures if the government is seen as honest and decent. Anecdotal evidence suggests that reducing the abuse of public office, particularly by the high profile politicians and civil servants could help to reduce the overall cost of public service provision. High profile bribery case involving former prime minister attracted a lot of attention during 2012: Mr. Ivo Sanader was sentenced to 10 years in jail by a decision of the court of first instance. Government also embarked upon sensitive territory of publishing register of the citizens who participated in the war, in light of the rumors that some people are receiving social benefits that they did not deserve. Finally, government recently took a firm position on the rights of Serbian minority with respect to the usage of Cyrillic script, defending the rule of law.

These different and not directly related activities may actually be a signal of the better environment for tough decisions that may be needed in time to come.





From the accounting viewpoint, the Czech government is relatively efficient in taming deficits. The chosen strategy for the whole period 2010–2014 is to raise approximately one extra Czech koruna in taxes for every two korunas saved from previously planned expenditures. On the other hand, the latest Convergence Program update reveals that over the period 2013–2015 only 43% of discretionary measures will be carried out on the expenditure side of the budget. It seems that further expenditure cuts will be increasingly difficult and we can expect increasing tax burden in the near future. But still, given that there is no clear consensus about the optimal solution of the interlinked problem of low economic growth, government revenue, expenditure, and debt, the approach of the Czech government seems to be relatively appropriate.

## State budget performance in 2012

The major problem of the state budget was, as in 2011, overoptimistic growth expectations for 2012 at the time the budget has been drafted. But unlike in 2011 when the real GDP growth has been just 0.5 percentage points below its predicted value, the economy has been expected to start to recover from the slump and increase its product by 2.5% in 2012. Unfortunately, due to a sizable drop in both foreign demand and domestic consumption, the reality turned out to be completely different. According to the latest data, the Czech real GDP actually decreased by 1% in 2012. Also the unemployment rate has been higher than predicted. It is, therefore, not surprising that the tax revenue fell short of expectations. From the budgeted amount of tax revenues only 96.5% was realized which is consistent with lower economic growth.

But taking a better look at the composition of tax revenues reveals some puzzling numbers. In 2011 the growth of the Czech economy was only 0.5 percentage points below expected, whereas in 2012 the difference between prediction, upon which the state budget was built, and reality was enormous – 3.5 percentage points. But still, realized tax revenues in 2012 constituted larger proportion of the budget than in previous year (94.6%). Moreover, realized revenue from personal and corporate income tax exceeded the budgeted amounts! Another odd figure is the year-on-year development in realized tax revenues. With the sole exception of property tax, all sources of tax revenue showed an increase even though the gross domestic product of the Czech Republic decreased in absolute terms in 2012. It is no surprise for the VAT because the reduced VAT rate has been increased from 10% to 14% in 2012. But other than that the source of increase is very unclear.



Development of government expenditure has been very similar – realized expenditure has also been lower than originally budgeted. These results follow the trend from the previous year and further strengthen doubts about quality and significance of predictions produced by the Ministry of Finance. Either they do not trust their own macroeconomic predictions and use internally other numbers than they release to the public, or their models are simply wrong. Regardless of the reason, the findings seriously harm transparency of public finances.

From the accounting viewpoint, the Czech government is relatively efficient in taming the deficits. We do not necessarily have to agree with the mix of expenditure and revenue measures, but we have to appreciate that the government expenditure in 2012 were in absolute terms slightly lower than the year before (by CZK 2 billion, € 80 million). And, moreover, it is the second year in a row of decreasing expenditure, even though the decrease is rather small.

### Long-awaited pension reform launch

One of the important changes taking place in 2013 is the launch of pension reform. From the beginning of 2013, the existing system has been extended by creation of a new pillar to support saving for old age. Now the pension system comprises of three pillars. Mandatory pension insurance (1<sup>st</sup> pillar), pension savings (the new 2<sup>nd</sup> pillar), and supplementary pension savings (3<sup>rd</sup> pillar), which has replaced the previously existing supplementary pension insurance pillar. Pension savings in the 2<sup>nd</sup> pillar are optional but participants who opt in must remain in it until they become entitled to receive the old-age pension. Participants in this new pillar will contribute 5% of their gross income and their payments to the mandatory pension insurance pillar will be reduced by 3%. Participants will therefore pay 3.5% of their gross income to the 1<sup>st</sup> pillar and 5% to the 2<sup>nd</sup>. Those who won't participate in the new pension savings scheme will continue to pay 6.5% of their gross income to the mandatory pillar.

After fulfilling conditions for becoming entitled to receive the pension, participants in the 2<sup>nd</sup> pillar will have their entire pension savings transferred as a single premium to an insurance company responsible for paying out the pension. Then they will have the possibility to select one of three options. First is a 20-year annuity with even monthly payments. In case the participant dies within this 20-year period, the heirs will receive the remaining funds as a one-off payment. Second option is annuity until the death of the participant, without any inheritance. And third option is again annuity until the death but with a supplemental three-year survivor pension.

But what happens if a participant in the savings pillar dies before even reaching retirement age? If the heirs are also participants in the 2<sup>nd</sup> pillar, accumulated funds will be transferred to their pension savings accounts. If they are not, the inherited funds will be paid out to them in cash. Minors will receive the money in the form of an orphan's pension over five years.



Individuals have to decide whether to opt in to this new savings pillar at the age of 35. Those who were already above 35 in 2013, had to make their choice by the end of June 2013. After that deadline, they cannot choose to participate in the savings scheme and will remain in the mandatory 1<sup>st</sup> pillar. The 3<sup>rd</sup> pillar will more or less stay the same as before, only non-negative yield will no longer be guaranteed for participants in supplementary pension savings but there will be a choice of a conservative, balanced, or dynamic investment strategy. Also, unlike the previously existing supplementary pension insurance, supplementary pension savings will not allow for payout before reaching the retirement age.

### **Employment contracts with sole proprietors and investment incentives**

During 2012 the Supreme Administrative Court repeatedly dealt with the problem of firms using contracts with sole proprietors (business entities owned and run by one individual in which there is no legal distinction between the owner and the business) instead of employing the workers in the usual way. This way of providing labor is called the “Švarc system” in Czech and was named after Czech businessman Miroslav Švarc who started to use this kind of arrangement during the 90s. An “employer” of an individual working in the “Švarc system” doesn't have to pay the part of social security which is, in the case of a normal labor contract, payable by the employer. Also health insurance is only optional in this case and both “employer” and “employee” in the “Švarc system” can lower their taxable income by subtracting some of their expenses.

As a consequence, this arrangement is generally perceived as a tool of tax evasion and was de facto illegal until 2006, when the new Labor code has been adopted. From 1 January 2012 the performance of dependent work by an individual outside employment arrangement is again regarded as illegal work. But the question of legality of the “Švarc system” per se is not the crucial one. The core of the majority of disputes lies in the definition of such “dependent work”. For instance, the Supreme Administrative Court ruled that providing services such as crane operation, welding, assembly and similar work over a long term and on a continuous basis cannot be based on a commercial law relationship, but has to be reclassified as a labor law employer–employee relationship.

But in another case, a similar contract between a self-employed professional sportsman and his sports club has been found unproblematic even though a sportsman has to follow the instructions of the club in almost the same way as a crane operator does. It seems that the rules are still very opaque and that the circumstances of each particular case have to be considered. The problem is that such unclear rules, of course, open door to tax optimization and related corruption.

Also in 2012 an amendment to the Investment Incentive Act has been adopted which introduces several changes to investment support through the CzechInvest organization. The main focus was on making the Czech investment



environment more attractive for investors. Among the main changes for manufacturing industry were: extension of corporate income tax relief from five to ten years; lower requirement of machinery proportion in the investment (50% instead of previously required 60%); better conditions for investments in regions with high unemployment or other disadvantages; and the minimum investment in building a new plant or extending an already existing one has been reduced from CZK 100 million (€ 4 million) to CZK 50 million (€ 2 million) for disadvantaged regions.

### Proposed solutions to the state budget imbalances

In order to further reduce public finance deficit and follow the path set in the previous years that aimed at pushing the deficit below 3% of GDP in 2013, additional measures had to be adopted. Already during the beginning of 2012, the Czech minister of finance started to prepare a new austerity package of tax increases and budgetary savings. Key proposals were to

- increase personal income tax (PIT) rate by one percentage point to 16% and introduce a second tax bracket with the rate of 31% for incomes above four times the average wage;
- reduce the lump-sum expense deductions for self-employed individuals;
- increase the common VAT rate, which was at that time supposed to be set to 17.5% from 2013, to 19 or 20% with an exception of a couple of items, or, alternatively, maintain two rates but increase both of them by one percentage point to 15 and 21%;
- introduce a new carbon tax;
- implement an excise tax on wine;
- double the electricity tax;
- abolish the excise tax exemption for natural gas for households, and for mineral oils used in agriculture (so-called “green diesel”);
- cancel the childbirth benefit and the poverty threshold housing benefit;
- temporarily freeze pensions;
- increase real estate transfer tax from 3% to 5% and/or real estate tax;
- increase the minimum assessment base for social security premiums of self-employed individuals from 25% to 50%.

After debates in the government, following measures were submitted to the Chamber of Deputies in May 2012:

- New limits on lump-sum expense deductions for PIT;
- increase in withholding tax on passive income (dividends, interest, royalties) vis-à-vis tax havens from 15% to 35%;
- restriction of the excise tax exemption for “green diesel” in 2013 and its abolition in 2014;
- increase of the real estate transfer tax from 3% to 4%;
- unification of social security housing benefits.



Moreover, following temporary measures effective only for the period 2013-2015 were submitted to the Chamber of Deputies as well:

- A 7% “solidarity increase” of PIT on income exceeding 48-times the average wage;
- abolition of the basic PIT allowance for pensioners, which was until 2013 available for all tax payers (in the amount of CZK 24,800 (approx. € 970) per year);
- increase of the VAT rates by 1 pp to 15% and 21%;
- cancellation of the cap on public health insurance premiums (was set at 72-times the average wage).

With the sole exception of the social security housing benefits unification, all measures submitted to the Chamber of Deputies in May 2012 were in the end adopted and approved by the president. The set of revenue-side measures has been accompanied by expenditure measures as well. In total, the austerity measures were supposed to cut government spending by CZK 100 billion (€ 4 billion) and increase tax revenue by CZK 37 billion (€ 1.4 billion) in 2012 against the long-term budgetary plan. For 2013 the austerity plan was CZK 96 billion (€ 3.8 billion) on the expenditure side and CZK 47 billion (€ 1.8 billion) on revenue side, and for 2014 CZK 115 billion (€ 4.6 billion) and CZK 76 billion (€ 3 billion). At the beginning of 2013, the Czech National Bank estimated the 2012 government deficit at 4.9% of GDP, and expected it to decrease to 2.7% of GDP in 2013 and 2.5% of GDP in 2014. The structural part of the deficit, according to the European System of Central Banks methodology, went from 3.4% of GDP in 2011 to 2.9% of GDP in 2012 and is expected to further decrease to 1.6 and 1.4% of GDP in the upcoming years.

### **In place of a conclusion: what does the theory suggest?**

Is the chosen strategy of balancing the budget a correct one? Numerous researchers recently tried to analyze whether cutting government spending in the current situation leads to positive or negative economic consequences both in short and longer run. Lawrence H. Summers and J. Bradford DeLong argue in a paper presented at the Spring 2012 Brookings Institution Panel on Economic Activity that as long as the government's real long-term money-borrowing cost is under 5%, short-term spending cuts in fact worsen the long-run fiscal picture. The authors think that in the current situation the governments should focus on plans and programs for long-run fiscal balance and structural reforms improving business environment. In their opinion, balancing the budget during an economic downturn caused mainly by pessimistic expectations is not an ideal strategy.

Pontus Rendahl in his 2012 article “Fiscal Policy in an Unemployment Crisis” draws a similar conclusion from a theoretical model: Expansion of public spending may replace pessimism about the future with optimism. Whereas the impact of government spending on total output is mostly negative during normal



times, because of the crowding-out effect of government money, in recessions the fiscal multiplier may be positive and rather high.

However, when increasing spending, the government has to either increase tax revenue, or let the deficits rise. Now, there is a vast literature on the negative consequences of public debt on economic growth. But as e.g. Panizza and Presbitero in their 2012 article "Public Debt and Economic Growth: Is There a Causal Effect?" point out, negative correlation, which is usually found, doesn't need to imply causal link from debt to growth. And while many authors, including Panizza and Presbitero, are trying to prove the existence of such causal link, they have been so far unsuccessful.

Even though there may be no convincing proof that high deficits and debts are harmful, the public tends to perceive them negatively. Therefore, growing government debts can significantly contribute to the overall pessimistic climate. If the government cannot increase its debt but wants to boost the economy by increase in spending, it has to increase the taxes as well. In many situations the governments even already have dire deficit and debt problems. Should they balance the budget by cutting spending, or by increasing revenue? In other words, is it more harmful for the economy when the government cuts spending, increases taxes, or increases debt?

As always, there is no simple answer. But there is a couple of interesting results available in the literature. Alesina et al. (2012) in their article "The Output Effects of Fiscal Consolidations" show that fiscal adjustments that put more weight on revenue growth are recessionary and there is no sign of recovery for three years following the adjustments. On the other hand, countries that cut expenses more than increase taxes either face no consequent recession or they go through a short recession and then the output returns to the pre-adjustment level.

Mertens and Ravn (2011) estimate the impacts of tax changes and decompose them into personal income taxes and corporate income taxes. They find that cuts in average personal income tax stimulate the labor market, private consumption, and investment but lead to a drop in tax revenues. On the other hand, cuts in corporate income taxes instead have little impact on tax revenues but also fail to stimulate the labor market and private sector consumption while they stimulate investment. From their analysis follows that increases in corporate taxes may not generate much tax revenue but will lead to lower investment activity. Increasing personal income taxes may help to generate higher tax revenue, but should be expected to have dire consequences for the economic activity.

Hences, even in the academic sphere there is no clear consensus about the optimal solution of the interlinked problem of low economic growth, government revenue, expenditure, and debt. It is, therefore, no surprise that policy makers also often do not know which avenue to take. Possible solutions to short-term issues as well as long-term problems stayed at the core of political debates during the last year not only in the Czech Republic, but practically all around the world. And as long as nothing unexpected happens, the same topics will stay with us during 2013, too.



## General assessment

Winning the September 2011-election on a promise of higher taxes, the centre-left government made good on election promises in the 2012-budget by increasing taxes by half a percent of total tax revenue. In the spring of 2012 further tax increases followed on cars and energy consumption. Increasingly, however, the tax hikes (implemented and promised) became unpopular with large parts of the population as well as the governments supporters in labour unions; and in the summer of 2012 the government and the right wing opposition agreed on an income tax reform which for the first time in many years actually lowered the overall tax burden. In many ways, the tax reform marked a turning point in the tax debate, and the 2013-budget surprisingly included a cancellation of a number of unpopular taxes.

## What a difference a year makes

As described in last year's report, the newly elected centre-left (minority) government made good on election promises by passing a 2012-budget which increased taxes by some DKK 6 bn. (€ 800 mill.) or equal to half a percent of total tax revenue. This was far less than the "promised" tax increases totalling some DKK 30 bn. (€ 4.0 bn.) describes in the common election manifesto of the Social Democrats and the Socialist People's Party, who make up to thirds of the three-party coalition government. The last coalition partner is the Social-Liberal Party who arguably is the reason why tax increases were so modest compared to the election promises made by leading figures of the then opposition, including now prime minister Ms Helle Thorning-Schmidt. Among taxes promised, but not implemented, were a 6 percent "millionaire tax", which would – again – bring the highest marginal tax on labour income above 60 percent.

Notwithstanding this, the 2012 budget – which was passed with the support of the Red-Green Alliance on the far left – contained a number of tax increases, many of which were afterwards rushed through parliament so that they could take effect from January 2012.

## Further widening of the personal income tax base

Effective from 2012, the value of private health insurance paid by the employer (and deductible as a business expense) is no longer tax-free for the employee. Thus the employee will face a tax of between 40 percent and 56 percent of the insurance premium. Also there are no longer any tax privileges if a company chooses to pay its employees in company shares. Hitherto, if all employees were access to the scheme, up to 10 percent of the salary could be paid in shares. The value of the shares would be fully deductible for the company (as would a normal salary), while the employee – upon selling the shares – would only be subject to





the tax that applies to the profit from shares (at most 42 percent depending on the total income from shares that year). This compared with a top marginal tax on wage income of 56.1 percent. As of 2012, shares given to employees as part of their salary is taxed as regular labour income at the moment the employees acquire the shares (so if it is a right to buy shares, not until they exercise this right).

Also, the government and the Red-Green Alliance agreed on a tightening of the tax privileges related to private pension schemes. Firstly, the yearly tax on the return on private pension schemes was raised from 15 percent to 15.3 percent. Secondly, the maximum deductible amount which can be paid into a private pension plan with more than ten years but less than life-long return payments was reduced from DKK 100,000 to DKK 50,000 (€ 13,400 to € 6,700). The DKK 100,000 ceiling was introduced in 2010, before which there was no limit on the deductible amount. This is still the case for payments to life-long private pension schemes.

All in all, the abovementioned widening of the tax base for personal income taxes raised the tax revenue permanently by approximately DKK 1.2 bn. (€ 0.16 bn.) or some 0.1 percent of total tax revenues. This is excluding the temporary effect of the ceiling on deductions for private pension contributions, which will bring forward some tax revenue that would normally not materialize until the pensions were paid out.

### The ghost of tax reforms past

It should be noted, that the increases to personal taxation in the 2012 budget came on top of increases already agreed upon in past tax reforms, most notably the 2010 tax reform (agreed upon in 2009) as well as the “Economic recovery package” (agreed upon in 2010).

The most subtle but also most significant of these tax increases was a four-year (2010-2013) nominally freeze of all tax thresholds, which are traditionally automatically indexed to reflect rising wages. Thus, the effect will be to keep all tax thresholds nominally unchanged from 2009 to 2013. The effect of the tax threshold freeze is best illustrated by looking at the effect on the number of taxpayers paying the top income tax rate.

In 2010 some 650,000 persons paid the top income tax, equal to 14 percent of all taxpayers. This was after the 2010 tax reform had brought the number down from 930,000 persons (20 percent) the year before. Normally, the automatic indexation of tax thresholds would keep the number of top income tax payers steady from one year to the next. But due to the tax bracket freeze, the number of persons affected by the highest marginal tax rate rose to 660,000 persons in 2011 and 710,000 persons in 2012.





Another aspect of earlier tax reforms affecting 2012 taxes was a gradual reduction of the standard deduction rate, which was part of the 2010 tax reform. The rate applies to e.g. labour union membership fee, unemployment insurance premium, but also net negative capital income (interest payments) above DKK 50,000 (€ 6,700). Hitherto such costs could be deducted against other taxes at a rate of 33.7 percent (average municipality), but beginning in 2012, the rate will be gradually reduced by one percentage point per year until reaching 25.7 percent in 2019.

### Higher taxes on consumption

Denmark already levies Europe's highest consumption taxes, mainly due to a uniform VAT rate of 25 percent as well as high taxes on candy, alcohol, cigarettes and a variety of other products. In 2012 (and again in 2013) these were raised as a consequence of the new government's 2012 budget agreement with the Red-Green Alliance.

In 2012, tax on soft drinks (with sugar), chocolate, candy, ice cream, beer, wine and tobacco was increased by some DKK 1.3 bn. (€ 170 mill.) in all. Interestingly, the increase in the tax on tobacco (which raises the price of a package of cigarettes from DKK 39 to DKK 42 or € 5.2 to € 5.6), was not expected to result in any extra revenue as the negative behavioural effects (less smoking and more cigarettes bought across the border in Germany) were expected to nullify the initial positive effects on tax revenues.

Also, a number of taxes or duties on as diverse products as light bulbs, coffee, tea and smokeless tobacco, along with the annual circulation tax on cars was increased in 2012 (and again in 2013) by a total of some 9 percent. These taxes had all been held constant in nominal terms since 2002 under the former government. Along with the abovementioned increases, this will bring the extra revenue on consumption taxes to some DKK 2 bn. (€ 270 mill.).

The 2012 budget agreement also contained a plan to raise a further tax revenue of DKK 1 bn. (€ 130 mill.) by introducing a tax on all food products with added sugar: Fruit yoghurt, marmalade / jam, ketchup, chocolate milk, etc. – but also relish or pickled products. The government had promised to present a detailed proposal for the tax later in 2012, but the tax became so unpopular, that the plans were scrapped in connection with the 2013 budget (see later).

Even before the proposed tax increases, official estimates put the total cross-border shopping out of Denmark at DKK 12 bn. (€ 1.6 bn.) or more than DKK 2000 (€ 270) per year per person.



## A higher price on doing business

Individuals were, however, not the only ones to feel the effect of the change of government. As indicated, some of the tax increases, which primarily affect consumers, also carry a burden for companies in terms of administrative costs and/or loss of business in their home market as shoppers head to Germany and Sweden. But Danish companies were also directly hit by a number of tax increases in the 2012 budget.

Most notably, the new government pushed through a quintupling of the tax on NO<sub>x</sub>-emissions from DKK 5 to DKK 25 per kg NO<sub>x</sub> (€ 0.67 to € 3.35). Effective from mid-2012 this drastic tax hike had grave effects on much of the Danish production industry already suffering under the increased energy taxes, which were parts of the 2010 tax reform. The environmental effects, however, are modest as less than five percent of the NO<sub>x</sub>-particles in Denmark are actually emitted in Denmark (the rest are carried into the country from abroad). Also, the largest emitter of NO<sub>x</sub> – transportation – will be exempt from the increase.

The government also tightened the rules concerning the tax-free transfer of family owned businesses from one generation to the next, and it tightened or introduced a number of rules in order to increase corporate taxes. These include higher fines for missing or incomplete transfer pricing documentation, limitations to the deduction of previous years' loss in this year's profits, as well as further limitations on the deduction of interest payments in company profits (mirroring German and French rules in this area). Also, beginning in the autumn of 2012, the corporate income tax payments of all companies have been made public.

Finally, the 2012 budget contained a number of business taxes that did not take effect until 2013 or later. In 2013 a work injury tax was introduced, which is supposed to reduce the number of work related injuries, but is arguably just another tax on having employees. The same year a tax on print ads distributed to private households were supposed to take effect; but it may not be compatible with EU-law and is still pending confirmation by the EU-Commission.

## No more tax on home computers and Internet

The only positive element in the 2012 budget was the amendment of one of the most criticised elements of the 2010 tax reform: ADKK 3,000/year (€ 400) add-on to taxable income for employees with (partly or fully) employer-paid telephone, PC or Internet available for private use outside the workplace. This corresponds to a tax of DKK 1,200-1,700/year (€ 160-230) depending on income (top income tax payer or not).

This “multi-media tax” was hotly criticised, and already in late 2010, the tax was amended to give married couples a 25 percent discount on the tax if they are both subject to it. Effective from 2012 the add-on to taxable income was lowered to DKK 2,500 (€ 340), and employer-paid PC and/or Internet were exempt, leaving only employer-paid telephone as the basis for the tax.



The government had originally estimated that this amendment would result in a loss of tax revenue to the tune of DKK ½ bn. (€ 70 mill.) or roughly one tenth of the total tax hike in the 2012 budget. But data has shown that the exemption of home computers and Internet had little effect on the number of people affected (mainly because of the spread of employer paid smart phones), and little if any tax revenue has actually been lost.

### Higher taxes on energy and cars

In the spring of 2012 two political agreements were reached which further increased the tax burden on households and companies.

In March 2012 a broad political agreement on energy policy 2012-2020 was reached, which aims to reduce overall energy consumption and increase the share of renewable energy. The total cost is estimated at some DKK 3½ bn. (€ 470 mill.), and will be mostly borne by private households. Among other things, the agreement calls for a “supply security tax”, i.e. a tax on all energy consumption to ensure tax revenue as the reliance on conventional (and highly taxed) energy is reduced. This would among other things entail a tax on firewood, which has since been widely ridiculed, but which is currently being seriously contemplated in the relevant ministries.

Secondly, the government reached an agreement with a majority in parliament to tighten the rules regarding the taxation of leasing cars and “demonstration cars” (cars, registered by the car dealer as demonstration cars, and then later sold to consumers). Denmark is renowned for its high taxes on vehicles (registration fee is 180 percent of the value of the car, on top of 25 percent VAT) and naturally this has sparked ingenuity in order to reduce the tax payment. Not least so in the areas of leasing cars, and demonstration cars, because such cars hitherto paid registration fee on a “minimum price” based on the import price of the car, which was traditionally lower than the retail price (excluding taxes). Thus, at the time of the intervention, more than half of all new cars were registered either as leasing cars or demonstration cars. The intervention aimed to reduce the scope for using the minimum price, and will increase tax revenue by DKK 1 bn. (€ 130 mill.). In 2011 the total tax revenue on motor vehicles amounted to DKK 42 bn. or almost five percent of total tax revenue.

### Growing dissatisfaction

Even though the many tax hikes were arguably a natural consequence of the election promises of the new government, they nevertheless came under increasing attack – not just by corporations, but also by the government's supporters in labour unions as well as the general public. Workers protested against the new business taxes which would accelerate the export of jobs to countries with lower taxes; and consumers reacted against the increase of excise duties at a time when wages stagnated. In 2012 the overall tax burden reached 48.5 percent of GDP.



To speak of a “tax revolt” of any kind is misleading, or at least premature; but it would be right to speak of a paradigm shift in the world's most heavily taxed country. To paraphrase former US president Ronald Reagan, higher taxes are increasingly seen not as the solution to the problems facing Denmark, but rather as part of the problem themselves. This change of perspective manifested itself for the first time in the tax reform agreed upon in the summer of 2012.

The tax reform had been announced already in the government manifesto, which pledged to “markedly” lower the tax on labour income in order to boost labour supply by at least 7,000 persons (equal to some 0.025 percent). The cuts to income taxes were to be fully financed by other tax increases; in fact the manifesto spelled out that the positive supply side effects of the extra labour supply – estimated at some DKK 3 bn. (€ 0.4 bn.) – would finance an *increase* in public spending. Even so, the plans were vividly criticised by the Red-Green Alliance on the political far left for focusing solely on lowering the tax burden on labour income, thus widening the gap between those in work and those on government welfare. Ironically, this was exactly the same criticism that the members of the then opposition now government raised against the 2010 tax reform implemented under the then centre-right government.

### First real tax cut in almost a decade

Late in May 2012 the government presented its proposal for a tax reform and invited all political parties to negotiations. As the government does not command a majority in parliament, the support of either the left wing Red-Green Alliance (on whose support the government came to power) or at least one of the right wing opposition parties were needed in order to pass the reform.

What was surprising about the proposal was not so much the cuts themselves (more on that later) but the way in which the government proposed to finance them. Contrary to the words of the government manifesto, the cuts to income tax were not fully financed through other tax increases. In fact, approximately one quarter of the tax cuts (totalling more than DKK 14 bn. or € 1.9 bn.) were financed through lower spending on transfer incomes. A larger part of the state pension will now be means tested, but more importantly, the government proposed that for eight years the automatic adjustment of welfare benefits in line with rising wages will be suspended, and benefits will only be adjusted to reflect inflation.

Not surprisingly, this caused uproar in the Red-Green Alliance who had already been critical of the focus on cutting taxes for those in the work force. In short, the centre-left government who had for a decade in opposition attacked the previous government for “taking from the poor and giving to the rich” was now proposing a tax reform that would do just that.

Nevertheless, the government now began parallel negotiations with on the one hand, their natural ally on the left, the Red-Green Alliance, and on the other hand the two parties on the right who made up the former government: The Danish



Liberal Party (Venstre) and The Conservative People's Party. In the end, the government ended up sealing a deal with the two opposition parties of the former (centre-right) government; much to the dismay of the Red-Green Alliance.

From a pro-tax cut perspective, the final deal was even better than the original proposal. Essentially all the proposed tax cuts were kept in place, while some of the tax increases were scrapped. Instead, more than half the total loss of tax revenue would now be found by reducing public expenditure: Cuts on the military and a Danish EU-rebate would cover the difference.

### Lower taxes 2013-22

As announced, the tax reform focused primarily on cutting the tax on labour income over a period of ten years. Most importantly, the threshold for the top income tax will be gradually increased from DKK 423,800 (€ 56,900) to DKK 507,600 (€ 68,100) with most of the increase in the years 2013 and 2014. This will reduce the share of taxpayers affected by the top income tax to less than 10 percent.

Also the “employment deduction”, which today effectively reduces the marginal tax by 1.4 percent for those earning less than DKK 320,500 (€ 43,000), will be almost doubled, resulting in a marginal of less than 40 percent for the lowest incomes when fully implemented in 2021. In 2014 an additional employment deduction for low income single parents will be introduced, reducing the marginal tax by further 1.6 percentage points for this particular group of taxpayers.

For businesses, the reform abolished the tax on corporate capital gains from shares in unlisted companies even when the share held is less than 10 percent (corporate capital gains on shares above 10 percent is already tax free). Also a 2013-2014 tax break for certain investments in e.g. machines was introduced.

The final agreement still contained some tax increases, most notably the “regulation” of all duties (on light bulbs, vehicles, coffee & tea, alcoholic beverages of all kinds, soda water, chocolate and candy to name a few things) with 1.8 percent per year in the years 2013-2022. The increase will not be yearly, but in the years 2013, 2015 and 2018. Also there are increases to the yearly tax on diesel car and the payroll tax in the financial sector, as well as a cut in the maximum yearly tax deduction available for workers working away from home on a temporary basis.

### Further tax changes in the budget

In fact, the agreement also contained an end to the special tax break available to Danes stationed outside the country, but still liable for Danish income taxes (e.g. because they have not given up their home). Hitherto, such persons would be tax exempt on the income earned outside Denmark, but this exemption was lifted, sparking fierce criticism from corporations, NGO's and others.



The criticism became so fierce that the exemption was reintroduced in the budget agreement for 2013 that was reached late in 2012 between the government and the Red-Green Alliance. The same budget also scrapped the fat tax that had been introduced in connection with the 2010 tax reform, and it shelved the plans for a tax on all food products with added sugar, which had been part of the 2012 budget and was supposed to take effect January 2013. Both the fat tax and the new sugar tax had been hotly criticised by corporations and were increasingly unpopular in the eyes of the general public.

Unfortunately, these much appreciated tax cuts were financed by increasing the state income tax by 0.19 percentage points. The lowest marginal tax rate will still be below 40 percent, but the top marginal tax rate will rise marginally to 56.2 percent as a result. Thus, despite all the positive changes in 2012, the problem with a high marginal tax on the most productive income earners remains.



While Estonia has rebounded well from the crisis and is still an attractive destination for Nordic companies there needs to be a political thrive towards keeping Estonia's competitive advantage. In the time were our close neighbours are discussing possibilities for making their economic environment more friendly to entrepreneurs, the local government has to react accordingly. Although being known for progressive and bold economic reforms, Estonia has become to a halt over the recent years. To battle the rising taxes and the growing public sector significant changes must be enacted. Unless necessary steps are made the current 10% public debt is only the beginning of a race to catch up with the Western Europe.

## **Estonia's return to fast paced development**

A fast growing economy has been Estonia's trademark for the past two decades. While the crisis saw the GDP turn towards a deep fall that reached -14.1% in real value, it has turned around once again and is one of the fastest growing economies in Europe with 3.2% growth in 2012. This was partly the result of some successful policies by the government that focused on making the labour legislation more flexible as well as promoting entrepreneurship. A noticeable contribution was also made by European funds that were used to help starting new companies. Estonia has since gained a reputation as a great place for start-ups. Still, the long term benefits of this policy can be debated, as there have been several projects that did not turned out well, along with several companies going out of business altogether. Causing losses of thousands of millions euros.

Also, Estonia benefited greatly from other countries having to bail out their economies, making it possible to place exports back on the road to growth. Trade with Nordic countries, especially Sweden, and Russia has been highly beneficial to the Estonian rebound. In 2010 and 2011 Estonia's exports grew more than 22% annually and in 2012 the growth continued at 5,6%. This surge resulted in a trade surplus; the first in a long time.

The recession has seen Estonian economy going through some structural changes with more focus towards sectors with high value added. Biggest shift in this direction has been in the production of electronic devices and equipment. Nordic countries that brought their production over here in order to escape from the more costly environment of their native countries plaid an important part in this change.

## **Taxes becoming a more important source of income**

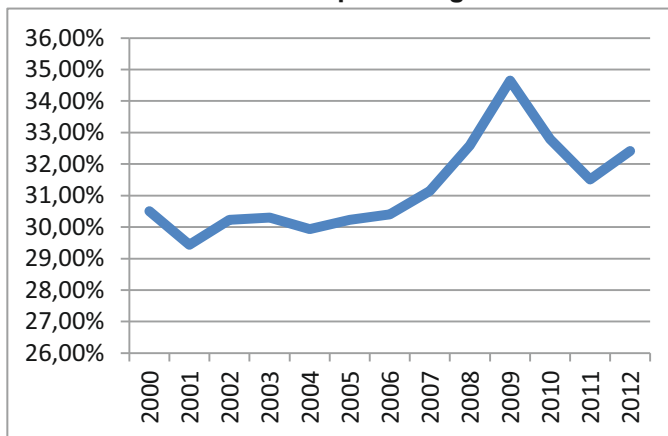
For a long time Estonia has been presented as a land of low taxes. Unfortunately this is a bit of a myth as the tax burden on Estonian citizens is not that different from what it is in other countries. Still, there remain significant differences in the



in the structure of tax code. For one thing, the lack of corporate income tax has shifted the tax burden towards labour taxes. There is also a strong tendency towards taxing consumption through the value added tax and a variety of excises.

While total tax revenues are currently only slightly above 32% of GDP they have been even lower in previous years. The shift upwards was strongly affected by the crisis, which at one point pushed the share of the tax revenue rise above 34% of the GDP.

**Tax revenues as percentage of GDP**



Although Estonian politicians have always tried to bend towards lower tax rates, this somehow changed during the crisis. To help combat falling tax revenues the value added tax and several excises were raised to avoid taking on too much debt.

Tax changes we have grown accustomed to are expected to stay for the future. It is indeed hard to imagine any significant fall in excise duties as they now provide a significant part of government's income. In recent years their share has grown to more than 10% of the entire government budget. Most income is provided through social welfare and value added taxes.

### Personal income tax

The flat tax system in Estonia has often been brought up as an example of a simple tax code. Right now the nominal tax rate on personal gross income is 21%. But there are some differences in the effective tax rate due, for instance, to tax-free income: No one will pay income tax on the first €144 of their income. In addition one can get extra tax-free income of €192 for pensions and €64 for work-related accidents and illness. The current tax rate is expected to remain the same until 2015 when it will be dropped to 20%.





### **Corporate income tax**

There is no corporate income tax as such in Estonia. Only the dividends that are paid out are taxed at the same 21% rate as personal income. This means that companies have a higher incentive to reinvest their earnings rather than pay out the profits to shareholders.

### **Capital gains tax**

There is also no separate capital gains tax in Estonia. Rather, the earnings from dividends and investments are taxed following a principle similar to the one used for companies. Hence, one can have a designated personal investment account in a bank and pay the regular income tax only once one starts to withdraw more from the account than originally deposited.

### **Social welfare tax**

The highest tax in Estonia is the social welfare tax that is 33% of the gross income and paid by the employer. Meaning that in addition to a €1000 gross wage paid to a worker the employer has to give an extra €330 to the state. This tax also applies to self-employed people who have to pay 33% of their income earned from business activities. The social welfare tax is meant to cover health insurance and other social benefits provided by the state.

### **Unemployment insurance tax**

Another tax related to labour is the unemployment insurance tax that is paid by both the employee and the employer. While the worker has a tax rate of 2.8% on their gross income, the employer pays a rate of 1.4%. This tax goes directly to unemployment office that uses it to provide unemployment benefits. In 2013 the two rates will be lowered to 2% and 1% respectively.

### **Pension insurance tax**

Final tax on personal income is the pension insurance tax at 2%. This is sent to individual's personal pension fund where it will be invested. In addition the state pays twice that amount to the same fund. This money can be accessed once one retires on top of their state pension. While during the crisis the state that was not able to fulfil their part allowed people to stop their own payments into pension funds as well, in 2012 the mechanism was back in full gear but keeping in mind that in 2011 the tax rates were halved.

### **Value added tax**

The value added tax used to be at 18% but was raised to 20% during the crisis. With some few exceptions this rate applies uniformly. There's a lower 9% rate that applies to books, printed periodicals, some medicaments and few other items. In addition exported goods, vehicles used for air and land transport and air and land transport services are tax-free.



## Excises

Excises have been rising constantly for years in Estonia. Alcohol excises rose about 5% on average in 2012 with smaller differences for light alcohol like beer and ciders and bigger gains for stronger drinks like wine and spirits. Also tobacco excises rose in 2012, at an average of about 10% varying according to the type of product. The tax is lower for cigarettes and higher for cigarillos, cigars and other products. The official reasoning behind those taxes is to guide people towards healthier habits. The most important excise in Estonia is the one levied on fuel which can be up to €400 per 1000 litres and is expected to rise even more in 2013. The tax makes for about 30% of the retail price of fuel. This money is meant to go into road maintenance and construction. In addition there are also some smaller excise duties on electrical energy, gas and packaging. The idea here again is to nudge people towards a more environment friendly behaviour.

## Fringe benefits and other taxes

On top of regular labour taxes the employer also has to pay for additional benefits provided to his workers. These can include a car for private use, healthcare and other services. In addition there are several taxes designed to protect the environment and modify people's behaviour. These taxes are based on pollution levels, usage of natural resources, gambling, land, heavy trucks etc. The tax on land will be relieved for homeowners in 2013 but right now ranges from 0.1% to 2.5%.

## Average income

The average gross income in 2012 rose to € 916 in the fourth quarter, which gives a yearly growth rate of 5.9%. In the next few years one could expect the gross income rising above the €1000 for the first time ever. The rise in income helped Estonians to bounce back from the hardships brought about by the recession. This has also provided fresh ground for private consumption, which finally in the last two years started to support exports in the recovery.

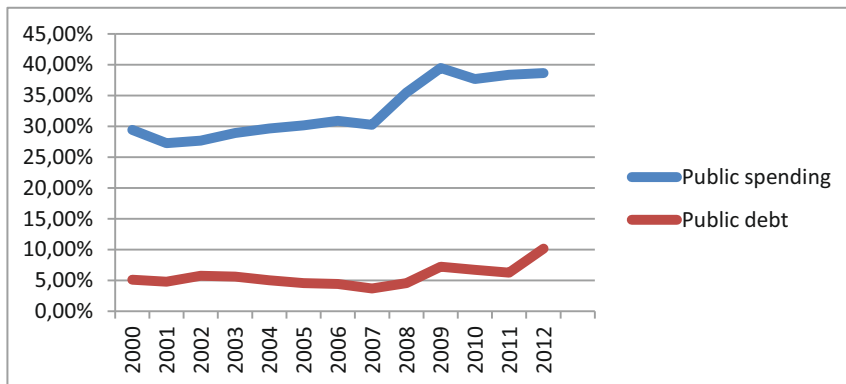
## More a push for euro than austerity

Estonia has always held true to the principle of a balanced budget, which has been included into coalition agreements. Along with the currency board and the interdiction for the central bank to loan to the government any money, this has tied governments' hands in case it wishes to go into any significant amount of debt. The government can only spend what it brings in in taxes and other revenue. In the past this has also helped to keep the public sector from growing too big.

The crisis brought a significant change in this regard. If Estonia used to see its balanced budget as a principle and some politicians have argued in favour of adding it to the constitution, some argue now that the balanced budget was simply the only option for a young country that has not yet managed to take on debt. But eventually will. As a matter of fact, the recession has seen Estonian public debt rise above 10% of GDP with the growth going on even now, despite the economy showing one of the best numbers in the entire Europe.



## Estonia public spending and public debt as percentage of GDP



Although the public spending did go down during the recession, courtesy of spending cuts, its share of the GDP grew dramatically from 30% before to almost 40% after. And as growth was already present before the crisis it is hard to argue that spending will ever go back to that low 30% again. And hence the public sector keeps getting bigger.

The spending cuts enacted by the government were at least partly a necessity and for that reason pointing to Estonia as an example of a successful austerity is misleading. The main reason for the cuts on spending was the long-term goal of joining the Euro area which meant that the government could not allow too much of a deficit spending.

In addition to raising taxes, deficit spending has been avoided by the help of European funds that increased significantly during the crisis and up to this year. But here lies an important issue. As Estonia expects to become wealthier it cannot expect to keep receiving these amounts of European support. This means that in order to prepare for the possible cut back in finances from Brussels the government should start thinking more about saving. As all the external funds make up about 20% of the governments budget, more attention should be directed to the issue. Otherwise Estonia will go down the same road that has gotten the developed world into financial troubles.

Another reason to be more careful towards spending is the already mentioned financial weaknesses of other countries. As Estonia has decided to partake in the safety net measures created to help ailing countries there needs to be sense of urgency towards creating the funds that might be needed in times of distress. One cannot hope that it would be possible to get a loan from the market at a time of financial turmoil.



## The dangerous road ahead for Estonia

The advantage that has played a part in the creation of the perception of Estonia as a low tax region is the relative simplicity of the local tax code. No small part in this has been played by the local flat income tax. Recently though this tax has become a target for growing criticism. Although the left leaning wing of the Estonian political landscape has been in favour of a more progressive tax system for a long time, there is additional pressure coming also from experts representing the European Union and other international organizations.

To think of possible effects of international politics on the Estonian tax code one only needs to think back to the time when Estonia was first joining the European Union. While before that step we had unilateral free trade across the globe, the decision to join the Union forced us to take on a great amount of trade tariffs. And the political trends in the European Union are having their share of influence again today with the coming of the financial transaction tax and possible environmental taxes. One can probably also expect the Estonian tax code becoming more complicated with the changes in international politics as can already be seen from different excise tax rates.

Another threat for Estonia is the push in Europe towards a more harmonized taxing. This goes directly against what has been Estonia's competitive advantage over the years. And in order to fight or prevent the consequences of such changes the local politicians need to look for new reforms.

As a country on the periphery of the European Union Estonia can not count on luck and needs to take more aggressive steps towards guaranteeing its own position of economic significance and the well-being of its citizens. Although the government has called out for more innovative entrepreneurship in recent years, there needs to be more decisive steps also from the side of legislation to accommodate the needs of businessmen. European funds and government financial programs alone cannot build a sustainable model.

*Opinions expressed in the article are purely the author's personal views and not related to the institution he represents.*

*Source of statistics: Statistics Estonia*



In the spring of 2013, the Finnish government held its half-way assessment, in which it reviewed and revised the government policy program for the remaining two years of its mandate, until the next general election in 2015. The main focus was again on the taxation of dividends. However, the proposal put forth by the government was met with so much criticism that even the leader of the Leftist party, one of the governing parties, turned against it. The government quickly published a revised proposal, but at the time of this writing, it is still unclear what the final rules will look like. It seems clear, however, that excise taxes such as taxes on alcohol, sweets and tobacco will be raised. The government is still trying to shrink the deficit and improve employment, but it is doubtful if it will be successful.

## The half-way reform

Speculations about the next major tax reform had been going on since 2010. It was expected to be included in the government's policy program from the beginning, but was put off until the half-way assessment. There has been a downward pressure on corporate tax rates for several years, not only in Finland, but also in other Nordic countries. Sweden has already reduced its corporate tax rate to 22 percent, with Denmark announcing to follow suit. The Finnish government didn't want the Finnish tax rate to be too high in comparison, which meant that another reduction was expected. For political reasons, however, any significant reduction in the corporate tax rate must be compensated by a stricter taxation of dividends, both from unlisted and listed companies. This "compensation" comes at the expense of individual investors and entrepreneurs, because the taxation of dividends between companies remains unchanged.

According to the initial proposal, the tax-exempt dividend currently available for owners of unlisted companies would be abolished, meaning that dividends become at least partially taxable from the very first distributed euro. In the current system of taxation of dividends from unlisted companies, an amount equal to 9 percent of a non-listed company's net wealth was tax exempt for an individual up to € 60,000. Instead, it was proposed that an amount equal to 8 percent of the net wealth would be 25 percent taxable and 75 percent tax-exempt capital gain income. With a capital gains tax rate of 30 or 32 percent, the effective tax rate of this relieved part of the dividend is 7.5 to 8 percent. In combination with the proposed reduction in the corporate tax rate from 24.5 percent to 20.0 percent, this reform would actually have benefited very wealthy private companies whose dividend distributions often exceeded the € 60,000 per shareholder tax-free limit, but remained within 9 percent of the companies' net wealth. It was primarily for this reason that the proposal was ultimately abandoned and revised.



It is also proposed that dividends from listed companies, which currently are 70 percent taxable capital gain income, would become 100 percent taxable income, an effective tax increase of 50 percent. The taxable part was later reduced to 85 percent instead of 100.

### *The proposed new dividend tax rules*

The proposed dividend tax regime is quite complicated, because it consists of so many different parts and even different tax rates. Below is an overview of how the system is supposed to work.

In the proposed system, the dividends are still divided into two parts: the part to which the specific relief is applicable and the part to which the general relief is applicable. The specific relief is reduced to 8 percent of the company's net wealth, down from the previous 9 percent.

An amount equal to 8 percent of the net wealth is 25 percent taxable capital gain income, but only up to € 150,000. To the extent the dividend exceeds € 150,000, it becomes 85 percent taxable capital gain income. To the extent the dividend exceeds 8 percent, it is likewise 85 percent taxable capital gain income, which is a significant change from the 70 percent taxable personal income in the previous system. On a general level, this favors wealthy companies with high distribution rates and punishes smaller companies; because the marginal tax rate paid on personal income tend to be higher than the capital gain tax rate for high-income earners, while the opposite is true for low-income earners.

Lastly, the government proposed to sharpen the progressivity of the capital gains tax. Currently, capital gain income is taxed at 30 percent up to € 50,000, capital gain income exceeding € 50,000 is taxed at 32 percent. This limit is to be reduced to € 40,000.

So in order to calculate his tax burden, the owner (usually an entrepreneur) must take into account all the various limits, taxable and tax exempt portions of the dividends, which tax rate is applicable and to what extent. It is not an easy thing to do, and the system itself defies all reason and logic.

### **Tax policy and reform**

As noted earlier, the main focus of the government's tax policy was taxation of dividends, primarily from unlisted companies. It remains to be seen if the proposal will be tweaked further. At the moment, there is a very strong political will to further increase the tax on dividends from unlisted companies, even within the government. Failure to achieve that may result in stronger demands for a smaller reduction in the corporate income tax rate.

From 1 January 2013, the much debated "solidarity tax" came into force, which in effect is a new tax bracket for personal income (primarily employee compensations such as salaries, bonuses, benefits etc.) that exceeds 100,000



per annum, with a marginal tax rate of 31.75 percent. That is in addition to the municipal tax, the average rate of which is about 20 percent. A similar add-on tax is implemented in the realm of inheritance and gift taxation. A new tax bracket is introduced for inheritances and gifts exceeding 1 MEUR. In tax class 1, the tax is 19 percent, in tax class 2, it is 35 percent.

The VAT rates were again increased by one percentage point to across the board, to 10%, 14% and 24% respectively. This increase was expected, as it was discussed a year ago when the VAT rates were increased. The VAT remains by far the most important single source of revenue for the government, making up about 40 percent of the total tax revenues.

As part of the tax overhaul, the Finnish government decided to implement thin capitalization rules, i.e. restricting the tax deduction on intra group interest payments, primarily interest payments to group companies outside of Finland. The purpose of these rules is to broaden the Finnish tax base and limit international tax planning, which by many is viewed as tax evasion. The limitation comes into force when the net interest expense exceeds 500,000 EUR. The exceeding part is deductible to an amount equal to 30 percent of the company's EBITDA. The undeducted expenses may be deducted in the following years, provided they fall within the limits. The new rules are to be implemented for the first time in fiscal year 2014.

The Finnish transfer tax (stamp duty), which is levied on the acquisition of shares, was increased from 1.6 percent to 2.0 percent on shares in real estate companies starting from 1 March 2013. In addition, the basis for the transfer tax is broadened. Previously, the debts of the company were deducted from the price of the shares. Under the new rules, the debts are included, thus increasing the amount on which the transfer tax is calculated.

There is some good news as well. A temporary R&D deduction is available for companies in the fiscal years 2013 – 2015. The deduction is based on the salaries that relate to research and development and is capped at 400,000 EUR per annum. The purpose is to attract people who work with research and development to Finland, to make Finland a country of choice when companies decide where to allocate their product development activities to Finland.

### **Fiscal matters and outlook**

Finland is still reeling from the financial crisis and the wider Euro crisis. The deficits are still large, and there is strong political opposition to any significant cuts in public expenditures. The public debt was about 86 billion EUR in 2012, which is about 46 percent of GDP, and continues to grow. The government claims to be taking action to address the deficit, which is still in the 7 billion EUR range according to the government's own budget estimate for 2013. The public is projected to grow to 95 billion EUR at the end of the budget year.



Unemployment is at 7.7 percent, but Finland has seen heavy job losses the past year with many major companies laying off thousands of people in Finland. Increasing the employment remains one of the single largest challenges, and has been a key issue in the political debate since the last elections. One of the main arguments for reducing the corporate tax rate was to boost employment, the thinking being that a low tax rate would attract companies to Finland, which in turn would hire lots of people.

However, investments, be they foreign or domestic, depend on many other things than the corporate tax rate. This especially true of employment, because employing people is both expensive and risky. With personal income tax rates ranging from 30 – 50 percent, the payroll costs quickly become significant, because the higher the tax rate, the more you must pay to satisfy your employees, as they for obvious reasons only care about how much money they actually receive on their bank account. Add to that social expenses like the mandatory pension insurance, and paying someone a net salary 3,000 EUR a may cost the employer almost the double.

Workers still enjoy very strong legal protections; the labor laws are very strict on the employers. Once someone is hired, he can't be fired very easily. Paradoxically, it is much easier to fire tens or hundreds of people than to fire single employees. Strikes are still a fairly common, though often quite limited, but the ease with which workers at various plants or companies can decide to walk off the job for a day or two is hardly reassuring for prospective employers.

Compared to many European countries, Finland is in a fairly decent economic position, but that is mostly due to the fact that other countries are so much worse off. There are few reasons to think that things are going to get better anytime soon, mostly because the unwillingness of politicians and the general public to make significant cuts anywhere. There is a belief that economic growth will take care of everything. When that growth is going to come and what is going to be driving it, however, is left unsaid.





## France fiscal and budget policy: The only thing really new in 2012 was the President

2012 has been an election year: President Sarkozy left office last May and President Hollande took over. As explained in our previous report, from a fiscal and budgetary standpoint, the programs of the two candidates were rather similar: to bring deficit down essentially through tax increases. As further detailed below, the new President added a layer of new taxes and did not significantly reduce public spending nor introduced structural reforms. Public expenditures have actually increased by 2.9%. The results were as expected: a deficit above the target, zero growth and a gloomy prospect for 2013.

### Corporate Income Tax

The regular rate remains at 33.33% of the benefits realized. A reduced rate at 15% is also maintained for companies with a turnover below € 7.63 million. Those companies will pay a rate of 15% on the first € 38,120 of benefices the rest being taxed at the regular rate.

On top of the corporate income tax a social contribution is levied. The social contribution is fixed at 3.3% of the benefits for any company with a turnover above € 7.63 million and profits above € 763,000.

Also, the “exceptional and temporary” contribution of 5% for firms with turnover above € 250 million—a contribution introduced by the previous government—is still alive. Although this measure was intended to last until the end of 2013, one of the conditions for terminating the levy is that the public deficit be reduced below the 3% threshold. As of today, the temporary measure is expected to last at least until 2015.

On November 6<sup>th</sup> 2012, the government presented a new reform to be implemented in 2013: a refundable tax credit designed to improve the competitiveness of French companies. The credit is fixed at 4% of the payroll of the company limited to those employees receiving less than 2.5 times the minimum salary. Reactions to the decision have been often critical pointing out to the complexity of the system while a mere reduction of social contributions paid by companies will be much easier to implement. Between 15 and 20 billion euro could hence be left to companies (and lead to expenditure cuts or new taxes). The global effect on the economy is the object of many debates the most optimistic betting on the creation of some 150,000 new jobs and 0.1% of extra growth while the most pessimistic claim that firms will not use the tax credit (too complex to implement) or use the money to increase the highest salaries while blocking lower salaries between 2.5 times the minimum salary so that they can benefit from the tax credit.



Large corporations are often said to pay proportionally less taxes due to systematic and sophisticated tax optimisation. In 2012 the debate on that issue went on. The most recent study (PcW) shows, however, that in 2012 the 40 largest capitalisation (CAC 40) contributed (in France and abroad) a total of € 35 billion in taxes. That represents an average effective tax rate of approximately 36%.

## VAT

One of the promises of President Hollande before the elections was the repeal of the so-called “social VAT” adopted by the previous parliament (cf. Yearbook 2012). Once elected, the President hurried up to fulfil his promise. One year later, however, with economic growth much below expectations, the government was desperately looking for extra revenues. The situation will be particularly urgent once the tax credit for corporation will be running at full power (see above, corporate income tax). It appeared then that there were not so many alternatives to a VAT increase. It was (politically) important, nonetheless, that the new increase of the regular rate be lower than the one voted by the previous parliament. Hence, the regular level is to be brought in 2014 from 19.6 to 20% (instead of 21.2 under President Sarkozy) and the intermediary rate from 7 to 10%, but the lower 5.5% rate should be further lowered to 5%.

From 2012 on there are also several economic sectors such as transports or restoration that enter the category of goods and services taxed at 7% instead of 5.5%. Those sectors will hence be concerned with the increase announced for 2014 from 7 to 10%.

## Personal Income Tax

In 2012, the tax brackets remained unchanged for the second consecutive years, which is equivalent actually to a tax increase proportional to the inflation rate. It also means that households with low salaries that are indexed on inflation might enter the lower bracket and start paying the PIT. Rumours circulate that the brackets will be frozen again in 2014 with, however, a mechanisms that will protect lower incomes.

Also, as announced during President Hollande's electoral campaign, a new bracket has been introduced in the 2013 fiscal law; namely, a 45% brackets for household incomes over €150,000 per share of family quotient in the household. Knowing that an adult counts for one share and each of the two first children for half a share of family quotient, a couple with two kids will be taxed at 45% if the household's incomes exceed €450,000. A single person will be in the 45% brackets after earning €150,000. Those incomes were previously taxed at 41%.

The very emblematic 75% tax rate on personal incomes above € 1 million was however rejected by the Constitutional Council in December 2012 on the basis that, in the French system, personal income tax is based not on individual income



but on the cumulated outcome of the household. Therefore, for a couple, the 75% rate could be applied only to income above €2 million euro... Being very attached to the symbolic of taxing at 75% income above € 1 million, François Hollande announced early 2013 that this tax will be paid by the firms that allow incomes (salaries, bonuses, stock-options included) above € 1 million per year. The project could be adopted for income realized in 2013, but one can already easily imagine its perverse effects such as firms that will delocalize high management or firms that will opt for lower salaries and higher dividends. When applied, the new tax should concern approximately 1,000 employees and yield an extra € 500 million to the State.

The fiscal advantages granted to family with kids were also reduced. While maintaining the mechanism of the family quotient (that divides taxable incomes by the “shares” cumulated by the household with one share for each parent, half a share for the second and third kids and one full share for the third kid and beyond), the 2012 fiscal law reduced the tax credit obtained via this mechanism from € 2,336 per half share to € 2,000. It is very likely that this figure will be further reduced to €1,500 in 2014.

A law of 16 August 2012 has also removed most of the tax exemptions granted to employees (and employers) for overtime work. This ends one of the mechanisms put in place by the previous government to give substance to President Sarkozy's policy: “work more and you will earn more”.

### Capital taxation

The socialist government has very ambitious projects about capital gains. Several reforms were announced (and some of them already adopted) guided by the slogan: “capital should be taxed at least as much as labour”.

In 2013, the basic rate at which capital gains are taxed will hence remain at 19 % plus social tax at 15.5% and a new “over-tax” of 2 to 6% will be imposed to gains above €50,000. The maximum rate will therefore be at 40.5%.

Turning to gains realized in 2012 on the sale of financial assets, the basic rate has been increased from 19% to 24% to which must be added 15.5% of social tax.

In 2013, gains realized from the sale of assets will be added to personal income and taxed at the corresponding rate. Keeping in mind that social tax and “over-tax” will still have to be added, a household in the 45% bracket will hence have its capital gains taxed around 62%. When the reform was announced in the fall of 2012, a group of “business angels” and start-ups' managers quickly gathered through social networks and started to complain about what they named a “spoliation”: why should we take risks and work hard, they say, if the State is then grabbing close to the 2/3 of the gains. The government, surprised by such rapid and violent reaction from those who call themselves “les pigeons” (the suckers) and desirous to give some substance to his desire to favour job creation and in-



-novation, decided to stick to the idea of “taxing capital and labour at the same rate” but introduced important tax allowances. For example, for the sale of a young company (less than 10 years old) of small or medium size, the capital gain tax allowance will be set at 50% if the shares have been held between one and four years, 60% between 4 and 8 years and 85% after 8 years. Those tax allowances will bring the effective rate between 26 and 35% depending on the type of capital gains.

Another pre-electoral promise of Hollande was the construction of 500,000 new homes per year, while the statistics are revealing less than 300,000 new constructions per year. In view of this effort to increase the supply of housing, it is surprising to observe that gains from the sale of a real estate that is not the main residence are heavily taxed. Indeed, until 2012, tax exemptions were granted in such a way that gains realized after 15 years of ownership were not taxed. The previous (François Fillon) government, however, had modified the mechanism so that, since February 2012, 30 years of ownership are necessary to get a full exemption. President Hollande announced that this duration should be brought down to 22 years starting September 2013.

### Wealth Tax

Besides the regular real estate taxes (« taxe foncière »), France sticks to a wealth tax introduced in 1982 under the first socialist government of the 5th Republic. Before leaving office, President Sarkozy had modified rates and brackets reducing the latter to two brackets: 0,25% for wealth between 1.3 and 3 million euro and 0.5 beyond that threshold; the wealth being taxed from the first euro. When President Hollande took office he immediately decided to increase the wealth tax to erase that “gift” just made to the rich. Consequently, in August 2012 an exceptional contribution based on wealth was introduced on top of the prevailing system. As a result the revenues from the wealth tax have been higher in 2012 than in 2011 reaching €5.175 billion against €4.3 billion the previous year.

In 2013, new brackets will be introduced that will make the tax more progressive. If the wealth is above €1.3 m, the taxpayers will be facing the following progressive scheme:

Base	rate
first € 800,000	0 %
from € 800,000 to € 1.3m	0.5%
from € 1.3 to € 2.57	0.7%
from € 2.7m to € 5m	1%
from € 5m to € 10m	1.25%
above € 10m	1.5%

Clearly, the French tax system remains very complex. “Niches”, that is, exceptions to the general rule, are myriad and the general rule itself is of an un-



unbelievable complexity. It is also without mercy for the successful. It is therefore not surprising that some French citizens and firms are looking towards “fiscal havens”; like the famous actor Gérard Depardieu who wrote in a letter to the Prime Minister: “I leave after having paid in 2012 85% of taxes on my income”. An explanation (or excuse) for increasing the tax burden can be found in a closer analysis of the budgetary policy of the French government.

### **Budgetary policy**

In terms of budgetary policy, the promise made (only!) one year ago to bring public deficit down at 3% of GDP was quickly abandoned, as we had foreseen in our previous report. The budget deficit remains indeed high, - 4.8% in 2012, and the projections for 2013 are close to 4%. This logically translates into higher public debt – 90.2% of GDP in 2012, which represents a 4.4 percentage points increase relatively to 2011. In the spring of 2013 France has got the benediction from Brussels to delay its return to a balanced budget in exchange for a new commitment – to reach the 3% target in 2015!

Interestingly, during the first quarter of 2013, State's expenses have continued to increase (+3.5% from their first quarter level in 2012) and, despite the increased fiscal burden, fiscal revenues increased by only 2.2%.

More problematic than the deficit run by the State is the deficit of the social security system. In 2012 the State spent € 369 billion to finance all of its “missions” (police, justice, national defence, school, university and research, economic programs, etc.); meanwhile, the budget of the social security (health, pensions, unemployment, work accident) for that same year reached € 536 billion. Curiously, however, there was a total lack of interest for that situation even though each year brings new deficits (€ 13 billion in 2012 and probably more in 2013). While the State budget is discussed and covered by media; the social security budget is voted almost with detachment. The time will soon come where this will have to change.





## The big picture

German fiscal policy is at present conducted under very favorable conditions. Capital flight into Germany during the Euro crisis has led to historically low interest rates on newly issued German public debt. Despite a not very low debt-to-GDP ratio of more than 80%, the absolute level of interest payments remains very low, and the share of interest payments in total public spending is not triggering any worries in the short or medium term. There are, however, also some risks in the seemingly very robust German fiscal situation. First and foremost, it is far from certain that low interest rates will remain on their historically low levels in the longer run. The emerging risk-sharing mechanisms within the Eurozone imply that fiscal problems of periphery countries could quickly translate into higher debt burdens for Germany itself. If on the other hand the troubles in the Eurozone are finally resolved, then the role of Germany as a safe haven for bondholders will also decline, and interest rates will rise to more conventional levels again. One way or the other, the country needs to prepare itself for the future by reducing public debt.

Germany's fiscal policymakers are already preparing for the constitutional debt brake, which will come into full effect from 2016, and aims at reducing the scope for public deficits on the federal level to 0.35% p.a. (structural deficit), and at completely eliminating structural budget deficits on the sub-central level. While preparations for the debt brake are slow and behind schedule in some sub-central states, like the largest state Northrhine-Westphalia, the federal government is expecting budget surpluses in the near future. This is both due to a strong increase in tax revenue, as Germany is one of the few Eurozone economies not hit by a recession recently, but also due to a decline of public spending relative to GDP. This share, which had reached levels below 44% before the financial crisis and increased to more than 48% in 2009, is expected to return to 44% by 2016.

Meanwhile, the German tax system still suffers from a number of serious problems. The income tax schedule is generally considered to be too progressive for middle-income earners, and therefore associated with adverse incentive effects on labor supply. The problem of cold progression (see previous issue of the Yearbook), which could technically be solved by simple inflation-indexing of the income tax schedule, is still unresolved. Sub-central jurisdictions, both states and municipalities, suffer from structural underfinancing that could be resolved with an increase in sub-central fiscal autonomy. These are only some representative issues that wait to be tackled; more will be discussed in the following



with an increase in sub-central fiscal autonomy. These are only some representative issues that wait to be tackled; more will be discussed in the following paragraphs.

### Recent changes in tax policy in Germany

There are two obstacles to tax reform in Germany at present: One is the abovementioned priority of budget consolidation and debt reduction. The German government is at this time not interested in large-scale tax reforms with uncertain revenue effects, but prefers a reliable stream of tax revenue that allows fiscal consolidation to be engineered with as few surprises as possible. The other obstacle is of a political kind. The centre-right federal government currently faces a left-wing majority in the upper chamber of parliament, the Bundesrat, which does not show any enthusiasm for tax cuts or efficiency-oriented reforms, even if they could be expected to be revenue-neutral. On the contrary, the strategy of the Social Democrats and the Greens appears to be the stalling of any important legislative initiatives by the government until the federal elections, which will take place in autumn this year. The opposition thereby revives a strategy that had already been successful for them prior to the 1998 federal election, which ended the Kohl government.

The policy preferences of both political camps on tax policy and fiscal policy in general are indeed in strong contradiction. For example, the federal government has in 2011 started a legislative initiative to reduce cold progression in the income tax, which has subsequently been vetoed by the Bundesrat in May 2012. The Social Democrat party runs its federal election campaign with the promise to increase top income tax rates from 45% to 49%, which is opposed by the current centre-right government. The government also opposes proposals by the Green party to re-introduce a reformed net wealth tax, which had been abolished in its old form in 1997, after having been ruled unconstitutional by the constitutional court. A majority in the Bundesrat is strongly in favor of extending income tax privileges intended for married couples to homosexual relationships, which is – so far – opposed by the Christian Democrats and therefore by the government. These are examples for strong ideological divisions on tax policy, and only the autumn federal election will reveal which fiscal policy program will eventually prevail.

Only few actual changes to the fiscal burden of taxpayers can be reported. The contribution rate to the mandatory public pension system has been cut from 19.9% in 2011 to 18.9% in 2013, which was possible due to the very positive development on the labor market. Deductibility of child-care expenses for working parents has become more generous in 2012, in another attempt to influence demographics through tax incentives. Cold progression still works very much in favor of the government and against the taxpayer; it is estimated that about € 3 bn in extra revenue in 2012 was due to higher nominal wages being taxed at higher marginal tax rates in the progressive income tax system.





The tax on nuclear fuels used in nuclear power plants, which was invented in 2011, is currently the subject of a legal controversy and is deemed unconstitutional by several courts. The issue has now been deferred to the constitutional court. While the tax itself – with a tax burden of € 145 per gramme of nuclear fuel – may seem a bit odd and irrelevant on first sight, it has yielded € 1,6 bn in 2011 and was initially expected to generate up to € 2,3 bn in annual revenues. Thus, there is a substantial amount at stake for the federal government, and also for the private energy producers who are liable to pay the tax, and also for the demand side of energy market, which eventually carries some of the tax burden through higher energy prices.

The federal government is still actively supporting the introduction of a financial transaction tax on the European level. If British legal action against the introduction of the tax is not successful and everything goes as planned, then 11 European countries including Germany and France will introduce such a tax starting January 2014. While such a tax is immensely popular among voters in Germany, the financial sector is still campaigning against it. Even the state-owned LBBW bank is part of this campaign; its CEO has recently argued that the bank may even be forced to go out of business if the burden of the financial transaction tax comes as planned. It remains to be seen if the campaign of the opponents of a financial transaction tax in Germany gains some traction in time before the legislative process is completed. Considering the so far broad political support, it is however highly unlikely that plans to introduce the tax will be stopped.

A spectacular event of German tax policy was the demise of the newly negotiated tax treaty between Germany and Switzerland. The treaty would have included a de facto amnesty for German tax evaders with hidden assets in Switzerland, albeit at a high price: Up to 41% of undeclared assets would have been automatically withheld in Switzerland and transferred to the German tax administration. A windfall of up to € 10 bn in revenues was expected by the German government. The left-wing majority in the Bundesrat was, however, strongly opposed to the tax treaty due to a perception of injustice with regard to the tax amnesty. Social Democrats and Greens prefer an, albeit costly, legal prosecution of tax evaders to the automatic taxation at the source and subsequent legalization of undeclared assets. With stolen data on German accounts in Switzerland now being sold often and almost routinely to German tax authorities, any plan for an amnesty for tax evaders has also become very unpopular among voters in Germany.

### Further developments and discussions on German tax policy

It is one of the prime objectives of the current German government (and also of any reasonably likely successor) to fight tax evasion. Germany is very active in organizing political pressure on so-called tax havens to become more transparent. The already mentioned tax treaty with Switzerland, which contained very favorable provisions for Germany, is an example showing that this strategy



can be very successful. The eventual demise of the treaty is to be explained with partisan politics in Germany, and should not be interpreted as a failure to come to reasonable terms with a country that is perceived as a tax haven. The next countries that are likely to be the target of similar political pressure are Luxembourg and Austria.

Ireland and the Netherlands, as two countries that facilitate legal tax avoidance for businesses, will also be exposed to more intense political bullying soon. In particular, the German finance ministry is an avid supporter of an OECD project against the erosion of tax bases in international corporate taxation. It is useful to remember that the campaign against income tax havens at its early stages also featured prominently a naming and shaming of the chief culprits by the OECD. The first OECD report on *Addressing Base Erosion and Profit Shifting* has been produced in early 2013, and it promises the development of a "global and comprehensive action plan" in the foreseeable future. In a similar direction, the German government also supports an initiative of the European Commission to reduce the scope for legal business tax avoidance, and the implementation of a so-called common consolidated corporate tax base in the EU that would put severe restrictions on international profit shifting within the EU.

Domestically, the necessity to reform the property tax (Grundsteuer) becomes more acute with time. The tax rests on a federal law, but gives local municipalities the autonomy to set tax rates and to collect and keep the revenue. There is a high likelihood that the property tax will be ruled unconstitutional in its current form by the constitutional court. The reason is that the values of property that enter the tax base are in general not current market values, but are based on estimates which are, in West Germany, almost five decades old. This is especially problematic for property with buildings, or even new buildings, whose market value may far exceed the old approximated values. Different reform options for the tax base are currently discussed: i) only the physical space of property, but not the value could serve as a tax base; ii) the use of current market values; iii) the use of the market value of the land, and the physical space of buildings as a tax base.

The first and third options attempt to circumvent the tedious task of keeping records of current building values. The first reform option is associated with very low administrative costs, but may be perceived as unjust in a world with large local variations in property values. The third option is a compromise in this respect, with land values often being easier to approximate than values of buildings. The second option can probably be considered the most equitable if ability to pay is the relevant criterion, but it is also associated with particularly high costs of tax administration. So far, it is uncertain which reform approach will receive the largest political support. A large coalition of local politicians is however in favor of simplifying the tax and keeping the costs of tax administration as low as possible, which clearly speaks against the second reform option.



Finally, the inheritance tax is also a candidate for reform again, after the last broad overhaul took place as recently as January 2008. The main problem here is the existence of generous tax exemptions for inherited businesses. The purpose of these exemptions is not to burden ongoing businesses with inheritance taxes, in order to avoid liquidity problems in case of a transfer of ownership from one generation to the next. The problem is now that these exemptions can also be used as a vehicle to avoid inheritance tax on non-business wealth transfers, through the shift of private assets into a business, which even may only be founded for the sole purpose of inheritance tax avoidance (the so-called "Cash GmbH"). There is a widespread consensus across the political spectrum that this type of abuse of the original tax exemption should be made more difficult, and legislation is likely to pass before the autumn elections.

In addition to this, there is also the possibility that tax exemptions for businesses in the inheritance tax will be outlawed completely by the constitutional court. Positive discrimination that favors specific types of transferred wealth relative to others may be unconstitutional: A certain interpretation of the German constitution demands that all types of wealth are treated equally in case of an inheritance. If the court will indeed rule along these lines, and the tax exemptions for businesses will have to be abolished completely, then the problem arises again that the inheritance tax may be associated with highly negative effects on the liquidity of ongoing businesses. Another larger-scale reform of the inheritance tax would be a probable outcome.

### Summary and discussion

Institutional, macroeconomic and political restrictions presently pose as obstacles against large-scale tax reforms in Germany. There would be plenty of tasks for policymakers, in particular with regard to simplifying the income tax and making it more efficient, but it is highly unlikely that the necessary majority in both houses of parliament could be secured at any time soon. In general, politics is currently often pushed into action by the constitutional court, instead of becoming active by itself. The frequency with which constitutional doubts with regard to the legality of tax laws occur, and also prove to be correct, is disappointing. The legal quality of the tax laws coming out of the legislative process appears to be deteriorating more and more.

The upcoming autumn elections are very important for the further development of tax policy. If the current opposition wins the election, it will have a majority in both houses of parliament and is likely to use it to increase the top rate of the income tax to 49%. It is also likely that other taxes and public spending would increase. If on the other hand the current government is re-elected, the current political situation will be prolonged, and the scope for decisive action in fiscal policy would remain small for the foreseeable future.





The Greek governments had followed expansionary fiscal policies for many years. The government spending remained at high levels, chronic budget deficits continued, tax collection weakened, and public debt exceeded the size of the economy. The global economic crisis that started to take hold in 2008 exposed the structural weaknesses of the Greek economy. After the eruption of the debt crisis, Greece has embarked on an adjustment program, aimed at tackling the fiscal imbalances. As a result of this effort, Greece has experienced the largest fiscal consolidation among all countries of the Euro area. Given the state of the real economy, the fiscal consolidation, required to restore sustainable public finances, should rely on curtailing public expenditures and strengthening the tax collection, instead of further increasing taxes.

## Current Situation

The Greek governments had followed expansionary fiscal policies for many years, which initially were financed by printing money and then by issuing Greek debt. The expansion of domestic demand generated an upward pressure in prices in non-tradable sectors. The increase in relative prices caused a reallocation of resources from tradable to non-tradable sectors, inducing an increase in labour costs and a subsequent loss in competitiveness, which resulted in external imbalances. The current account deficit rose to 12.1 percent of GDP in 2012 and the net international investment position amounted to -92.5 percent of GDP in the same year. The global economic crisis that started to take hold in 2008 unveiled the chronic and structural weaknesses of the Greek economy. Apart from the external imbalances, the main economic problems of Greece were located in the sphere of fiscal imbalances, with the structural deficit approaching at 10 percent of GDP in 2008 and the public debt exceeding 110 percent of GDP that same year. Since 2010, Greece has embarked on an adjustment program, implemented with the technical and financial support of the International Monetary Fund, the European Union and the European Central Bank, which aimed at tackling the fiscal imbalances and setting the economy on the right track with growth and prosperity. The austerity program has relied on cutting wages and salaries, and increasing taxes. As a result, the domestic demand has been severely decreased and the real economy has fallen in depression. The real GDP in constant prices was reduced from EUR 225.3 billion in 2009 to EUR 168.5 billion in 2012, which amounted to a reduction of about 25 percent, while unemployment jumped to 26 percent in the fourth quarter of 2012 from 10 percent in the corresponding period of 2009. On the fiscal front, the developments in the fiscal aggregates during the last twelve years are presented in Table 1 below. The data up to 2011 were obtained from Eurostat, while the data



for 2012 were obtained from the Ministry of Finance. The fiscal deficit was decreased from 9.4 percent of GDP in 2011 to 6.5 percent in 2012, while public debt was reduced from 170.6 percent of GDP in 2011 to about 152.6 percent of GDP in the third quarter of 2012, after a write down of the privately held Greek debt. The fiscal deficit in 2012 reflected a fall in revenues, on the one hand, and, on the other hand, a collapse in real output. The general government revenues were decreased from EUR 112.6 billions in 2011 to EUR 106.2 billions in 2012, while the total government expenditures (primary and interest payments) were decreased from EUR 133.3 billions in 2011 to EUR 118.8 billions in 2012. These changes reduced the general government deficit from EUR 20.6 billions in 2011 to EUR 12.5 billions in 2012. In Table 2 below, we show the revenues accrued from direct and indirect taxes. On inspection, we observe that the indirect taxes accounted for the bulk of tax revenues in both 2011 and 2012.

**Table 1: Fiscal Aggregates as percentage of GDP**

Year	Expenditures as % of GDP	Revenues as % of GDP	Fiscal Deficit as % of GDP	Public Debt as % of GDP
2012	61.3	54.8	-6.5	152.6
2011	51.8	42.3	-9.4	170.6
2010	51.5	40.6	-10.7	148.3
2009	50.4	38.3	-15.6	129.7
2008	50.6	40.7	-9.8	112.9
2007	47.5	40.7	-6.5	107.4
2006	45.3	39.2	-5.7	106.1
2005	44.6	39.0	-5.2	100.0
2004	45.3	38.1	-7.5	98.6
2003	44.7	39.0	-5.6	97.4
2002	45.1	40.3	-4.8	101.7
2001	45.4	40.9	-4.5	103.7
2000	46.7	43.0	-3.7	103.4

Source: Eurostat and Ministry of Finance (General Government Data, Monthly Bulletin, December 2012)

**Table 2: Tax Revenues (in millions of euro and percent of GDP)**

TAXES	2011		2012	
<b>Direct taxes</b>	<b>20,318</b>	<b>9.74%</b>	<b>21,097</b>	<b>10.89%</b>
Income tax	12,934	6.2%	13,311	6.87%
Property taxes	1,172	0.56%	2,857	1.47%
<b>Indirect taxes</b>	<b>28,632</b>	<b>13.73%</b>	<b>26,082</b>	<b>13.46%</b>
Transaction taxes	17,790	8.53%	15,686	8.09%
Consumption taxes	10,131	4.86%	9,627	4.97%

Source: Ministry of Finance



## Tax Policy

According to Heritage's 2013 Index of Economic Freedom, the overall tax burden in Greece in 2012 amounted to about 31 percent of GDP. The tax burden can be measured with several alternative indicators, including marginal and average personal tax rates. Marginal tax rates, which indicate the tax payable on additional earnings, affect incentives to increase work effort, while average tax rates levied on personal incomes may affect incentives to participate in the labour market. The statutory tax rates together with the tax base constitute the most important factors which determine the tax burden. In conjunction with statutory rates, other elements of the tax system contribute to the public finance. The main sources of the public revenues are the following:

### *Personal income tax*

Since 2010, Greece has introduced an eight-bracket system, as a part of its fiscal consolidation strategy, which lasted until December 31, 2012. All types of income were unified and taxed based on the income tax scale with progressive tax rates ranging from 10 to 45 percent for income over EUR 100,000 (see Table 3). Since January 2011, a solidarity contribution has been imposed on all taxpayers with annual income exceeding EUR 12,000, with a progressive scale starting at 1 percent and rising to 4 percent for annual income over EUR 100,000. Thus, the top statutory tax rate on personal income amounted to 49 percent in 2012 and remained unchanged from the last year. The tax rate was above the European Union (EU-27) average of 38.1 percent and Euro area (EA-17) average of 43.1 percent. In 2011, the tax-free threshold was reduced from EUR 12,000 to EUR 5,000 and remained unchanged in 2012. The tax free allowance was given to taxpayers who had an annual income up to EUR 60,000 and collected receipts of living expenses covering at least 25 percent of the taxable income. If the collected receipts covered a smaller proportion of the taxable income, a tax of 10 percent was levied on the difference between the amount collected and the required amount.

The personal income tax system has been reformed with the law 4110/2013 which has brought profound changes to income taxation from every source. A three-tier system is introduced for employees and pensioners. The new tax scale imposes a tax rate of 22 percent on incomes up to EUR 25,000, a tax rate of 32 percent on incomes from EUR 25,001 to EUR 42,000 and a tax rate of 42 percent on higher incomes (see Table 4). A tax credit of EUR 2,100 is established and given in full to all employees and pensioners with annual income up to EUR 21,000. For higher incomes, the tax discount is reduced to EUR 100 per EUR 1,000 of income until the full amount is exhausted.



**Table 3: Personal Income Tax**

Income scale (in euro)	Tax rate (%)	Scale tax (in euro)	Income total (in euro)	Tax total (in euro)
5,000	0	0	5,000	0
7,000	10	700	12,000	700
4,000	18	720	16,000	1,420
10,000	25	2,500	26,000	3,920
14,000	35	4,900	40,000	8,820
20,000	38	7,600	60,000	16,420
40,000	40	16,000	100,000	32,420
Over 100,000	45			

Source: Ministry of Finance

**Table 4: Personal Income Tax (new scale)**

Income scale (in euro)	Tax rate (%)	Scale tax (in euro)	Income total (in euro)	Tax total (in euro)
25,000	22	5,500	25,000	5,500
17,000	32	5,440	42,000	10,940
Over 42,000	42			

Source: Ministry of Finance

### *Corporate income tax*

The statutory rate was cut from 25 percent in 2009 to 20 percent in 2010 and remained unchanged until December 31, 2012. At the same time, a special contribution at progressive rates was levied for enterprises with a net income above EUR 100,000. The top rate was 10 percent, thus increasing the top statutory tax rate on corporate income to 30 percent in 2012. This rate remained unchanged from the last year. The tax rate was above the EU-27 average of 23.5 percent and EA-17 average of 26.5 percent. With the new tax law 4110/2013, a progressive tax rate is imposed on private companies and self-employed (see Table 5). For the portion of income till EUR 50,000 the tax rate will be 26 percent and for higher incomes the tax rate will be 33 percent. The same scale is applied to General partnerships, limited partnerships, civil societies engaged in business or profession, civil or nonprofit companies, joint or invisible companies and joint ventures that do not maintain double-entry books. When the above maintain double-entry books, a tax of 26 percent is levied on their total net income. A tax of 13 percent will be levied on incomes earned from private agricultural businesses.

**Table 5: Corporate Income Tax (new scale)**

Income scale (in euro)	Tax rate (%)	Scale tax (in euro)	Income total (in euro)	Tax total (in euro)
50,000	26	13,000	50,000	13,000
Over 50,000	33			

Source: Ministry of Finance





### *Investment income tax*

A withholding tax of 25 percent was levied to dividends and distributed profits paid by enterprises in 2012. This rate was increased by 4 percent from the previous year. A withholding tax of 10 percent is levied to capital interest. The real estate income is taxed at 1.5 percent, which increased to 3 percent if the surface area of the property is greater than 300 square meters. With the new tax law 4110/2013, rental income as well as investment income, excluding income taxed at the source with no further tax liability, will be taxed at a rate of 10 percent up to EUR 12,000 and 33 percent for higher brackets. The tax rate on dividends and distributed profits will be reduced to 10 percent, the withholding tax on capital interest will be increased to 15 percent, and the withholding tax from derivative income will be increased from 15 to 20 percent.

### *Value Added Tax and Excise duties*

The standard VAT rate, which applies to most goods and services, was 23 percent in 2012 and remained unchanged from the previous year. The tax rate was above the EU-27 average of 20 percent and EA-17 average of 21 percent. A reduced rate of 13 percent applies to certain goods and services, such as fresh food products, pharmaceutical, electricity, transportation, hospitality and other professional services. There also exists a super-reduced rate of 6.5 percent which applies to very few goods and services, such as books, newspapers and periodicals, and hotel accommodation services. In addition, specific rates of 5, 9 and 16 percent apply to some islands of the Aegean Sea. Excise tax rates are levied on mineral oils, beer, alcoholic beverages and tobacco, and have been increased repeatedly.

### *Wealth tax/Property tax*

There is no a wealth tax in Greece. The taxation of properties was based on their objective value, determined by surface area, location and construction year. Based on the tax reform introduced with the law 3842/2010, a tax rate ranging from 0.2 to 1 percent was levied on properties from EUR 200,000 to EUR 5 million. The top rate was applied to real estate over EUR 800,000. For properties over EUR 5 million the rate was 2 percent. Since 2011, a real estate tax duty has been levied on residential property, calculated on the surface area of the buildings and taken into account location and age and is collected through the payment of electricity bills.

### *Capital gains tax*

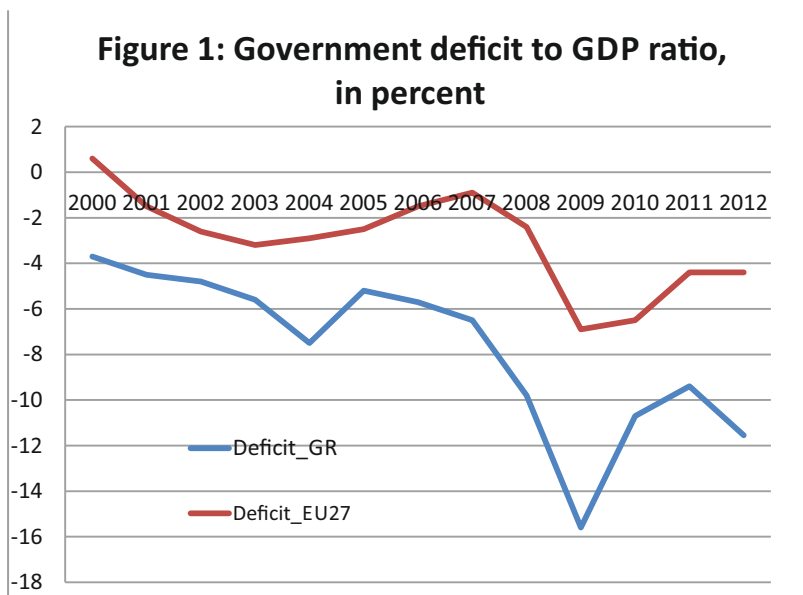
The capital gains realized from the sale of a business, a share in a business or business rights are taxed at 20 percent. A tax of 0.2 percent is also levied on the sale of shares traded on the Athens stock of exchange or on foreign exchanges. The tax rate on capital gains realized from properties purchased after 2006 depended on the holding period. With the new law 4110/2013, capital gains derived from the transfer of real estate acquired after January 1, 2013 will be taxed with a rate of 20 percent. The taxation will be computed on the difference between selling and buying prices. The capital gain will be deflated and adjusted



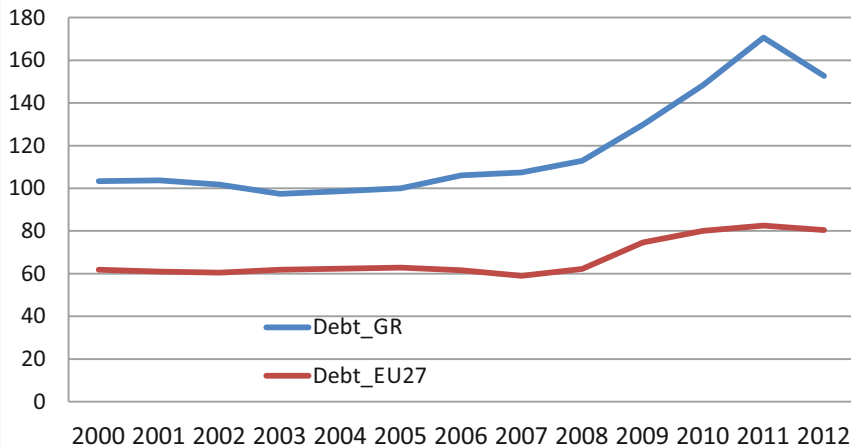
with rates depending on the years of ownership of the real estate.

### Budgetary policy

As we can see from Figure 1 below, the government deficit to GDP ratio in Greece was hovering between 4 and 6 percent until 2006, and then, as a result of expansionary fiscal policies, it was dramatically increased to over 15 percent of GDP in 2009. Thereafter, as a result of fiscal consolidation, it declined to an average of 11.5 percent of GDP in the first three quarters of 2012, but remained above the EU-27 average of 4.4 percent. Nevertheless, Greece has experienced the largest fiscal consolidation among all countries of EU-27. By inspecting Figure 2 below, we can see that the same story emerges from the government debt to GDP ratio. Until the middle of last decade, this ratio was fluctuating around 100 percent. Since then, it has started to increase substantially, reaching 170.6 percent in 2011. Greek government debt was reduced to 152.6 percent in the third quarter of 2012, thanks to the debt restructuring conducted over the course of the year. The picture which emerges from the budgetary adjustments can be characterized as the best change in 2012.



**Figure 2: Government debt to GDP ratio, in percent**



## Conclusions

Fiscal policy in Greece has paved the way for the current economic crisis. For many years government spending remained at high levels, chronic budget deficits continued, tax collection weakened, and public debt exceeded the size of the economy. In the aftermath of the debt crisis, Greece has embarked on economic reforms in order to bring its public finance on a sustainable path and set the economy on the right track with growth and prosperity. Given the collapse of real output and soaring unemployment, the stabilization of the real economy, in the context of fiscal consolidation, should rely on curtailing public expenditures and strengthening tax collection, instead of further cutting wages and salaries, and increasing taxes. In addition, structural reforms are required to open production and labour markets, eliminating the rampant tax evasion in the private sector, improve investment climate and increase productivity, thus increasing real incomes and economic welfare.



## Systemic chaos

Looking at the main tax types, there was no change in the corporate profit tax in 2012, the rate of the personal income tax remained 16% but the tax temporarily became progressive due to changes in the calculation of the tax base while the standard VAT rate increased from 25% to 27%. Furthermore, the sectorial taxes previously claimed to be temporary were definitively incorporated in the tax system, and a number of small-volume consumption taxes were introduced under the pressure for continuous budget adjustments due to the deteriorating economic figures.

## Taxes on income

In 2012 the Government went ahead with the overhaul of the personal income tax regime started in the previous year. In 2011 the progressive tax regime, with tax rates of 17% and 32% (in theory – in practice, the rates were 21.6 and 40.6% due to the so-called 'half-supergrossing' arrangement) was replaced by a linear tax rate of 16% (in theory; 20.6% in practice). (The details of 'half-supergrossing' are discussed in Box 1.) In 2012, half-supergrossing was abolished up to an annual income level of HUF 2,424 thousand (EUR 8376), that is, the effective tax rate dropped to 16 percent. However, the system of employee tax credit that existed up to 2011 was abolished at the same time (for the discussion of tax credit see Box 1). The abolishment of tax credit would have resulted in a decrease in after tax income for low income earners; therefore, the Government increased the minimum wage by 19 % to HUF 1,116 thousand (EUR 3856) a year and announced, in a decree, the rates of wage increase they expected employers to implement in each income bracket. Failure to comply incurred no sanctions for undertakings; however, if the company did comply, they could make use of another tax benefit in the social contribution tax regime (new name of the social security contribution).

The new law that came into effect in 2013 eliminates 'half-supergrossing' in its entirety and creates the personal income tax regime with a flat 16% tax rate envisaged by the Government.

No substantive change occurred in the corporate profit tax in 2012 or 2013. The standard rate continues to be 19 percent but a rate of 10 percent is applicable to the tax base up to HUF 500 million (EUR 1.73 million).



## Consumption taxes

As of 1 January 2012 the standard VAT rate was raised to 27 %, the highest among EU Member States. The two reduced rates and the scope of products subject to these rates did not change: the tax rate for milk, bread and accommodation services remained 18% while the rate for therapeutic equipment, books, newspapers and district heating stayed at 5%.

Taxes on consumption other than the VAT also increased: the Government hiked the excise tax on alcohol, tobacco products and automotive fuels twice in 2012, followed by yet another rise at the beginning of 2013. However, the tax hike did not extend to alcohol produced for own use (mostly home-distilled brandy), which continues to be exempt up to 1000 litres (a legal procedure is to be expected on the EU level as the Commission considers the Hungarian legislation giving preferential treatment to home distilling to be incompatible with EU rules).

Other special consumption-type taxes have been added to the two large taxes of this kind. Producers and providers of pornographic content has been liable to a cultural tax since the beginning of 2012 while mandatory motor liability insurance has been subject to a so-called accident tax since September 2011. The telecom tax entered into force in the middle of 2012: HUF 2 (0.007 euro) tax is payable on each minute of phone call and each text message sent. For private individuals, the first 10 minutes are free each month and there is a cap of HUF 700 (EUR 2.4) a month for private individuals and HUF 2500 (EUR 8.6) a month for corporate subscribers.

The public health product tax entered into force already in September 2011. It is payable on foodstuffs that the Government considers unhealthy (soft drinks, energy drinks, sweetened products, salted snacks). The scope of products covered was expanded early in 2012 (flavoured beers, fruit jam) and the legal definition of certain terms was amended in response to producers circumventing previous definitions by altering their recipes.

## Other taxes

The so-called crisis taxes, introduced in 2010, were abolished on paper in 2013; in practice, however, this mostly means a simple change of name. The bank levy remained in place in unchanged form, that is, it is calculated from the balance sheet total of 2009 (!) at a rate of 0.1 percent on the first HUF 50 billion (EUR 172.76 million) and at 0.53 percent above that threshold. The Government raises HUF 190 billion (EUR 0.65 billion) of revenues from this levy, which is close to the total profits of credit institutions in the pre-crisis year of 2007.

The special tax on financial institutions does not apply to insurance companies; instead, the aforementioned accident tax has been introduced together with a new insurance tax payable on all insurance transactions except the MTPL.

The special sectoral tax on telecommunications companies has been replaced by the telecom tax mentioned above.



As a novel form of collecting the crisis tax on the retail sector, the rules applicable to the local business tax have changed: only a part of the cost of goods sold can be deducted from the tax base. Essentially, retail chains and energy suppliers are subject to a substantially higher local business tax.

Instead of the abolishment of the profit-based crisis tax on the energy sector at end-2012, it has been extended to other utility companies as of 2013 and its rate has increased from 8 percent to 31 percent. Thus the corporate profit tax of energy companies is 50 percent instead of the standard rate of 19 percent.

From 2013 on, utility companies operating line networks (including most energy suppliers) are also subject to a so-called public utility tax, at the rate of HUF 125 (EUR 0.0043 ) per metre of utility line.

The tax on financial transactions entered into force in 2013, imposed on payment transactions of households and businesses alike. Previously some South American countries have implemented such a tax, which is almost the direct opposite of the Tobin tax imposed on securities and foreign exchange transactions to curb speculation. While the Tobin tax basically affects speculative and derivative transactions and does not apply to non-speculative transactions (wage, transfer, purchase of goods and services, etc.), the Hungarian (and previous South American) taxes hit especially these non speculative transactions, while the interbank and other “wholesale” transactions are exempt. Moreover the tax is degressive with a single rate (currently 0.2% of the transaction value) with a cap at HUF 6 thousand (EUR 20.7), except for cash transactions, where the rate is 0.3%. The Government proposes to raise HUF 283 billion (EUR 1 billion or 1% of GDP) from the transaction tax in 2013. According to recent data this is a gross overestimate of the actual revenue to be expected.

(The Government appears to be well prepared on the Tobin tax for once, as the law also provides for the transaction tax on securities that is being discussed in the EU, but the entry into force of those sections is conditional on the adoption of the levy on the EU level.) The Government intended to expand the transaction tax, originally proposed to have a rate of 1 thousandth, to the transactions of the National Bank of Hungary (central bank) but it gave up on that plan in response to the intense opposition of the EU and the ECB. The revenue foregone has been offset by doubling the tax rate.

### **Changes in the system of social contributions and the pension system**

As of 2012, the Government has combined the various contributions payable by employers (health insurance, unemployment insurance, pension) into a single tax, the social contribution tax. The rate of the new tax is 27%, the same as the aggregate rates of the contributions replaced. The sole purpose of the name change was to exploit a legal loophole. In 2011 the Government nationalised the



overwhelming majority of pension funds relying on a threat. They stated that private pension fund members refusing to 'voluntarily' return to the state pillar, i.e., to pay the 8.5 percent employee contribution previously paid into the private pension fund to the state and also to donate the accumulated savings, potentially amounting to millions of forints, to the state would not be eligible to any state pension in their old age. One of the many legal issues with this threat was the fact that pension entitlement is based on the employee as well as employer contributions. Employer contributions were, and still are, paid into the pay-as-you-go state pillar, therefore those who remained private pension fund members should have obtained pension entitlements by virtue of contribution paid by their employers. The Government took that entitlement away by renaming the employer contribution a 'tax', which, in the interpretation of the Government, does not give rise to any pension entitlement. Before 2010 the relevant act could have been challenged in the Constitutional Court; at the end of 2010, however, the governing parties, with their two-thirds majority in parliament, changed the Act on the Constitutional court, declaring that the Constitutional Court has no remit in cases affecting the budget.

In 2012 labour income above HUF 7.94 million (EUR 27.4 thousand) was not subject to the 10 percent employee contribution payment. As of 2013, this cap, which had affected some 2-3 percent of persons submitting PIT returns, has been abolished.

### **Tax benefits to promote employment**

Mention should be made of the pro-employment measures of the Government. In order to safeguard jobs and to improve the position of SMEs, the Government announced a so-called Job Protection Action Plan in the summer of 2012. Under this programme, from 2013 on reductions are available from the social contribution tax for certain labour groups while two new tax regimes have been added to those already available to SMEs.

The special labour groups include employees below 25 and above 55 years of age, persons employed in jobs not requiring vocational qualifications, long term unemployed persons and women returning to work after giving birth. Of these, the social contribution tax for the long-term unemployed and women returning to work after giving birth is forgiven in its entirety up to the wage of HUF 100 thousand (EUR 345), while the tax is halved for the other groups. Moreover, under other laws, reductions are available to persons employed by projects established in free enterprise zones and to researchers employed in R&D, in both cases the entire sum of the social contribution tax is forgiven up to wages of HUF 100 thousand and HUF 500 thousand (EUR 1,727), respectively.

Under the itemized tax of small businesses, one of the tax regimes for the SME sector, upon the payment of HUF 50 thousand (EUR 173) per month, the enterprise is relieved from almost all tax and administration burdens. Under the





small business tax, a 16% tax is payable on the basis of the annual wage bill and the changes in financial assets during the year. The latter is more favourable than the 27% social contribution tax but higher than the 10% corporate profit tax, therefore it depends on the ratio of the components of the tax base whether this is advantageous for a particular business.

**Table 1: Main changes in taxation**

Name of tax	Sector	Description of the tax
2012		
PIT	Households	Up to an annual income of HUF 2.4 million (EUR 8376) the elimination of 'half-supergrossing' (See box 1), abolition of tax credit.
VAT		The standard rate increased from 25% to 27%.
Social contribution tax	Employers	The aggregate of the pension, health care and labour market contributions renamed a tax, at the rate of 27%.
Cultural tax	Producers and suppliers of pornographic content	25% of the net turnover from the activity concerned.
Accident tax	Insurance companies	Tax on mandatory third party liability insurance; 30% of the premium.
Telecommunications tax	Telecommunications	HUF 2 (0.7 euro cent) on each minute of call and each text message sent, but the first 10 minutes are free for private individuals and the monthly tax amount is capped (at HUF 700 for private persons and HUF 2500 in general).
2013		
PIT	Households	The abolition of 'half-supergrossing' in respect of all income (See Box 1).
Special tax on the energy sector	Energy sector	On top of the 10/19% corporate profit tax, a 31% profit tax, from which the value of investments can be deducted up to 50% of the tax.
Utility tax	Energy sector, telecommunication, public utility companies	A tax of HUF 125 (EUR 0.4) on each meter of utility line owned, progressive depending on the total length of lines: companies owning small networks need to pay only part of the tax.
Local business tax	Retail chains, energy sector	The items deductible from the base of the local business tax are reduced by brackets, that is, if higher turnover is generated, the tax based is reduced by a proportionately smaller amount.
Insurance tax	Insurance companies	Tax on insurance products other than the mandatory third party liability insurance; 10% of the premium (15% for Casco).
Financial transaction tax	Financial sector	0.2% of the value of bank transactions must be paid as transaction tax, with a cap of HUF 6000 (EUR 20.7). The tax rate on cash transactions is 0.3%. Securities-related and speculative transactions are not subject to the tax.
Itemized tax of small businesses (KATA)	SME sector	Upon the payment of HUF 50 thousand (EUR 173) the employer is exempted from other dues payable to the central budget.
Small business tax (KIVA)	SME sector	A flat tax of 16% is payable on the wagebill and cash-based profits, but it replaces the 27% social contribution tax and the 10/19% corporate profit tax.

## Whitening of the economy

The Government expect substantial budgetary income from the measures aiming to curb the black economy. One of the most important elements of this is the on-line connection of cash registers to the National Tax and Customs Administration, through which the tax authority would be able to verify every retail invoice. The system was originally proposed to start up early in 2013 but now it is expected to be implemented only in the second half of the year, thus the additional income of HUF 95 billion (EUR 328 million) expected by the Government may turn out to be lower. The examples of other countries (Bulgaria,



Sweden) indicate that this measure may indeed improve the efficiency of tax control. The limitation of cash payment serves the same purpose as cash payments between two businesses may not exceed HUF 1.5 million (EUR 5183) a month, while in case of intercompany payments of at least HUF 2 million (EUR 6910), the companies affected need to submit the related VAT returns itemised by invoice.

**Box 1: Half-supergrossing, pension reform and tax credit**

**Half-supergrossing:** In the Hungarian regime the so-called half-supergrossing simply meant that the PIT base was not simply the gross wage but the sum of the gross wage and the employer contribution (renamed social contribution tax from 2012 on), that is, 1.27 times the gross wage. As the employer contribution was 27 percent throughout the existence of the half-supergrossing regime, this substantively corresponds to a tax rate increase of 127 percent. This arrangement was introduced primarily for considerations of political marketing: 'at first glance' this made the nominal rate lower, thus and a higher tax bracket ceiling could be included in the law. Originally, the proponents of 'supergrossing' did not have this type of political marketing in mind when putting forth their ideas. Instead, they thought that if employees are confronted with the total levies on their labour, namely, the tax wedge between the total cost to the employer and the net wage of the employee, this may be conducive to greater social support for the reduction of labour taxes and the government policies aimed to improve the international competitiveness of the Hungarian economy.

**Pension reform:** In two steps in 2010 and 2011 the Hungarian Government forced 97% of private pension fund members to transfer to the state pillar, confiscating some HUF 3 thousand billion (corresponding to approximately 10% of the annual GDP.) At the same time, the 10% pension contribution payable by the employees was also diverted into the central budget, thus the members remaining in private pension funds can add to their accumulated savings only through voluntary payments. As a result of these measures, a number of pension funds have closed down or merged, and the second pillar of the pension system has disappeared. Simultaneously, the Government also revised the rules of retirement and the tightening trend started in 2008 was continued, primarily by limiting the possibility to go into early retirement. However, the sustainability of the pension system was worsened by the abolition of the ceiling on contributions in 2013, as the cap on pensions to be paid has also been removed.

**Tax credit:** A tax allowance employed in the Hungarian personal income tax regime between 1997 and 2012. Taxpayers could deduct a certain percentage of their income from employment from the amount of tax up to a specified ceiling. The employee tax credit has the advantage of alleviating the tax burdens of low-income persons without giving high income earners any part of the benefit. The challenge is to find a way to assure that the tax credit is not available above a certain income level. In the band where the tax credit drops from maximum to zero, the marginal tax rate is higher than the legal rate, which provides incentives to reduce the reported income (less work and/or concealment of income).

## Summary and some interpretation

In 2012 numerous tax measures were implemented in Hungary. These were driven by two main motives: the Government that obtained qualified majority at the election of 2010, in order to offset the effects of the significant PIT rate cut implemented in 2010, continued last year to raise consumption taxes and special sectoral taxes so that it can permanently reduce the fiscal deficit below 3 percent of GDP. In 2011, due to one-off measures (such as the nationalization of the assets of private pension funds) the Government was able to produce a substantial fiscal surplus corresponding to 4.3% of GDP. However, the position of the budget was less favourable because without the one-offs the deficit amounted to 5.5% of GDP, which in effect represented a 2 percentage point relaxation as compared to 2010. Consequently, in 2012 the Government had to adopt a number of decisions to improve the fiscal balance. Due to the structure of the measures adopted, growth prospects continued to worsened, therefore the



macroeconomic path moved even further from the unrealistically optimistic scenario originally envisaged by the Government. Even though the Government managed to achieve its goal through a series of adjustments (a total of 9 packages in the course of 2012), and the deficit calculated with the EU methodology was around 2.7% of GDP (according to preliminary data) in line with the undertakings of the Convergence Programme, the potential growth rate was reduced to near-zero. The public debt to GDP ratio fell from 81.4% at end-2011 to 79.1% at end-2012. However, some 40% of the debt is denominated in foreign currencies, and thus by February 2013 the ratio rose to above 80% again due to the weakening of the EUR/HUF exchange rate.

In possession of its qualified majority, the Government would be able to implement structural reforms, but most of these are still waiting to happen. Even though the spring Convergence Programmes of 2011 and 2012 both included ambitious expenditure cuts, a substantial part of these were never realised (e.g., the reform of public transportation as recommended by international organisations failed to happen, and health care and education also saw only centralisation while efficiency increases are still to be seen). In addition to the absent reforms, the overly optimistic growth expectations led to constant adjustment needs in the budget. The tax revenue increasing proposals thought up in the last minute were prepared in a frenzy and legislation already adopted often had to be amended due to difficulties encountered in their implementation. Frequent amendments in turn led to increased uncertainty, which is shown by the fact that SMEs are very reluctant to switch to tax regimes entailing smaller tax burdens for them - approximately one third of the potential targets made use of the opportunity offered. Effectively, the Government has manoeuvred itself into a vicious circle: it wants to address fiscal problems with haphazard decisions, but the price of short term benefits (in a few months horizon) tends to be the inception of longer term problems (with growth, regulation and credibility). In this respect, the tendency to be expected in 2013 is not substantially different from the trends seen in the previous year.

The tax changes of the 2010-2013 period can already be evaluated from three aspects:

1. The cut in income tax rates in 2010, the linear PIT system and the increase of the ceiling of the corporate profit tax bracket from the former HUF 50 million to HUF 500 million did not trigger the explosive growth envisaged by the Government; indeed, the ad hoc, unpredictable measures to stop the gap thus generated in the budget definitely and significantly reduced the growth rate. In 2012 household consumption declined by 1.2%. Based on model estimates, the flat-rate PIT system increases employment, a priority among the Government's goals, by a mere 0.4% in the long term, thus no exceptional consumption growth is to be expected from this effect either (Benczúr et al: Assessing changes of the Hungarian tax and transfer system: A general equilibrium micro-



-simulation approach, 2011, p.10, URL: <http://goo.gl/FQZsv>). The adoption of a linear tax regime may also appear rather peculiar in a regional context as other countries in the region have admitted difficulties in maintaining the flat-rate system, and some countries have already re-introduced the progressive tax regime.

2. The constant hikes in consumption tax rates have increased inflation and kept inflation expectations high. Even though in 2013, as the effects of previous consumption tax increases fade, inflation will fall below 3 percent, the expected treatment of the persistent fiscal problems (more consumption tax hikes) is more conducive to higher inflation. (This may temporarily be dampened by the new method of the Government whereby, irrespective of profits, purchase prices and any other taxes, it compels utility companies to reduce their rates by 10 percent but this obviously cannot be maintained even in the medium term, and it is already under legal scrutiny by the EU.)
3. Through taxing businesses (primarily multinationals) the Government saves households from the burdens of taxation only on the level of communication, as consumers will eventually have to pay for those taxes as the costs are passed through to them. If the companies are unable to pass through the new or increased taxes to consumers or their own employees, then in order to restore their profit rates, they will move towards constraining their activity, investments and exposure to Hungary, which will definitively undermine long term growth prospects.



# Ireland

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2012 saw the stabilisation of the economic situation in the Republic of Ireland. Irish GDP returned to growth with real GDP rising by 0.9 percent and real GNP rising by an unexpected 3.9 percent. The Budget for 2013 comes in the aftermath of three years participation in a bailout and stability adjustment programme implemented by the Troika (European Central Bank, European Commission and the International Monetary Fund). Contingent in this programme saw dramatic tax increases and spending cuts amounting to over €15bn or 9 percent of GDP. The adjustment measures were front loaded however, resulting in the majority of the measures being implemented during the first two years of the programme, between 2011 and 2012. Thus, the Irish Budget for 2013 saw markedly fewer changes in comparison to the previous two years. VAT, income and corporate tax remain broadly untouched. Excise duties saw the bulk of tax increases, especially on alcohol, cigarettes, and petrol. The real story of the 2013 budget was the re-introduction of a property tax into the Republic, which has not been seen since 1977.

## **2012: A year of calming Irish seas**

The Irish government has reached and surpassed all of the targets imposed on it as part of the Troika stability adjustment programme it entered into in 2010 following the collapse of its banking sector. The cost of borrowing has fallen to nearly pre-crisis levels as the Irish government prepares itself to return to bond markets as planned in 2015. In many ways, Ireland has been the success story for the Troika programmes, and the record looks like it will hold. The underlying deficit is estimated at 7.7% (target was 8.6%) and the actual general government deficit at 8.2%. The difference between the actual and underlying deficit reflects financial sector measures, otherwise known as one-off bailout transfers to failing financial institutions, estimated at €6.8 billion in 2011, €0.1 billion in each of 2012-2014 and €50 million in 2015.

Furthermore, since the publishing of the 2013 budget in December 2012, the good news with regards Ireland's economic progress was further reinforced by newly released figures in April 2013 revealing a higher than estimated nominal GDP for 2012, better than anticipated Exchequer outturn for 2012 and, of course, the liquidation of the Irish Bank Resolution Corporation (a "bad bank" formed in 2011 that contained two previously nationalised banks called Anglo Irish Bank and Irish Nationwide Building Society) which saw a restructuring of Irish debt and a lowering of the projected General Government deficit by approximately 0.6% of GDP for the years 2014 & 2015.



## Personal income Tax

There are no changes to income tax rates or standard cut-off points in 2013. Maternity benefit will now fall under taxable income and “Top Slicing Relief” will be reduced by the middle of the year. Top Slicing Relief is where recipients of severance packages pay the same percentage of tax on their one-off pay packet as they did for the previous three years even though the severance package may push their income for that year into a higher bracket.

	2010		2011, 2012 and 2013	
	Taxed 20%	Taxed at 41%	Taxed at 20%	Taxed at 41%
Single person	€36,400	Balance	€32,800	Balance
Married couple/civil partners, one income	€45,400	Balance	€41,800	Balance
Married couple/civil partners, two incomes	Up to €72,800  (increase limited to the amount of the second income)	Balance	Up to €65,600  (increase limited to the amount of the second income - see example below)	Balance
One parent family	€40,400	Balance	€36,800	Balance

<u>Measure</u>	<u>Yield/Cost</u> <u>2013</u>	<u>Yield/Cost</u> <u>Full Year</u>
Maternity Benefit to be taxable for all claimants with effect from 1 July 2013.	+€15m	+€40m
Top Slicing Relief will no longer be available from 1 January 2013 on ex-gratia lump sums in respect of termination and severance payments where the non-statutory payment is €200,000 or over.	Nil	+€10m



## VAT

Budget 2013 saw the standard rate of VAT remain unchanged at 23% since 1<sup>st</sup> January 2012. VAT accounting thresholds were increased facilitating cash-flow and the VAT flat-rate for unregistered farmers was also lowered.

<u>Measure</u>	<u>Yield/Cost 2013</u>	<u>Yield/Cost Full Year</u>
<b>Increase in VAT Cash Accounting Threshold</b>	<b>-€20m</b>	<b>Nil</b>
The annual turnover threshold for eligibility for the cash receipt basis of accounting for VAT for small and medium enterprises will be increased from €1 million to €1.25 million with effect from 1 May 2013. This change will assist such businesses in the critical area of cash-flow & reduce administration		
<b>Reduction in the Farmer's Flat-Rate Addition from 5.2% to 4.8%</b>	<b>+€18m</b>	<b>+€21m</b>
The farmer's flat-rate addition will be reduced from 5.2% to 4.8% with effect from 1 January 2013. The flat-rate scheme compensates unregistered farmers for VAT incurred on their farming inputs.		
The flat-rate addition is reviewed annually in accordance with the EU VAT Directive. The new 4.8% rate continues to achieve full compensation for farmers. The flat-rate scheme compensates unregistered farmers for VAT incurred on their farming inputs.		

## Corporate income Tax

The Irish corporate tax rate on trading income has not been changed and remains at 12.5%. This rate has been repeatedly cited as a primary factor in Ireland's economic renaissance. Despite intense international pressure for it to be 'harmonised' towards the far higher German or French levels, it has remained at its comparatively low level providing an outpost for tax competition throughout the European Union.

There are three rates of corporation tax in the Republic of Ireland:

- 12.5% for trading income
- 25% for non-trading income
- A special rate of 10% for companies involved in manufacturing, the International Financial Services Centre (IFSC) or the Shannon Free Zone ended on 31 December 2003.

There have been no changes to any of these rates since 2003. Tax-relief has been extended to start-up companies, a tax credit has been provided for incremental expenditure on certain types of research and development, and the amount of income that can be retained by a close (privately held) company without incurring a surcharge has increased.



<u>Measure</u>	<u>Yield/Cost 2013</u>	<u>Yield/Cost Full Year</u>
<b>3 Year Relief for Start-up Companies</b>	<b>Nil</b>	<b>-€10m</b>
This scheme provides relief from corporation tax on trading income (and certain capital gains) for new start-up companies in the first 3 years of trading. This relief is being extended to allow any unused relief arising in the first 3 years of trading due to insufficiency of profits to be carried forward for use in subsequent years.		
This is subject to the maximum amount of relief in any one year not exceeding the eligible amount of Employers' PRSI in that year.		
<b>R&amp;D Tax Credit</b>	<b>-€4m</b>	<b>-€4m</b>
The R&D Tax Credit regime provides for a 25% tax credit for incremental expenditure on certain research and development (R&D) activities over such expenditure in a base year (2003). Finance Act 2012 provided that the first €100,000 of qualifying R&D expenditure would benefit from the tax credit without reference to the 2003 threshold. The amount of expenditure so allowed on a volume basis is being increased to €200,000.		
The R&D Tax Credit regime will be reviewed in 2013.		
<b>Amend the Close Company Surcharge</b>	<b>-€2m</b>	<b>-€14m</b>
The de minimis amount of undistributed investment and rental income which may be retained by a close company without giving rise to a surcharge on such income is being increased from €635 to €2,000. A similar increase is being made in respect of the surcharge on undistributed trading or professional income of certain service companies. This measure will assist cash-flow of companies by increasing the amount of income which a company can retain for use as working capital without giving rise to the surcharge.		





## Capital gains

The rates of Capital Acquisitions Tax and Capital Gains Tax (CGT) have been increased to 33% from 30% from 5 December 2012. The first €1,270 of taxable gains in a tax year are exempt from CGT. If you are married or in a civil partnership this exemption is available to each spouse or civil partner but is not transferable. Farmers benefit from CGT relief if the proceeds of the sale of farmland are reinvested in farming.

<u>Measure</u>	<u>Yield/Cost 2013</u>	<u>Yield/Cost Full Year</u>
The current rate of 30% is being increased to 33%. This increase applies in respect of disposals made after 5 December 2012.	+€50m	+€51m
<b>Carried interest provisions</b>		
Review of carried interest provisions in the tax code with the aim of appropriate reform to make arrangements work as intended.		
The purpose of any reform would be to help companies involved in innovation activities to access investment from venture capital funds.		
<b>Relief for Farm Restructuring</b>	-€3m	-€5m
To enable farm restructuring, relief will be available where the proceeds of a sale of farm land are reinvested for the same purpose.		
The sale and purchase of the farm land must occur within 24 months of each other and the initial sale or purchase transaction must occur within the period commencing 1 January 2013 and ending on 31 December 2015. The relief will also apply to farm land swaps subject to certification by Teagasc for all transactions seeking relief.		
The commencement of the relief is subject to receipt of EU State Aid approval.		



## Excise tax

Excise tax rates have been increased: Vehicle registration tax, alcohol, tobacco, carbon tax.

<u>Measure</u>	<u>Yield/Cost 2013</u>	<u>Yield/Cost Full Year</u>
<b>Vehicle Registration Tax (VRT)</b>	+€50m	+€50m
Rates of VRT are being increased with effect from 1 January 2013.		
<b>Motor Tax</b>		
Motor Tax rates across all categories will increase with effect from 1 January 2013.	+€100m	+€100m
<b>Alcohol Products Tax</b>		
The excise duty on a pint of beer or cider, and a standard measure of spirits is being increased by 10c (including VAT); the duty on a 75cl bottle of wine is being increased by €1 (including VAT), with pro-rata increases on other products. These increases will take effect from midnight on 5 December 2012.	+€180m	+€180m
<b>Tobacco Products Tax</b>		
The excise duty on a packet of 20 cigarettes is being increased by 10 cents (including VAT) with a pro-rata increase on the other tobacco products, with effect from midnight on 5 December 2012. The excise duty on roll-your-own tobacco is also being increased by 50c per 25g pouch with effect from midnight on 5 December 2012.	+€25m	+€25m
<b>Carbon Tax</b>		
The carbon tax will be extended to solid fuels on a phased basis. A rate of €10 per tonne will be applied with effect from 1 May 2013 and at a rate of €20 per tonne from 1 May 2014.	+€6m	+€22m
<b>Auto-diesel excise duty relief for licensed road hauliers</b>		
A relief from excise duty on auto-diesel for licensed road hauliers will be introduced from 1 July 2013. Under State	-€35m	-€70m
Aid rules Ireland must inform the EU Commission.		

## Property tax and tax on savings

The worst change in 2012 was the introduction of a property tax in the 2013 Irish budget. The current Irish Taoiseach (Prime Minister) Enda Kenny famously declared in 1994 that "It is morally wrong, unjust and unfair to tax a person's home." Nonetheless, in December 2012 he came to the conclusion that the residential Irish housing market was ripe to be used as a new source of government revenue.

Government coffers overflowed with revenue from stamp duty acquired from housing sales during the boom. Since 2008, a collapse in trade volume and an unprecedented average fall in house prices by approximately 60 percent in Dublin has occurred drying up this once rich well of government revenue. It is clear that to compensate for this loss the Irish government has come to the con-



-clusion that the value remaining in Irish housing must be tapped in a different manner, this time with a fixed tax on the value of properties. The initial national central rate of the tax will be 0.18% of a property's value up to €1 million, and in the case of properties valued over €1 million, 0.25% on the balance and hopes to raise initially only €250m.

Although the property tax has the economic effect of further depressing the already battered residential housing market and driving greater numbers of struggling mortgage holders deeper into negative equity, the Irish government appear undaunted. The unintended consequence of a property tax is that the resultant downward pressure placed on housing prices further impairs the balance sheets of Irish banks holding Irish mortgages. In turn, the taxpayer funded bailouts of these institutions must be enlarged, ironically requiring further tax increases.

There is no wealth tax in Ireland. However, interest earned on bank deposits and withdrawals from life insurance policies shall be taxed at a higher rate.

<u>Measure</u>	<u>Yield/Cost 2013</u>	<u>Yield/Cost Full Year</u>
<b>Deposit Interest Retention Tax and Exit Taxes on Life Assurance Policies and Investment Funds</b>	+€50m	+€64m
The rate of retention tax that applies to deposit interest, together with the rates of exit tax that apply to life assurance policies and investment funds, are being increased by 3 percentage points and will now be 33% for payments made annually or more frequently and 36% for payments made less frequently than annually. The increased rates will apply to payments, including deemed payments, made on or after 1 January 2013.		

### **An Uncertain Future**

Despite the impressive performance of the Irish economy in 2012, and the broadly positive projections of how the economy will perform in 2013, achieving the Department of Finance's forecast of 1.5 percent real GDP growth in 2013 will be challenging. Given the weak growth in both the United Kingdom, which accounts for approximately 17 percent of Irish exports, and the European Union in general, which accounts for another 42 percent of Irish exports, it seems unlikely that export growth shall be capable of maintaining its recent momentum. If Ireland's international trading partners do slip back into recession (as it appears France has already done) it is conceivable that the 2014 budget shall require renewed tax increases and expenditure cuts to ensure the Irish government reaches its Stability Programme targets by 2015.





## The economy, the budget and the political system

There seems to be no respite to Italy economic and political torments. The year 2012 witnessed a deepening of the downturn of the economy. The Italian GDP declined by a huge 2.4%, brought mainly by a deep fall in the domestic demand. Increased taxes dented heavily household's incomes, while gloomy domestic and international perspectives induced firms to postpone investment plans and families to increase precautionary saving. Public expenditure was not really cut but mainly postponed, particularly with reference to payments due by all levels of government to their providing firms, especially in the health and construction sectors. Only exports had an appreciable resumption, showing the resilience of the Italian industrial sector.

The fall of GDP slimmed dramatically the gains on the general government balances that the exceptionally large adjustment measures taken in 2011 through tax increases and expenditure cuts and postponements would otherwise had made obtainable. The combined effect of adjustment policies brought, in 2012, the primary balance of general public sector to 2.4 percent, against a previous year 1.2 percent. The level reached, 2.4 percent, is a level that in an ordinary situation would be considered as a pretty healthy one. Unfortunately—but in Italy misfortune is produced largely domestically—the expenditure for interest on public debt is very high, absorbing a share of 5.4 percent of GDP. This is because of the size of the public debt. During 2012, interest expenditure was also swollen by the increased spread between the Italian interest rates on bonds and the benchmark (the German rates on 10 years maturity bonds).

The difference between the expenditure for interests and the primary balance determines almost completely the deficit of general government: 3, 1 percent. (To be more precise, the gap between this increase and the deficit is explained by the contribution of Italy to the European Financial Stability Facility and by the subscription of shares of the European Investment Bank and securities issued the *Banca Monte dei Paschi*.) While this deficit is in line with the engagements taken by Italy with the EU institutions, its expanding impact on the stock of the public sector debt continues to operate. More precisely, the combined impact of the budget deficit and of the fall of GDP brought an increase by almost 6 percentage points of the share of public debt on GDP.

The deepening of the economic depression concomitant with the tax increases dented the popularity of the government led by Mr. Monti that lost most of its parliamentary support. A widespread anti-tax attitude was also fostered by the bolder behavior of the tax administration agency (*Agenzia delle Entrate*) that



strengthened control of evasion and made expanded, if not excessive, use of penalties for formal errors and delays of payments. Also the (usual) harsh methods used during controls by the tax police contributed to increase popular resentment.

Mr. Berlusconi, whose government had presided to the dramatic worsening of the Italian public finances, distanced totally from the Monti government and took a rather populist, anti-tax stand against what were labeled as Europe unduly imposed austerity measures. Most other parties followed, starting a competition of tax reductions promises. The national elections of February 2013 brought a deep split of votes between the traditional parties considered to be responsible of the economic woes and newly emerging political anti-establishment movements.

### Tax policies

Changes have been very limited during 2012. The absence of measures did not impede a rapid increase of tax collections that brought tax pressure to the unprecedented level of 44.0 percent of GDP, following the full implementation of the measures taken during 2011. One has to signal in this regard the re-introduction, during 2012, of the local property tax (IMU) on primary residences; the submission to taxation of real property owned abroad; the introduction of a registration tax on financial assets held at banks, which works, although partially, as a tax on financial wealth; and finally the renewed levy on financial assets repatriated in the past years. The legal ground for this levy is, however, quite shaky, since it reneges a previous contract between the State and taxpayers who repatriated their assets.

The dynamics of direct taxes, determined mainly by the above mentioned taxes on wealth, was matched by a similar dynamics of the collections from VAT and excises on fuels.

The government tried to re-take control of tax policy in December by bringing to Parliament a partial reform of the personal income tax through the lowering of the tax rates applied to the lowest income brackets combined with an increase from 10 to 11 percent of the VAT tax rate applying to food, fuels, transportation and culture. However, the proposal was defeated by the Parliament, whose main worry was to avoid further tax measures on the eve of national elections.

The main tax measure that was approved has been the introduction, since March 2013, of a modest version of Tobin Tax applying initially to all transactions made by residents of stocks of major companies (with a stock capitalization of more than 500 millions) with a modest tax rate of 0.12 per cent.

The government was more successful with a new legislation enshrining the balanced-budget principle in the constitution, although its implementation will be quite likely as shown by other countries experiences.



### Short-term perspectives

Do not look clearly bright. If growth does not resume quickly — something that looks rather unlikely, unfortunately — the Italian government will have to implement harsh measures to keep deficit under control. In fact Italy, more precisely the Monti government, took commitment to increase VAT from 21 to 23 percent in 2013, in case expenditure cuts of a corresponding amount cannot be implemented. However, the space for further tax increases is very narrow, if not non-existent, due to the high tax/GDP ratio. Taxation of labor is high and distortionary and should be reduced if Italy intends to increase the competitiveness of its economy. Some rebalancing of taxation from incomes to consumption would be desirable, but it should take place through reduction of evasion rather than increases in tax rate.

### Main fiscal and economic indicators

	2008	2009	2010	2011	2012
Public debt (% of GDP)	105.7	116.0	118.6	120.1	127.0
Public deficit (% GDP)	2.7	5.3	3.9	3.9	3.1
Public expenditure (% of GDP)	49.4	52.5	51.2	50.5	51.2
Interest payments (% of GDP)	4.6	4.7	4.6	5.0	5.5
GDP Growth	-1.0%	- 4.8%	+1.8%	+0.4%	-2.4
Primary balance (% of GDP)	2.5	-0.8	0.1	1.2	2.4
Tax pressure: taxes and social contributions on GDP	42.8	43.3	42.3	42.2	44.0

Increased taxation would depress further the economy. Moreover, it seems quite unlikely that political parties will accept new increases in view of the promises to reduce taxation they are presently dispensing.

### A few, debatable, lessons from recent events

First, come the limits of the so-called technical governments, such as the government led by Mr. Monti, in pursuing effective long-term reform policies. More specifically, disregard of popular consensus - in other words, the use of democracy deficit to impose harsh measures — may turn presumed long-term gains into only short-term gains. Clearly, the distributional impact of the adjustment programs, particularly on the poorest segments of the population, was disregarded by the Monti government. Some support to these segments, attenuating the burden of tax increases on them, would possibly have increased the popular acceptance of the measures.



There was also underestimation by the government of the capacity taxpayers have to bear taxes. This was utmost clear in the case of the local property tax. Tax rates were quite high and applied to obsolete and quite erratic evaluations of properties. Practically no exemptions on property owned by poor individuals were given. This strategy (if there was one), the high visibility of the property tax and the fact that an overwhelming proportion of Italians, including the less wealthy, are owners of the apartment they reside in lead to the formation of an anti property tax front quickly exploited by Mr. Berlusconi's party.

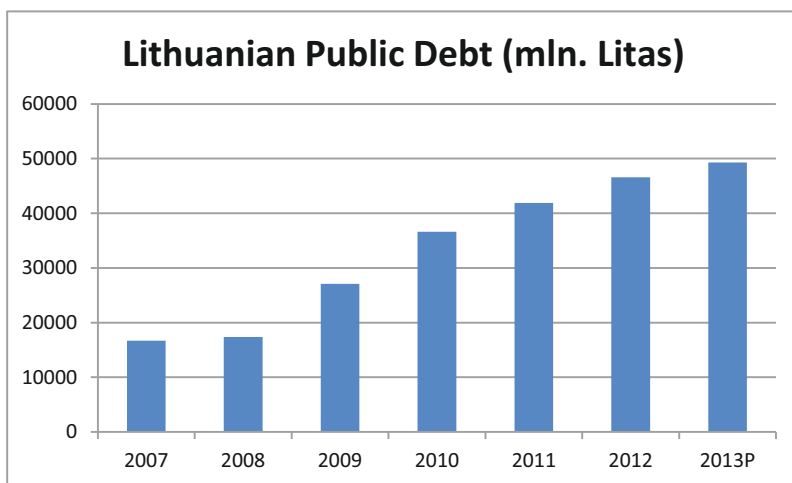
The support from European and other supra-natural institutions cannot obviate the need that all governments have to try to gather domestic consensus even in difficult times. This is more evident with tax policies.





## Budget Deficit, Public Debt and State Social Insurance

Lithuania is often viewed as a success story of austerity measures. Although the country did reduce public spending, it also suffered from high budget deficits that translated into a sharp public debt growth. Budget deficits have been reined in from 9.4% of gross domestic product (GDP) in 2009 to 4.1% in 2012, in part thanks to a rebound in economic growth that reached 5.9% in 2011 and 3.6% in 2012. However, total public debt has grown from 16% of GDP in 2008 to 41% in 2012 and has almost tripled in absolute terms:

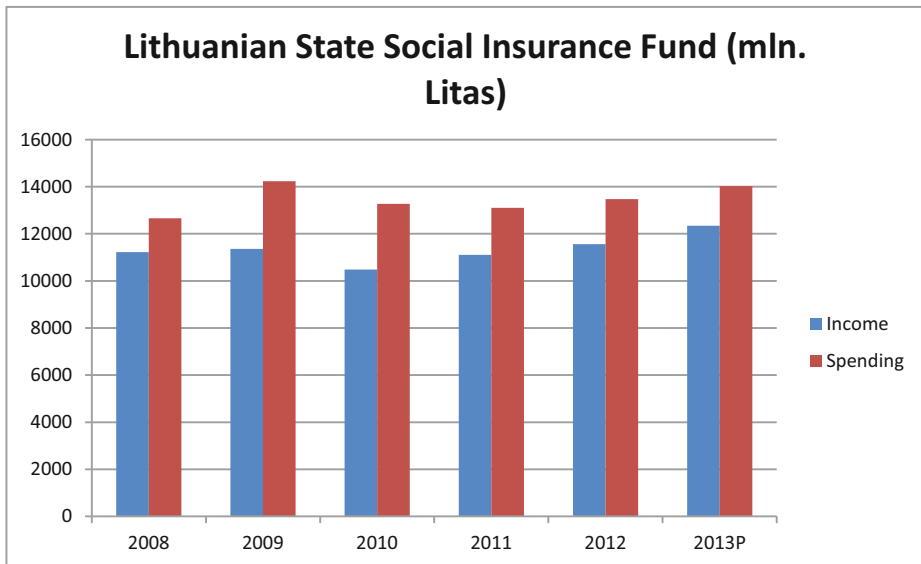


A growing public debt has implied growing interest payments, which have also nearly tripled from LTL 833 million (€ 241 million) to LTL 2.3 billion (€ 668 million). Heating prices are a source of significant worry for most Lithuanians and it was interesting to compare this price with debt interest payments. Research shows that in 2012 public debt interest payments for a family of three equalled the heating price of an average apartment over the entire heating season. While heating prices are a topical issue every winter in Lithuania, the problem of rising interest payments has not yet been fully recognized by the general public.

Lithuanian State Social Insurance Fund has been severely strained due to pensions increases, approved before the economic crisis of 2008. In 2009, the parliament cut pensions and other benefits. However, these cuts were temporary as they lasted only 2 years and were brought back to their previous level begin-



-ning 2012. This is in line with the ruling of the Constitution Court, which indicated that any social insurance benefits' reductions have to be temporary and compensated. Total outstanding debt of the State Social Insurance Fund currently stands at LTL 10.1 billion (€2.9 billion) or 9% of GDP, while the interest payments in 2013 will amount to 6.6% of fund's income. The prospects of the public pension scheme appear bleak, no comprehensive reforms are being discussed and it is unclear how the debt will be repaid.



To make matters worse, in the past 6 years the state has undermined the only real alternative system to the public pension fund. In 2004, Lithuania introduced a private funded pension scheme (II pension pillar) that was meant to alleviate future strains on the public pension system that will arise due to unfavourable demographic tendencies. This scheme was funded by a small part of social insurance contributions. The economic crisis and the growing deficit of the State Social Insurance Fund induced the parliament to cut the contributions to the funded scheme from 5.5% in 2008 to 1.5% in 2012, slightly increasing it to 2.5% in 2013. As of 2014, the contributions rate will be 2% with an additional subsidy of 1% of the average wage given for those willing to contribute 1% of their after-tax income. In 2016 both the subsidy and the individual contribution are set to increase to 2%. The conditionality of the subsidy implies that the individuals with lowest earnings may be unable to save an adequate amount for their pension.



## Personal Income Tax

Throughout 2012, the personal income tax rate remained stable at 15%. Nonetheless, there have been debates on scrapping the flat tax in favour of a progressive income tax. In November 2012, a new centre-left wing government came into power following parliamentary elections. The government's programme includes a position that the progressivity of the income tax should be increased, although this can be done either by abandoning the flat tax or by increasing the tax-exempt amount. It appears that the latter measure will be chosen to implement the government's program.

As of 2012, the minimum fixed amount of personal income tax levied on business certificates has been increased from LTL 120 to LTL 1440 (€35 and €417, respectively). Business certificates are the simplest way to pay taxes for self-employed entrepreneurs, since they enable entrepreneurs to pay fixed personal income tax, social insurance and healthcare insurance contributions prior to their activities and there are no requirements for extensive accounting. The only requirements are to give receipts to customers upon request and submit an income declaration. After the tax was raised, the number of individuals paying taxes by purchasing business certificates has dropped by 11%. During the temporary tax cut during 2012, the number of individuals grew by 27%. The following table illustrates how tax-cuts spur economic activities and promote entrepreneurship.

	Personal income tax	Number of business certificates' owners	Change from the previous year
2010	LTL 1440/€ 417	67 405	
2011	LTL 120/€ 35	85 641	+27%
2012	LTL 1440/€ 417	76 330	-11%

Since the business certificates are associated with minimal administrative and tax burden, the state has often attempted to curb their use. As of 2011, individuals cannot carry out their activities under business certificates if their turnover has reached the threshold required to register as a value added tax payer (LTL 155,000; €44,930). As of 2012, individuals cannot earn more than LTL 15 000 (€ 4 348) from businesses – the rest must come from person-to-person transactions.

As of 2012, individuals can donate 1 percent of their paid personal income tax to a political party of their choice. Lithuanians may also donate 2 percent of their paid personal income tax to charities, religious institutions, NGOs or public sector institutions such as kindergartens. In 2012, 411 000 individuals donated LTL 40 million (€11.6 million) to almost 19 000 organizations and 49 200 individuals dona-



-ted LTL 2.1 million (€0.6 million) to political parties. The lower number of donations to political parties indicates that the Lithuanians are much less willing to support political parties and would even prefer that money be spent by the state budget.

### **Social Insurance Contributions**

As of August 1, 2012 first-time employees have to pay full social old-age insurance contributions. Prior to this date, employers of new entrants to the labor market did not have to pay their old-age social insurance contributions (amounting to 23.3%) if the employee's earnings were under 3 minimum wages (at the time, the minimum wage was LTL 800 or €232).

A new maximum social workplace accident insurance came into effect as of 2012. Prior to that, there were three rates – 0.18%, 0.38% and 0.9%. Afterwards, a new rate of 1.8% was introduced for the riskiest employers and the rate for third riskiest employers was raised from 0.38% to 0.42%.

### **Healthcare Insurance Contributions**

Healthcare insurance contributions for regular employees remained stable throughout 2012. Healthcare insurance contributions paid by self-employed individuals are fixed at 9% of the minimum wage. The minimum wage was raised twice in 2012: first from LTL 800 (€232) to LTL 850 (€246) as of August 1, 2012 and then to LTL 1000 (€290) as of 2013. This means that the healthcare insurance contributions for self-employed entrepreneurs have increased from LTL 72 (€21) per month for LTL 90 (€26), which is a raise of 25%.

### **Guarantee Fund Contributions**

Guarantee Fund provides payments to employees of bankrupt companies and is financed through current employees' contributions. As of 2012, the contributions rate was doubled from 0.1% to 0.2% of an employee's income.

### **Corporate Income Tax**

Standard corporate income tax rate in Lithuania is 15%, with a reduced rate of 5% applied to small companies. Prior to 2012, the reduced rate was applied to companies with income under LTL 500,000 (€145,000) and as of 2012 the threshold has been doubled to LTL 1 million (€290,000). This has allowed more companies to apply the reduced rate and therefore lowered the tax burden on businesses.

### **Value Added Tax**

As of 2012, the threshold to register as VAT payer has been increased from LTL 100,000 (€29,000) to LTL 155,000 (€44,930). This move will reduce the tax burden on small businesses, therefore improving business conditions in Lithuania. However, there remains room to raise this threshold since the maximum threshold legislated by the European Union stands at LTL 345,000 (€100,000).



At the end of 2012, the parliament amended the Law on Value Added Tax and extended the use of VAT reduced rates. Reduced rate of 9% applied to heat energy, hot and cold water was set to expire in the end of 2012 and the parliament extended it to the end of 2013. Deadline for applying a reduced rate on medicine and other medical services compensated by the state was also extended from the end of 2012 to the end of 2013. Similar laws have been passed for a number of years, each year extending the use of the reduced rate on heating and medicine for an extra year.

In 2012 a reduced VAT rate on hotel and special housing services expired. The reduced rate was in effect only throughout 2011. Interest groups have been advocating a reintroduction of the provision, claiming the reduced rate would allow hotels to invest and thus attract more visitors to Lithuania. It is yet unclear whether the provision will be brought back into law.

### Excise Duties

Most of the excise duty rates remained stable throughout 2012, with the exception of excise duty on intermediate products with alcohol concentration under 15% that was raised from LTL 198 (€57) to LTL 216 (€63) per hectolitre.

### Residential Property Tax

After a decade of debates whether Lithuania needs a residential property tax, a poorly prepared law introducing the tax was hastily passed in late 2011. Total time of draft law hearings and voting in the parliamentary session amounted to less than an hour. A tax of 1% is applied on total family-owned property valued above LTL 1 million (€ 290,000). Revenues of the commercial property tax go to municipality budgets, yet revenues of the new residential property tax go into the coffers of the state budget. This means that these revenues will not be used to improve the local roads or finance other local services, as is typically the case with residential property taxes.

When the new tax was introduced, the parliament expected its revenues to total LTL 17 million (€4.9 million) or 0.1% of state budget tax revenues. Many potential taxpayers tried to avoid this tax by giving away a part of their property to adult family members, decreasing the official property value or using legal loopholes in the law. Actual revenues amounted to only LTL 3.8 million (€1.1 million), or just 23% of the official forecast. This means that the residential property tax is inefficient, since it brings in low revenues yet produces an administrative burden both to the taxpayers and to the tax administrator. Even though this tax can be viewed as a failure and should be abolished, there are calls from some politicians to lower the tax-exempt threshold or even make it a universal tax.



## Land Tax

In late 2011, the parliament passed a law changing the land tax from a fixed rate of 1.5% to introducing a bracket of 0.01-4%. The parliament gave the power to the municipalities to set the exact land tax rate, depending on the use of land and other criteria. The law also changed the value-setting method: prior to this the tax was levied on old calculations of land value, while the new law stipulates the tax will be paid according to a “market” value of the land.

The changes have come into effect as of 2013 and many landowners have seen drastic increases in their taxes, sometimes by more than 100 times. Some municipalities have set a 4% tax rate on “unused” land, which is a big issue for landowners since their land may be unused due to poor market conditions or prolonged bureaucratic procedures in obtaining building permits. A draft law has been registered in the parliament in early 2013 to postpone this law, which would allow the taxpayers to better adapt to the increased tax burden.

## Tax on Natural Resources

As of 2012, the tax on natural resources was raised by 10 – 323%. The lowest tax increase was on clay and the highest tax increase – on turf (from LTL 0.62/m<sup>3</sup> to LTL 2/m<sup>3</sup>, that is, € 0.18/m<sup>3</sup> and € 0.58/m<sup>3</sup>, respectively).

## Future Prospects

In early 2013, the newly appointed center-left wing government formed a Tax Commission to oversee a potential tax reform. The commission consists of government officials as well as market representatives, auditors and tax policy experts. Key issues on which the commission should decide are progressive income tax, reduced VAT rates and residential property tax. The most likely outcome of the commission is to keep the flat tax and instead to raise the tax-exempt amount. It is also likely that no reduced VAT rates will be introduced. There is a danger that the commission will propose an introduction of a proper capital gains tax and a universal residential property tax. Therefore, it is expected that further tax discussions and decisions will focus on lowering the tax burden on labor and raising it on wealth and capital.



## Unjustified outside pressures

A line must be drawn between, on one hand, what has happened and continues to happen in the country itself due to its own will and the decisions of its government and parliament and, on the other hand, what will shortly happen in the country because of decisions made by foreign governments.

In first place in the list of outside pressure one clearly finds the decision made by the US government to impose to the rest of the world – with the noticeable exception of the commercial partners it must remain in good terms with or the countermeasures of which it must fear such as China or Russia — an automatic exchange of information with respect to financial assets held abroad with foreign banks by US citizens or taxpayers. The FATCA rules demand from banking institutions in Luxembourg in particular horrendously expensive investments to be able to provide the reports the IRS want. The EU representatives have shown very little fighting spirit when bending in front of such claims not even requiring that it be a mutual right of information that the US banks would have to provide on assets held with them by non-US residents.

Closer to Luxembourg, various scandals in neighbouring countries have been used by their respective governments to point out to “tax havens” and distract attention from the public. It is much easier for them, indeed, to criticise other countries supposedly offering better tax treatments than their own and to divert scrutiny of their major flaws with respect to public debt, public spending and good management.

Finally, the failure for Switzerland to extend the number of Rubik agreements with foreign tax authorities –as was the case with the German government— shows that it will be a matter of a few years only before the automatic exchange of financial information between tax authorities be achieved.

The general climate in Europe is that of a fierce fight against so called dirty money into which Luxembourg would play a major role.

The issue of dirty money started back in the 80s. The money tracked at that time was proceeds from drugs, arms, human trafficking as well as from crime in the common sense of the term. Then came the US' desire to fight terrorism after 09.11.2001 and latter the financial crisis of 2008. Reacting to those events, governments generally have extended the scope of money laundering to the smallest offense, making virtually everyone susceptible to be prosecuted under an additional money laundering qualification. Clearly, the European field will soon be a completely transparent field in every respect including tax matters.



This being said, however, contrary to what is repeated ad nauseam by the media—mainly from its neighbouring countries showing by doing so a rather poor intellectual honesty—Luxembourg is not a tax heaven. Who would dare pretending that an average total tax burden (taxes plus social security charges) of 37.2% (compared to less than 30% in several Eastern European countries and Ireland and to 47.7% in Denmark – source Eurostat), a corporate income tax rate of 29.22 %, personal income tax of 43.6 % and the strict implementation of EU Directives (such as the parent-subsidiary one) should qualify for this reward?

Today, we should worry about the silence from both the political world and the media about the current situation. The real reasons of public debt are largely untold: the fact that governments have been spending for years and years without any limit – see in comparison the Swiss situation where politicians have since 2004 no longer been allowed to do this; the ill considered need for always more public intervention in every sector; the misplaced toleration for public deficits and the rolling over of the debt to the next generation. Instead of “money laundering”, what should come in the light and trigger a totally open debate are the extremely poor return on citizens' investment, that is, what they receive from their state for the huge but never large enough amounts of taxes they pay.

Wouldn't it be the time, at last, to question the efficiency of the European states' organisation (in terms of quality of education, of their health care system, of transportation and mobility, of their roads and water ways, of number of strikes, of indulgence by their social system for people not even trying to work, etc.)? A lot would be gained from such debate in terms of motivation and entrepreneurship.

## A relatively stable domestic fiscal policy

### VAT

As outlined above, rules and rates remained quite stable over the last 12 months in Luxembourg, pursuant to the policy of consistency of public decision makers. The highest tax increase is probably yet to come and will be a raise of VAT rates, which has just been announced by the prime minister. Luxembourg wants however to keep the lowest VAT rate in Europe. As the second lowest rate is 18% (Malta), the local standard VAT rate could rise by up to a couple of percentage points. It is to be noted that VAT accounts for a quarter of the tax revenue of the State, and Luxembourg has been successful in attracting a lot of e-commerce B2C business where the applicable VAT is the one where the supplier is located, namely, Luxembourg. As from 2015, this rule will however change and VAT will be applicable at the rate of the country of the EU customer. The difference will result in a significant loss of tax revenue per year (estimated at € 700 Mio per year).





## Personal and corporate income taxes

On the front of individual income tax, an additional bracket has been added at 40% to which must be added a 9% (instead of 6%) maximum employment fund contribution. This results in a maximum effective tax rate of 43.6% for the highest bracket.

Concerning non-resident individuals, Luxembourg has recently agreed to communicate automatically to other EU countries the interest income earned in Luxembourg by their residents, as required by the European Savings Directive. These transfers of information will be applicable as of 2015. This upcoming change of rule is expected to push a number of individual portfolio holders to move assets away from Luxembourg. The authorities however do not expect the long-term effects of this change to affect the economy of the country.

Corporate taxation was also slightly modified. The employment fund contribution has been increased from 5% to 7%. When applied to the basic income tax rate of 21% that is then added to the Municipal Business Tax of 6.75% (Luxembourg City), it results in an effective tax rate of 29.22%.

Another change in corporate taxation relates to the extension and change of the minimum levy. Up to 2012, this minimum levy applied to companies not subject to approval by a Minister nor by the supervisory financial authority ("CSSF") and with 90% or more of their assets made of participations, securities, cash and deposits. The minimum was fixed at € 1,575. This amount is doubled to € 3,210 as from 2013.

As from 2013 also, the scope of companies subject to that minimum taxation is broadened to all other companies. However, the applicable minimum tax for those other companies will be determined based on the below rule:

€ 535	if the total assets are lower or equal to EUR 350,000
€ 1,605	if the total assets are higher than 350,000 and lower or equal to 2,000,000
€ 5,350	if the total assets are higher than 2,000,000 and lower or equal to 10,000,000
€ 10,700	if the total assets are higher than 10 mil and lower or equal to 15 mil
€ 16,050	if the total assets are higher than 15 mil and lower or equal to 20 mil
€ 21,400	if the total assets are higher than 20 millions



## General outlook

- In the current difficult economic period, Luxembourg has been barely growing (GDP growth of 0.3% in 2012, lower than expected). However, it performs better than most of the other European countries, especially in respect of budget deficit (€ 359 millions or -0.8% of GDP) and public debt (€ 9,232.2 mil, or 20.8% of GDP). Luxembourg's outlook is a 1% growth in 2013 and 2.3% in 2014.
- Public deficit will only be reduced to 0% by 2016 as European VAT rule changes will significantly impact Luxembourg VAT revenue on e-commerce as from 2015.
- Employment should rise by 1.6% in 2013 and unemployment should slightly decrease to 6.7% in 2013 and to 6.4% in 2016.
- Inflation should remain under 2%.

The government is confident that the Luxembourg financial place will keep performing well in the future, but it also wishes the country to diversify its activities; therefore it will stimulate SME's, tourism, agriculture, logistics services, IT, and finally industry. Hence, Luxembourg's State kept investing despite the crisis in various areas (R&D, education, family support...).

As Prime Minister Juncker very realistically stated in his April 2013 government declaration to the Parliament, the budget deficit was not totally under control, but remained reasonably on track. Savings have to be made, but at a pace that will allow for the realisation of long-term objectives and without strangling the economy.

This is however a very political view which does not at all take into account the slow down of the local economy which is to be undoubtedly anticipated, which does not take into account the ever growing burden for the payment of the pensions and yet tolerates that the states running own expenses grow much faster than inflation or than the national economy.

There remain therefore many reasons to doubt the rosiest future for Luxembourg that the government is promising us.



## The big picture

Dutch fiscal policy has recently been designed predominantly to speed up fiscal consolidation and to reduce public deficits. This takes place amidst a recession in 2012, where Dutch GDP shrank by 1.3%, after slightly positive yet very low growth in 2011. The fiscal deficit is expected to be at 3.3% of GDP in 2013. It would therefore be an extreme exaggeration to speak of austerity policies in the Netherlands, but in the current volatile framework of the Eurozone crisis, where interest levels can increase quickly if bondholders lose confidence in a country's ability to service its debt, the Dutch are also cautious enough to refrain from uncontrolled deficit spending. For Dutch private households, declining property price levels in combination with high levels of private debt have been a problem. Households in the Netherlands are heavily invested in property, and also suffer from declining real wages with inflation rates slightly above the Eurozone average.

Given this mostly pessimistic macroeconomic outlook and an emphasis on short-term fiscal consolidation, a proposed reduction of the top corporate income tax rate from 25% to 24%, which featured prominently in the Dutch government's 2011 tax policy paper, has not been enacted. Due to fiscal motivations, the general tendency has been more in the direction of tax rate increases, which of course may result in problems for the Netherlands' long-run growth prospects. Nevertheless, the Dutch have so far preferred to consolidate through revenue increases rather than decreases in public spending, which to the contrary has still increased to a small extent in 2012. For the coming years, the new grand coalition government does however also plan substantial spending cuts, in particular in social transfers and development aid. The regular pension age gradually increases from 65 years today to 67 years in 2024. Attempts to cut the budget had earlier led to a demise of the former centre-right government, as the party of right-wing populist Geert Wilders refused to support budget cuts, which he denounced as having been imposed by Brussels.

## Specific recent tax changes

The regular VAT rate has been raised from 19% to 21% in October 2012, due to budgetary needs. The lower VAT rate remains at 6%. A special arrangement has been made for the VAT on performing arts and on the import on antiquities. This rate was originally supposed to rise from 6% to the regular rate, but this particular planned increase has eventually been repealed. The VAT change is expected to generate an additional revenue of € 4bn overall. Some specific consumption taxes, e.g. on tobacco, soft drinks and also alcohol, have also been increased.



Also, the rate of the insurance tax is doubled, to 21%.

In the income tax, the regular top tax rate is reduced from 52% to 49% according to the 2013 tax plan. The top tax rate on imputed incomes from owner-occupied housing has on the other hand substantially increased, as the imputed income is now raised from 0.55% to 1.30% of property values above € 1 million, and is planned to increase even to 2.30% in 2016. Also in the income tax, the deductibility of commuting costs has been considered for abandonment, which would have led to significantly higher tax burdens for some commuters. These plans have however been repealed in the 2013 tax plan. The deductibility of interest payments of mortgages has been restricted. On the other hand, the property transfer tax for owner-occupiers has, at first temporarily and now permanently, been reduced from 6% to 2%, in an attempt to increase the number of transactions on an ailing property market.

The Netherlands has also introduced a new bank tax. This new tax has been advertised as a reaction to the rescue of banks by the Dutch government: The participation of the financial sector itself in financing these rescue efforts, which have led the taxpayer to inject roughly € 40bn into Dutch banks, has been a popular talking point all over Europe, and also in Dutch politics prior to the introduction of the new tax. It does, however, also serve the more immediate purpose of compensating for the revenue loss from the reduction of the property transfer tax. The government expects the new bank tax to generate around € 600mio in revenue. Subject to the tax are all legal entities that either have a Dutch banking license, or operate in the Netherlands and have a foreign banking license.

In addition to the revenue objective, the bank tax is also supposed to provide incentives for banks to reduce risky positions in their balance sheets. This is achieved by using – roughly – the unsecured debt position in a bank's balance sheet as the tax base. The tax rate on long-term debt, which is to be redeemed in one year or more, is 0.022%, and is doubled for short-term debt with a maturity of less than one year. The focus is therefore less on the risk of the individual debt position (long-term debt does obviously not systematically increase in risk when it comes closer to maturity), but rather on the risk of the overall debt structure. Furthermore, a bank is fiscally punished if it pays a bonus to its management that is considered too high, from an economically arbitrary and purely political point of view. In particular, a bonus that exceeds 100% of the fixed salary leads to a multiplication of the normal tax rates with a factor of 1.1. The tax thus increases the incentive for banks to transform bonus payments into fixed contractual payments.

Clearly, it is doubtful that a micromanagement of banks' payment structures by the government is helpful in any economic sense. This part of the bank tax probably owes more to political symbolism than to economic reason. More impor-



-tantly, the Dutch Central Bank has also warned that the bank tax may have other unintended consequences. A significant reduction of borrowing by Dutch banks is expected, with clearly adverse macroeconomic effects. Furthermore, banks that are taxed on their balance sheets and thus strapped of liquidity regardless of their profit level may find it difficult to increase their share of equity quickly, and thus run into problems reaching the equity levels demanded by Basel III regulation.

The Netherlands at present does not intend to follow EU proposals for a financial transactions tax. The Dutch bank tax can be interpreted as a substitute for a transactions tax, at least in a political sense, since it meets the popular demand for a levy on the financial sector. The tax may thus be justified in terms of political strategy: It helps to avoid the transfer tax as an economically greater evil, associated with higher tax wedges. In terms of traditional normative tax theory and the benefit principle, it is however difficult to justify. The support of banks by the government took place in the form of loans and equity, not as subsidies. At present, no substantial definitive costs have emerged for the Dutch taxpayer.

Another controversial instrument of recent Dutch tax policy is a one-off crisis levy, which had been decided upon in 2012, as part of the budget compromise after the collapse of the centre-right coalition. This crisis levy was originally due to be paid in April 2013, but is still the subject of intense legal discussions. The crisis levy is to be paid on the fraction of wages that is considered to be "excessive" by policymakers. In this case, a levy of 16% on all individual wage income above € 150,000 per year is to be paid by employers. Since the levy is designed to be retroactively applied to 2012 wages, in a way that does not give taxpayers any chance to adjust their behavior to the tax, it may be violating basic EU law and could be successfully challenged in court.

### Further discussion

The Netherlands still enjoys a status as a tax haven for multinational corporations. In particular, Dutch tax law and double taxation agreements facilitate constructions such as the notorious "*Double Irish with a Dutch Sandwich*" that can significantly reduce the tax burdens of multinational corporations, in some instances to almost zero. Pressure to change the status of the Netherlands as a *de facto* tax haven for these companies is coming not only from foreign governments, but somewhat surprisingly also from the Dutch public itself, since the newspaper *De Volkskrant* revealed in its January 12, 2013 issue that about 100 multinationals have routed roughly € 57bn through the Netherlands in 2011 alone. There are no concrete policy proposals so far, but it remains to be seen whether internal and external political pressures will lead to a tax regime change in the future.



## Summary and Discussion

Dutch policymakers appear to be somewhat undecided what the rational response to the current macroeconomic problems and the related issues on the financial markets is. A different explanation for the lack of coherence in fiscal policy may be the grand coalition government, which requires broad and sometimes unorthodox compromises. In any event, current fiscal policy in the Netherlands is to some degree self-contradictory. There is a willingness to reduce budget deficits, but a political will to enforce substantial spending cuts is missing – the share of public spending relative to GDP has been above 50% in 2012.

Similarly, a general insight that the economy would benefit from lower tax rates is there, and reflected in the decrease of the top rate in the income tax. Nevertheless, political symbolism and a strong emphasis of distributional issues in the political debate lead to inefficient or even illegal tax innovations such as the bank tax and, in particular, the one-off crisis levy. A more comprehensive tax reform, in particular a simplification of the very complicated Dutch income tax associated with a substantial reduction of tax burdens, is at present not in sight.



## Main characteristic of tax policy

The main objectives for the Norwegian Government's tax and fiscal policies are, according to the Ministry of Finance, *"... to secure public revenue, to help bring about a fair distribution of wealth, promote employment throughout the country and to improve the efficiency of the economy"*.

The Government continues to propose rules aimed at further strengthening the tax system's contribution to a *"fair income distribution and to a better environment"* ("green" taxes).

The Norwegian tax system is characterised by a relatively high share of indirect taxes by international standards. Value Added Tax (VAT) and excise duties amounts to approximately onethird and income tax and net wealth tax levied on individuals to approximately one fourth of total tax revenues. Corporate tax, including employer's part of the social security contribution to the National Insurance Scheme, (NIS), and tax on oil and gas activities each amounts to around one fifth of total tax revenues.

Total tax revenues in 2013 are expected at 1 314 billion NOK (€ 176.4 billion), to be compared with total revenues in 2012 at 1 278 billion NOK (€ 171.5 billion), according to the revised 2012 National Budget; that is, an increase of approximately 2.8%. The tax revenues consists of two main elements:

- Direct and indirect taxes from oil and gas activities, estimated at 401.2 billion NOK (€ 53.9 billion), in 2013, compared to 412,8 billion NOK (€ 55.4 billion), according to the revised 2012 National Budget, - a decrease of 2,8%; and
- Direct and indirect taxes from mainland Norway, (namely, revenues other than from oil and gas activities), estimated at 913.2 billion NOK, (€ 122.6 billion), in 2013, to be compared with 865.2 billion NOK (€ 116.1 billion), in the revised 2012 Budget; - an increase of 5,5%.

(Exchange rate used in this document is €1 = NOK 7.45).

Revenues from the oil and gas activities are deposited in the Government Pension Fund Global, (GPF), and the return from the fund is used to finance the public sector. By the end of 2013, the market value of the GPF should reach approximately 4 281 billion NOK (€ 574 billion).



The Government Pension Fund Global and the Government Pension Fund Norway constitute the Government Pension Fund. The purpose of the Government Pension Fund is "... to support Government savings to finance the pension costs of the National Insurance Scheme and long term considerations in the spending of Government oil and gas revenues..."

## **Taxation – Social security contributions, allowances, rates and amounts for 2012-13**

No major changes in the tax system is proposed for 2013, although some changes will be made in certain tax areas including an expanded base and increased basic allowance for net wealth tax for individuals, measures designed to close certain tax loopholes in corporate taxation (such as limitations on deduction of intercompany interests) and strengthening the environmental components of the motor vehicle tax.

The figures below show tax rates for 2012 with 2013 rates in brackets.

### *Income tax – Companies/Corporations*

Ordinary income,  
capital gains inclusive:                      28%      (28%)

Depreciation rates (depreciation on assets) varies from 2% per annum (office and other buildings used in the line of business), to 30% per annum (office equipment etc.), depending on type of asset and calculated according to the declining balance principle.

Dividends distributed from a Norwegian domiciled limited liability company to another Norwegian domiciled company or to a comparable type of company domiciled within the EEA, are normally tax exempt under current Norwegian tax rules, that is, no withholding tax.

When a limited liability company domiciled in Norway receives dividends distributed by another Norwegian resident company or by a comparable type of company resident within the EEA, 3% of the received amount is taxed as ordinary income on the hand of the receiving company.

Dividends received by a Norwegian domiciled limited liability company on shareholding in a comparable type of company domiciled outside the EEA are normally taxed in Norway as ordinary income with, however, a right for the receiving company to deduct taxes withheld in the foreign company's country of domicile.

Dividends distributed by a Norwegian domiciled limited liability company to a comparable type of company domiciled outside the EEA, is subject to 25% with-





-holding tax in Norway. Normally, the 25%-rate is reduced to 15% or less under most tax treaty rules, provided a certain minimum (normally 10% or more) of ownership in the distributing company.

CFC-rules may apply in some cases. (CFC = Controlled Foreign Company.)

### *Personal income tax*

Ordinary income tax:	28%	(28%)
Capital income tax:	28%	(28%)

Dividends received by a Norwegian domiciled individual are subject to ordinary income tax. Withholding tax on dividends paid to the distributing company's country of domicile, are normally deductible in the Norwegian taxes levied on the same income.

Surtax on wage income and income from self-employment:

• From (threshold (+ 4%) Rate	NOK 490 000 90%	(NOK 509 600) (90%)
• From (threshold (+ 4%) Rate	NOK 796 400 120%	(NOK 828 300) (120%)

### *Individual's contribution to the National Insurance Scheme, (NIS)*

Lower threshold for contribution to the NIS	NOK 39 600	(NOK 39 600)
• Wage income contribution	78%	(78%)
• Contribution on income from self-employment in the primary sector (i.e. forestry, farming, fishing)	78%	(78%)
• Contribution on other self-employment income	110%	(110%)
• Contribution on pension income	47%	(47%)



## *Employer's contribution to the National Insurance Scheme*

Varies depending on the geographical location of the employer's business

0.0% - 14.1% (00% - 141%)

### *Maximum marginal tax rates*

• Wages	47.8%	(47.8%)
• Self-employment	51.0%	(51.0%)
• Dividends and withdrawals, (including 28% corporate tax)	48.2%	(48.2%)

Special rules apply for calculating the basis for tax on dividends, - in some cases also on interest income.

• Pension	44.7%	(44.7%)
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### *Allowances*

Personal allowance for taxpayers in Class 1 (single) is NOK 45 350 in 2012. Increased by 4% in 2013 to NOK 47 150.

Personal allowance for taxpayers in Class 2(supporting/single parent) is NOK 90 700 in 2012. Increased by 4% in 2013 to NOK 94 300.

Basic allowances in wage income. The 2012 rate is 38%, increased to 40% in 2013, i.e. up 2 percentage points. Lower limit is NOK 4 000 in 2012, unchanged for 2013. Upper limit is NOK 78 150 in 2012. Increased to NOK 81 300 in 2013 (+ 4%).

Basic allowances in pension income. The rate is 26.0% in 2012, unchanged for 2013. Lower limit is NOK 4 000 in 2012, unchanged for 2013. Upper limit for 2012 is NOK 65 450, increased to NOK 68 050 in 2013 (+ 4%).

Total basic allowance in wage income and basic allowance in pension income is limited to the maximum basic allowance in wage income.

Special wage income allowance is NOK 31 800 for 2012, unchanged for 2013. Taxpayers who only have wage income are entitled to the higher of the basic allowance in wage income and the special wage income allowance.



There are special allowances for, for instance:

- Disability etc.
- Special tax allowance for pensioners
- Taxpayers living in the northernmost areas of Norway (Finnmark and Nord-Troms).
- Seamen
- Fishermen
- Self-employed within farming/agriculture.
- High expenses due to illness
- Payments to individual pension schemes.
- Travel between home and work site/office.
- Union fees.
- Saving schemes for young individuals under 34 years of age.
- Documented expenses for child-minding and childcare.
- Donations to voluntary organisations.

### *Tax on Net Wealth*

• Threshold, municipal tax (+ 16%)	750 000 NOK	(870 000 NOK)
• Rate, when exceeding threshold	0.7%	(0.7%)
• Threshold, state tax (+ 16,1%)	750 000 NOK	(870 000 NOK)
• Rate, when exceeding threshold	0.4%	(0.4%)

### *Inheritance tax*

Thresholds:

• Level (1)	470 000 NOK	(470 000 NOK)
• Level (2)	800 000 NOK	(800 000 NOK)

Rates:

• Children/parents, level (1)	6.0%	(60%)
• Children/parents, level (2)	10.0%	(10.0%)
• Others, level (1)	8.0%	(8.0%)
• Others, level (2)	15.0%	(15.0%)

“Discount” on the value of non-listed shares is 40%. The rate is unchanged in 2012 and 2013. The “discount” applies when calculating basis for inheritance tax on non-listed shares and shares in general partnerships. The maximum amount enjoying this “discount” is limited to 10 million NOK.



### *Value Added Tax (VAT)*

The ordinary VAT rate in 2012 is 25%. Reduced rate is 15%. Low rate is at 8%. A zero rate applies in some cases. Unchanged in 2013.

Norwegian VAT legislation contains rules for adjusting the basis for VAT when certain assets (real estate etc.) are sold or otherwise changes ownership.

### *Stamp duty*

Stamp duty on sale of real estate is 2.5% of the sale's price in 2012. Unchanged in 2013.

### *Excise tax*

Heavy excise tax is levied on tobacco, alcohol, cars, gasoline, etc.

### **Economy**

Norwegian economy is expected to continue its growth in 2013.

By the end of 2012, the Norwegian mainland economic growth had exceeded the average for the last 40 years. Low interest rates and income growth have contributed to a sustained increase in household demand.

The economy is also stimulated by relatively high oil prices. This is reflected in the rapid growth in activity within the construction sector and amongst petroleum industry subcontractors. Unemployment is low in historical terms as well as in comparison with the levels seen in other countries.

Strong growth in some parts of the Norwegian economy contrasts with the position of those parts of the economy that depend on demand in European export markets. Weak developments in Europe in combination with high wage costs and a strong NOK exchange rate, mean that many Norwegian exporters are facing a challenging situation. Although exports of traditional goods have bounced back somewhat during 2012, these still remain lower than before the financial crises. The Norwegian Government emphasizes the need for fiscal constraint to support continued balanced developments of the economy and to reduce pressure on exposed industries.

European financial markets have experienced much turbulence in recent years. Norwegian banks are less affected by the volatility in Europe than other European banks. Norwegian banks have avoided lending large amounts to businesses or governments in exposed euro zone countries. At the same time activity in the Norwegian economy has kept up rather well. Therefore, Norwegian banks have slightly improved their solvency and established a somewhat more robust funding over the last couple of years. However, Norwe-



-gian banks have slightly improved their solvency and established a somewhat more robust funding over the last couple of years. However, Norwegian banks have borrowed extensively abroad, and this makes them vulnerable.

The Government proposes a relatively neutral budget for 2013: the structural, non-oil and gas deficit is expected to increase more or less in line with the growth in mainland Norway trend GDP.

The main features of this budget are:

- Spending of petroleum revenues, as measured by the structural non-oil budget deficit is estimated at NOK 125.3 billion (€ 16.8 billion) in 2013.
- The real underlying growth in the expenditures from 2012 to 2013 is estimated at 2.4%, of which approximately half originates from growth in old age pensions.
- Net cash flow from petroleum activities is estimated at NOK 123.7 billion (€ 16.6 billion). This deficit is covered by transferring money from the Government Pension Fund Global.
- Unchanged level of taxation.

Key figures for the Norwegian economy (preliminary national account figures):

Private consumption increased by 3.7% in 2012 to NOK 1 170,3 billion (€157.1 billion EUR), from NOK 1 128.6 billion (€ 151.5 billion) in 2011. Expected further increase in 2013 at 4.0%.

Public consumption increased by 1.9% in 2012 to NOK 596.9 billion (€ 80.1 billion), from NOK 585.8 billion (€ 78.6 billion) in 2011. Expected further increase in 2013 at 2.2%.

Consumer Price Inflation (CPI) increased by 0.8% in 2012. The forecast for 2013 is a further 1.9% increase.

Wages (on average) increased by 4.1% in 2012. The forecast for 2013 is 4%.

Unemployment rate for 2012 was 3.1% of the total work force. A slight increase to 3.2% is expected in 2013.

The Central Bank of Norway (Norges Bank) lowered its key policy rate to 1,5% p.a. on March 15<sup>th</sup> 2012. The rate is expected to remain at this level for some months to come, depending, however, on the Norwegian currency's (NOK's) strength against other currencies, primarily EUR, GBP and USD.

*Sources: Publications of Finansdepartementet (Ministry of Finance) and Statistisk Sentralbyrå (Statistics of Norway).*





# Poland

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## Political economy background

In November 2011, for the first time in the post-socialist era in Poland, the incumbent government was re-elected for the second turn in the office. The coalition of the Civic Platform (*Platforma Obywatelska*) and Polish People's Party (*Polskie Stronnictwo Ludowe*) maintained sufficient electoral support and, hence, received mandate to continue with the political legacy commenced in the late 2007. This was despite the fact that in many countries the incumbents were treated as scapegoats for triggering economic crisis (Greece, Italy – Silvio Berlusconi's government) or pursuing austerity measures (France, Italy – Mario Monti's government). Similar political turmoil did not occur in Poland since, contrary to the other EU countries, it did not experience recession in years 2009-2011. It is worth noting that in 2009 Poland was the sole country in the EU to preserve positive economic growth and in years 2010-2011, along with other central-eastern EU member states, Poland was a growth leader. However, those favourable economic circumstances, which undeniably contributed to the incumbents' re-election, turned out to be the smokescreen of the lame public finance stance in Poland.

Despite the effort to consolidate public finance, the general government deficit amounted to 3.5% of GDP in 2012 (reduction by 4.4 percentage points between 2010 and 2012). This level of deficit is still above the European threshold of 3% of GDP and does not permit ceasing the excessive deficit procedure imposed on Poland by the European Commission in May 2009. Although this level of the total deficit is not particularly excessive as compared to the EU average of 3.8% of GDP, worse picture emerges whenever one looks at the structural (cyclically-adjusted) indicators of budget balance. According to the European Economic Forecasts from 2013, Polish deficit expressed in structural terms reached the level of 3% of GDP, i.e. 0.3 percentage points higher than the means for the EU. Consequently, the deficit in Poland only to a minor extent can be explained by the operation of automatic stabilizers. It is rather a result of the discretionary political decisions.

Strikingly, during the whole post-socialist era Poland observed only one budget surplus in 1994. As a consequence of this cascade of deficits, substantial public indebtedness was accumulated. According to ESA-95 methodology, in 2012 the gross public debt in Poland hit 55.8% of GDP. Theoretically, it was above the precautionary threshold of 55% of GDP imposed by the Law of Public Finance of 2005. This legislation puts forth the preventing mechanisms for breaching of the constitutional fiscal rule limiting public debt in Poland to 60% of GDP. The debt



threshold of 55% of GDP has crucial political implications. After exceeding this level, the government is required by law to enact the budget act without any deficit. However, the necessity of enacting deficit-free budget for 2013 did not materialize due to the fact that less encompassing definition of public debt is applied in Poland. For instance, some off-budget activities such as the debt issuance by the Road Fund are not revealed in the official public debt statistics. As a result of those fiscal gimmickries, at the end of 2012 the indebtedness in Poland attained roughly 53% of GDP and avoided the legalization of the deficit-free budget for 2013.

Regardless of the methodology at work, the public debt in Poland should be considered as high, particularly as juxtaposed with the debts of countries with similar level of socio-economic development. For instance, among former socialist economies that are currently the members of the EU, only Hungarian indebtedness is higher (78.6% of GDP) than the one observed in Poland. This permanently high debt might have severe negative economic consequences. Even without considering long-term adverse effects of excessive and chronic debt, i.e. higher taxation, inflationary pressures, more volatile exchange rates and deeper economic inequalities, the yearly tangible cost of debt (debt servicing cost) accounts for 2.7% of GDP in 2012. This is more than the annual general government expenditure on the police service and the tertiary education jointly.

All abovementioned fiscal burdens and negative assessments of Polish tax system by the international organizations (see Doing Business ranking in the following section) pressure the government to further reform public finance during the second term in the office. The need for reforms echoed in Prime Minister's exposé from 2011, where particular tax reforms and amendments to the pension system were announced. Those declared changes were to a large extent the continuation of earlier reforms aimed to increase taxation, broaden tax base, decrease disability pension, modify public pension system and dismantle private one (see Yearbook on Taxation 2011, 2012).

### **Fiscal reforms in 2012: good, bad and ugly**

In line with the Prime Minister's announcements, the year 2012 brought several public finance reforms. Those reforms could be classified as good, bad and ugly to paraphrase the title of a famous American western.

#### *Good (but could be better)*

After abolishing earlier pensions and thus increasing effective age of retirement during the first turn in office (before this reform Poland had the lowest effective retirement age in the OECD, i.e. 57 years for men and 55 years for women), the government continues reducing pension privileges also after the re-election. The reform is twofold. First, it limits special privileges of uniformed services. Police officers, uniformed public officers and soldiers will work 10 years longer (increase from 15 to 25 years). In addition, they will acquire pension rights after fulfilling age





requirement, i.e. minimum 55 years old. Although this change constitutes a move into the right direction, it seems that the reform could be much bolder making the uniformed service pension system even closer to the general system. For instance, in Germany policeman retire at the age of 60 the earliest. In the Netherlands, in turn, there is no special pension system for uniformed service. That means that policemen, for example, retire at the age of 65.

The second crucial reform relies on the equalisation and gradual increase of the retirement age for men and women. Targeted retirement age is 67 and is meant to be reached in 2020 for men and in 2040 for women, after increasing the retirement age by 3 months each year. Also in this case, one could cast that the age increase is too sluggish since it merely slows down the worsening of the proportion between population in the working age and retired population. While currently there are on average 3.71 persons in working age per every retired person, after the reform this ratio will drop to 3.45 and in 2021 further to 3.13. If instead the increase of retirement age had been faster at 9 months each year, this proportion could be kept stable around 3.8-3.9. While the current reform is supposed to generate public saving of PLN 25.8 bln, the alternative scenario could result in PLN 40.4 bln savings in 2022 (Bukowski and Lewandowski 2011).

The amendment of the personal income tax regulation was the third flagship reform in taxation. The reform abolished the tax relief for Internet and limited the tax benefit for copyright contracts. The 50 per cent tax-deductible income will apply exclusively to authors with income below the threshold of a maximum of PLN 85,000 a year.

The World Bank Group in its annual Doing Business report also noticed reformist moves. In the “paying taxes” category of the latest edition of Doing Business, Poland improved its rank by 10 positions. The authors of the report appreciated the efforts to promote the use of electronic filing and payment systems. Nevertheless, the overall easiness of paying taxes in Poland is critically assessed. Among 185 countries classified by the report, Poland is ranked 114. It turns out that Polish tax system is more complicated and business unfriendly than in underdeveloped countries such as Uganda (93) or Zambia (47). Employers in Poland emphasise four main problems with taxation. First, the basic 23% rate of VAT in Poland is one of the highest in Europe. For instance, in Germany and Spain the basic rate of VAT is fixed at 19% and 18%, respectively. Second, employers complain about the complicated legal construction based on a classification of products and services. This results in uncertainty in determining the correct rate of VAT. Third, tax obligation is created in an often disadvantageous moment for employer. For instance, the VAT obligation is effective instantly after issuing invoice, even where the buyer delays its payment. Lastly, employers underscore the negative effects of excessive taxation imposed on labour. Consequently, although small steps to simplify and make tax system friendlier for taxpayers were pursued, it seems that the key reforms in taxation are still to be launched.



*Bad (the same outcome could be achieved more persistently)*

The year 2012, however, was also rich in reforms that could be assessed critically in the sense that the outcome of those reforms, i.e. consolidation of public finance, could have been achieved in a more sustainable way. This is particularly true of many tax increases that were pursued in the last year. First in the list comes an increase of disability pension contribution paid by the employer by 2 percentage points (from 4.5% to 6.5%). It is a conventional wisdom that taxes imposed on labour decrease the demand for workforce. Therefore, the potential result of this reform is a decline of employment that is however crucial for economic growth. Another reform of the list is the taxation of copper and silver of which Poland has among the richest deposits in Europe.

As Alesina and Ardegnà (2009) and Giudice, Turrini and In't Veld (2003) underscore, the fiscal consolidation based on expenditure reduction are more persistent and are positively correlated with faster economic growth. Much better than the fiscal adjustments based on taxes. Although in Poland, the fiscal consolidation is mostly pursued through spending cuts (2.6% of GDP) and revenue increases are also large (1.8% of GDP).

*Ugly (déjà vu)*

Changes in pension system were the main source of controversies in the deficit reduction plan adopted in 2011 (see Kantorowicz and Łaszek 2011). The bill reducing part of the pension contribution going to second (capital) pillar of the system obliged the government to present report on the pension system two years later, in 2013. The report is due to be presented in May, yet the debate about pension system has already started.

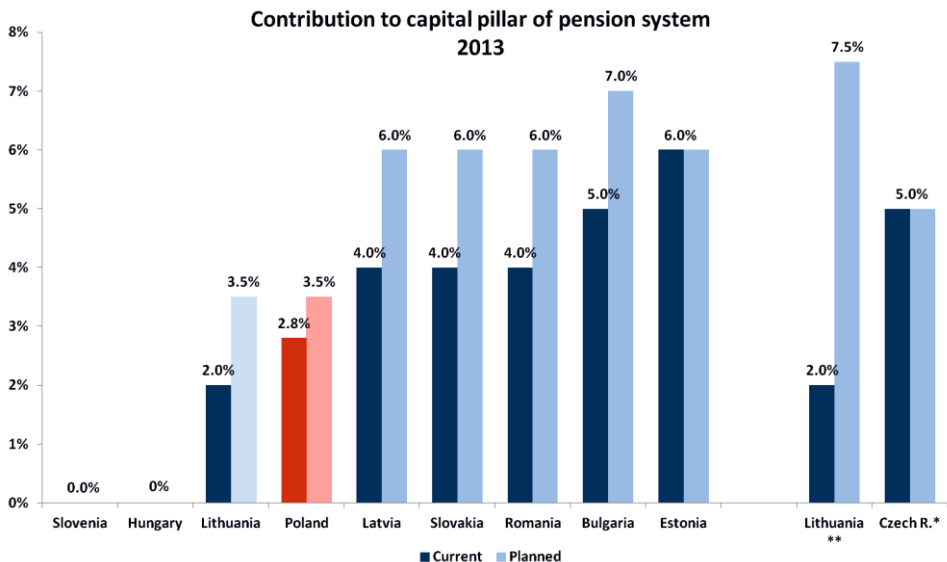
Similarly to the discussions in 2011, the most debated issue is the impact of second pillar on public finances, as the transition period requires additional financing (current generation is both paying for current pensions and accumulating savings for their retirement). For the period 1999-2012, the sum of the contributions transferred to second pillar amounted to 16.8% of GDP. It should be noted, however, that during the same period income from privatization amounted to 12.8% of GDP and was meant by the authors of the reform to be used to limit the increase in public debt. Therefore, the increase in public indebtedness (from 39.6% GDP in 1999 to 55.8% of GDP in 2012) should be attributed, not to the pension reform, but to other spending.

Another caveat concerns the lack of a pay-out mechanism. The main question is whether the assets accumulated during the period of work after retirement should remain in private institution or should be transferred to public social security provider. The latter alternative is tempting for the government as it offers possibility to reduce public debt, particularly if the transfer of the asset does not occur only at the retirement, but is gradual and starts a few years before retirement (this would limit the problem of variation in the asset prices at the retire-



retirement date). Such transfer of the assets could reduce public debt by 2-3% of GDP in 2014. This might be important as public debt, according to national definition (as mentioned above different from ESA95), is close to statutory threshold of 55% GDP. Although legal consequences of breaching this threshold are not as severe as violating constitutional limit of 60% GDP, political costs in the election year might be high. Despite the politics, such transfer of pensioners' assets from private to public sector would undo the benefits of capital character of the second pillar.

One overlooked issue in the current discussion is the question of efficiency of pension funds managing companies. Their fees are too high and benchmark for their performance, i.e. average rate of return of pension funds, encourages herd behavior (companies managing pension funds whose rate of returns are smaller than half of the benchmark rate, or benchmark rate minus 4 percentage points must make up for the difference). Benchmarking pension funds against other market participants would create better incentives for good management. Similar debates about the future of the second pillar take place in other countries of the CEE region as well. It should be noted, however, that at this moment both current contribution to capital pillar as well as its planned level are among the lowest in the region. See below Figure.



\*for citizens willing to pay additional 2% of their wage state will add 3%, bringing the contribution to 5%

\*\* for citizens willing to pay additional 2% of their wage state will add 2% which together with mandatory contribution of 3.5% will give 7.5%

Source: INESS , LFMI, IME , LiberalismiAkadeemia , Liberalni Institut , OECD, press.



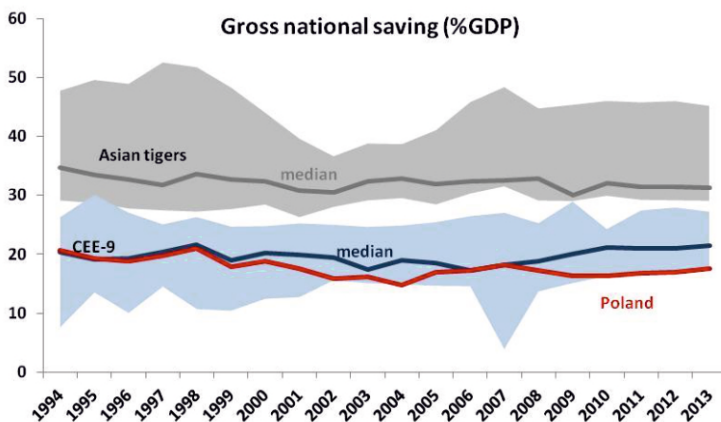
### Long-term consequences

Both questions of public deficit and capital pillar of pension system are highly related to one of the major obstacles to faster economic growth, i.e. a persistent low gross of national saving rate. During the last decade Poland was among the countries of the CEE region with the lowest saving rate. As it turned out this rate was roughly twice smaller than that of Asian tigers, i.e. countries that successfully caught up with the Western Europe and USA. See below figure.

One of the main explanations to the low gross of national saving in Poland, as compared to the other CEE-9 countries, was general government deficits. Persistent deficits and low public investments have significant and negative influence on gross national savings. Capital pension system, which works in other direction by accumulating mandatory savings of households, could positively affect the gross national saving.

Reduction of contributions to the second pillar in the short-run was neutral with regard to gross national saving – the reduced private mandatory saving was compensated by reduced general government deficit and thus higher public sector saving. In the long run, however, reduced general government deficit will limit the incentives to undertake other deficit reducing reforms. Thus the gross national saving will be lower than in the scenario were mandatory private saving remain unchanged and general government saving are growing due to other deficit reducing reforms.

#### Gross national saving in Poland, CEE-9 and Asian tigers in the period 1994-2013



Source: IMF WEO; CEE-9: Bulgaria, Czech R., Estonia, Hungary, Latvia, Lithuania, Romania, Slovakia, Slovenia; Asian tigers: South Korea, Taiwan, Singapore, Hong Kong.



## Conclusion

The reduction of deficit in Poland in the period of 2010-2012 was one of the boldest among the large countries of the EU. Despite this adjustment effort, the deficit in Poland is yet above the Maastricht Treaty threshold of 3% of GDP. This excessive level is supposed to last for at least two following years. The European Commission forecasts an overall deficit in 2013 and 2014 at respectively 3.4% and 3.3% of GDP. Therefore, a further fiscal tightening would be welcome in Poland, particularly if focused on expenditure cuts. To liberate the entrepreneurship and attract new investments to Poland, it is also urgent to simplify the tax system, i.e. in particular the regulation concerning VAT.

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# Portugal

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In any undergraduate course the value of legal certainty is taught. Fiscal policy, of all policies, should be following the principle more strictly, as it is one of the basic elements for any investment decision – and investment is the basis for economic growth and job creation. But that has not been the rule in Portugal, and in fact this report would be rather different if it was written six or even three months ago. For that reason, this year's report will focus on the most important issues of the year, without giving fully detailed account date by date, which would be tiresome and useless for the reader.

## Austerity?

Portuguese left is so pro-spending that the government's fleet reduction was approved with the votes of only the government-supporting right wing parties. Portuguese left is a staunch believer in pro-growth rhetoric and claims that “austerity” is not working and that further credit spending is needed to solve the credit crisis. Despite all the evidence from the last decade, they claim that the new loans will stimulate new spending and bring the economy back on track.

Both Portuguese right-wing parties are in the government coalition under the financial guidance of Vitor Gaspar, former top economic advisor for José Manuel Barroso. Mr. Gaspar had promised a budget correction based 70% on expenses; but, due to various pressures, he ended budgeting a correction based for 19% on expenses, and for 81% on an “enormous” (his word) tax hike.

Portugal's heart is traditionally on the left, calling the right wing leaders to office only in order to deal with IMF requirements – 1977/78, 1983/85, 2011/14. No surprise therefore that, over the last 40 years of democracy, the state burden has grown from 20% to 50% of GDP. The present crisis, however, is a bit different, coming after the country has absorbed a great deal of European funds in the eighties and nineties. The challenge is now to introduce changes in a country that has grown used to foreign funds – either in the form of aid, either in the form of credit expansion.

Portugal was meant to go bankrupt in June 2011. Then it was meant to “return to the markets” in December 2013. Now, the IMF no longer believes that the State can recover full finance independence before the end of 2014. With elections coming in 2015, this will be the first time a right-wing government is called to office following an IMF intervention and fails to fix the problem before the next national elections arrives.



In last year's report, it was said: "The Troika Program had as objectives to reduce government deficit below € 10,068 million (5.9% of GDP) in 2011, 7,645 million (4.5% of GDP) in 2012 and 5,224 million (3.0% of GDP) in 2013 by means of 'high-quality permanent measures and minimizing the impact of consolidation on vulnerable groups; bring the government debt-to-GDP ratio on a downward path as of 2013; maintain fiscal consolidation over the medium term up to a balanced budgetary position, notably by containing expenditure growth; support competitiveness by means of a budget-neutral adjustment of the tax structure'". The reality was different! After the € 16,982 million deficit of 2010 (9,8% of GDP), in 2011 the deficit reached € 7,525 million (that is 4.4% of GDP, or 8% of GDP before EU's acceptance of the absorbing of banking pension funds into the social security). In 2012, it rocketed to 10,596 million (6,4% of GDP, as € 2,650 million in extraordinary measures were not considered by EU). Consequently, State debt rose from € 185,240 to € 204,485 million (112% to 123,6% of GDP) in just 2012; a € 19,245 million (11,6% of GDP) increase financed mostly by the ECB.

### Fiscal Policy

As mentioned above, Portugal went through an "enormous" tax hike to fight the loss in tax revenue provoked by a decrease in consumption, imports and revenues in general. The main changes are presented below.

#### *Personal income tax - Labour*

The number of brackets for residents has been reduced from 8 to 5, the new brackets being:

- Up to 7,000 EUR – rate of 14.5%
- 7,000 to 20,000 EUR – rate of 28,5%
- 20.000 to 40.000 EUR – rate of 37%
- 40.000 to 80.000 EUR – rate of 45%
- More than 80.000 EUR – rate of 48%

Self-employed residents will pay a flat tax of 25% on 75% of services provided.

Non-residents face a rate of 25% tax on all employment income, commissions and royalties.

Both residents and non-residents will pay income taxes on pensions (14.5% to 48% for residents, 25% for non-residents). When visiting Portugal on a short-term assignment (less than 183 days in Portugal), the individual will qualify as tax non-resident and be liable to personal income tax only on the Portuguese-income source.

An extraordinary surtax of 3.5% will be levied on incomes that exceed the minimum wage (€ 6,790 annual income). An additional "solidarity tax" will be added to the higher bracket, with the rates of 2,5% being charged from € 80.000 to € 250.000 and 5% above € 250,000. Meanwhile, deductions, allowances and benefits have been greatly reduced to fulfil international obligations (memorandum with Troika), but are still possible for a myriad of expenses.





All these new rates and rules are expected to bring in 2013 a 35% increase of revenues from the personal income tax.

### *Personal income tax - Capital*

Rate is now 28% for all kind of capital income, namely: dividends, interest from bank deposits, interest from shareholder loans, interest from debt securities, rental income, capital gains and other investment income. Keep in mind that, only a few years ago, that rate was at 20% for most capital gains and at only 10% for capital gains on shares if the investment was done less than 12-month ago – exempt if it exceeded that time limit.

### *Social Security*

Social Security rates are 11% for employee and 23.75% for company (11% and 11.9% respectively if the employee is handicapped). For age pensioners in employed activity the rates are 7.5% for pensioner and 16.4% for company, while for handicap pensioners the rates raise to 8.9% and 19.3% respectively. Age pensioners did not pay social security until two years ago.

Rates for self-employed are 29.6% for employee and 5% for the company – employee only pays after 12 months, if the gross annual income is above € 3,593, and company must pay only if 80% or more of the amount of rendered services is for that business group.

Employee must pay 34.75% if he/she would like to be also protected in the event of unemployment.

### *Corporate Income Tax*

Corporate taxes are 25% in mainland and Madeira (a huge increase in Madeira, due to the region's financial situation) and 17.5% in Azores. A municipal surtax ("Derrama") of up to 1.5% of taxable profit may apply, especially in mainland urban areas. A state surtax will also apply if the company has a taxable income over € 1.5 million – the surtax rates are 3% for companies with a taxable income of € 1.5 million up to € 7.5 million and 5% for companies with a taxable income of more than € 7.5 million. Deductions were reduced across the board to fulfil a compromise with Troika.

The 12.5% bracket for small companies is no longer applicable, while the state surtax for "very profitable" companies will be introduced in 2013.

### *Corporate Income Tax – Payments on Account*

Payments on account are owed based on the CIT assessed in the previous year, net of withholding taxes incurred that cannot be either offset or refunded. For tax year beginning on January 1<sup>st</sup> 2013, the amount of payment on account due is CIT paid in 2012 minus 80% of withholding taxes in 2012 if the turnover is less than € 500,000, and 95% instead of 80% otherwise.

Companies are liable to the Special Payment on Account ("Pagamento Especial por Conta" or PEC), which in practice results in a minimum tax burden, regardless



the results obtained – and remember that 70% of Portuguese companies report a loss. The formula is: 1% of the turnover of previous tax year minus payments on account of previous year. To be more precise instead of 1% of turnover the formula for Payment on account uses a minimum of € 1,000 or if larger the maximum of 1% of turnover or € 1,000 EUR + 20% of the surplus limited to € 70,000. This payment is deductible from the CIT assessed in the year and the following four years. Any part that cannot be deducted due to the insufficiency of tax assessed will only be refunded upon request, which immediately triggers a full tax inspection. Entities totally exempt from the tax are not required to make the special payment on account, even if the applicable exemption does not include income subject to withholding tax at flat rates.

Additional payments on account (“Pagamento Adicional por Conta”) is due by entities subject to either payments on account or special payments on account that have reported, in the previous tax year, a taxable profit exceeding € 1.5 million. The rates of that additional payments are 2.5% for companies with a taxable income above € 1.5 million up to € 7.5 million and 4.5% otherwise. Companies that reported a loss in a given fiscal year have risen from two thirds to above 70%, but that does not mean that they do not pay taxes now – the assumption being that if the company is still open it must be that the owner profits from that fact.

### *Corporate Income Tax – Capital*

Dividends, interests, rental income, royalties and capital gains all pay 25%, except if it is capital income paid or made available to entities resident in blacklisted jurisdictions or capital income paid or made available in open accounts on the name of one or more owners but on behalf of third parties not identified, in which cases the rate is 35%.

### *Value Added Tax*

VAT tax rates are: 23%, 13% and 6% in mainland, 22%, 12% and 5% in Madeira and 16%, 9% and 4% in Azores. Again, Madeira had to adjust upward due to its very weak financial situation. The reduced rate is applicable to the supplies of some basic foodstuffs, periodical publications, books, pharmaceuticals, hotel accommodations, agricultural goods and passenger transports. The intermediate rate is applicable to supplies of some foodstuffs and to admissions to concerts, shows, theatre, cinemas, circus and bullfighting. There are movements to lower VAT on books and other cultural items, but such a change seems unlikely in the foreseeable future.

Most self-employed also pay VAT (adding a pre-tax to the 25% PIT and the 29,6% of Social Security) on their incomes – a situation very common for youngsters, which now abandon the country at a rate of 100,000 per year, the 2<sup>nd</sup> highest ever (after the Colony Wars period). Exempted activities include financial services, nursing services, medical and paramedical services and all earning below € 10,000 of taxable income. For this reason many self-employed opt for opening a personal company and bill the employer from the personal company.



### *Value Added Tax – Fighting Evasion*

A new rule aimed at fighting VAT fraud and evasion allows resident taxpayers to deduct, for Personal Income Tax purposes, 5% of the VAT incurred on certain expenses by any member of the household, up to annual limit of € 250. In 2013, the VAT paid must relate to certain business sectors, such as maintenance and repair of cars and motorcycles, hotel and restaurant bills and hairdressing. This tax incentive may be extended to other business sectors in 2014. Effective January 1st 2013, all Portuguese taxpayers (Portuguese companies or foreign companies with a permanent establishment in Portugal) must communicate by electronic means to the Portuguese Tax Administration relevant data of the invoices issued during a particular month, at the latest on the 25th day of the subsequent month. Note that the rules for the elements and comments that must be included on VAT invoices have been standardized at the EU level, and consequently several changes have been introduced in Portugal regarding the content of invoices.

### *Property Tax (IMI)*

Property taxes were based on the old value of the building. No longer: all the buildings are being re-valued by the state (done by self-employed architects earning € 50 for 10 evaluations), with the option for the owner to ask for a second re-evaluation if one does not agree with the first one (billed € 204 if the value remains unchanged or raises).

Rates are as follow: Urban property (appraised under the former legislation “Contribuição Autárquica”) – 0.5% to 0.8%, Urban property appraised under the IMI Code – 0,3% to 0.5%, Rural property – 0.8%, Property owned by residents in off-shores (except individuals) – 7.5%.

Urban properties considered as a permanent place of residence are exempt the first 10 years if three conditions are fulfilled: the property value must be below € 125,000, the buyer's taxable income in the year prior to the acquisition was lower than € 153,300 and if he submitted an application for recognition of IMI exemptions during the first 60 days following the transfer of property.

Companies realizing “relevant investment” in 2013, benefit from IMI exemption for a period up to five years, regarding real estate acquired that constitute “eligible investment”.

Real estate was a nice investment before this crisis. Now with declining home prices (-6% in 2012) and raising taxes, people are considering other investment options.

### *Property Transfer Tax (IMT)*

Property Transfer Tax is a municipal tax on transfers of real estate. Such transfers may also be subject to Stamp Duty. The acquisition of more than 75% of the share capital of a company incorporated as “sociedade por quotas”, which owns real estate located in Portugal, is subject to IMT.



Rates for urban properties or property units considered solely as a permanent place of residence are divided in brackets. Marginal tax rates are: up to € 92,407 – 0%; between € 92,407 and € 126,403 – 2%; between € 126,403 and € 172,348 – 5%; between € 172,348 and € 287,213 EUR – 7%; from € 287,213 to € 574,323 – 8%. Finally, above € 574,323 the rate is a single rate of 6%.

Rates for other kinds of properties are flat rates: rural properties – 5%, other urban properties and other acquisitions for consideration – 6,5%, the acquirer is a tax resident in an off-shores (except individuals) – 10%.

There are several exemptions, namely: acquisition of properties for resale by Real Estate companies, acquisition of real estate by Open-end Real Estate Investment Funds or by closed-end of public subscription, acquisition of real estate by Real Estate Investment Funds for Residential Letting (FIIAH), operations of concentration or cooperation (such as mergers and demergers), acquisition of an urban property, object of urban rehabilitation and acquisition of buildings classified as of national/public/municipal interest. Any of these exemptions imply the fulfilment of a long list of requirements.

Companies realizing “relevant investment” in 2013, benefit from IMI exemption for a period up to five years, regarding real estate acquired that constitute “eligible investment”.

### *Other changes*

Several other changes were made to the tax system, especially to tax high earners. For example a stamp duty of 20% was imposed on lottery prizes (including Euro Millions) exceeding € 5,000. Property, usufruct or surface right on urban property with tax registration value above € 1 million is now taxed at 1%.

A more subtle change concerns the purchase of a car above with value above € 50,000, the state immediately checks if the owner as earnings that allows him to buy that car. If not, an automatic tax of 20% is levied for the taxes the individual should have paid on earnings that he must have hidden. The person can then dispute the claim, after paying. For this reason, a new trend in these situations is the “technical loan”, a loan that a rich person with no need of it contracts to buy a € 50,000 car to avoid triggering an automatic state treasure investigation.

### **Beyond fiscal policy**

The Troika Memorandum is a complete government program, signed by PS (member of European Socialists), PSD and PP (both members of EPP), representing 85% of the political spectrum. As the Socialists lost the elections in June 2011, PSD invited PP for a majority government and both have been implementing the program ever since.

Since June 2011, the Memorandum has been the great excuse to implement some needed reforms and cuts, but also some tax hike as explained above. Memorandum reforms are generally considered a need but it has faced some obstacles, including: inability of the government to cut on public-private partnerships and other rent-seeking entities, inability of the troika members to ex-



explain some policies and deal with the press (going so far as to publicly demonstrate surprise for the unemployment rate), natural pressure on the socialist leader to “rip the aggression pact”, resistance of pressure groups to the cuts being made on their incomes and calls on the press for “growth policies” from numerous “specialists”.

These are the main changes budgetary non-fiscal changes intended to put forth by the government to try to balance the budget from the expenses side.

### *Public-Private Equality*

The Constitutional Court has made the strongest opposition to the cuts. The court was silent to the repeated breaks of Article 105 of the constitution – the one that requires receipts to cover expenses – and to the build up of rights to the public sector. But now claims that the withdrawal of rights from the public sector without equivalent changes in the private sector is deemed unconstitutional because it violates Article 13 – the one on the equality principle.

Answering to the equality argument, these are the measures that the government will try to implement during 2013:

- Single wage table – Special careers on the public sector (such as judges, policemen, military, doctors, nurses, or teachers of all levels) will converge to a single wage table of civil servants. 90% of the Education Ministry costs are wages and the same applies to the Defence Ministry, so the potential savings here are huge;
- Convergence of employees and self-employed – The young generation that “entered” the public sector in the last 10 years are generally not employees, but “service providers” with much less labour rights. Those two statuses shall converge.
- Convergence of retirement age – probably to 67, up from 62.5 in the private sector and 60.1 in the public sector (interestingly, the judges of the constitutional court can retired at age 40 with 10 years of service);
- Convergence of pensions – Social Security (for the private sector) and Retirement General Service (for the public sector) pensions shall converge;
- Convergence of healthcare services – National Healthcare Service (for the private sector) and Public Sector Social Protection (for the public sector) shall converge, with the goal of eliminating the deficit between the receipts and the expenses of the second;
- Public-private labour rights equalisation – Labour law will be change to make the two sectors converge as much as politically possible

### *State Owned Companies*

On the ownership front, the state has sold EDP (energy) and ANA (airport management). TAP (air travel) was not sold due to the lack of buyers but it is probable that it will be sometime in 2013. RTP (television) and Águas(water distri-



-bution) are stopped and are slipping from the government priorities, as the opposition to their selling is too strong.

Interestingly, the six big state-owned transport companies remain untouched, although they are responsible for almost all debt of the state owned companies and provide a diminishing and low-quality service when compared to private bus companies.

Public-private partnerships remain a problem, as the cuts were skin-deep at best. The contracts are so shielded that a special tax is being considered as the only way to affect those profiting from them. Basically, the state (or the town hall) ensures a return (generally 10% to 15%) on investment every year without risk transfer. For example, if it is a toll highway and it is running a 2% loss due to lack of usage, the state pays 12% of investment to ensure an annual profit of 10% to the company. The cost is estimated to have reached € 59,600 million for the next 40 years. Also note that the contracts are private and their disclosure can lead to imprisonment. This would be a great savings priority and one popular with the general public, but unpopular with lawyers and campaign financiers.

### Final Remarks

Unemployment has reached 17,5%, the third highest in OECD countries and the highest ever recorded – an appalling number considering the low medium wage of the country (€ 777), that traditionally guaranteed Portugal a low unemployment figure (such as 4.3% in 2001). Emigration remains high – above 100,000, or 1% of population – and worrisome as it is the “best prepared generation ever” that is leaving, unlike in the sixties. On Economic Growth, the Bank of Portugal forecasted – as late as March 2013 – that GDP will fall by 2.3% in 2013, after the 3.2% drop in 2012, in both cases mainly due to a weak domestic demand.

On a positive note, the trade balance, in deficit since 1995, has reached a surplus in 2012, due to a boost in exports and a decrease in imports. The banking sector is also de-leveraging quickly (tier 1 is now between 10% and 14% for the most important banks) and the country's debt as a whole (public and private) is now only € 385,246 million (as of December 2012), down from over 400,000 some quarters ago, and to be compared with a GDP of € 165,387 million in 2012.

Portugal is facing the costs of its adjustment program, or, put in other words, the hard truth that it cannot sustain 2007 consumption levels with the current low volume of production while counting on foreigners to finance the other 10%. What would be the alternative: a deficit of 15%? Or even 20%? Portugal is learning that the key is to boost production, not consumption. And for that Portugal needs a smaller state, savings, investment and a productivity jump. Portugal is learning it the hard way.



## Background

Political instability and its corresponding fiscal uncertainty characterized the 2012 election year (local in June, legislative in December). A cabinet resigned, another was dismissed by the Parliament after few months, a new cabinet took over and was replaced after the legislative elections, but it kept the same Prime-Minister. A referendum for the resignation of the President had highly controversial results (87% in favor, but with no consequences because of insufficient participation). The Constitutional Court took almost two months to decide the referendum's (lack of) effect. Meanwhile, the incumbent president was suspended and replaced by an interim president, who actually was his main opponent and among the initiators of the referendum.

Proposals to increase, maintain and reduce the main tax rates were issued simultaneously or in an erratic succession by representatives of the same political force. Proposals to suppress old taxes and/or introduce new ones were issued and withdrawn frequently. However, miraculously, the main tax rates remained the same (PIT 16%, CIT 16%, VAT 24%, as well as social security contributions).

Uncertainty affected also the next year. For example, at the end of 2012, the future of the flat tax was still unknown, as well as the level or the very existence of other taxes.

## Personal Income Tax

The Romanian flat tax survived its eighth year, despite various frontal or subversive attacks. Since the 21<sup>st</sup> May 2012, the government has been controlled by the Social-Liberal Union (SLU). This is a political alliance between the Social-Democratic Party (SDP) and the National-Liberal Party (NLP) who won local (41%) and legislative elections (2/3 majority in both Chambers). One point of SLU's election platform was, according to one of its representatives, *“keeping the 16% flat tax rate but with the introduction of two additional brackets”* (8% and 12%) for lower incomes (corresponding to approximately the minimum wage and, respectively, the average wage). This obvious contradiction was amplified in June 2012 by the proposal (made by a SLU co-chairman) to introduce a *“supplemental 16% flat tax”* for public employees, which would be applied to incomes over €1,000. It seems that they are so attached to the 16% flat tax that they want to apply it twice.

Neither one of these proposals was enforced in 2012 or in the first quarter of 2013, but the cycle of launch- withdraw- re- launch increases fiscal uncertainty





concerning one of the main taxes. Despite its potential un-constitutionality, the proposal of a supplemental solidarity tax paid by public employees was renewed in April 2013 by the Prime-Minister (president of SDP and SLU co-chairman), but with a lower level (10%) and with a specific destination (pensions for the military). Contrary to the summer of 2012, this proposal was vocally opposed by the other SLU co-chairman (president of NLP, Senate president) and by some trade unions leaders from both public and private sectors. There is absolutely no way to predict if this tax will be enforced next month, next year or if it will just keep haunting the Romanian business environment.

The opposition, mainly the Democrat-Liberal Party (DLP), is “under reconstruction” after the election debacle. The DLP supports a 12% flat tax, but its political weight being at a slightly higher level, we can identify at least one fiscal certainty in Romania: this measure will not be enforced during the next three years.

As a result, in 2012 and first quarter 2013, there have been no significant changes, either in the tax base or in fiscal deductions (detailed in previous editions of this Yearbook).

### Corporate Income Tax

A remarkable achievement of the fiscal authorities is the stability of the 16% corporate income tax rate since its introduction in 2005. It seems that there is an implicit consensus among relevant political concerning this topic. As mentioned in previous editions of this report, this rate concerns only undistributed profits. Dividends distributed to individual stockholders are considered part of their personal income and subject to an additional 16% withholding personal income tax. Under certain conditions, dividends paid to another EU company are exempted from this additional taxation.

The tax base was increased “temporarily” in 2010 by restricting the deductibility of some expenses, like those for motorized vehicles. These restrictions were maintained in 2011 and extended in 2012 to other categories of vehicles and related expenses, previously exempted. They were still in force during the first quarter of 2013. Ceilings on deductible depreciations for most motor vehicles have been in force since February 1<sup>st</sup>, 2013.

Countless other dispositions were introduced in order to cap and/or to reduce the deductibility of certain expenses (e.g., employees' per diem for business trips that are 2.5 times higher than the legal limit, interest expenses over certain rates etc.).

A source of confusion is that deductibility rules for corporate income tax are not completely “harmonized” with those concerning the VAT.

Among the good news, we can mention the increase in the deductibility threshold of R&D expenses (starting with 2013) from 20% to 50%.

Since 2001, microenterprises (companies with fewer than nine employees and turnover of less than €100,000) had the option to choose between the general





rule of 16% corporate income tax and a tax on turnover, which fluctuated over the years between 1.5 and 3%, its current level. This incentive was suppressed in 2010 (when all companies were subject to corporate income tax) and then reintroduced for 2011 and 2012. In 2013 the nine-employee ceiling has been phased out but the turnover ceiling has been reduced from €100,000 to €65,000 and almost all microenterprises became subject to a 3% corporate turnover tax (but not to CIT). The exceptions are microenterprises involved in banking, finance, insurance, reinsurance, stock market, gambling, consultancy and those state-owned.

Briefly, after being forbidden in 2010, this fiscal incentive became mandatory in 2013.

A source of fiscal uncertainty in 2012 and 2013 was and is still represented by the authorities' intention to reintroduce "*an improved version*" of the minimum corporate income tax. Its application in 2009 and 2010 regardless of company profitability is considered responsible for the closure of 100,000-200,000 companies (see *Taxation in Europe 2010*, Romania). Details concerning the "improved version" are scarce and inconsistent, but according to some officials, it will probably be applied only to some sectors, more prone to fiscal evasion (tourism, restaurants, beauty centers etc.). Its formula will be complex enough to take into account the real (or the average?) company profitability, depending on sector, location, commercial goodwill and seasonality. This topic was not included either in the SLU election platform, or in its December 2012 government program. As of April 2013, there is no law project on this measure, which is supposed to be implemented starting July 1<sup>st</sup> 2013.

Capital gains are taxed at 16%. There is still no consolidation or group taxation in Romania. A holding regulation proposal was submitted to the Parliament in 2009. As of May 2012, the holding law project was still "on hold" and another year later it has not been yet voted by the newly elected Parliament.

### Value Added Tax

After a sharp increase in 2010 from 19% to 24%, fiscal authorities decided to maintain unchanged the standard rate, close to the maximum level allowed by European regulations. The lower-level rates applicable to a short list of products stayed the same (at 9% or 5%, depending on the case). There are constant calls to enlarge this list and/or to further reduce the lower rates, but without any effect in 2012 or first quarter 2013.

One of the best fiscal news was the increase of the threshold from which companies and authorized individuals are required to register for VAT, from €35,000 to €65,000. This 85% increase is actually less impressive than it appears because it must be converted in Lei at the exchange rate at the accession moment (3.3817 RON/EUR). Therefore, €65,000 "accession Euros" represent only about €50,000 at the average 2012 exchange rate of 4.4560 RON/EUR, but it is still a significant 40% increase from the original level.



Since July 1<sup>st</sup> 2012, the VAT deduction has been subject to new restrictions for vehicles (and related expenses) that are not used exclusively for business purposes.

A permanent presence in public debate is the proposal to apply a reduced rate (9%) for basic products like bread. The arguments of its proponents that it will increase social protection, via lower prices and that it will decrease tax evasion or, at least, attenuate its distortions have not yet convinced the government to enforce its election promises.

A major change in VAT took place in 2013, when, under certain conditions, some businesses could opt to, or actually, were forced to adopt the application of the *VAT at payment*. The measure was presented as a fiscal incentive for small and medium enterprises by postponing their fiscal obligations from the moment of invoicing to that of cash receipt. However, because the invoice-based VAT general rule is still in force, the administrative burden could surpass the gains from this incentive (companies need to update their accounting software and keep two VAT registers). Moreover, this incentive offered to SMEs is actually supported by the larger firms, who would prefer to avoid them as subcontractors. This potential adverse effect had been signaled by some analysts and seems to be confirmed in the first months of enforcement. This measure could be better understood as a tool against (intra-communitary) VAT fraud. Because of its limited and mixed results, the payment-based VAT system could be made optional, but there have been no changes as of April 2013.

### Excises

Excise levels are set in Euros but their payment is made in Lei, at the exchange rate calculated by the European Central Bank in the first business day of October 2011. Based on this reference, the Leu depreciated slightly against the Euro (0.8%), but excise level increased at higher rates. For example, cigarette excises increased with 3.38% in Euros, starting with July, 1<sup>st</sup>. For 2013, excises are calculated with a Leu 5.2% weaker relative to the Euro.

Starting with 2013 until 2017, excise level for cigarettes will be increased on April 1<sup>st</sup> each year, compared to July 1<sup>st</sup> until now.

“Harmonized excises” on energy, tobacco and alcohol are still lower than EU minimum levels, but the difference is supposed to be reduced in future years, according to Romania-EU accession treaty. According to the most recent schedule available, the last increase will take place in 2018.

Concerning “un-harmonized excises”, Romania is among the few European countries that maintain excises on coffee (since 1998) despite the fact that they were supposed to be abolished in 2010.

In 2013, new excises were introduced for beer.



## Social security contributions

Romanian legislation maintains the conventional but flawed distinction between employer and employee social security contribution. Table X outlines the recent evolution of social security contribution rates. Business associations, trade unions and some opposition parties ask for their reduction. According to government officials, a reduction in social security contributions is desirable but contingent upon economic growth. Despite this national consensus, no significant changes took place in 2012 nor are there any expected for 2013. The main reasons are the country's demography and structural deficit of the public pension system (dependency ratio around 1).

The tax base for social security contributions is the gross wage and all “dependent work”-related income, which means all income earned under what the fiscal code considers employee-employer contracts. The purpose of this provision is to close previous loopholes used to avoid social security contributions.

Social security contributions are capped at a level equal to five times the average gross salary. In 2012, for fiscal purposes, the average gross salary was 2,117 Lei, about €480 per month. Therefore, for gross salaries above €2400/month, social contributions are regressive.

For 2012, the contribution to the second pillar (private system, based on capitalization) was 3% in January-February and 3.5% in March-December. It increased to 4% in 2013. Contributions to the first pillar (public, pay-as-you-go system) decreased accordingly, as the total employee pension contribution represents 10.5% of gross salary. (See Taxation in Europe 2009 for more details concerning pension reform and contributions.)

## Local taxes

Transfers from the state budget represent the main source of income for local budgets. They are calculated as a percentage of VAT, corporate and personal income tax collected from taxpayers at the local level. These “entitlements” established by law can be supplemented with additional transfers. The criteria are supposed to achieve redistribution toward poorer municipalities/counties and/or to follow the national strategy for development. However, all governments have been accused of helping especially municipalities run by mayors from their political party. Taxes on real estate (land and buildings) and motor vehicles are another financing source for local budgets.

On 27<sup>th</sup> of December 2012, the government implemented a new level of local taxes for 2013, indexing them to the inflation rate, as is supposed to be done every three years. The cumulated inflation rate and, therefore, the increase of local taxes was 16%.

Local authorities were left to decide whether or not to increase local taxes, but the Prime-Minister warned those tempted to leave them unchanged that this will jeopardize their allocations from the central government.



In January 2013, the government submitted to public debate many amendments of the fiscal code. The proposals concerned microenterprise taxation, depreciation rules, the tax on agricultural income, rules for the payment-based VAT system etc.

### Quasi-taxes and other administrative fiscal burdens

Since September 2012, the application of a stamp and signature by the tax authority is no longer required to validate a fiscal document. This looks like a small step, but it could be the early sign of a paradigm shift in Romanian bureaucratic philosophy, from paper to digital world.

Many “anti-abuse” measures were introduced in the fiscal code (with immediate effect), like the new concept of “*artificial transactions*”. This explicitly allows fiscal authorities to apply a tax treatment according to what they consider the “real” purpose of any operation, even for transactions covered by conventions concerning the avoidance of double taxation. The practical consequence of such measures will be higher potential of arbitrary and uncertainty.

In March 2013, in the general anti-tax-heaven ambiance, the government set a 50% withholding tax on income (dividends, interests, royalties, services provided in Romania or abroad) paid after February 2013 in a country with which Romania had not signed an agreement concerning the exchange of fiscal information. This represents a significant increase compared to the previous level (16%) of the withholding tax.

Another change that took place during the fiscal year (January 2013, effective in February) will have a major impact on non-residents. They will have to include in their income earned in Romania the income from services rendered outside Romania, with the exception of international transport and ancillary services.

The number of fiscal changes represents a problem in itself. Their speed only amplifies the issue at levels unmanageable even for fiscal authorities. For example, in January 2013, within less than 48 hours, a project to amend the fiscal code was submitted to public debate, discussed with the Group of Social Dialogue, debated in the mass media and implemented by government ordinance. It took the government almost two months to take into account taxpayers and experts' reactions and to publish the details concerning the enforcement of these changes that affected the taxation of microenterprises and non-residents.

The imbalance between the state and the taxpayer persists and takes many forms: how their mutual obligations are handled by fiscal regulation, the level of penalties, the ease of their enforcement etc. The taxpayers' access to justice is limited because it must be preceded by a response from fiscal authorities that can be delayed for six months. In contrast, a fiscal fine is due immediately. Part of the fine represents a “bonus”, a supplemental income for fiscal employees who have



financial responsibility if the decision is invalidated in court.

There is an apparent consensus among the authorities, all political forces, mainstream analysts and journalists, tax, accounting and audit professionals and even business association representatives that two of Romania's main problems are a low weight of taxes in the GDP and a high level of tax evasion. It is significant that the economic and mainstream press refers to the T/GDP indicator as “budgetary income ratio” rather than “fiscal pressure ratio”. More significantly, political forces (DLP, self identified as center-right) that explicitly defend the flat tax and even its reduction at 12% are partisans of an “*increase in budgetary revenues from 35.5% in 2013 to 37.5% in 2015*” (Anghel, 2012), a little bit higher (36% in 2016) than the objective set by a finance secretary of state in a center-left government (Bostan, 2012).

After the elections, SLU, the winning coalition, announced its government program for 2013-2016, but without specific intermediary deadlines. The most important fiscal measures are: keeping the 16% tax and the introduction of two lower brackets (12% and 8%) and different deductions; the reduction of employer social security contributions by 5% and an additional 1% deduction, valid one year, for jobs created and maintained one year; a VAT reduction (from 24% to 19%, and to 9% for agricultural products); a reduction in half of the number of quasi-taxes; increased deductions for R&D spending; and tax exemptions for investments in the tourism sector etc.

Taxation of agricultural income was considered unsatisfactory by fiscal authorities but any significant measure was carefully avoided in the 2012 election year, in a country with about 40% rural population. However, in January 2013, the government clarified its intention to change the tax base, replacing the (under-) reported agricultural income with agricultural assets like land, animals etc. The argument is that the number of farmers who benefit of agricultural subsidies (670,000) is about ten times higher than the number of those who pay any tax on income. Small farmers (those who have less than 2 hectares of land or 500 square meters of greenhouses, 3 cows, 6 pigs, 10 sheep, 100 chickens etc.) are exempted. Of course, this fiscal change was made effective on February 1<sup>st</sup>, 2013 – after the elections were over.

A new tax on vehicles, the so-called “environment stamp”, represents a reincarnation of a tax introduced in 2007, mostly for protectionist purposes and as a result contested successfully at EU level and revised many times. A detailed analysis of this new version shows that its green camouflage is worse than previous versions (30-40 year-old cars are more heavily taxed than 3-4 year-old cars that pollute much less). Its protectionist intentions are not too obvious (not only imported second-hand cars are taxed, like in an earlier version, but also new cars). However, it is interesting to notice a strange coincidence: taxes are much higher for the imported second-hand cars that could be an alternative for “our” Dacia Logan.



Romanian taxpayers, especially businesses and individual entrepreneurs, bear a high administrative burden. In 2012, *Monitorul Oficial* (the official gazette) had 898 issues, 40 less than the previous year. The instability, ambiguity and inconsistencies generate incalculable costs.

- Fiscal instability. At the very end of 2010, the government modified more than 100 articles of the fiscal code. The complementary regulation ("norme de aplicare") was drafted and published only mid-February 2011. In 2011, the fiscal code was amended five times. This represents an obvious improvement compared to 14 modifications in 2010. The figures refer to the number of laws and government ordinances that amended the fiscal code. If we take into account other relevant pieces of regulation, the improvement is less impressive: 26 changes in 2011, compared to 27 in 2010. Of course, all these modifications ignored the spirit of Article 4 of the fiscal code, which stipulates that changes are made "usually" only by law (and not by government ordinance) and at least six months before their enforcement.
- Fiscal ambiguity. Regulations are not always formulated in a way that protects taxpayers against authorities' arbitrary decisions;
- Compliance costs: high frequency of required reporting and payments, despite the elimination or consolidation of certain taxes and forms. Progress made in e-governance has not yet eliminated the direct (physical) interaction with the authorities.

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## Abstract

From the perspective of fiscal adjustment, year 2012 was lost. In an attempt to collect more revenues, government increased general VAT rate, excises on tobacco, personal income from capital gains.... Government has also prepared the draft of the Law on Corporate income tax proposing an increase in the rate from 10% to 15%. Simultaneously, government abolished dozens of quasi-fiscal charges (communal taxes, different fees) in an attempt to improve business environment. Despite the tax measures that helped increase the revenues, government's budget actually ended with higher deficit for the simple reason that additional expenditures were higher than additional revenues. The recently adopted general fiscal rules are not likely to be honoured in the medium term. Getting priorities right is difficult, dispensing with populist policies even harder. Risks of fiscal unsustainability are elevated.

## Should government tax more all citizens to grant subsidies to buyers of Fiat produced in Serbia?

Looking at the tax and budget policy in 2012, the answer to questions similar to this one is clearly positive. General VAT rate was raised from 18% to 20% in October 2012. Tax rate on personal income from dividends, interest, personal insurance premium, and capital gains has been increased from 10% to 15%. Fixed share of excise on tobacco was increased from 33 dinars to 43 per 20 cigarettes whereas proportional excise from retail price was reduced by 1 percentage point (from 34% to 33%). An excise on diesel was increased from 37 to 42 dinars per liter, whereas excise on LPG has been increased from 18 to 30 dinars.

The fact that government has prepared a draft law on corporate income tax including an increase in tax rate from 10% to 15% is reflection of the need to provide for permanent increase in revenues, the need which is better understood if a broader picture of fiscal problems is taken into consideration.

## Changes in fiscal architecture: recognition of the problems in public finances

Serbia had undergone interesting changes in its fiscal architecture since the onset of the crisis. First and foremost, Fiscal council, independent government body responsible to the National assembly, was established in October 2010 and became operational in April 2011. The need to establish a new body was recognition that existing institutions are insufficient to secure fiscal sustainability and maintain fiscal risks under control. Second, concomitant to the establishment of the Fiscal Council, fiscal rules were enacted providing for general and specific targets to policy makers. The task of the Fiscal council, whose President is proposed by President of the Republic of Serbia and whose





President is proposed by President of the Republic of Serbia and whose two remaining members are proposed one by Minister of Finance and the other by the Central Bank Governor, consists among other things, in the evaluation of fiscal policy strategy proposed by the government and assessment of the budget execution against the fiscal targets. General fiscal rules set upper limit for public debt to 45% of gross domestic product (gdp), and fiscal deficit in medium term to 1% of gdp. Deficit rules allow for countercyclical fiscal policy, allowing for deviation of the fiscal targets if the gdp is below/above potential gdp growth rate, assessed to be 4% for the period 2011-2013. Specific rules target one of the major weaknesses of public expenditures, namely reduction of current expenditures for the pensions and limiting the growth of the wages of public servants. Serbia spends more than 13% of gdp to the pensions and specific fiscal rule enacted in the Law on budget system sets a target at 10%. Similarly, public wages take around 12% of gdp and the goal is set to reduce it to 8%.

### Will that be enough?

Neither introduction of the independent body nor enactment of the fiscal rules will guarantee fiscal sustainability. If the public and politicians are not willing to change the habits, forgone private political interests, rules will not work and targets set will not be achieved. However, the functioning of the Fiscal council represents huge improvement in the availability of information and professional evaluation of the policies proposed by the government. Lack of realism in revenue projections, overoptimism in expectations from the enactment of policy measures, or wrong policies all together are now identified more easily. The establishment of the Fiscal council definitely contributed to the quality of the public debate. Of course, there is no guarantee that Fiscal council will in all instances provide good advice, particularly if it operates under implicit assumption that social/political constraints for adequate policy making are very strong. Quality of the policy making depends ultimately on the demand from general public.

### Initial performance under the rules is not encouraging

General government public debt in Serbia increased from 30% in 2007 to 61.5% (63%) at the end of 2012. Several factors contributed to this dramatic increase: nominal depreciation of the dinar, real GDP fall, and huge fiscal deficits. Public debt of the central government increased from € 14.7 billion at the end of 2011 to more than € 17.6 billion end of 2012. The fact that fiscal numerical target (upper limit of the debt to GDP ratio) was exceeded soon after its enactment, did not help to increase credibility of the fiscal policy. On the contrary, if there is enough courage to implement the politically expensive but economically beneficial measures, it is doubtful whether enacting the rules is actually just waste of political energy. The general fiscal rule remains as a sort of the anchor or future goal to be reached. In the meantime, government has to start with bold fiscal adjustment consistent with attainment of the debt rule, under difficult economic circumstance.





After timid recovery of real GDP in 2011 by 1.6%, real GDP fell by 2% during 2012. Faced with lower than expected growth and revenue collection, Government rebalanced the budget, adopting the measures both on the revenue and expenditures sides. Fiscal council was critical of the rebalanced budget because the deficit has actually increased compared to the original budget (see Ocena rebalansa budgeta za 2012 godinu i predloga zakona sa fiskalnim uticajima, available at [http://fiskalnisavet.rs/images/dokumenti/ocena\\_rebalansa\\_i\\_zakona\\_2012.](http://fiskalnisavet.rs/images/dokumenti/ocena_rebalansa_i_zakona_2012.))

The revenue measures taken in 2012, should be seen as a firefighting measures in the context of radical increase in public debt and increasing need for financing under unfavorable terms. These measures notwithstanding, the booked fiscal deficit not only was bigger than originally planned but also widened compared to the 2011 by almost 2% of GDP. However, since the real GDP is projected to have fell by almost 2% in 2012 (against 4% assumed potential growth rate used for application of the fiscal rule), the deficit widening for proponents of the countercyclical fiscal policy is not entirely against the logic. This reasoning, however, has to be confronted with the quality of public spending.

### **Populist measures and delayed adjustment**

Professionalization of policy making might not work if the general public demand wrong policies. Radical policies, policies that reduce benefits rarely win elections. Serbia, is not an exception in this regard. Although Fiscal council advocated fiscal consolidation through expenditure reduction, it was actually also advocating further increase in the general VAT rate from 18% to 22% (and to use the additional revenues to decrease labor taxation). The increase in taxes that occurred in 2012 will contribute permanently to the increase in tax revenues, and is therefore expected to contribute to the deficit reduction over the coming years.

The arguments for increase in taxes should be evaluated against additional spending that is financed from higher tax revenue. Securing fiscal sustainability and avoiding debt crisis would require bold policy measures, such as reducing the size of the public system, transformation of the state owned enterprises, reducing the pension benefits, and better targeting grants to individuals. Is this what the government is using the money for? No. Transition that has never finished in Serbia means above all change in the life style, change in habits, and change in expectations from the government. Not true reforms.

Like in many other countries, employees of the public system receive premium over the comparable private sector wages. In addition, again like in many other countries, there are potentials for reducing number of employees in the public sector. But nothing is done. Meanwhile, the answer to the question why govern-



government should subsidies FIAT's car buyers is twofold: an attempt to attract foreign investors and the protect domestic production in difficult times, both justification, in my view, relying on wrong understanding. Therefore, despite expected positive effect of the tax increases to satisfy general fiscal rules (debt to GDP of 45%, deficit 1%), the poor performance on the expenditure side raise concerns whether the consolidation will really occur.

### **Fight against corruption: real change or populist window dressing?**

Year 2012 saw also an inflation of high-profile business fraud and corruption cases. The jury is still out whether these cases where just political processes, window dressing or proper criminal prosecution. The public welcomed arrest of some extremely wealthy persons that get rich in privatization processes. If this is a sign of decisive action that will result in breaking the nexus between corrupted officials and privileged business, the outcome might be beneficial not only for cost of goverment, but for creation of an environment more conducive for unpopular measures.

### **Government's best bet: continue removing obstacles to business**

Government failed to increase credibility of fiscal policy in 2012. Although experts generally welcomed tax measures that are expected to increase revenues permanently, serious threat to the fiscal sustainability results from quasi-impossibility to enact more radical adjustment on vulnerable categories (wages, public employment, and pensions), dangerous increase in debt and violation of the general fiscal rule. On the positive side, removal of more than 100 quasi-fiscal fees with will reduce burden to business, particulary for start ups. More business friendly measures are needed if debt sustainability is to be secured.



## Abstract

Fiscal consolidation should have been the priority of the government in 2012, but due to early elections in spring, most of the measures were deferred to year 2013. As a result, public deficit of 4.6% of GDP did not change compared to previous year. New leftist government applied some moderate changes in taxation and social contributions in 2012, but main tax package came into force in 2013. Flat tax rate was wiped out, tax hikes in corporate and personal income tax rate has been introduced. With a 6% growth of total government expenditures in 2012, the public deficit exceeds 10% of total government tax revenues leaving the question of further tax hikes open.

## General environment in 2012

Year 2012 should have been a turnaround year. Strong growth, decrease in unemployment, huge government revenues increase. The optimism of seemingly overcome crisis in summer 2011 lead the Slovak politicians as well as European Commission to great expectations. As many times before, the real development proved that government projections are often written with pink glasses.

Although the GDP growth in 2012 outperformed the EU average with 2.0% growth in real terms, in nominal terms it was 4.5pb lower than expected (7,2%) in the original budget proposal. Instead of expected decrease in unemployment rate, the share of people without jobs increased to 14 %. The wages decreased in real terms, nominal growth was 2.5pb lower than expected. These economic indicators had profound impact on government revenues.

But not only that. The fiscal stability of the country was hit mostly from its own local political authorities. The government, which prepared the 2012 budget, lost the confidence of the parliament before legislating it. The breaking point was the vote on newly adjusted EFSF that was seen as the savior for the euro zone at that time. One party member of the government coalition refused to vote for the new agreement. The opposition exchanged its support of EFSF for early elections, conditioned by request that the budget will not include several austerity measures and, especially, that the labor tax reform will not be adopted. As a result the deficit of approved budget had reached 4.6% of GDP, the same as in 2011, despite the fact, that the country has been in the Excessive Deficit Procedure. Weak fiscal performance had significant impact on growth of public debt, which soared also due to membership of Slovakia in the Eurozone bailout mechanisms. Although the 52.1% of GDP debt level could be considered as extremely low by European standards, the weight of the debt measured by the number of annual tax and contribution revenues now equals the EU 27 average.



A single leftist party (SMER-SD) won the sufficient majority in parliament elections and the single party government was appointed in April 2012. New government faced two major obligations. First, to adopt measures to meet the 2012 deficit goal in worsening macroeconomic conditions. Second, to legislate the measures that would enable substantial deficit cut to 2.9% of GDP in 2013, as required by the Excessive Deficit Procedure.

### Changes in taxation in 2012

Special bank tax was introduced in 2012. The tax base was defined as total liabilities discounted for own equity and individual deposits under the state guarantee scheme. The 0.4% rate has been one of the highest among the countries that implemented such tax. The revenues from this tax shall be collected to special account as a part of government financial assets to provide a source for compensations in the case of financial sector problems. Although it is always difficult (if not impossible) to regard any fractional reserves banking system as healthy, compared to many other EA countries, liquidity and solvency indicators of Slovak banking sector are exceptionally good thanks to a restructuring that took place in 2001. For this reason, this tax shall be considered as a measure to decrease the deficit rather than a banking sector stability measure.

Except for this tax, small changes were applied in CIT base (+ € 27 mill.) and the tobacco tax rate was increased earlier than previously planned (+ € 30 mill.). Special radio and television tax had not been cancelled as originally budgeted, thus contributing to budget revenues for some € 76 mil.

Previous government planned to adopt major tax reform and labor reform together with budget in the end of the year 2011 (especially the merging of contributions of employee and employer into only employee contribution), with neutral effect on the government revenues. In 2012 the social contribution decrease should follow. Nevertheless, none of these happened as the new government completely refused this model. Leftist SMER SD party won the elections with a promise of sustaining current system but with increased taxation of the rich. Both obligations mentioned above, 2012 deficit and plan for 2013 should have been achieved thanks to increased taxation.

The mandatory contribution into private pension fund (tax exempted) had been significantly decreased to 4% from previous 9% (the law stipulates linear increase to 6% within next 11 years); the change of 5% will be transferred to public PAYG system, improving its balance by € 145 mill. in 2012 (€ 0.5 bn. in 2013). The position of private pensions was weakened, especially with re-introduction of voluntary entry to this scheme (app. 10% roll-in expected). The primary motivation was to tackle the deficit, nevertheless this approach corresponds with long term disagreement of the new government leaders with private savings; it has also forced majority of savers from equity funds to conser-



-vative bond funds. On top of it, the private pillar had been opened for several months in 2012 and 2013 so that savers could withdraw their savings and exchange them for the claim from PAYG public pensions system. As the rules for this transfers were set very generously (the savers could bring back contributions in full amount, as if they never paid any fees for fund management and never suffered any loss in the value of their investments) almost 80,000 savers returned back, bringing € 43 mill to PAYG pillar in 2012 and over € 243 mill in 2013. Nevertheless, high deficit of PAYG system forced government to adopt some reasonable changes (although with deferred effectiveness). The retirement age will be linked to average life expectancy and the indexation of pensions will be based on pensioner's price index. Nevertheless, even these measures are not sufficient to eliminate the debt of the PAYG system, which should reach as much as 6% of GDP in 2060.

Otherwise, it was especially the banking sector that had to contribute to deficit decrease. Not only the existing **bank tax** was almost doubled in September 2012 by broadening the base for individual deposits, the financial institutions also had to pay another **extraordinary fee**, increasing the projected tax load by €62 mil. Banking sector should on top of income tax pay another €169 mil, what effectively doubles its tax load. Even before the bank tax, the sector contributed app. 10% of CIT. In exchange for this increase, banks do not have to contribute to deposit guarantee scheme (app. € 50 mil). The bank tax rate should be halved, when the reserve exceeds € 0.5 bn., which is expected to happen in 2015.

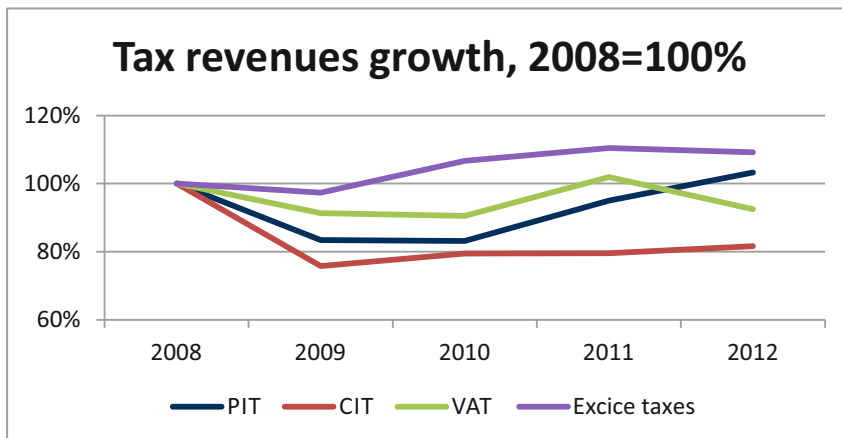
Another example of one off tax measure is the **special fee for large companies operating at the regulated markets**. The “right” to be taxed emerges when more than 50% of the company turnover is coming from regulated activities and the profit exceeds € 3 mil. The tax base is the profit exceeding this amount, and the rate is 0.363%. The special tax shall be applied during both 2012 and 2013.

The taxation policy of the government in 2012 corresponded with its left leaning orientation. It focused on banks (“undeserved” profits), rich (large companies) and on the private pensions (decrease in contributions).

### When a growing economy does not pay more taxes

In nominal terms, Slovak GDP is 7% higher than in 2008. Despite this growth, the tax revenues of public sector (not including contributions) are lower than in 2008. The development of four most important taxes generating 96% of revenues is illustrated in following chart.





Source: Ministry of Finance SR, author

The share of excise taxes is less than 20%, therefore lower VAT revenues (42% share) and significantly decreased CIT revenues (17%) drives the total below 2008 level. Such development had a significant impact on fiscal policy of the government. Especially costly and ineffective social policies, with their automatic annual indexation rules, create permanent pressure to “discover” additional revenues (e.g. fee paid at the registration of car based on the number of horse powers) and cuts in important expenditures.

There are various factors behind this development. The most important is the structure of GDP growth, which was lately driven solely by increased productivity of export oriented industrial sector, especially car manufacturing. Although three Slovak automotive companies increased the number of produced cars by more than one third (!) in 2012, this growth had only limited impact on state coffers, as export does not pay VAT. Furthermore, Slovak automotive companies operate as assembly factories, with little value added and with majority of the supplies imported from abroad. This fact, in combination with tax holidays of many foreign investors is the reason that the production growth does not translate into growth of CIT revenues. More effective assembly lines do not employ new people, hence persistently high unemployment rate with weak wage growth keeps purchasing power low, leading to stagnant domestic economy and VAT revenues (despite increased rate to 20% in 2011). General weakness of European economy keeps the profits down; corporates are also decreasing their tax burden by discounting for losses recorded in 2009-2010 period. The only “powerful” tool to increase tax revenues proved to be the tobacco tax with almost 40% growth within the last 5 years. Naturally, harmonization of tax levels in this field will not generate revenues growth indefinitely, also due to the fact, that tobacco tax rate is currently the highest among the countries of Visegrád region. Notwithstanding the economic factors the effectiveness of tax collection is rather weak. According to



OECD estimates based on 2006 numbers, the gap between projected and collected VAT is almost 30%, one of the highest in EU. Effective tax rate of VAT is currently estimated to be 10.4%, although it had been over 13% in period of 2004-2007. Non-compliance, fraud but also weak and costly performance of taxation authorities, are the main reasons behind this development.  
End of Box

### Changes in taxation for 2013

There were only few rather insignificant changes in taxation enacted in 2012, but full package of tax hikes had been adopted last year and came into force in January 2013. The legend of Slovak flat tax rate had been definitely wiped out.

The second tax rate had been introduced to personal income tax. Taxable annual income exceeding € 39,725 will be taxed by 25%, the amount below the threshold remains taxed at 19%. Other small changes, mostly regarding the tax base (e.g. rent income) will lead to higher tax burden as well.

The most significant change is the increase in corporate tax rate to 23%. Despite weak performance of the collection of this tax, the parliament decided to bring it to the highest level among the neighboring post communist countries while such countries like Sweden, UK, Finland or Denmark plan to bring this rate below this level (although, unlike these countries, Slovakia has still no dividend tax).

Not only income tax changes will have negative effects on labor market; the later will also be impacted by measures adopted in the area of social and health contributions. Increase of the ceiling of the tax base for **social contributions** to unified 5\* average wage (from previous 1.5 and 4\*average wage) will affect especially highly qualified well paid workforce. But introduction of contributions to special short term limited contracts (called "Agreements") lead to elimination of one quarter of these mostly part-time jobs (150 000 in absolute terms). Also minimum contributions paid by self-employed were increased.

In total, the 2013 budget expects an increase of revenues by € 1.6 bn. based on the adopted measures – almost 10% increase of the revenues from taxes and contributions. As there were many changes adopted, the overview with its impact on budget is listed in the following table:



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Changes in Taxation and growth of revenues in 2013	Eur ths
Corporate income tax rate from 19% to 23%	298 292
Personal income tax rate, 25% for income over 39,725 €	52 948
Tax base changes for self employed	19 543
Increased contributions of self employed	51 517
Increase in the maximum contribution base up to 5 times the average wage	129 977
Changes in 2nd pillar (including the transfer of savings to PAYG € 243 mil.)	701 363
Contributions from ST agreements	124 807
TV and Radio Tax	73 881
Extension of bank tax	88 997
Temporary tax on enterprises operating in regulated sectors	81 000
Others	6 048
Sum of measures	1 628 373
-in % of GDP 2012	2.3

### Fiscal outlook

The first three months of the year already proved that the government was too optimistic. The projection of the GDP growth in 2013 had been decreased already several times and the government corrected expected tax revenues by 2% (0,5% GDP).

From a fiscal point of view, achievement of the deficit below 3% of GDP in 2013 will be a difficult challenge. More than two thirds of the consolidation package was based on increased revenues. Although government created a reserve to face potential revenues drop, it might turn out to be insufficient. Potential risk is that the biggest chunk of expenditures cuts was based on formal agreement with representatives of local governments and municipalities, but the government lacks any tools to enforce these savings. European Commission already expects the public deficit to reach 3.3% of GDP. If it becomes true and the nominal GDP will be lower than expected, another threshold (55%) of the Debt Brake Law will





be violated forcing government to cut 3% of the most of expenditures and it will not be possible to increase the consolidated expenditures in nominal terms in 2015. If the weak fiscal performance continues in forthcoming years, and the debt exceeds 57% of GDP, according to that same constitutional law the government will have to prepare balanced budget for the year following the official announcement of the breach.

Although the government plans to deal with the deficit mostly through further cost cutting in public services and benefits systems, further increase in taxation shall be expected. Systematic pressure from international organization (e.g. OECD) to increase property taxes meets with the program of ruling leftist party.





## Main problems

For many years since the break-up of Yugoslavia in early 90's, Slovenia represented a success story which was not frequent among transitional countries. The world's financial crisis came to Slovenia in 2008 and caught the country totally unprepared. The value of most shares decreased sharply thus resulting in serious losses which in turn became a problem for Slovenian banking sector due to the fact the banks in most cases were financing purchases of the shares for the investors (state-owned banks have the biggest proportion of bad debts). Since then Slovenia is facing general economic downturn and in 2013 Slovenia the banking system is still not working properly resulting in very low activity of domestic banks. On top of this, this country is facing a recession – GDP fell by 2,3% in 2012 and is very likely to further decrease by 2,1% in year 2013. The investment activities decreased tremendously and the almost entire construction sector went bankrupt in 2012. In addition Slovenia was very slow in cutting the expenditures – simply, there was not enough political will to adopt crucial structural reforms in the area of social welfare (labor and pension legislation, social transfers, ... ) in the mandate of Slovenian government between 2008 and 2011. Hence, reforms had to wait until early 2013, but then the government was again changed. Today the whole EU is looking towards Slovenia to see whether it is going to be the next country after Cyprus to require a EU aid package. The new government is saying Slovenia does not need aid, but needs time.

**Table 1: Gross domestic product by expenditures**

	Gross domestic product	Domestic consumption			External trade balance		
		total	final consumption	gross capital formation	total	exports of goods and services	imports of goods and services
2008	37.244,40	38.182,30	26.341,50	11.840,70	-937,8	25.293,10	26.231,00
2009	35.556,10	34.844,30	26.969,00	7.875,30	711,8	20.860,80	20.149,00
2010	35.607,00	35.244,20	27.742,90	7.501,30	362,8	23.500,20	23.137,30
2011	36.171,80	35.732,20	28.451,50	7.280,80	439,6	26.201,50	25.761,80
2012	35.466,30	34.057,30	28.010,60	6.046,70	1409	26.603,60	25.194,60

Source: SOME IMPORTANT STATISTICS ON SLOVENIA, volume VIII, No 3 Ljubljana, 2013, ISSN 1854-4657; <http://www.stat.si/doc/pub/PSP/00-PS-912-1303.pdf>



## Current situation

The Slovenian tax system consists of three main categories of taxes: direct taxes on income, direct taxes on property and indirect taxes. All taxes are collected by Tax Administration of the Republic of Slovenia except for customs duties, excise duties and value added tax on imports where Customs Administration of the Republic of Slovenia is in charge.

**Table 2: Consolidated general government tax revenues**

In 1000 EUR	Tax revenues	Taxes on income and profit	of which		Social security contributions	of which		
			Individual taxes on income and profit	Corporate taxes on income and profit		Employees contributions	Employers contributions	Self- employed contributions
1995	4.001.898	669.211	615.210	54.001	1.692.902	815.445	810.345	54.647
1996	4.491.191	821.776	728.755	93.021	1.753.329	926.095	743.179	71.637
1997	5.022.492	949.857	809.807	140.050	1.869.977	1.032.877	730.110	86.201
1998	5.656.300	1.055.482	890.261	165.221	2.091.141	1.155.086	815.274	106.377
1999	6.499.147	1.142.622	966.620	176.002	2.313.457	1.275.452	898.149	127.801
2000	6.953.756	1.299.569	1.083.433	216.136	2.584.147	1.427.679	1.000.602	141.359
2001	7.804.021	1.493.394	1.206.403	286.991	2.926.699	1.576.604	1.124.037	151.330
2002	8.353.758	1.648.494	1.334.595	313.899	3.231.328	1.734.411	1.255.263	164.001
2003	9.560.470	1.921.718	1.473.570	448.148	3.501.988	1.864.979	1.381.452	173.067
2004	10.210.728	2.115.163	1.596.240	518.923	3.753.129	2.004.327	1.485.930	186.382
2005	10.883.952	2.241.947	1.647.720	594.227	3.987.693	2.133.797	1.582.684	200.428
2006	11.761.990	2.735.294	1.792.964	942.330	4.231.224	2.262.935	1.682.844	211.878
2007	12.757.942	2.917.670	1.804.427	1.113.243	4.597.973	2.464.786	1.831.132	225.118
2008	13.937.365	3.442.172	2.185.135	1.257.037	5.095.009	2.731.100	2.027.957	247.507
2009	12.955.413	2.805.088	2.092.860	712.228	5.161.254	2.743.212	2.037.073	268.997
2010	12.848.422	2.490.703	2.039.298	448.602	5.234.485	2.770.803	2.058.123	275.492
2011	13.209.222	2.723.521	2.054.312	667.637	5.267.607	2.774.034	2.060.342	281.234
2012 (prelim)	13.117.635	2.656.583	2.077.142	576.885	5.244.083	2.701.319	2.066.717	310.141

Source: Bulletin of Government Finance 3/2013

## Corporate Income Tax

Corporate income tax rate will be gradually reduced in the years 2013 to 2015. In 2013 it will be set at 17%, then CIT rate will be set at 16% in 2014 and 15% for the year 2015 and beyond.

## Dividends

A company paying dividends to residents and non-residents of Slovenia must withhold tax at a rate of 15% on each dividend paid. In the case of parent companies and subsidiaries of different Member States the Directive on a common system of taxation has been implemented.

## Personal Income Tax

For taxation purpose one distinguishes between several categories of income: income from employment, business income, income from basic agriculture and forestry, income from rental and royalties, income from capital (interest, dividends and capital gains) and other income.



The following taxes are taxed at a flat rate:

- dividends and interest income at 20%,
- capital gains depends on the holding period:
  - for a holding period of up to 5 years the rate is 20%,
  - from 5 to 10 years; 15%,
  - for a holding period from 10 to 15 years; 10%
  - 5% for a holding period from 15 to 20 years
  - and a tax exemption for a holding period greater than 20 years.

Income tax on other categories of income is paid in advance during the tax year (income from employment, business income, income from basic agriculture and forestry, rental income, royalties and other income).

#### *Derivative Instruments Gains Tax*

The tax is payable by resident individuals and is defined on the difference between the value of the derivative instrument upon disposal and its acquisition value. The rates are degressive from 20% to 0% - depending on the period of holding. Gains realized from short-term contracts are taxed at 40%, when the period of holding is longer than 20 years the rate falls to 0%.

#### *Contractual Work Tax*

The contractual work tax is levied on gross payments made to individuals performing temporary contractual work, at a rate of 25%.

#### *Value Added Tax*

There are two VAT rates: a standard rate of 20% and a reduced rate of 8.5%.

#### *Tax on Insurance Services*

This tax is levied on insurance premiums and must be paid by insurance companies at a rate of 6.5%.

#### *Social Security Contributions*

Besides personal income tax, individuals must pay compulsory social contributions.

According to KPMG survey, Slovenia has the highest rate in the world for personal income tax and social security contribution at 54,9% (<http://www.finance.si/255785>)



## Conclusions

At the moment it looks like Slovenian government is looking for a short term solution for the stabilization of the economy. Slovenia's public deficit fell to 3.7 percent of gross domestic product (GDP) in 2012 -- down from 6.4 percent a year earlier. However the public deficit in 2013 is expected to increase to 4.2 percent of GDP. Slovenia's public debt reached 54.1 percent of GDP at the end of 2012 compared to 46.9 percent in 2011, according to a first estimation.

In 2013, Government is looking closely at those issues regarding fiscal policy, government spending, public expenditure, reforms of labor legislation and social welfare... Despite the savings expected from these reforms and from cuts on expenditures, it is very likely however that one of the main sources chosen to put public finance back in order will be tax increases. Unfortunately.



## **Fiscal adjustments of the new Spanish Government: focus on rising taxes, not cutting spending**

The economic crisis in Spain highlighted the lack of response from the Government as well as the wasteful public spending, both mirrored in the huge public deficits and the resultant sovereign debt crisis. The Socialist Party called early general elections for November 2011 due to lack of popular support and credibility. The alternative, the conservative Party (Popular Party) went to the election promising not to raise taxes and, even, lower them, and bring order to public finances. Surprisingly, immediately after the Popular Party won the elections, the new Executive approved one of the largest tax hikes of the Personal Income Tax in the history of Spanish democracy. In fact, this rise anticipated the kind of fiscal policy the government implemented later: multiple tax increases aimed to avoid cutting an oversized public spending which grew without limits during the economic boom, characterized by the credit-fueled real estate bubble.

It is true that public spending has also been reduced, but this has been timid compared to what it should have been done. Indeed, an overall analysis of the fiscal policy followed by the Government during the year 2012 allows us to understand that the spending cuts would have been even smaller if they could have collected more tax revenues in the short term. Even so, the fiscal austerity measures imposed on the population (tax increases) have amounted to more than the austerity measures the Government has applied itself (spending cuts). In total, the fiscal policy adjustment has amounted to approx. € 21 billion: € 11,237 million collected through tax hikes (without these tax increases, tax revenues would have been reduced by 2.7%, according to the Tax Authorities), while public spending cuts have amounted to approx. € 14 billion (estimations).

## **Expenditure cuts**

Between the fiscal years of 2001-2007, tax revenues increased significantly by € 175 billion (in total). Politicians collected huge amounts of money through the tax revenues and decided to spend it lavishly. They considered that tax revenues were a permanent income flow. Consequently, the Government size grew at high rates. In particular, Spain was the third EU country with the highest public spending growth (approx. 56.7% in only 6 years), just behind Ireland and Greece.

Moreover, the good performance of tax revenues coincided with a process in which public services were decentralized (e.g. education or health services) and, therefore, transferred from the State to the Regional Governments. This decentralization process was wrongly done as it encouraged faster growth of



public spending and created bad incentives: public spending was decentralized but tax revenues remained centralized. Thanks to this lack of fiscal responsibility Regional Governments spent a lot of money without thinking how to finance it. As a result, both the Central Government and Regional Governments grew exorbitantly.

However, even with all this excessive growth of the State and the public spending, the Spanish conservative Government chose not to downsize it seriously but to maintain its dimension, at least up to date. This is the reason why it is said that the reduction of public spending has been timid, because the Government could have implemented a thorough reform of the whole structure of the State. And this reform could have been oriented to eliminate the existing duplications and redundancies, and also to rationalize all the public spending as well as to remove gradually many public services that could be provided by the private sector.

Instead of that, the Government has implemented patches and tweaks and refused to attack the core of the problem. It has been preferred to introduce copayments, surcharges or degrade the quality of the public services before reforming the entire way through which they are provided (e.g., giving more freedom for the private sector to provide such services). In this sense, the main adjustments applied during 2012 could be summarized, among others, in the drastic reduction of public investment and the spending cuts on health and education, the establishment of pharmaceutical copayment, the Christmas bonus removal for public employees and the decline of unemployment benefits (not because the unemployed are finding new jobs but as a consequence of an increasing number of long-term unemployed people who are no longer legally entitled to these benefits). As we said, all these reductions amounted to an estimate of € 14 billion (estimations) during 2012, a very modest figure when compared with a high public deficit of more than € 70 billion (about 7% of GDP), and public debt to 84,1% of GDP (14.8 percentage points more than in 2011, a historical record).

### Tax policy measures

As said, the lack of political will to implement a deep reform of the public administrations is manifested in the fact that the Conservative government has approved the minimum cuts on public spending. And this strategy implies to raise taxes sharply. So much so that, during 2012, the Government launched a reform of the entire Spanish tax system increasing almost all taxes. The aim of these rises was twofold: first, to keep and increase the tax revenues collected in the short-term during one of the deepest recessions suffered in Spain in recent times. With these tax increases and the small spending cuts, the Government has tried to restore confidence in international financial markets regarding the sovereign debt and public finances. Second, the medium-term target is to build a high level of taxation that, once the economy stop contracting, will provide the Government with a high level of tax revenues to make the oversized State and public spending sustainable. In what follows, we summarize the main tax increases.





## Personal Income Tax (PIT)

### *PIT rates hike*

Merely a few weeks after the election of the new Administration, the new Spanish conservative Government announced a significant tax hike affecting the Personal Income Tax. The measure mainly consisted of a so-called solidarity surtax to come on top of tax rates on income and capital gains. Following the tax increase, Spanish individuals are paying one of the highest Personal Income Tax rates in Europe<sup>1</sup>.

However, if one takes into account local surcharges imposed by some Spanish Regional Governments, the top marginal rates rise further. In Catalonia, for example, the top tax rate is 56%.

### *Capital gains tax hike*

Taxation on capital gains has been increased twice. The first increase came into force as from 2012, while the second is effective as of 2013. The rates after these tax hikes are no longer low and competitive, relative to other European countries. Before the first capital gains tax increase, capital gains were taxed at a progressive rate of 19% for the first € 6,000 and 21% for gains above that amount. As from 2012, there are three different rates: 21% for the first € 6,000, 25% from 6,000 to € 24,000, and 27% for capital gains above € 24,000.

In addition to this rise, the conservative Government also increased the tax rates on short-term capital gains (those generated over a period of less than a year). As from January 1, 2013, short-term capital gains are taxable at the PIT general progressive tax rates (top marginal rate of 52%) in lieu of the formerly applicable tax rate (21%-25%-27%). That means an average increase of the short-term capital gains taxation of 50%. Considering these increases, the rates are as high as in Germany and considerably higher than those of Italy and the new top rate almost match those of Finland and Norway.

### *Withholding rate hike (1 September 2012 until 31 December 2013)*

In principle, from 1 September 2012 until 31 December 2013, the withholding tax rates of the following activities are increased:

- To professional activities, the withholding tax is increased from 15% to 21% (from 7% to 9% in certain cases). The same modified rates will be applicable to work income derived from teaching courses and similar activities, and from the production of literary, artistic and scientific works.
- To remunerations paid to the directors and members of board of directors, the withholding tax is increased from 35% to 42%.
- To income derived from investment funds or capital gains, the withholding tax is increased from 19% to 21%.

<sup>1</sup>See for more details the report elaborated by the Juan de Mariana Institute dated on January 2012 (here in Spanish language and here a summary in English).



### *Housing tax credit removed*

The compensation for removing the housing tax credit available to the taxpayers who had acquired their housing prior to 20 January 2006, is removed.

### *Non-Resident Personal Income Tax*

During 2012 and 2013, the standard rate of the Non Resident Income Tax is increased from 24% to 24.75%, and from 19% to 21% to income transferred abroad by permanent establishments and to dividends, interest and capital gains obtained without a permanent establishment.

### **Corporate Income Tax<sup>2</sup> (CIT)**

There are two types of measures approved: those applicable indefinitely and those limited to fiscal years 2012 and 2013. Although taxes have increased for both large companies and SMEs, the first have suffered the most.

Measures introduced for an unlimited period for fiscal years beginning as of January 1, 2012, are the following:

*Limit on the deduction of financial expenses.* Thin capitalization rule is replaced by the “*earning-stripping rule*”. Starting in 2012, financial expenses may be deducted as follows:

- The net minimum deductible financial expense of one million Euros is maintained (this amount must be pro-rated according to the length of the tax year if it were shorter than a calendar year).
- The new rule limits the tax relief for net interest expenses to 30% of the taxpayer's earnings before interest, taxes, depreciation, and amortization (“EBITDA”), with some adjustments. In case the entities are part of a tax-consolidated group, this 30% limit applies to the EBITDA of the group.
- Interests not deducted under this new rule can be carried forward 18 years (similarly to tax net operating losses). If interest expense in a given fiscal year is below the 30% limit, the rule allows the unused deduction capacity to be carried forward five years.
- As was already the case for credit entities, an exception is made for insurance entities to which this rule does not apply.

Measures applicable to fiscal years 2012 and 2013:

- *Restrictions on tax loss carry forwards.* A limit is placed on the amount of prior years' tax losses that can be offset by companies with a turnover of more than € 6,010,121.04, provided that their net sales amounted to at least € 20 million (both thresholds refer to the 12 months preceding the tax year of the compensation).

<sup>2</sup>For a summary of the economic impact of some of the CIT hikes described in the text, see “The Spanish Corporate Income Tax Hike Will Hurt Economic Recovery”, published in the IREF website.



- According to the new restrictions, the tax losses that can be offset in each year will be limited to 50% of the tax base prior to compensation for those companies with a net sales figure of at least € 20 million but less than € 60 million, and to 25% of the taxable base for companies with net sales of at least € 60 million.
- *CIT payments on account.* This is one of the most important changes in the Spanish CIT that has provided more tax revenue to the Spanish Government during 2012. The changes have focused on one way of calculating CIT payments on account, the taxable base method. According to the new rule, the percentages of these payments are increased from 21%, 24% and 27% to 23%, 26% and 29%, depending on the taxpayer's net sales. In addition, the taxable base over which these percentages should be applied will now include 25% of the foreign source dividends and income exempted. In any case, CIT payments on account of companies with net sales during the 12 months of the previous tax year of at least € 20 million cannot be lower than 12% (6% in certain cases) of the positive result of the Profit and Loss Account. This amount cannot be reduced by the tax losses pending compensation, tax incentives or withholdings (although they can be by the preceding payments on account of the same year).
- *The tax depreciation deduction for fixed assets.* For intangible assets with an indefinite useful life the tax depreciation deduction is limited from a 10% to a maximum of 2% per year. For tangible fixed assets is limited to the 70% for large companies.

Measures applicable only in 2012:

*Tax amnesty.* The Spanish Government approved a tax evasion amnesty for undeclared assets or those hidden in tax havens. Repatriation of such assets would be allowed by paying only a 10% tax, with no criminal penalty.

## Value-Added Tax

Two important changes in the VAT Law have been made into effect as from 1 September 2012: 1) the increase of the standard and reduced VAT rates and 2) the shift of taxation of many products from the standard VAT rate to the reduced VAT rate.

### VAT rates hikes

The general VAT rate went from 18% to 21%, and the reduced rate increased from 8% to 10%. The 4% super-reduced rate was maintained.

Likewise, the retailers' supplementary VAT charge rates have been changed, increasing from 4% and 1% to 5.2% and 1.4%, respectively, and the flat-rate compensations percentages of the common flat-rate scheme for farmers increase from 10% and 8.5% to 12% and 10.5%, respectively.



### *Products formerly taxed at the reduced VAT rate, now under the standard one*

On the other hand, certain products and services formerly subject to the reduced 8% rate will now be subject to the standard rate, which is a tax increase of 162%. This is the case of flowers and ornamental plants, mixed hotel/restaurant services, theatres, circuses and other spectacles, and services rendered by entertainers or artists (individuals) and sales of works of art, sports services and non-exempt health services, mortuary services, hairdressing services and digital TV.

### **Tax audits**

After the year with the highest number of tax increases during one of the worst recessions in Spain, the Government has also decided to increase the pressure on taxpayers. The number of tax audits has increased considerably. These inspections have increased tax revenues by more than 12.6% from the previous year. Control actions performed by tax auditors grew by 16.9%. Almost one third of the procedures, 32.3%, is concentrated in large companies, compared to 28% last year, or in professionals. On the other hand, the government has also increased inspections with the aim to get a major impact on the media, in order to increase a psychological pressure and induce fear on the taxpayers.

### **Delayed tax refunds**

During the last months of 2012, the government delayed tax refunds (especially to companies) in order to reduce public deficit for that year. Refunds have been finally paid at the beginning of 2013. However, during times of extreme liquidity restrictions, these delays translate into higher financial costs to Spanish firms.

### **Excise duty modifications**

Regarding the taxation of tobacco products, the 2012 measures include the introduction of a single minimum tax rate for thin and thick gauge cigars, and the tax rates on cigarettes and loose tobaccos have increased. These modifications are applicable as of the enactment of RDL 20/2012 (15 July 2012), with the exception of those applicable to cigarettes, which went into effect as of 1 September 2012.



# Sweden

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Sweden has a center right government since 2006. This government has reduced the total taxes as percentage of GDP from 48,8 in 2006 to 44,0 in 2012. Only Denmark has higher total taxes. In 2013 the corporate income tax was reduced to 22 percent. Including taxes on income paid by employers, Sweden still has the highest marginal tax rate in the world, 70 percent. The Swedish National Tax Agency is perhaps more important on tax policy than the ministry of finance.

## Lower taxes but higher tax revenues

Sweden has a center right-government since 2006. During its first term, 2006-2010, this government made substantial cuts in the personal income taxation. Taxes on personal income were reduced with earned income tax credits, especially for people with lower income.

Total tax, as percentage of GDP, has been reduced from 48.8 percent in 2006 to 44.0 in 2012. During this period total yearly tax revenues have increased from SEK 1423 billions (€161 billions) to SEK 1583 billions (€179 billions), an increase with 11 percent.

In the general 2010 elections the center right-government continued to rule but lost its majority. Due to this tax policy has been more cautious and dependent on support from the opposition parties. The biggest party in the government, the moderate party, has proposed further reductions of personal income taxes through earned income tax credits. The support for this has been little and recent surveys show that as few as ten percent of the Swedes know by how much their own taxes has been reduced since 2006.

Sweden still has the highest marginal tax rate on personal income. Including taxes on income paid by employers, the top marginal tax rate in Sweden is 70 percent. This is of course a severe problem for business. Many studies show that a reduction of the top marginal tax rate would also increase total tax revenues. The leading party in the government, the moderate party, has made it a political issue, not to reduce the top marginal tax rate. Minister of Finance Anders Borg from the moderate party made a clear announcement in case he will be reelected in 2014: A reduction of the top marginal tax rate is not a priority, not during this term. Not in the next term.

In January 2013 Sweden reduced the corporate income tax from 26.3 to 22 percent. This reduction will be followed by significant reductions in the allowance for deduction of corporate debt.



A state commission has proposed an important simplification reform for Swedish industry. VAT on import from outside the EU has been handled by the Swedish Customs. The proposal is that the tax authorities will take over this and this will make it much easier for industry.

The Swedish National Tax Agency has got a perhaps too important role in policy shaping. The director of the Tax Agency, Mr Ingemar Hansson, is a former Secretary of State for the minister of Finance. Ingemar Hansson has a high profile in Swedish debate on tax policy and sometimes it seems like he is more important than the politicians when it comes to decide on tax policy. On television Mr Hansson has said that businesses should show their commitment to the Swedish society by paying more taxes than actually stipulated by law.

### **The highest marginal tax rate in the world**

Including taxes on income paid by employers, the top marginal tax rate on personal income in Sweden is 70 percent. The highest tax level starts already at a yearly income of €62,000. The government has since 2007 lowered income taxes quite substantially with an earned income tax credit but they have not reduced the marginal tax. The earned income tax credit depends on the total income. It is constructed to give the highest tax credit for lower income levels. The opposition parties in the parliament have proposed changes in the earned income tax credit system, lowering the credit for higher incomes. This proposal would increase the top marginal tax rate even further.

The taxation of personal income starts with local taxes, which are decided on a local level, the local tax rates ranging from 28.89-34.32 percent. Personal income below SEK 12,500 (€1500) is tax-free.

For annual personal income of SEK 426,300 (€50,900) and above, working Swedes have to pay state tax set at 20 percent. The top marginal tax level is a supplementary state tax of 5 percent. This tax starts at an annual income of SEK 604,700 (€ 62,160) for working citizens. In total this makes the top marginal tax rate 20 plus 5 plus the local tax, which varies from 28.90 to 34.30 percent. Adding social tax contributions you reach the 70%.

### **Lower taxation on corporations but still high taxes on ownership**

In 2009 the corporate income tax was lowered from 28 to 26.6 percent. In the state budget for 2013 the government introduced another change and from January 1st 2013 the Swedish corporate income tax is 22 percent. This reduction can be seen as an advanced result of the state committee on business taxation. The moderate party, which is the biggest party in centre-right government, was pushing towards lower corporate tax. The socialist party is also in favor of lowering corporate tax levels. Both the moderate party and the socialist party consider lower corporate taxes a competitive advantage, which will attract businesses to Sweden. The social democrats support the reduction in corporate



tax but think the reduction was too big and have proposed a reduction to only 24.3 percent.

In 2010 the government appointed a state committee to look into the taxation of businesses. This committee's task was to evaluate the corporate tax system. Its mission was also to find solutions to make it more tax favorable to use equity than debt to finance business investments. As the politicians already have reduced the corporate income tax the state committee now has to look into ways to finance this tax reduction. The committee is most likely to propose limitation on deduction of interest of corporate debt. How these limitations will be constructed will not be presented until 2014. Prior Swedish regulations on limitation of deduction of interests have been complicated and contained a considerable amount of legal uncertainty.

A similar committee was appointed in 2012 to look into the taxation on individual entrepreneurs. The outcome of this committee is yet difficult to assess.

Since the 90s Sweden has a dual tax system with different tax levels on personal income and capital gains, dividends etc. To avoid income shifting from personal income to capital gains in closely hold companies Sweden introduced a complicated system of regulations on how high the capital gains in a business could be. Higher gains was considered as personal income and taxed as such. These rules were much criticized by the business community and in 2005 the regulations were changed, when a socialist government was in charge. New regulations included lower capital gains tax for closely hold companies and allowed higher gains if the companies hired more people. These new regulations were further improved by the center right-government in 2007 and the result of this reform has been impressive. Total capital gains from closely hold companies have increased threefold. With lower taxes Swedish business owners have focused more on profit. Unfortunately the center-right government now has proposed changes in this legislation that might be a setback in this development. The new government policy against closely hold companies is characterized by suspicion.

### **No more debate on the wealth tax**

Sweden abolished the taxes on inheritance and gifts in 2004 and the net wealth tax in 2007. It was a socialist government that abolished the inheritance tax and the support for this reform is still strong. The wealth tax was abolished by a center right-government and a reintroduction was on the agenda for the socialists until 2012. This changed in 2012. The new leader for the social democrats in Sweden, Mr Stefan Löfven, has been very clear; no new wealth tax.

Sweden has a tax of 30 percent on interest, dividends and capital gains. This tax is the same for both short trade and long investments. In 2012 an Ernst & Young report compared the Swedish tax with the tax rates on dividends and capital gains



for the OECD, EU, and BRIC countries. The average top personal dividend tax rate in the OECD, EU, and BRIC countries in 2012 was 20.2 percent and the average top personal capital gains tax rate was 14.9 percent. A reduction of the Swedish capital gains tax rate is a priority for the Swedish business community.

### **Sweden a stronghold against taxes on financial transactions**

"The Swedish government opposes supranationalism in tax policy and national taxes shall not constitute own resources for the EU ", Minister for Finance Anders Borg said in January 2013.

The Swedish resistance against a financial transaction tax comes from its experience from the 80s when Sweden introduced a national tax on financial transactions. Most of the stock market moved away from Sweden due to this tax. Swedish politicians still remember how harmful this tax was to the economy and this explains why the support from Sweden for the EU commission's proposal on a FTT is low.

### **"Investing in the future"**

Investing in the future was the name of the state budget for 2012. Minister of finance Anders Borg writes in the budget: " The strong Swedish public finances enable the Government to propose measures totaling SEK 22.7 billion in 2013. This still leaves margins to further stimulate the economy should the crisis in the euro area deepen."

The most important measures in the budget for 2012 are investment in infrastructure and education together with the reduction of the corporate income tax.

Sweden has continued its cautious budgetary policy aiming at a budget surplus. A surplus target was introduced in the 90s when Sweden was hit by a financial crisis. The financial savings of the consolidated public sector shall on average be equal to 1 percent of GDP over a business cycle. Sweden also has an expenditure ceiling and a requirement on local governments to have balanced budgets. In 2012 Sweden had a minor budget deficit (SEK 13 billions) and the consolidated public debt was 37.7 percent of GDP.

The tax revenues as share of the GDP continued to decrease. In 2012 total taxes as share of GDP was 44.0 percent, compared with 44.3 in 2011. The consolidated tax revenues increased with 2.3 percent in 2012.

Although Sweden as a nation has a strong economy, Swedish families are exposed to financial uncertainty. A threat within the country is household indebtedness in relation to a cooling housing market. Swedish household debt is growing rapidly and amounts to 164.3 percent of disposable income (2012), an increase of 55 percentage points since 2000. Installment time for an average fa-





-mily house is now as high as 100 years (most Swedes newer pay their houses, they have loans without or with very small installment. This is probably Sweden's biggest problem today). Today Sweden has a high capital gains tax of 30 percent and interest on loans for houses is also deductible against personal income at 30 percent. This tax regime is stimulating debt and limits savings, especially in a country with high taxes on personal income. A recent report from the EU Commission proposed that Sweden should reduce the possibility to deduct interest on loans for houses from personal income taxes.

### **The Swedish system with special sanctions for tax crimes will be challenged**

Today the Swedish tax authorities can sentence a taxpayer to pay a penalty tax, usually 20 or 40 percent extra tax. Tax crimes are also a part of the regular judiciary system and the offender can thus also be sentenced with a fine or, in severe cases, to jail. Sweden has twofold punishment for tax crimes. This twofold punishment is not in conformity with judgments by the European court of justice. Recent judgments in Swedish courts have challenged the twofold punishment in the tax system. The European court of justice has given preliminary approval and the Supreme Court of Sweden will now examine the question. The Swedish system will also be tested in four new judgments from the European court of justice. It is most likely that the Kingdom of Sweden will lose its fight for a twofold punishment for tax crimes in the coming years.





Internally, corporate taxes have been lowered further in several cantons. Much uncertainty surrounds the planned corporate tax reform to increase acceptance of the Swiss tax system towards the European Union, which has been criticizing some cantonal corporate tax rules for years and is expecting progress on the part of Switzerland. In the field of international tax compliance of non-resident clients of Swiss banks, agreements have been implemented with Austria and the UK on a withholding tax designed to regularize the situation of potentially untaxed assets, and with the United States on a simplified implementation of its controversial FATCA legislation.

## Corporate taxes going down further in the cantons

The trend to lower corporate taxes carried on in Switzerland. For 2013 corporate income tax rates have been lowered slightly in three cantons: Basel-City, Neuchâtel and Zug. In December 2012, however, citizens in the city of Lucerne voted in favour of a tax increase (after adopting record low rates in recent years), and citizens in the canton of Zurich refused a government proposal to cut taxes, signalling that in some cantons a threshold has been reached. In addition, much uncertainty surrounds the contemplated Swiss-wide reform to solve the tax dispute with the European Union over some cantonal tax regimes (see section below). New measures may be needed to increase international acceptance of the Swiss system while maintaining the country's competitiveness, which calls for a difficult act of balance.

The average tax burden in the cantonal capitals (including direct federal tax) went down from 19% to 18% since 2009 according to an estimate. The effective tax burden is lower than statutory tax rates since taxes can be deducted as business expenses. Differences between cantons, however, remain substantial (Table 1). The most attractive cantons have corporate income tax rates between 11% and 12%, about half as much as in the most expensive canton, Geneva. Yet Geneva, together with Vaud, Basel-City, Zurich and Zug belong to the cantons that would be most impacted by legal modifications to solve the dispute with the EU, and Geneva's cantonal government has tentatively announced it might choose to reduce its corporate tax rate to 13% for all companies. Otherwise it could face migration of companies to lower-tax cantons, or to overseas locations.



**Table 1: Corporate income taxes in 2013 in the Swiss cantons  
(including 8.5% flat federal tax)**

	Effective tax rate (%) in cantonal capital city	Lowest-tax commune in the canton
Lucerne	12,20	Meggen 11,18
Schwyz	13,95	Wollerau 11,56
Appenzell A.-Rh.	12,66	canton-wide rate
Nidwalden	12,66	canton-wide rate
Obwalden	12,66	canton-wide rate
Appenzell I.-Rh.	14,16	canton-wide rate
Schaffhausen	15,97	Rüdlingen 14,57
Zug	14,80	Baar 14,70
Uri	15,14	misc. 14,79
Thurgau	16,43	Bottighofen 15,12
Glarus	16,46	Mollis 16,41
Fribourg	19,63	Greng 16,61
Graubünden	16,68	canton-wide rate
St. Gallen	17,14	canton-wide rate
Ticino	20,67	Paradiso 18,21
Solothurn	21,80	Däniken 18,30
Zurich	21,17	Rüschlikon 18,71
Basel-Country	20,70	misc. 18,77
Aargau	18,87	canton-wide rate
Bern	21,64	Iltigen 19,88
Jura	21,14	Boncourt 19,99
Neuchâtel	20,94	canton-wide rate
Vaud	23,48	Coinsins 20,95
Valais	21,57	canton-wide rate
Basel-City	22,18	canton-wide rate
Geneva	24,17	Genthod 23,22

Source: Pascal Hinny (ed.), Steuerrecht 2013, Zurich, Schulthess-Verlag, 2013.

### **Tax dispute with the European Union: the search for a solution goes on**

Corporate taxation is an important component of international competition between business locations. However, the attractiveness of Switzerland's taxation system is also causing its international acceptance to be regularly questioned, often with dubious arguments, such as the European Union's complaint that some cantonal tax regimes violate the 1972 free-trade agreement between Switzerland and the EU. Although the European Union has been criticizing some Swiss tax practices since 2007, the issue has gained in momentum following the increasing financial and economic difficulties in many European countries as a result of fiscal mismanagement and irresponsible public governance, leading to a desperate quest for more tax revenues.



The Swiss government has stressed that it remains “firmly committed” to Swiss sovereignty and open tax competition. It has also highlighted the special tax regimes applied in the EU as well as the public subsidies to industries and companies that distort competition in many European countries. However, in 2012 it entered into a “dialogue” with the EU, whereby various meetings at the political and technical levels have already taken place. The three objectives of the dialogue, from the Swiss government’s standpoint, are the preservation and further development of Switzerland’s attractiveness as a business location, the promotion of international acceptance of the Swiss tax system, and the safeguarding of “sufficient” tax revenues to finance public activities. Brussels now expects “concrete progress” from the Swiss side by the summer of 2013 as to which solutions could solve the controversy. The issues raised concern mostly the allocation between domestic and foreign profits and their tax treatment, in particular for holding and service companies that carry out various functions of headquarters (such as strategic planning, financing, research and development, etc.) but have no commercial activity in Switzerland.

Since September 2012, the central government and the cantons have been working together closely on drawing up a series of corporate tax measures. The project would reform the corporate tax system in a way that ensures competitiveness and international acceptance, but it is still unclear in which direction it will go. A steering body working on this is composed of four equal representations from the Confederation and the cantons, and is chaired by the Head of the Federal Department of Finance. Needless to say, the stakes are very high for Switzerland as one of the world's most competitive economies. It is suspected that the EU is simply pursuing its usual “raising rivals’ costs” strategy to increase its relative attractiveness, instead of carrying out competitive reforms itself. The Swiss government is well aware of that dimension, which is not only harmful for Switzerland, but for the whole of Europe, as it raises the costs of doing business.

### **Withholding tax for Austrian and UK depositors in Swiss-based banks**

In order to maintain the confidentiality of international depositors and regularize potentially untaxed funds in Swiss-based banks, two largely identical bilateral agreements with Austria and the United Kingdom came into force on 1 January 2013. A similar agreement with Germany was turned down by the German parliament, so that the provisions only apply to Austria and the UK at the present time. Other countries in Southern Europe, most notably Greece, have signalled an interest in such an agreement, yet no tangible progress has been made at this stage. Under the agreements depositors have two options to regularize untaxed assets held in Switzerland: They can either pay a flat rate one-off sum anonymously, or voluntarily disclose untaxed assets to their national tax authorities (or otherwise close their banking relationship in Switzerland).



For the future and in case the clients do not declare their assets to their national tax authorities, the Swiss-based banks deduct a tax amount annually on an anonymous basis from any income incurred. Alternatively, clients have the option to authorize their bank to report their income to the national tax authorities through the Swiss Federal Tax Administration in order to disclose it in their tax return. The agreements allow Austrian and UK resident clients with bank accounts in Switzerland to be fully tax-compliant for the past and the future while maintaining their privacy as an option at the same time. They also aim at decriminalizing banks, bank employees and bank clients as regards the past.

Based on the agreement with the UK, Swiss banks already made an upfront payment of CHF 500 million to the UK government through the Swiss Federal Tax Administration. This is meant as minimum tax revenues from anonymous retrospective taxation. The reimbursement of this upfront payment to Swiss banks will start as soon as CHF 800 million from retrospective taxation has been transferred to the UK tax authorities. Once the system of regularization of the past has generated CHF 1.3 billion in additional tax revenues for the UK government, then the upfront payment to Swiss banks will be fully reimbursed. (The withholding tax agreement with Austria made no similar provision for an upfront payment.)

These withholding tax agreements have come under fire, especially in France and Germany, by opponents of banking confidentiality for preserving the account holders' anonymity (who often stored assets in Switzerland not to escape tax but as a way to protect themselves from inflation, confiscatory taxation or government mismanagement). For the protection of wealth in Europe and the diversity of legal systems, however, the agreements are also bad news and mean a further erosion of individual property rights in Europe.

### **FATCA agreement with the United States**

In view of the entry into force as of 2014 of the controversial U.S. Foreign Account Tax Compliance Act (FATCA), which targets the assets of U.S. taxpayers abroad, the Swiss and U.S. governments signed an agreement designed to simplify implementation, as have done several other countries. FATCA legislation provides that all income from accounts held abroad by persons liable to pay taxes in the U.S. be disclosed for U.S. taxation purposes. It requires foreign financial institutions to conclude an arrangement with the U.S. tax authorities which obligates them to report identified U.S. accounts under the threat of a 30% withholding tax on all transfers from the U.S. and eventually the exclusion from U.S. financial markets.

FATCA is still fought against in the U.S. on grounds that it undermines the competitiveness of U.S. financial markets and creates administrative difficulties for U.S. citizens abroad. In Switzerland, the legislation was criticized for violating national sovereignty, although it is clear that without an agreement Swiss financial



markets and creates administrative difficulties for U.S. citizens abroad. In Switzerland, the legislation was criticized for violating national sovereignty, although it is clear that without an agreement Swiss financial institutions would be at a competitive disadvantage given the international influence of the U.S. government arising from the size of the U.S. economy.

The simplifications agreed with Switzerland apply in particular to public and private retirement funds and casualty and property insurances, which are exempt from FATCA, as well as to the due diligence requirements of financial institutions. Collective investment vehicles as well as financial institutions with a predominantly (98%) local clientele (including clients who are European Union citizens) are deemed to be FATCA-compliant and are subject only to a registration obligation. The due diligence obligations on the identification of U.S. clients, to which the rest of the Swiss financial institutions are liable, are set in such a way that the administrative burden can be tolerable.

Under the Swiss-U.S. agreement, accounts held by U.S. persons at Swiss financial institutions are reported either with the consent of the account holder or by administrative assistance channels through group requests. If consent is not given, the information will not be exchanged automatically, but only on the basis of the administrative assistance provision in the Swiss-U.S. double tax treaty. This is a small relief for the persons concerned by FATCA. The agreement is subject to the approval of the Swiss Parliament and to an optional treaty referendum. It is expected that it will be approved reluctantly, but nevertheless approved given the need for Swiss financial services firms to be active in the U.S. markets.







# United Kingdom

Philip Booth and Anthony Evans

The government is embarking upon a programme of fiscal consolidation, though delivering the reduction in the government's deficit has not been as successful as it hoped. The fiscal consolidation was largely achieved through tax increases in the early years. Government spending remains very high as a proportion of national income. At the same time, with very little room for manoeuvre given the decision not to cut government spending faster, the government is trying to cut some tax rates. In particular, the level of earnings at which individuals start to pay tax has risen and the corporation tax rate is falling. The tax system in the UK is very complex and, especially when combined with the impact of the benefits system, some very unfortunate results are achieved when it comes to work incentives and incentives for saving and family formation.

## Tax policy

There has been a general move by the coalition government to increase the level of earnings at which individuals start to pay tax. In 2009-10, individuals paid tax once their earnings reached £6,475. In 2013-14, they will not pay tax until their earnings reach £9,440 and that level will be increased to £10,000 in 2014-15. At the same time, the government has changed other tax thresholds to ensure that those earning around £40,000 a year or more do not benefit from some of the annual increases in the point at which individuals start to pay tax. Between 2012-13 and 2013-14, the income level at which higher rates of tax will be paid has actually been lowered by £1,025. This policy of gradually pulling more people into higher rates of tax simply exacerbates a long-running trend. Between 1979 and 2010, the bottom of the higher rate tax band fell by 42 per cent in earnings-adjusted terms and by nearly 10 per cent in real terms. The further big falls in the level of income at which higher rates are paid since 2010 has had dramatic effects and, in just five years, the number of higher-rate taxpayers will increase by about two-thirds. In the UK, "bracket creep" is happening, not just because of rising real incomes but because the brackets themselves are creeping downwards.

More generally, income tax policy is very haphazard in the UK. Whilst the number of taxpayers has been reduced, the government has tried to raise more revenue from the falling number of people paying income tax. Not only has the income level at which higher-rate tax is payable fallen, but there is now a special rate of tax above the 40 per cent rate (though this is reducing from 50 per cent to 45 per cent) and there is a strange 60 per cent effective tax rate on £13,000 of earnings starting at £100,000 when the personal income tax allowance is withdrawn. This is a clear disincentive to promotion and progression and creates more complexity in the system.



Employees and employers also pay national insurance contributions (a social security tax). This system is very complex as a result of reforms undertaken by the previous administration. The UK has a rather limited set of social insurance benefits and the criteria for accruing these benefits are quite straightforward. However, we have a very complex system of payroll contributions to finance these benefits. For employed people, there are five different thresholds that determine the income levels at which contributions are paid and benefits accrue. Broadly, employees and employers pay a payroll tax of 12 per cent and 13.8 per cent respectively on all earnings from £7,748-£41,443 per annum (2013-14). Employees' contributions fall to 2 per cent once an earnings level of £41,444 is reached, but employers' contributions continue at the rate of 13.8 per cent. Given that none of the UK social insurance benefits are earnings related – they are all flat rate – this is a remarkably complex system of graduating contributions. There has been some political pressure to merge the tax and national insurance systems given the confusing nature of the UK system. However, there is also opposition to this. Some see the retention of a contributory national insurance system as an important principle that is worth preserving. There are also practical problems in merging income taxes and social security taxes given that workers above state pension age do not pay national insurance contributions and there are reduced rates for the self-employed and much lower contributions for those with several jobs (because the annual allowance is per job and not per person).

The government also announced in the 2013 budget that the UK's state pension systems will be replaced by a single system providing a pension of about £144 a week and that the proposed reform will be accelerated to 2016. Currently, the self-employed do not receive one of the state pensions and this explains why they pay lower national insurance contributions. The incoherent UK national insurance system will probably be even more difficult to justify when the pension reform is implemented.

Over the last few years, the government has also been phasing out the concept of “contracting out” of national insurance pensions. For fifty years, one of the features of the UK social security system was that those who provided themselves with a funded private pension could pay lower national insurance contributions and receive a lower state pension. This form of voluntary privatisation of social has now been phased out for individuals with their own personal pension scheme and will be abolished for members of company schemes when the new state pension is brought in. The Conservative government is therefore bringing to an end arguably one of the most important welfare part-privatisations in the post-war settlement in Europe so that welfare provision will be even more dominated by the state in the future.

The UK also has a very complex system of so-called tax credits given to both pensioners and people of working age. The system is especially comprehensive for working age families with children. Whilst called tax credits, the payments are



are really means-tested benefit payments. Because they are means tested, their withdrawal leads to an extraordinarily high level of effective marginal tax and benefit withdrawal rates for families with children. For every extra pound an individual earns, many families lose around 70p or more in income tax, national insurance and lost means-tested benefits. The following table (reproduced from an article by Philip Booth on - <http://conservativehome.blogs.com/platform/2012/05/philip-booth.html>) shows the tax and benefit withdrawal rates facing a single-earner family with three children in 2012-13 at different levels of earnings. The picture has been made more complex by the withdrawal of a benefit that was previously universal (child benefit) on those earning over £50,000 a year.

The figures ignore the withdrawal of council tax benefit, housing benefit and the impact of employer's payroll taxes and indirect taxes. The coalition government promised to bring forward a measure to allow tax allowances to be transferable between husband and wife to reduce the penalties faced by single-earner couples and reduce the bias against couples in the tax and benefits system. So far there has been no sign of that measure being brought forward. Overall, the UK's system of family taxation and benefit provision is horrendously complex and corrosive of incentives. There is a strong case for abolishing many of the benefits and bringing in a simple household tax allowance based on the number of adults and children in a household as happens in some European countries.

Earnings band	Total marginal tax and benefit withdrawal rate	Income tax	National insurance	Benefit withdrawal
£6,420-£7,592	41%	0%	0%	41%
£7,592-£8,105	53%	0%	12%	41%
£8,105-£38,798	73%	20%	12%	41%
£38,798-£42,475	32%	20%	12%	0%
£42,475-£50,000	42%	40%	2%	0%
£50,000-£60,000	67%	40%	2%	25%
£60,000-£100,000	42%	40%	2%	0%
£100,000-£116,200	62%	60%	2%	0%
£116,200-£150,000	42%	40%	2%	0%
£150,000+	47%	45%	2%	0%

The problems in the UK tax and benefits system are illustrated by the OECD's calculation of the "low wage trap"—this is the loss of income through the tax and benefits when a family's income rises from 33 per cent to 67 per cent of the average private sector wage. This figure is 79 per cent in the UK.

## Business taxation

There was an important announcement about business taxation in the 2013 budget. The rate of corporation tax is to be reduced to 20 per cent – the same rate as the basic rate of income tax. An IEA paper called for this particular reform in



2012 and it appears that much of the reasoning used in that paper has been used by the government see: (<http://www.iea.org.uk/sites/default/files/publications/files/Aligning%20Corporation%20and%20Income%20Tax.pdf>). The move will allow some simplification through the abolition of the smaller companies' regime because smaller companies currently pay corporation tax at the same rate as the basic rate of income tax and it should be possible to abolish some other special schedules too. As well as reducing the tax burden on companies, the move will also reduce the tax bias against equity finance in the UK tax system. Overall, this is a very positive move.

The reduction in the corporation tax rate is going to be phased in. The corporation tax rate for 2013/14 will be 23 per cent, for 2014/15 21 per cent and 20 per cent from 2015/16. The UK has the longest tax code in the developed world. Whilst length of tax code does not necessarily automatically translate into complexity, our corporate tax system is also extremely complex. The government has said that it wishes to simplify the system. However, the actual policy moves – except for the reduction in corporation tax – have been quite different from the declared policy. A number of special reliefs from business taxation have been created in recent years (for example, special treatment of profits from patents) and more were announced in the 2013 budget (for example, special reliefs for the purchase of low-emission vehicles and the use of energy-saving technologies, the extension of tax credits for research and development, and allowances for investment).

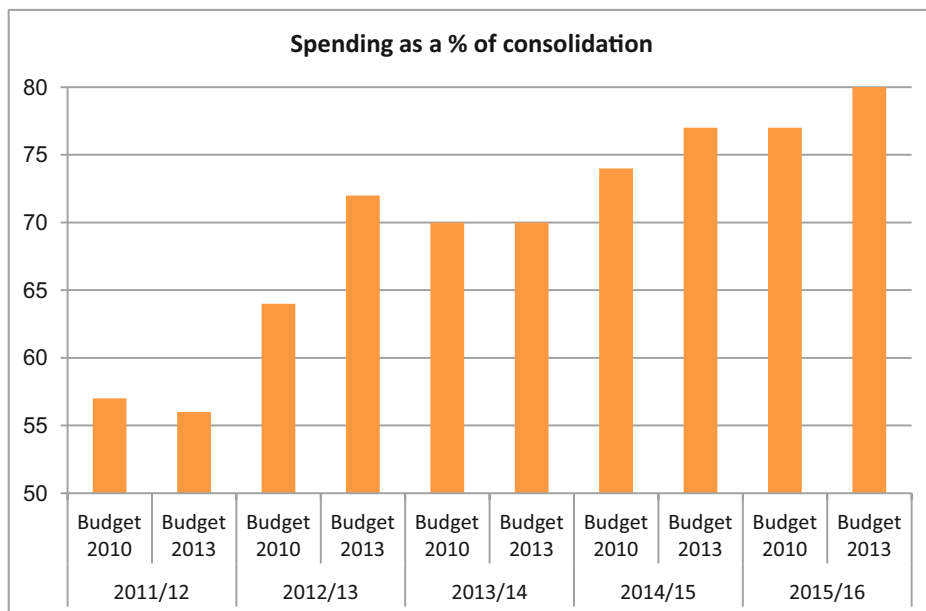
### Fiscal consolidation

When the present coalition government was formed in 2010 it identified fiscal consolidation as its economic priority. Policy responses to the 2008/09 financial crisis have led to the largest post-war deficit and the intention was to steadily eliminate this by the end of 2015/16. The government proposed a number of spending cuts and tax rises in order to achieve this goal, but have struggled in their ability to follow through.

The original intention was for the majority of the consolidation to come from spending cuts, but because tax rises have a more immediate impact they were favoured early on. The chart below compares the 2010 plan for fiscal consolidation, with the actual results achieved up to 2012/13 as reported in the 2013 Budget and the 2013 Budget plan for future years:



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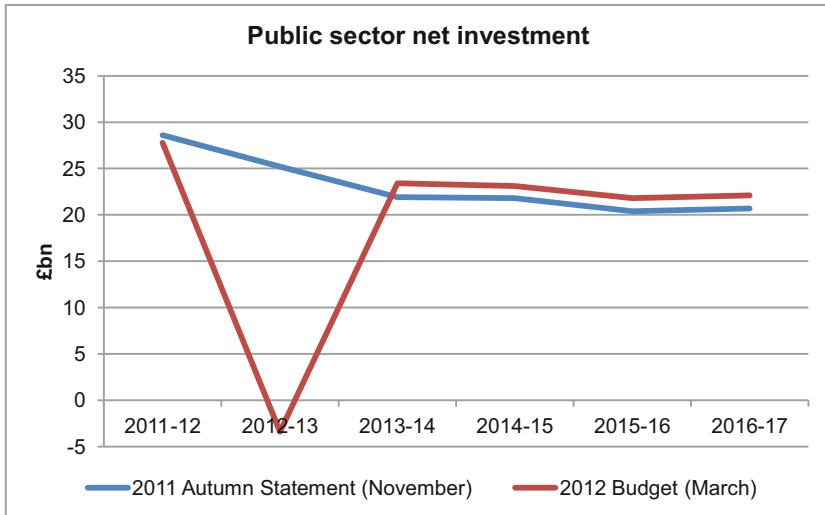
Just 57 per cent of the intended consolidation in 2011/12 was through spending cuts, and the reality was even lower. Increases in VAT and capital gains tax accounted for much of the consolidation. The original plan was for spending cuts to gradually take on a larger share of the consolidation, reaching 77 per cent in 2015/16. However in 2012/13 spending cuts already accounted for 72 per cent of the consolidation, as opposed to the planned 64 per cent. This was expected to fall back to 70 per cent in 2013/14, before rising again to hit a 2015/16 target of 80 per cent. The plans delivered the worst of both worlds – consumer confidence was weakened both by *planned* spending cuts, and *actual* tax rises.

The reason why the outturn has been as shown above is not because the government has been more stringent on public spending than it planned in the first few years of fiscal consolidation. It is because tax revenues have not risen as expected as a result of the absence of economic growth. Because tax revenues have not risen, the amount by which the deficit has fallen is smaller and so the spending cuts are a bigger percentage of a smaller level of deficit reduction.

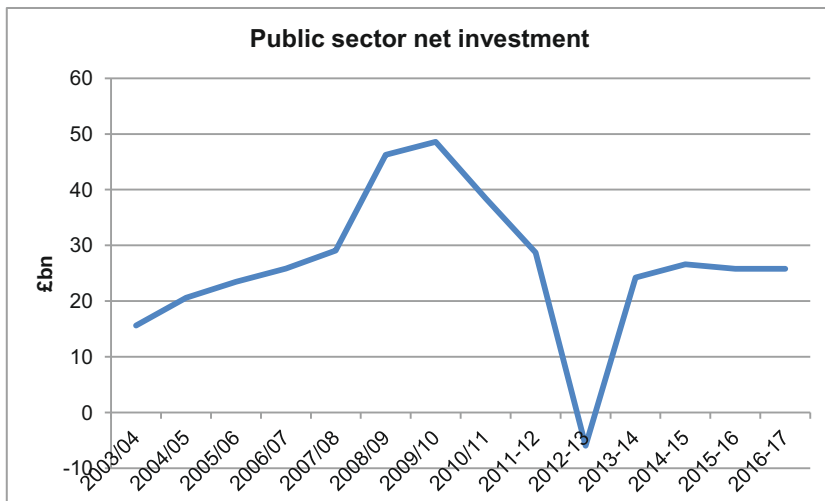


## Cuts to public investment

The source of the spending cuts in 2012/13 was a dramatic fall in the amount of public sector net investment (gross investment less depreciation). This can be seen most starkly by comparing the forecast for net investment from the November 2011 Autumn Statement with the March 2012 Budget.



However, this focuses on a fairly narrow time period. If we look at public sector net investment (PSNI) from 2003-04 we see the following:



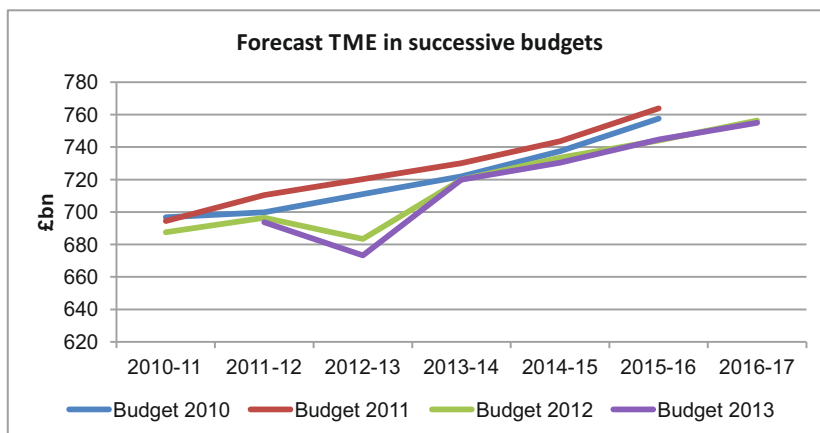
The drop in 2012/13 remains dramatic, but it is important to realise that from 2014/15 PSNI is forecast to be £26.6bn, which is the same level as 2007 (i.e. im-



-mediately prior to the crisis). Taking the peak of PSNI as the reference point is misleading because the UK had a £20bn fiscal stimulus in 2009 that deliberately brought forward some capital spending from 2010/11. In other words part of the reason for the slump is a prior boom.

### Increases in government spending

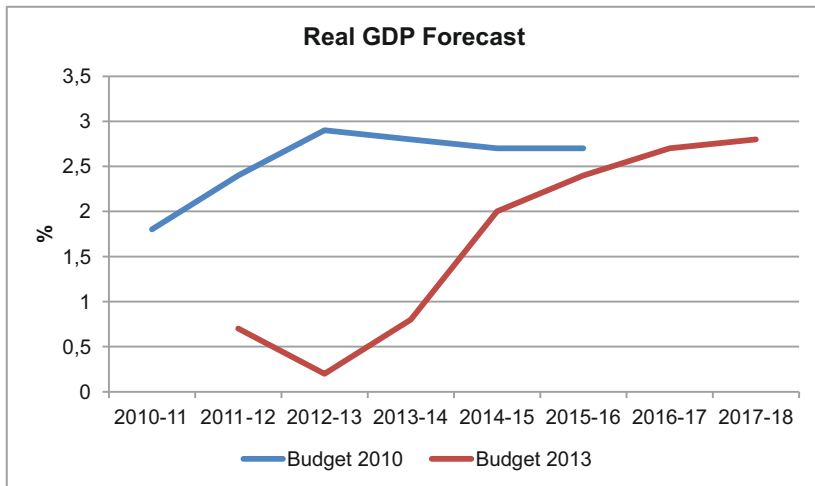
It is dangerous to read too much into the drastic decline in public sector net investment and government spending more generally. There have been various one-off adjustments. Items such as the transfer of Royal Mail pension plan to the public sector; the sale of Olympic tickets; proceeds of 4G spectrum licenses; and cash transfers from the Bank of England's Asset Purchase Facility (APF) have all made it hardy to identify the path of government spending. These types of accounting tricks can undermine the credibility of consolidation. "Total managed expenditure" (TME) is the sum of "public sector current expenditure" and "Public sector gross investment". The 2012/13 dip is possibly at least partly being explained by special factors. Despite this, TME is forecast to grow from 2011/12 – 2017/18. The chart below shows how this has been revised through successive budgets:



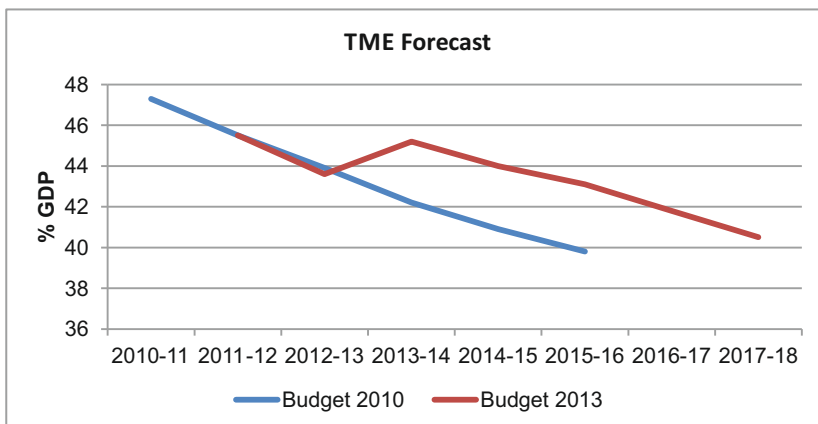
### The growth dilemma

Government spending as a proportion of GDP is dependent on two different forecasts – government spending, and GDP. The chart below shows how optimistic official GDP forecasts have been. The concerning thing is that even the forecasts from the 2013 Budget envisage Real GDP growth returning to over 2 per cent within 2 years. The government is still expecting a recovery, but more delayed.





Thus far the steady decline forecast in 2010 has failed to materialise, with an increase in spending, *even as a proportion of GDP*, being projected for 2013/14 because of slow economic growth whilst government spending continues to rise. Once again the projected declines seem more likely the result of over optimistic growth forecasts than genuine cuts to spending. Rather than offer a plan to cut spending, the government's hope was for the economy to reduce its debt burden through higher growth. As this future growth fails to materialise it becomes clearer that the original consolidation plans were growth-led, rather than led by reductions in government spending.



### Ringfencing cuts

The government has continued to ringfence the budget of the National Health Service (NHS) and given that this is the second largest part of government spending

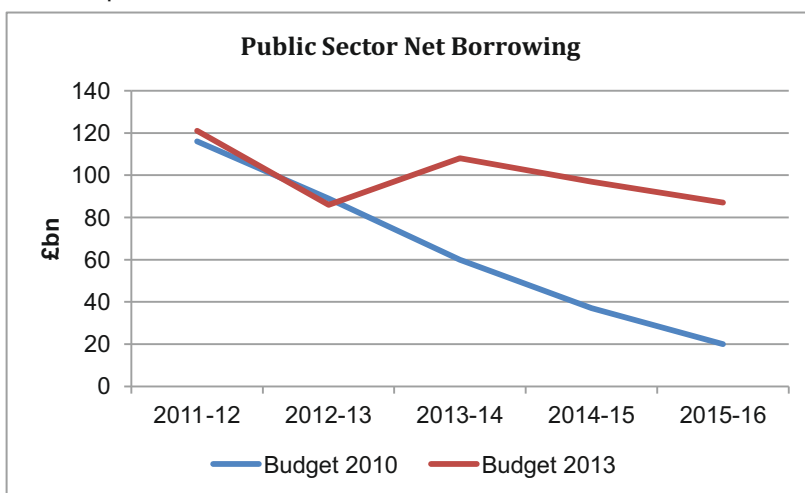




-ding (after “social protection”) it means the planned cuts to Department Expenditure Limits (the part of current expenditure over which the government has most discretion) will be concentrated heavily on specific departments. From 2012/13 to 2014/15 Department Expenditure Limits for current spending are forecast to rise from £317.8bn to £323.6bn, with 10 departments receiving a rise and 12 a cut. The big losers are Local Government; Business, Innovation and Skills; and Defence. Over the same period spending limits for capital spending is expected to rise from £38.6bn to £46.9bn, with 14 departments having a rise and 4 having a fall. Depending on the measure of inflation being chosen some of the departments with nominal increases will receive real cuts.

### Borrowing will rise

All of the above help to explain why the government's plan to reduce borrowing has disappointed. In the 2010 Budget the government set out a clear plan to steadily reduce the size of the budget deficit. However, over the course of 2013, borrowing is now forecast to rise, only to begin falling from 2014 onwards and at a much slower pace.



Commentators disagree on why growth has stalled, with some arguing that it is because the intended pace of consolidation was too harsh, some saying it was too cautious, others pointing to supply-side problems such as regulation and taxation, and others saying it is due to external events such as the euro zone crisis. But what we can conclude is the following:

- There has been more rhetoric about spending cuts than actual cuts in spending
- The completed part of the fiscal consolidation has focused on tax rises, not on spending cuts though tax revenues are still sluggish
- Proposed spending cuts as a proportion of national income have been exaggerated due to implausible growth forecasts.





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