EFB Response
to the Green Paper on the Long-Term Financing of the European Economy

FB has answered the questions that it deems core to the interests of family companies across the European Union, and where its expertise can contribute to the debate about how to foster the supplyof long-term financing.

Question 1:

Do you agree with the analysis out above regarding the supply and characteristics of long-term financing?

EFB agrees with the underlying analysis regarding the supply and characteristics of long-term financing. But, EFB sees that, for the real economy, more focus and recognition is needed on equity as the logical source of long-term financing.

Equity finance is key to strong and sustainable business growth. For most companies it is the most important form of finance. It comes in two main forms, paid-in capital and retained earnings. For external stakeholders, a sound equity base in a company is an indication of a long term commitment to the company by its owners. For financial institutions, a strong equity to assets ratio makes lending reasonably unproblematic even under Basel III and Solvency II. A weak equity position raises concerns among external stakeholders, not least among banks. Without equity, there is no other finance.

Banks that offer debt finance typically require of their customers at least some amount of equity for every unit of debt provided. The stronger the equity base of a company, the better its ability to raise loans. Conversely, the weaker the equity position of a company, the less it is able to raise loans and the less it is able to invest in growth and job creation.

Finally, while the paper refers to household savings as the main source of funds to finance investments, the paper does not recognise households as Investors. EFB believes that there is lack of recognition that households are an important driver of the economy, actors/subjects who can make a huge difference as entrepreneurs or as co-financers of entrepreneurial activity. The amount of passive household savings in the EU area is substantial. Therefore, it is of the essence that households are encouraged, i.a. by means of promoting a lucrative taxation of equity, to invest their savings in businesses.

Question 3:

Given the evolving nature of the banking sector, going forward, what role do you see for banks in the channelling of financing to long-term investments?

As the Green Paper rightly underlines, the role of the banking sector will undoubtedly change. EFB fully supports the Commission's efforts in creating a legislative framework where the banking sector is not allowed to return to the excesses of the past. But, family businesses across Europe are in favour of a banking sector whose primary focus is on serving the needs of the real economy, and therefore, it must continue to be a major player in the provision of long-term financing. With the introduction of BASEL III and CRD IV, there is a danger of creating rigid banking structures which limits risk-taking and, therefore, undermine entrepreneurial spirit. The EU and its Member States must be flexible and ensure that the banking sector is encouraged to take back its primary function of serving the real economy rather than financial speculation.

The areas in which banks can increase value for the customers in the future, are risk assessment, credit monitoring, and therefore prudent lending. Competition among lending institutions is the means to ensure a swift transition to a new banking model and effective channelling of financing to long-term investments. A move towards higher integration of banking activities at a European level would therefore be desirable.

Question 5:

Are there other public policy tools and frameworks that can support the financing of long-term investment?

The Green paper aptly notes that, in certain instances, the banking sector has tended to focus on short-term profit generation at the expense of the real economy. Quantitative easing in Europe has not had the desired effect. Central Banks have been loading banks with reserve, but the credit has not been provided to the private sector (in particular SMEs). This is often due to the relatively little influence a central bank has on direct the money to where it is needed. Stock markets might have recovered but this is no way reflect the real economy. The outcome is that it might be many years before lending to the real economy stabilises, and as mentioned above, the role of the banking sector will undoubtedly change.

EFB fully supports the redevelopment of national, multilateral banks, or investment schemes to fill the gap when the private banking system does not meet demand, with a particular focus on financing the real economy. In addition, EFB supports the creation of government and privately backed funds that invest and provide equity

financing to SMEs, which are denied access to stock or bond markets.[1] For example, the UK Enterprise Investment Scheme, has proven to be quite successful. Other similar schemes should be promoted across the EU. EFB believes that the Commission must establish methods of dialogue to promote these types of schemes.

Finally, EFB would like to note that, too often, ground level business owners do not know that other forms of finance exist, and rarely look outside of the conventional commercial banks. Funding opportunities provided by the European Budget to the real economy must be expanded and better communicated to the target recipient.

Question 6:

To what extent and how can institutional investors play a greater role in the changing landscape of long-term financing?

Institutional investors are key to the provision of long-term financing. Their liabilities are also long-term and allow them to hold stable investment positions. Nevertheless, their exposure to nascent businesses is very low in some countries. EU legislation should be aligned in this regard and require that a low level of managed funds (1%) be invested in venture capital funds. Finally, in general terms, there must be a better dialogue between each 'side' with the aim of a closer alignment.

Question 11:

How could capital market financing of long-term investment be improved in Europe?

Capital market financing for long-term investment could be improved by tax incentives for investors in new projects in the EU, similar to the ones in the UK (e.g. but no only, Business Angels).

The provision of the long term equity is unpredictable and fragmented, and few arrangement exist for the provision via market mechanisms for small businesses to access long term capital. The Alternative Investment Market in the UK does provide access for SME and private companies a vehicle that could be used across the EU, since it enjoys tax incentive an open market regulation.

(1) Background information: The Norwegian oil fund is a huge governmental fund that does not operate specifically on this basis but resembles it a bit (although investing in several other asset classes than private equity as well). Finland is about to introduce such a fund, and a fund concentrating on providing loan financing has been operating since 2008.

Question 16:

What type of CIT reforms could improve investment conditions by removing distortions between debt and equity?

In the wake of the European debt crisis it is of paramount importance to strengthen the equity base of European companies. Equity is a prerequisite for all other finance. The need for equity finance will increase further as Basel III becomes the norm and forces banks to demand higher equity ratios from their customers than before.

Many National, European, and global institutions have recently performed studies on the impact of tax codes and their role in financing decisions. These have shown that most tax codes contain a bias to the advantage of debt finance and to the disadvantage of equity. Put simply, income from equity finance is taxed more heavily than income from debt finance in most Member States of the European Union. A recent Commission Working Paper[2] Taxation Paper, has highlighted that 'the welfare impact of this bias (debt bias) is relatively large as capital is misallocated by tax arbitrage (both between jurisdictions and types of financing) and risks are exacerbated by increased leverage and probability of default.'

For family businesses, it is important to consider, the different levels of taxation which are incurred at the business level but also crucially the owner/household level. Therefore, when trying to mitigate the adverse effects of the debt bias, one must look at the Total Efficient Tax Rate (TETR)[3]. When households/private persons consider, whether to invest their funds in the equity of businesses generating growth and employment or in instruments of a more passive nature such as bonds or bank deposits, they consider the total tax burden facing the profit from their investment. As equity is inferior to debt in this comparison, it diverts the flow of capital away from businesses.

The remedy to correcting the debt bias in taxation, would be to implement a tax system that does not favour debt and other forms of investment over equity but creates a level playing field for all forms of savings and all types of owners. This would, firstly, encourage the flow of private and household savings to businesses and, secondly, encourage businesses to re-invest their retained earnings in the business. This would contribute to economic growth and employment in Europe.

There are several different ways in which this aim can be achieved, helping businesses to strengthen their equity capital and reducing the current tax discrimination that favours debt over equity. European Family Businesses supports the system called Allowance for Corporate Equity or ACE.

(2) Taxation Paper No 33 (2012): The Debt-Equity Tax Bias: consequences and solutions. Written by Serena Fatica, Thomas Hemmelgarn and Gaëtan Nicodème

(3) TETR = Tax on corporate profits payable by the corporation + tax on dividend payable by the recipient of the dividend distributed from the corporate profits

The ACE system works such that the taxable income of a company is the Net Result less the cost of equity. The cost of equity is calculated as per a notional interest rate defined in the tax code. The result at company level is that a company's tax position does not automatically deteriorate when it uses equity finance rather than debt finance. At owner level the result is that the total efficient tax rate on dividend distribution is the same as on interest payments. This would reduce the cost of equity finance, lead to stronger capitalization of businesses with equity in the real economy and hence provide more capacity for long term investments and job creation. At the same time it would help to balance the structure of household savings by adding a stronger element of equity ownership as a complement to bank deposits, bonds and property.

Due to the continuing crisis in Europe, there is need for the European Union and its Member States to start encouraging the design of growth friendly tax policies. It is encouraging that numerous institutions have identified one of the root causes of the crisis and also seem reasonably unified in their recommendations on how to remove the problem.

The discrimination of equity in most of Europe's tax codes has affected the economic decisions of millions of family business owners who would ideally prefer to invest and re-invest equity in their companies for the long term. Indeed, tax codes that favour leverage and treat equity less favourably than debt have caused European businesses to be much more vulnerable to economic downturns than they would be if there was a level playing field for equity finance.

European Family Businesses believes that the introduction of tax codes that use the concept of an Allowance for Corporate Equity (ACE) would be an ideal way of delivering some much needed private investment in Europe. A system that puts equity on the same level as debt in terms of taxation bears strong potential to bring about increased growth, private investment, and employment.

Finally, EFB believes that the Commission must take up the ambitious task of a full reassessment of tax codes across the EU 27. It is more than possible that the various codes, schemes etc. have grown up over time and may now be so complex that they result in perverse outcomes and disincentives. As a result of such a reassessment, the Commission would have a comprehensive list of best tax practices that it could publish and thereby support the development of tax systems in the EU to better promote growth and employment.

EFB stands ready to help the European Commission with this endeavour.

Question 18:

Which types of corporate tax incentives are beneficial? What measures could be used to deal with the risks of arbitrage when exemptions/incentives are granted for specific activities?

The above-mentioned ACE model including a deduction for equity would favour equity in general, not any specific type of business or assets. Therefore, it would not create such distortions between different kinds of businesses that most narrow tax incentives do.

For example lowered tax rates for immaterial rights (e.g. Patent Box) could be an effective manner to encourage R&D activity and to foster innovation. To foster employment, tax incentives could be made dependent on the salaries of the personnel engaged in R&D activities. A similar tax incentive has been introduced in e.g. Finland.

Question 19:

Would deeper tax coordination in the EU support the financing of long-term investment?

EFB supports a general strategy of best practice alignment between Member States, as deeper tax coordination, per se, would not automatically support financing of long term investments. However, for international companies operating throughout the EU, it would definitively be an advantage if tax rulings could be agreed upon when several jurisdictions are involved, coordinated by the respective home EU jurisdiction.

Question 24:

To what extent can increased integration of financial and non-financial information help provide a clearer overview of a company's long-term performances, and contribute to better investment decision-making?

Non-financial reporting requirements need to balance the possible gains from information efficiency with the administrative costs and the strategic vulnerabilities arising from an asymmetric information framework (e.g. EU companies not having access to the same information for other companies listed in foreign markets)

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Question 29:

What further steps could be envisaged, in terms of EU regulation or other reforms, to facilitate SME access to alternative sources of finance?

EFB fully recognises the benefits of alternative systems of finance for SMEs, but these systems must be supported from infrastructural point of view. Meaning, simplified rules of procedure, and fiscal incentives for participation.

Question 30:

In addition to the analysis and potential measures set out in this Green Paper, what else could contribute to the long-term financing of the European economy?

Other public policy tools to support the financing of long term investment include:

1) Setting up credit rating services (e.g. at national central bank level) to value debt issued by SMEs, which can be used in the ECBS open market operations. However, care is needed over reporting requirements and the size of any associated regulatory burden placed.

2) Adopting standards for non-financial corporate debt securitization in order to increase transparency and reduce complexity.