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EU TAXATION POLICY DURING FINANCIAL CRISIS

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Abstract

The paper deals with the problems of tax coordination and perspectives during and after financial crisis. As we see the 2008 financial crisis is the worst economic crisis. Great Depression of 1929 was financial crisis which know all world financers and we can compare these days financial crisis with 1929 financial crisis. Thr 2008 financial crisis has been characterised by a rapid credit expansion, high risk-taking and exacerbated financial leverage and credit crunch when the bubble burst. In particular, it reviews the existing evidence on the links between taxes and many characteristics of the crisis. Finally, it examines some possible future tax options to prevent such crises.

This financial and economic crisis presents major challenges for tax administration. With the economic downturn, tax agencies are encountering growing compliance risks and greater demands for taxpayer support in the face of prospective budget cuts. This paper examines these challenges and sets out a strategy and measures for responding to them. Theoretical and empirical studies suggest that an economic downturn tends to worsen taxpayer compliance in important aspects. While a drop in compliance may have some countercyclical effects on the economy, tolerating noncompliance is not an appropriate response to the crisis because it is distortionary, inequitable, and, perhaps most importantly, hampers the rebuilding of tax bases over the medium-term.

The crisis therefore presents the financial authorities – central banks, regulators and finance ministries – with two challenges:

The first and most urgent is to design short-term policies so as to at least limit the adverse impact of deleveraging and deflation on the real economy. We cannot make that impact nil, but we do know how to avoid the policy mistakes which turned the initial problems of 1929-30 into the Great Depression. Fiscal and monetary policies need to be carefully designed, and – as we approach a zero interest rate and consider quantitative easing options – need to be increasingly coordinated. And there are a wide range of policies which can be taken to free up financial markets, funding guarantees, liquidity provision, tail risk insurance, direct central bank purchases of assets, and regulatory approaches to capital regulation which avoid unnecessary pro cyclicality in capital adequacy requirements. The measures announced by the Chancellor of Exchequer on Monday were designed as an integrated package, which will have a significant impact. And if more measures are acquired they can and will be taken.

It is not, however, on this challenge of short-term economic management – where the lead must be with the fiscal and monetary authorities. But instead on the second challenge: how to design the future regulation and supervision of financial services so that we significantly reduce the probability and severity of future financial crises.

Financial sector innovation. The fundamental macro economic imbalances have thus stimulated demands which have been met by a wave of financial innovation, focused on the origination, packaging, trading and distribution of securitised credit instruments. Simple forms of securitised credit – corporate bonds – have of course existed for almost as long as modern banking. In the US, securitised credit has also played a major role in mortgage lending since the creation of Fannie Mae in the 1930s; and securitisation had been playing a steadily increasing role in the global financial system and in particular in the American financial system for a decade and a half before the mid-1990s. But it was from the mid-1990s that the system entered explosive growth in both scale and complexity.

Keywords:

Economics, economic policy, finances, financial crisis, tax system, taxation, indirect tax, direct tax, tax rate, VAT.

Introduction

The financial crisis is not over. Neither tax rebates nor low interest rates nor higher or lower exchange rates can do the job of reviving an economy that is burdened by debt loads that are too high. On the contrary: the policy measures that the US authorities have been applying will prolong the agony. Be prepared for the challenges of extended financial turmoil and economic stagnation.

Economic policy as it is currently practiced is in a fix: lower interest rates may temporarily help to alleviate the financial crisis, but they exacerbate the fundamentals that are the cause of the financial crisis. Equally, a lower dollar would make imports costlier for the United States, while a strong dollar comes with lower import prices. But while a low dollar would help to expand exports, a strong dollar impedes export growth. Therefore, the United States will have high trade deficits as long as the economy does not fall deeper into recession.

The collapse of a global housing bubble, which peaked in the U.S. in 2006, caused the values of securities tied to real estate pricing to plummet thereafter, damaging financial institutions globally. Questions regarding bank solvency, declines in credit availability, and damaged investor confidence had an impact on global stock markets, where securities suffered large losses during late 2008 and early 2009. Economies worldwide slowed during this period as credit tightened and international trade declined. Critics argued that credit rating agencies and investors failed to accurately price the risk involved with mortgage-related financial products, and that governments did not adjust their regulatory practices to address 21st century financial markets. Governments and central banks responded with unprecedented fiscal stimulus, monetary policy expansion, and institutional bailouts. [18]

A European package of spending increases and tax cuts are worth €200bn (£170bn), or 1.5% of the European Union's gross domestic product.

The 27 countries would provide €170bn of the €200bn - or 1.2% of European GDP - while the other €30bn would come from Brussels' coffers in the form of EIB loans, and accelerating payments from the cohesion and structural funds, which go mainly to the new members in central Europe.[2]

Research problem: Taxation policy during financial crisis, what ways choose countries to avoid financial problems.

Object of this article – tax tendencies and tax perspectives in European Union member states during finacial crisis.

Aim of this article – to identify tax tendencies during financial crisis. To expose the necessity to find the best way to normalaize finances during financial crisis.

Tasks of this article:

- To analyze 2008 financial crisis problems;
- To present financial policy chalanges;
- To uncover the taxtion policy during financial crisis.

Research methods: analysis of primary, secondary literature and statistical data.

Financial crisis of 2008

The financial crisis that made crash of the global economy since the summer of 2007 was without precedent in post-war economic history. Its size and made problems of this economic crisis are exceptional. The crisis grow by long period of rapid credit growth, low risk premiums, abundant availability of liquidity, strong leveraging, soaring asset prices and the development of bubbles in the real estate sector.

In its early stages, the crisis made itself as an acute liquidity shortage among financial institutions as they experienced ever stiffer market conditions for rolling over their debt. In this phase, concerns over the solvency of financial institutions were increasing, but a systemic collapse was deemed unlikely. This perception dramatically changed when a major US investment bank (Lehman Brothers) defaulted in September 2008.

Investitors massively liquidated their positions and stock markets due to survive during this difficult time. The cross-border transmission was also extremely rapid, due to the tight connections within the financial system itself and also the strongly integrated supply chains in global product markets. EU real GDP is projected to shrink by some 4% in 2009, the sharpest contraction in its history. And although signs of an incipient recovery abound, this is expected to be rather sluggish as demand will remain depressed due to deleveraging across the economy as well as painful adjustments in the industrial structure. Unless policies change considerably, potential output growth will suffer, as parts of the capital stock are obsolete and increased risk aversion will weigh on capital formation and R&D.

Comparison with previous crises and economic outlook

If we compare the 2008 crisis with some previous stocks crashes: the 1929 Great Depression, the 1973 Oil Shock, the 1987 Black Monday and the 2000 IT bubble. It shows the historically extreme severity of the stock markets' decline. Interestingly, the 2008 financial crisis started on the same paths as the 1973 oil shock before dropping on the same paths as the 1929 Great Depression. Two additional interesting points are worth mentioning. First, the comparison reveals that the stock decline can be long. The 1973, 2000 and 1929 stock declines last 626, 913 and 1,025 days respectively. At the time of writing, the 2008 crisis hit its bottom-low point after 517 days. Second, the return to pre-crisis levels takes very long. It took more than 7 years after the

2000 IT bubble and 7 ½ years after the 1973 oil shock, while WWII never allowed stocks to return to their pre-1929 levels. However -, the 2008 crisis has one of the fastest recovery rate to date.

The policy response

One important and welcomed difference with the Great Depression is that public authorities have acted to provide a policy response to the crisis. Central banks have reacted in two ways to ease monetary conditions: injecting liquidity in the market and lowering interest rates. On 9th-14th August 2007, the Federal Reserve, The ECB and the Bank of Japan coordinated their efforts to respectively inject USD 64 Bio, EUR 229 Bio, and JPY 1 trillion to provide banks with liquidities. New large injections of liquidities occurred ever since. Central Banks also rapidly lowered their interest rates. Other Central Banks followed suit and many additionally engaged in programmes to offer alternative funding.

In the midst of the crisis, governments were also forced to rescue banks to avoid a collapse of the whole financial system. For example, Member States of the European Union committed (individually) to recapitalisation of their financial institutions, guarantees on bank liabilities, relief of impaired assets and liquidity and bank funding support for a total representing 43.6% of their combined GDP (European Commission, 2009).

The third part of the policy response to the crisis is the fiscal stimulus packages. A first step was the Economic Stimulus Act of 13th February 2008 which provided U.S. taxpayers with various tax credits for a total of over USD 150 billion. On 26th November 2008, the European Commission unveiled the European Economic Recovery Plan for Growths and Jobs (EERP), which includes a mix of tax and expenditure measures to support the real economy and to boost confidence. The plan proposes a EUR 200 billion (i.e. 1.5% of EU GDP) fiscal stimulus, shared between the European Commission (EUR 30 Bio) and the Member States (EUR 170 Bio), and is made out of a set of proposed actions from which individual Member States can choose.

The various measures taken by the Member States in the context of the EERP have largely been documented. The total fiscal impulse amounts to about 1.8% of EU GDP. It is however arduous to provide an exhaustive lassification of the tax measures taken by EU Member States to fight the economic crisis, not the least because already decided measures may have been relabelled or modified to fit into national stimulus packages. Table (1) provides a tentative typology of tax measures that were taken in the EU. Generally, measures have consisted in a lowering of existing taxes but the budgetary position of some countries - such as Latvia, Lithuania or Ireland (among others) - has forced those to increase taxes instead. The bulk of the measures have focused on a decrease in labour taxes, in particular by lowering personal income tax rates or increasing tax brackets. Another sizeable part of tax measures has focused on decreasing corporate income taxes, alternatively lowering the rate or the base. Interestingly, no country has acted to cut standard VAT to try to boost consumption, the UK being the (temporary) exception.[18]

Table 1. Tax measures taken by EU-27 Member States

	Lowering Taxes	**Increasing Taxes**
Labour Taxes		
Personal Income Tax	OE, DK, FI, FR, DE, HU, LV, LT, LU, MT, NL, PL, PT, SI, SK, SE	EL, IE, UK
SSC Employers	CZ, FI, HU, NL, SE	IE, RO, UK
SSC Employees	CZ, NL, SE, SK	LT, RO, UK
Withholding taxes	BE	
Deductions	OE, BG, DE, IT, PT, SK, ES, SE	
Capital Gains	RO	IE
Deferral of reform		CZ, EE
Corporate Income Tax		
CIT rate	EL, LU, PT, SE	IT, LT
Allowances	OE, BG, ES, IT, NL, DE, FR, LT, PL, PT, SI, SK	
Value-Added Tax		
Standard Rate	UK	HU, IE, LV, LT
Reduced Rates	BE, CY, CZ, FI, FR, MT, RO	HU, EE, IE, LV, LT
Property and inheritance taxes	EL, ES, IT, LU, PT	
Environmental taxes	DE, NL, RO	FI, IT, LV, LT, SI, UK

Source: adapted from European Commission (2009c).

Financial policy chalanges

The current crisis has demonstrated the importance of a coordinated framework for crisis management. It should contain the following building blocks:

- *Crisis prevention* to prevent a repeat in the future. This should be mapped onto a collective judgment as to what the principal causes of the crisis were and how changes in macroeconomic, regulatory and supervisory policy frameworks could help prevent their recurrence. Policies to boost potential economic growth and competitiveness could also bolster the resilience to future crises.
- *Crisis control and mitigation* to minimise the damage by preventing systemic defaults or by containing the output loss and easing the social hardship stemming from recession. Its mainobjective is thus to stabilise

the financial system and the real economy in the short run. It must be coordinated across the EU in order to strike the right balance between national preoccupations and spillover effects affecting other Member States.

- *Crisis resolution* to bring crises to a lasting close, and at the lowest possible cost for the taxpayer while containing systemic risk and securing consumer protection. This requires reversing temporary support measures as well action to restore economies to sustainable growth and fiscal paths. Inter alia, this includes policies to restore banks' balance sheets, the restructuring of the sector and an orderly policy 'exit'. An orderly exit strategy from expansionary macroeconomic policies is also an essential part of crisis resolution.[12]

Tax policy during and after financial crisis

The International Monetary Fund (IMF) has argued that the global financial crisis was exacerbated (though not caused) by tax policies which fuelled the credit boom that preceded the economic downturn. The IMF proposes1 that governments should consider changing the rules that have encouraged companies to seek finance using debt rather than equity, and allowed individuals to take put larger mortgages. Many tax regimes allow companies to deduct interest payments against tax but not against returns on equity; this has resulted in an increase both in leveraged buy-outs by private equity organisations and in the holding of debt rather than equity by other financial institutions. The IMF argues that 'corporate level tax biases favouring debt finance including in the financial sector are pervasive, often large and hard to justify given the potential impact on financial stability.'[10]

Finally, all tax systems should abide by a review principle whereby tax legislation is periodically overhauled and consolidated to bring it up to date and make it easier to follow. Outdated laws should be removed.

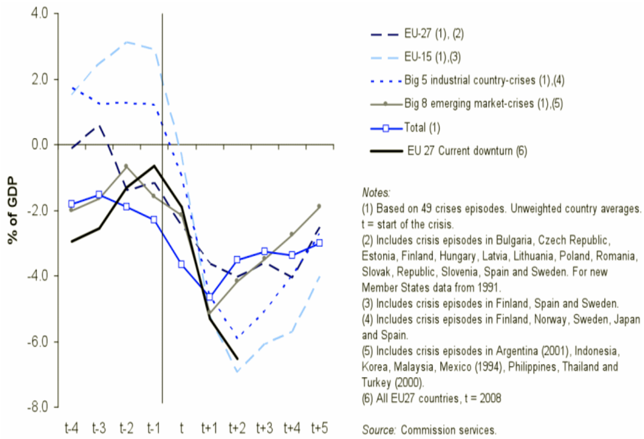
Corporate tax rates at EU

Business is becoming increasingly global and companies now do more and more business across national boundaries. In response to these developments, governments around the world have lowered corporate tax rates in order to entice businesses to locate in their countries.

The intellectual property issue illustrates the fact that the overall corporate tax rate – so often referred to by the UK government, which cut it to 30% shortly after coming to power in 1997 – is only a part of the overall cost of production which the tax charge comprises. Governments around the world seem to have realised it is a symbolically important aspect of the initial impression an investing entity has of a location, rather as a supermarket always displays its big offers near the entrance. This has been borne out by the way corporate tax rates have changed over the past three decades; in the 1980s they were in the 50% range, by the 1990s rates in the range of 30% were the norm, but since the turn of the millennium such rates are now considered high, which is why the UK has steadily slipped down the corporate tax league table, even with a current rate of 28%.[8]

The symbolic power of the corporate tax rate means that governments are still reluctant to raise it. The Irish government's 'austerity budget' of April 2009 – in which personal taxation was raised in an effort to combat the deficits caused by the property crash and bank failures – left corporate rates alone. In 2008, Japan also preferred to raise VAT through individuals. Further, Canada, Germany, Russia and Singapore have all cut their corporate rates. People are regarded as less mobile than corporations, and are therefore a more tempting tax target.

The public finances of countries with important financial centres and/or that have seen major housing and construction booms have been particularly affected. To some extent this is deliberate, broadly in line with the distribution of "fiscal space" and serving to provide short-run demand support. But, as may be expected, public indebtedness is increasing too, and this will need to be reversed when recovery takes hold. As indicated by Figure 3, the projected increase in public debt – about 20% of GDP to end 2010 – is typical for a financial crisis episode. However, the jumping-off point is considerably higher than in the past.



Source: voxeu.org (2009).

Figure 1. The fiscal position relative to previous banking crises

A recent IMF paper stated, however, that 'we find evidence that lower corporate income tax rates and longer "tax holidays" are effective in attracting Foreign Direct Investment (FDI), but not in boosting gross private fixed capital formation or growth. In other words, such tax cuts generate initial interest and investment but not long-term commitment.

Conclusions

EU member states participating in EMU have given up the possibility of an independent monetary policy. Therefore, they have fewer policy options, so they might have incentives to use taxes to achieve competitive advantages, which may intensify tax competition. However, tax burdens in the EU increased on average by almost 50% in the past 35 years, while they did not converge. Since capital is much more mobile than labor it can be expected that the tax burden has partly shifted from capital to labor. Yet, there is no evidence for a "race to the bottom".

Countries have implemented strong policy responses to the crisis. In particular, many countries have taken tax measures as part of broader fiscal stimulus packages. They have however come short of changing tax systems. Two issues have attracted some attention. The idea of a transaction tax to prevent speculative bubbles is not recent. For its proponents, such tax would reduce volatility and bring additional tax revenues. A review of the existing theoretical and empirical literature shows however mixed results and does not exclude that such a tax would instead increase volatility. A promising avenue is the development of tax systems that are more neutral with regards to the source of financing as existing systems render debt more tax-attractive, possibly leading to too high levels of leverage.

EU decision-making on taxation still requires unanimity making progress in tax harmonization a difficult and cumbersome process. So far, the achievements with regard to tax harmonization in the EU have been most pronounced in the field of indirect taxes, in particular the VAT. Minimum rates have been set, but no maximum rates. As a result, VAT rates differ across EU member states. Moreover, VAT tax bases differ between member states because of derogations and exemptions. Less progress has been achieved with regard to harmonization of excise taxes. Harmonization in this field has been very slow and often spontaneous.

Governments should address substantive issues of tax law that cause distortions, rather than relying on headline corporate tax rates and 'holidays' to attract FDI. The system should be kept as simple and homogeneous as possible in order to provide the certainty that business needs.

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