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Towards a robust financial sector – how should tax and regulation evolve?

Cristina Berechet

The economic and financial crisis has affected the ability of the EU financial sector to channel funds towards the real economy. Heavy dependence on bank intermediation, combined with bank deleveraging and reduced investor confidence, has reduced funding to the economy. Firms in Europe rely on bank funding for approximately 85% of their funding needs, with the remainder coming from capital markets, while in the US the split is 45/55. At same time, the European Commission is trying to offer a clear solution to the problems raised by the banks that are too big to fail, too costly to save and too complex to resolve.

Thus the Commission is trying to calibrate the regulatory framework to ensure that it effectively enables the financial sector to support the real economy without jeopardizing financial stability. For the banking sector it has defined the Liquidity cover Ratio and the Net Stable Funding Ratio; for insurers it is finalizing the acts under Solvency II and it considers ways to revive sustainable securitization markets. The Commission put forward a draft that would limit the potential for banks to expand their balance sheets through proprietary trading and, in certain cases, to separate trading from a bank's deposit taking and commercial lending activities.

Nevertheless, alternative solutions to statutory regulation could be studied. First of all, the centralization of regulation crowds out regulatory mechanisms that arise naturally in the market in the form of financial institutions that exhibit virtues of trustworthiness; have good reputations; have mechanisms of corporate governance and ownership that protect customers; and so on. At the same time, the failures of statutory regulation are almost impossible to correct, given the absence of any real accountability of government bureaus.

There is also need to refine the role of the central bank as the lender of last resort and the government should remove guarantees of depositors' capital and, instead, provide some guarantee of their liquidity.

Although banks will continue to play a vital role in financing SMEs, it is necessary to tap additional sources of funding, in particular to meet the funding needs of small businesses. Crowdfunding, which has become a very viable funding option for many startups and a wide variety of projects, is one such alternative source. In countries like Spain, where access to capital has been frozen after the financial crisis, crowdfunding has grown substantially. Following in the footsteps of countries like the UK, Belgium or Italy, the Spanish government drafted a regulatory proposal for equity-based crowdfunding platforms.

On the taxation front, the Commission has adopted a proposal to implement a Financial Transactions Tax through enhanced cooperation within eleven Member States. The tax would cover all financial instruments including shares, government bonds, derivatives and structured products. The proposed tax rates go from 0.01 % for all financial transactions concerning derivatives agreements, to 0.1 % for all financial transactions other than those concerning derivatives agreements.

The Commission's aim is to harmonize existing legislation, limit undesirable market behaviour and thereby stabilize markets and ensure that financial institutions make a fair and substantial contribution to cover the costs of the recent crisis. On one hand, the impact assessment suggests that if the revenues were used for debt reduction, tax cuts or productive public investment the net impact of the tax on GDP would be neutral or even positive. On the other hand, the Commission estimates that the annual revenues raised by the FTT will be around €31 billion for the EU11.

Enhanced cooperation was described by the Commission itself as the third-best solution, as there will be a great risk of reallocating activities outside EU11 or EU27. Furthermore, the proposed tax would more than double current taxes on capital. According to the Commission's own assessment long-run GDP may fall by 0.28% due to the capital tax raise, which is likely to generate a fall in overall tax revenues. Additionally, the loss in output in the financial services industry will have a knock–on effect throughout Europe's economy, inflicting a loss of as much as 614,000 jobs. And finally, evidence suggests that there is a positive relationship between transaction costs and volatility; suggesting that a transactions tax will increase not decrease volatility. In sum, the costs of implementing this policy will reduce economic growth, investment and job creation while doing little to improve financial stability.

Cristina Berechet is Head of Research at Civismo.

Further reading:

Pomés, Julio. "The policy recipes which will not save Europe." *Expectativas* journal, 17 (2014). On the banking union and financial transactions taxes. http://www.civismo.org/files/informes/revista-expectativas/17-Expectativas/2014EXPECTATIVAS17_5-Las-recetas-no-salvaran-Europa.pdf

"My name is Bond… Eurobond." Civismo Analysis, *Expectativas* journal, 10 (2012). http://www.civismo.org/files/revista/N10_5-My%20name%20is%20Bond...%20%20Eurobond.pdf

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