



Innovative financing at a global level

Jean-Pierre De Laet

***Head of Unit "Economic Analysis, Evaluation and
Impact Assessment Support"
DG Taxation and Customs Union
European Commission***

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Plan of presentation

- Motivation: Why innovative financing?
- Definition and assessment criteria
- Review of selected instruments in relation to the financial sector
- Instruments related to climate change and development
- Conclusions



Why innovative finance?

Political Background

- At its meeting of October 2009, the European Council invited the Commission to examine innovative financing at global level (related to climate and development finance as well as exit strategy)
- In its plenary session of March 2010, the European Parliament adopted a resolution on the taxation of financial transactions
- Increasing international debate on possible sources of finance to support fiscal consolidation, to ensure that financial sector contributes to the cost of past bail-outs and future crisis intervention and to finance provision of global public goods
- Commission Staff Working Document on Innovative Financing at a Global Level and Communication on Bank Levies
- Ongoing G-20 discussions on the basis of the IMF report



Why innovative finance? Challenges

- **Need for budgetary consolidation:**
under no-policy change scenario, debt would rise to above 100% of GDP by 2014 in the EU27
- **Financial stability**
The financial sector should contribute to the costs of financial stability.
Estimated sustainability gap of 6,5% of GDP on average in EU
- **Climate change/ Copenhagen Accord**
Fast-start of USD 30 billion 2010 to 2012 and the goal of USD 100 billion dollars a year by 2020 by developed countries to developing countries (ca. 7.2 billion for EU)
- **Development**
Millennium Development Goals (MDGs), Commitments on scaling up Official Development Assistance (ODA) (ca. 50 billion for EU by 2015)



Despite current focus on “new” taxes, reform options of existing fiscal systems should be high on the agenda, too.

- **Expenditure**
Reduction in non-productive spending tends to have more long-lasting effects if linked to structural reforms
- **Traditional additional tax revenues**
Increases in rates, in tax bases and in efforts to fight tax fraud and tax evasion
- **Review quality of revenue side of the budget**
Reduce existing distortions and improve efficiency. Notably distortion between debt and equity in CIT systems.
- **Innovative sources of financing**



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- **Review of existing tax systems**
Reduce existing distortions and improve efficiency.
- **Innovative sources of financing**
Analysis of economic effects and revenue potential



Innovative financing Issues

- **Definition**
Public finance that is raised in non-traditional ways; does not include mechanisms that are exclusively private finance
- **Importance of implementation at global level**
Fair burden-sharing and global political commitment needed; risks of tax evasion by relocation of economic activities or tax bases depending on the innovative instrument considered



Overview of selected instruments in the financial sector

- 1. Financial transactions tax**
- 2. Pricing of leverage and risk-taking (bank levy)**
- 3. Bonus tax**
- 4. Additional profit tax**
- 5. Financial activities tax (combination of 3 and 4)**



1. Potential to raise revenues:

Serious budgetary challenges to be addressed

2. Effects on efficiency and stability:

Internalisation of external costs and benefits (“double dividend”)

3. Effects on equity and income distribution: Tax Incidence

4. Administrative and legal aspects:

May complicate feasibility



- **Rationale:** increase cost of financial transactions, stabilise financial markets, raise revenue
- **Revenue** estimates of more than €50 billion worldwide and of about €20 billion for Europe (estimate without derivatives and 0.1% tax rate); geographical concentration
- **Efficiency:** uncertain, FTT may increase price volatility; cumulative effect of tax;
tax avoidance: transactions to be relocated and substituted if tax not general and global
- **Incidence:** unclear, likely to be partly borne by customers and economic operators via higher costs of capital and risk hedging



Stocks and Bonds (spot transactions)

- Tax base for a transaction tax is the price of the assets as valued in the transaction
- Example: Investor sells 1,000 stocks of a company for 1,000 Euro each, tax base would be 1,000,000 Euro. A tax rate of 0.1% would lead to a tax payment of 1,000 Euro
- Effective tax rate (tax payment divided by cash-flow) is indeed 0.1%. Similar examples can be made for government or company bonds

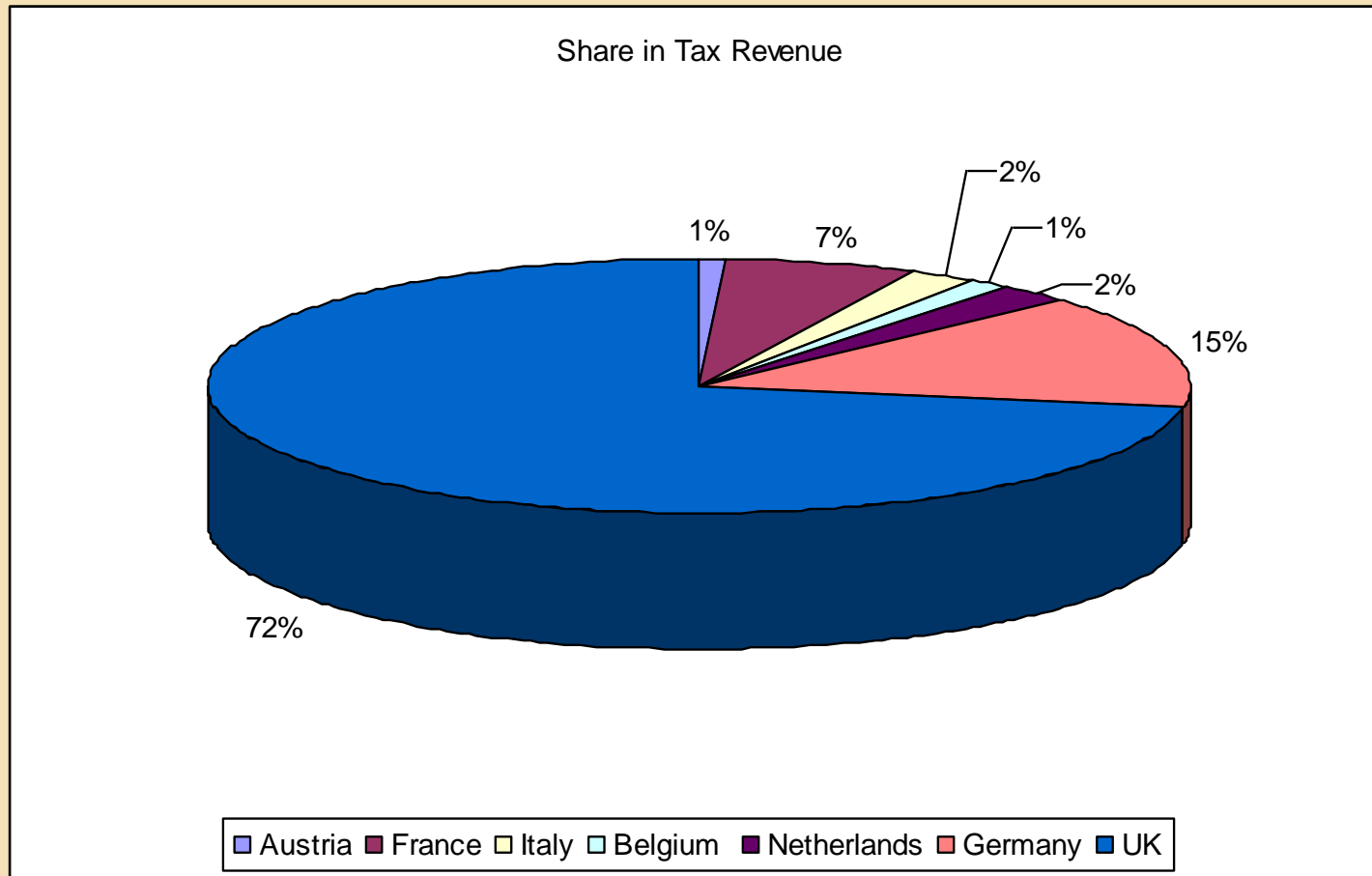


Risk-hedging (use of derivatives)

- EU-based company has to pay a bill of 11m USD in 3 months and fears further decrease of Euro
- Hedge risk that Euro falls below 1.10 USD. Option to buy USD at this price in 3 months. Premium for this is currently ca. 30,000 EUR
- Value of the underlying: 11m USD = 10m EUR), tax rate 0.01%, tax payment 1,000 EUR
- Tax payment (1,000 EUR) to real Cash-flow (30,000 EUR): 3.3% (effective tax rate)
- If company wants to hedge an extreme case (Euro drops below parity), premium is only 5,000 EUR. Tax base (11m USD = 11m EUR), Tax payment 1100 EUR, effective tax rate 22%!
- “Effective Tax Rate” can be very different depending on contract



Hypothetical revenue distribution 2007 for selected EU countries



Source: Wifo (2008)



Pricing of leverage and risk taking – bank levy

- **Rationale:** Levy/ tax on certain balance sheets positions of financial institutions, with the revenues being channelled either into a crisis resolution fund (Commission proposal) or the general govt budget (U.S.); tackle excessive risk-taking
- **Revenue:** Depending on rate and base, e.g. extrapolation of Swedish proposal with 0.036% tax rate: €13 bn
- **Efficiency:** can foster financial stability by slowing the build up of excessive risk positions in balance sheets, esp. if risk-adjusted; risk of tax avoidance: less prone to re-location
- **Incidence:** tax might be partly shifted to clients. (depends on concrete design and level of competition in markets)



Taxation of bonus payments

- **Rationale:** reduce managers' or traders' incentives to take excessive risks (UK, France -> one-off tax)
- **Revenue:** Around €4 billion for EU
- **Efficiency:** in long-run tax might have some positive effect on risk taking; but: possibly some relocation of activities to non-taxing countries or areas and to quasi-financial sector and other tax avoidance effects
- **Incidence:** uncertain; probably some redistribution effects, when born by high-income earners and bank shareholders



Increase in profit taxation

- **Rationale:** Higher rate or surcharge on corporate income tax; idea: taxation of extra profits from implicit state guarantees
- **Revenue:** around €4 billion in EU depending on level and design of surcharge
- **Efficiency:** Partly taxing pure rents; could raise the required pre-tax profit and thereby increase risk taking
- **Incidence:** might be partly rolled to clients, some redistribution effects from impact on bank shareholders



Financial Activities Tax (FAT)

- **Rationale** similar to bonus and profit tax: Tax on profits and remuneration paid to staff
- **Revenue:** Example UK: 2% FAT rate; Revenue: up to 0.2% of GDP (€3.2 bn)
- **Efficiency:** similar to extra-profit tax as it may be designed to fall on pure rents of financial sector; could also reduce size of the sector; tax avoidance: perimeter and relocation issues
- **Incidence:** depends on definition of tax base, if solely pure rents are taxed incentives to shift to consumers is reduced. Otherwise parts of the burden might be shifted to purchasers of financial services



Administrative and legal Aspects

- Tax on leverage and risk-taking as well as a surcharge on the corporate income tax easy to administer
- Concerns about compatibility of FTT with the EU Treaty provisions of free movement of capital and with GATS
- Profit tax: easy to implement since it builds on existing tax systems



Instruments not related to the financial sector

- **Innovative financing related to climate change:**
 - Auctioning emission allowances
 - Carbon taxes
 - Pricing carbon emissions from international maritime and aviation transport
 - Flexible mechanisms under the Kyoto Protocol
- **Innovative financing related to development:**
 - Frontloading public funding through the capital market
 - Leveraging private finance through public incentives



- In the financial sector: Different objectives – different instruments
 - ➔ Financing of resolution of failing banks - Bank Levy
 - ➔ Contributing to crisis cost/ fiscal consolidation – FTT or FAT (or components); Further analysis needed, search for “double dividend”
- Better regulation and supervision remains paramount
- Exit strategies need balanced mix of instruments: Expenditure cuts; Revenue side: not only new sources, review quality of existing tax systems (tax gaps, distortions)
- Global coordination (G-20) essential as isolated action is less effective, risk of tax avoidance



- The Commission Staff Working Document can be found at:
- http://ec.europa.eu/taxation_customs/common/publications/com_reports/taxation/index_en.htm



Thank you!