Future of taxation in EU
Opportunities for change

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Overview

1. Recent EU-wide tax policies
2. Post-crisis opportunity regards to finance
3. Key issues to be addressed
4. Conclusion

EU tax policy

- Latest Council Conclusions, 1-2 March 2012
  - Strengthen fiscal sustainability
  - Mostly a response to sovereign debt crisis
- Aim to
  - Reduce distortions
  - Shift taxes away from labor
  - Broaden tax base
  - Remove unjustified exemptions
  - Improve tax collection
- Not very specific
  - Some issues may be useful if implemented

EU tax policy

- Tax policy in EU is national-interest driven
  - Most issues prove highly divisive at EU-level
  - Divulging views on harmonization & competition
  - Exaggerated fear of loss of sovereignty
- Ex: Common consolidated corp. tax base (CCCTB)
  - Substantial academic & expert support
  - Eliminates compliance costs & uncertainties
  - Improves competition (comparability of tax rates)
  - But even the optional form attracts resistance
  - Unlikely to be adopted EU-wide

Post-crisis opportunity

- "A crisis is a terrible thing to waste"
  - Political inertia may be used to address weaknesses
  - Far-reaching policies may receive support now
  - Likely to persist in upcoming years
- Recent interest in financial taxes
  - Would be a divisive topic 5 years ago
  - Current debate focused on instruments: FAT, FTT,…
  - Not always based on what is desirable
  - In some cases, need further scientific evidence

Post-crisis opportunity

- Taxes can be an important regulatory tool
  - Supplement regulatory integration
  - Need for EU-wide coordination in various areas
- Areas where EU-wide initiatives are needed
  - End preferential treatment of debt
  - Retract tax incentives that contribute to bubbles
  - Address macro-prudential concerns
  - Mitigate tax arbitrage opportunities

Debt-equity bias

- Preferential treatment of debt vs. equity
  - Deduction of debt interest but not dividends/cap. gain
- Leads to various distortions
  - Excessive build-up of leverage
  - Against intrinsic-growth & increases cost of capital
  - Excessive issuance of hybrid instruments
  - Tax planning
- Various responses offered
  - Comprehensive business income tax (CBIT)
  - Allowance for corporate equity (ACE)

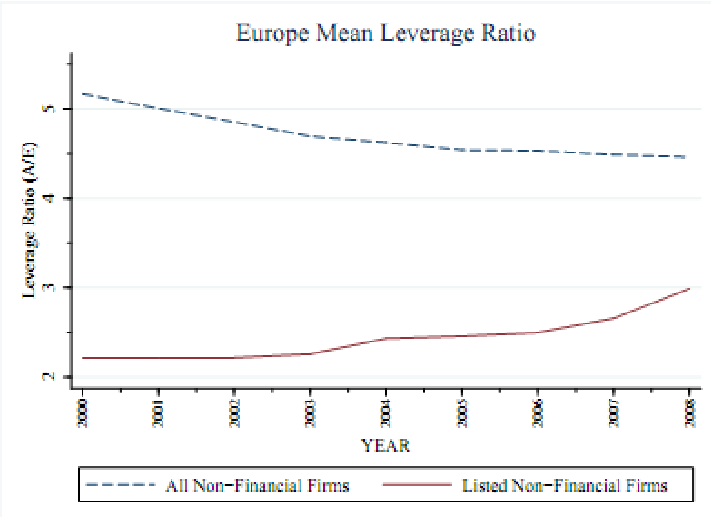
Debt-equity bias

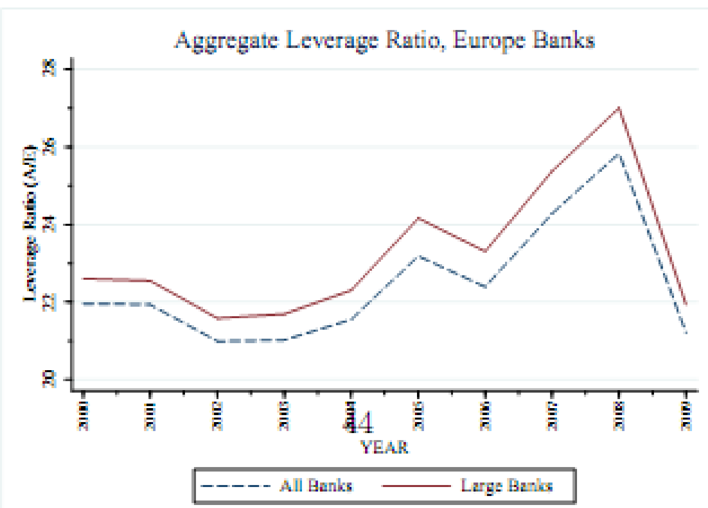
- Leverage (debt/assets) sensitive to tax rates
  - Detailed meta-study of de Mooij (2011)
  - Typical tax elasticity: Between 0.17 to 0.28
- Hard to ascertain causality w/ reported taxes
  - High leverage → lower (average) tax rate
  - Confounding tax-related factors
  - May bias estimate of impact of taxes on leverage
  - Limited variation in statutory rates (less so in EU)
  - Literature uses estimates of marginal tax rate

Debt-equity bias

- Financial institutions not studied in detail
  - Hard to obtain comparable tax data on banks
  - Cross-border issues also problematic
- EU banks are highly & increasingly leveraged
  - Substantially more so than non-financials
  - In US, leverage multiple (asset/equity) cannot exceed 20 for "well-capitalized" banks
  - No current leverage limit in EU
  - Part of Basel III; only disclosure req. under CRD IV

Debt-equity bias





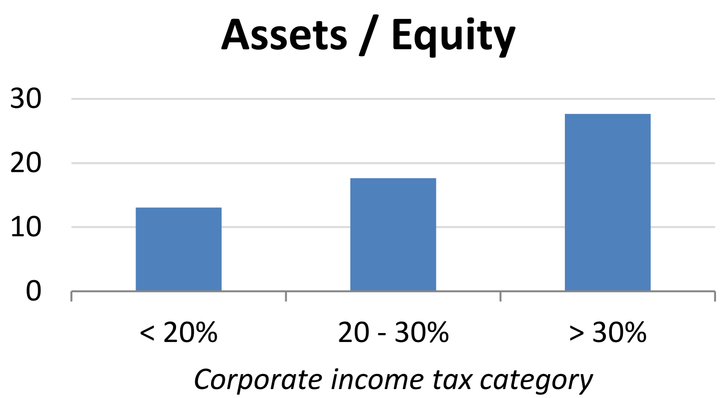
Source: Kalemli-Ozcan et al. (2011)

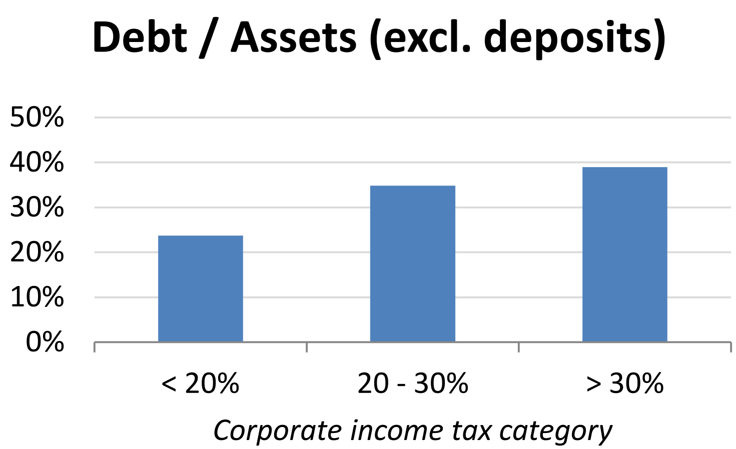
- High leverage for EU banks
  - Leverage = Assets / Equity
  - 25 for EU banks over 2000-9
  - Increasing until 2008
  - Much lower (~4) for non-fin.
  - Lower (~12) for US banks
- Results dependent on measure used
  - More spectacular rise with common equity Tier 1
  - Same w/ only tangible assets

Debt-equity bias

- What impact of taxes on bank leverage?
- Use CEPS EU Bank Monitoring Database
  - 74 top banks, 2006-2010
  - Covers 20 member states
- Method
  - Country-specific 2008/9 statutory rates
  - Assess impact on average leverage (2006-10)
  - Use of statutory rates overcomes endogeneity
  - But no consideration for non-debt tax adjustments

Debt-equity bias





Source: CEPS EU Bank Monitoring Database

- Strong positive relation
  - Leverage greater where statutory rates higher
  - Estimated tax elasticity of 0.96 for debt/assets (excl. deposits)
  - Smaller elasticity (0.04) when deposits are included; ltd expansion?
- Tax policy <u>has</u> macro-prudential implications!

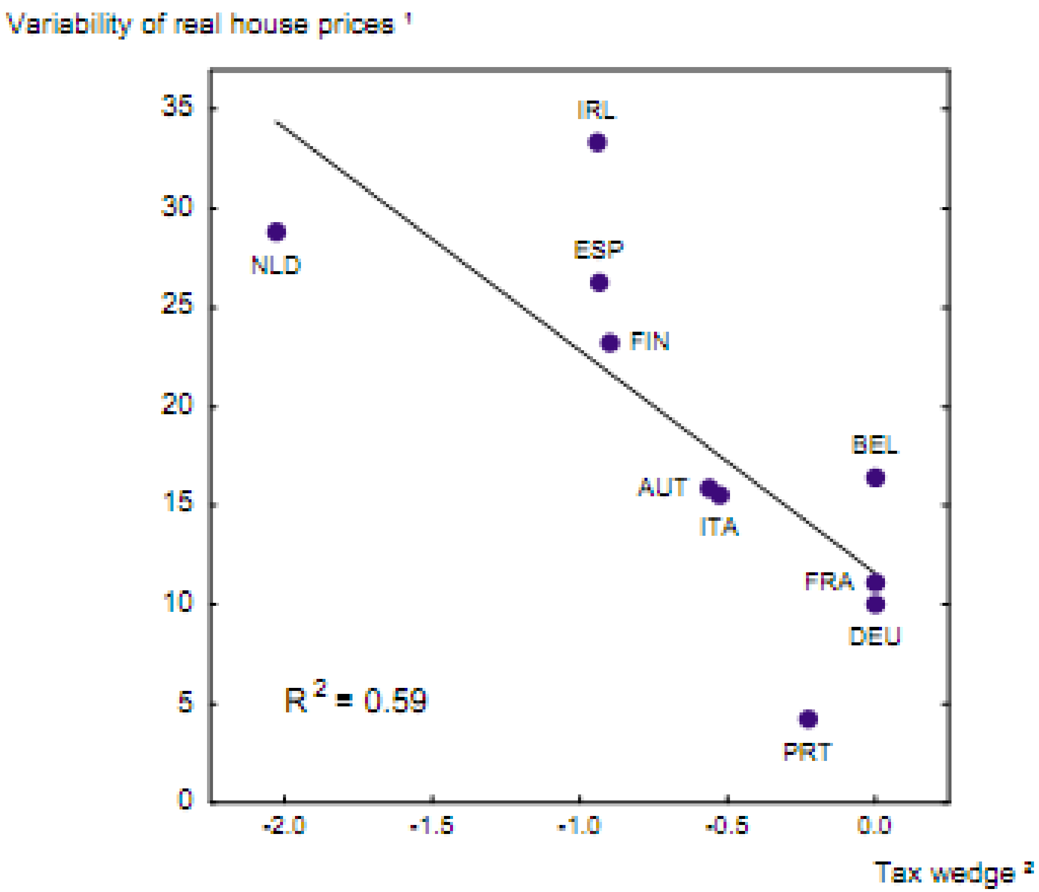
Tax incentives and bubbles

- Pro-housing tax policy
  - Not a principle driver of housing bubble
  - Lower interest rates more to blame
  - Preferential taxes can increase price volatility
- Various permissive policies implicated
  - Mortgage interest tax relief
  - Taxation of imputed rents
  - Capital gains taxation
  - Permissive policy in NL, LX, IE, ES (Hemmelgarn & Nicodeme, 2011; Adams, 2010)

Tax incentives and bubbles

- Several reasons behind incentives
  - Positive externality of home ownership
  - Impact on community
  - Intergenerational wealth
- But, incentives have limited impact
  - Incentives lead to higher home prices
  - May lead to lower ownership (Andrews & Sanchez, 2011)
  - More gains for higher income families
  - Impact on volatility of house prices

Tax incentives and bubbles



Source: Van den Noord (2003)

- Price volatility
  - Tax wedge = pre- minus post-tax interest rates
- Permissive taxes lead to greater price volatility
  - More research needed on more current data

Macro-prudential concerns

- Aim of macro-prudential policy
  - Identify, prevent, and mitigate systemic risks
  - Reduce costs of disruption in financial services
- Externalities that induce systemic risks
  - Systemic costs from failure exceed individual costs
  - Excessive leverage
  - Losses to taxpayers & debt holders
  - Precautionary hoarding of liquidity
  - Too-big-to-fail subsidy & risks

Macro-prudential concerns

- Taxes to account for externality costs
  - Several instruments already proposed
- Liquidity risk charge (Perotti & Suarez, 2009)
  - Short-term debt enabler of credit growth
  - Sudden stop & fire sale risks to other banks
  - Requires bail-outs & CB liquidity
  - Levy charges on short-term debt
  - Other possibilities: Charge on non-core liabilities

Macro-prudential concerns

- Tax “over-borrowing” (Bianchi & Mendoza, 2010)
  - Good times: Increasing collateral prices
  - Over time, collateral constraints bind
  - Leads to fire sales & lower collateral (feedback)
  - Leading to Fisher’s debt-deflation spiral
  - Economy’s borrowing capacity drops severely
  - Tax on debt to weaken magnitude of externality

Macro-prudential concerns

- Taxation vs. “quantity regulation
  - Why use taxes and not capital requirements?
  - Or, liquidity coverage ratio?
  - Taxes allow more flexibility if set correctly
  - No need for re-adjustments through cycle
  - Buffers impose may not bind when liquid assets are cheap, (Perotti & Suarez, 2011)
  - Revenues may be used to contribute to macro-prudential aims or crisis management funds

Tax arbitrage

- Partly behind growth of “shadow banking”
  - Securitization to “leverage up” (Adrian & Shin, 2009)
  - Demand for safe assets (Acharya & Schnabl, 2009)
  - Aim is to set up bankruptcy-remote SPVs/pools
  - Any location (w/ strong legal base) would work
  - Low-tax jurisdictions emerge w/ cost advantages
- Tax arbitrage as a regulatory concern
  - Cooperation with low-tax jurisdictions
  - Information exchange often limited

Conclusions

- Political opportunity
  - Address tax-related factors contributing to crisis
  - DG TAXUD has already done substantial work
  - Need policy initiatives
- Correct tax distortions contributing to crisis
  - Debt-equity bias
  - ACE already implemented in BE; why not across EU?
  - Taxes & bubbles in housing and others (SME loans?)

Conclusions

- Account for externalities
  - Taxes as a macro-prudential tool
- Some degree of harmonization needed
  - Level playing field
  - Enhance (not undermine) integration
- Need policy-oriented scientific research
  - Impact on society; financial institutions
  - Empirical evidence