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PRESS RELEASE

Macroeconomic and fiscal impact of the risk capital allowance

(Article published in the Economic Review, September 2008)

The Economic Review contains the study which has been published by the Bank on his website on July 23 and which was produced in response to the federal government's request for an assessment of the macroeconomic and fiscal impact of the risk capital allowance. More particularly, it aimed to assess the extent to which the objectives of the law of 22 June 2005 introducing a tax allowance for risk capital have been achieved.

This press release renders, for reference, the contents of the executive summary which accompanied the said study on its circulation. This study could not have been finalised without the assistance of the tax authority of the FPS Finance, as it was essential to obtain a number of detailed, unpublished data on corporation tax for the 2007 tax year. These data were made available to the Bank on 9 July 2008.

It should be noted that the risk capital measure is relatively recent and that an economic assessment of its impact is not always easy in these circumstances, particularly as regards the measure's dynamic effects or its impact at the most disaggregated level. It was therefore necessary to make a number of assumptions. Although this exercise aimed at maximum accuracy, there are still some areas where the estimates are only approximate. It was therefore decided to assess a range within which the net fiscal impact of the measure for the 2007 tax year is likely to fall. It was also necessary to confine the sectoral approach to an estimation of the gross fiscal impact of the risk capital allowance, as the data are still too fragmentary to attempt any disaggregated quantification of its secondary effects on employment, investment or the public finances.

The introduction of the risk capital allowance led to a structural change in the financial behaviour of companies, as it was very much in their interests to adapt their financial structure to take full advantage of the tax concession. It could therefore be to their advantage to establish a subsidiary or to operate via finance companies.

One aim of the tax reform was to strengthen the solvency of companies established in Belgium. In that regard, a very marked increase in shareholders' equity and authorised capital was recorded in 2006 and 2007. This increase was due to capital contributions of both Belgian and foreign origin.

Nonetheless, the real impact on corporate solvency must be qualified, as the very strong rise in equity capital is due largely to investments by Belgian companies in the shares of other companies, in most cases for tax reasons. However, such transactions did not bring any improvement in the solvency of Belgian companies, if viewed on a consolidated basis.

On the other hand, the inflow of foreign capital, notably via the replacement of current borrowings with shares in company capital and the formation of finance companies, did in fact strengthen the solvency of companies established in Belgium. That is also true of capital increases financed by households. In 2006 and 2007 there was a sharp rise in both the expansion of shareholders' equity resulting from inflows of foreign capital and that financed by households. This shows that the solvency of companies in Belgium increased following the introduction of the risk capital allowance. The relatively slower growth of debt financing, primarily in SMEs, during the 2006-2007 economic boom seems to indicate that firms are making less use of this source of funding and more use of equity capital, so that the solvency of that type of firms has improved.

The risk capital allowance was also designed to make Belgium more attractive from the tax angle, and to offer an alternative to the coordination centres, which are destined to lose their special tax status shortly. The way in which the risk capital allowance is applied makes Belgium an attractive location for multinational groups to set up their financial centres there. The introduction of the risk capital allowance seems to have procured a trend reversal, limiting the outflow of capital from the coordination centres which have lost their

Communication
National Bank of Belgium Ltd.
boulevard de Berlaimont 14
1000 Brussels
phone + 32 2 221 46 28
www.nbb.be
Company's number:
0203.201.340 – RLP Brussels

approval. However, it should be pointed out that this is still a very provisional finding, since some of the largest coordination centres only lost their approval very recently and others still have an approval. On the basis of the tax returns for the 2006 and 2007 tax years, it seems that a number of the coordination centres whose approval had not yet expired nevertheless opted to apply the risk capital allowance. At the same time, there has been a marked rise in the number of other finance companies of Belgian or foreign origin, particularly the finance centres of international groups.

The introduction of the risk capital allowance has undeniably had a considerable impact in terms of financial flows. Conversely, the impact on the real economy, measured via a simulation based on the Bank's econometric model, seems to be fairly limited in the short term, but it may become a little more noticeable in the medium term. On the assumption that the tax reform will be neutral for the government budget, companies' gross investments in fixed assets can be expected to increase by around 400 million euro over a five-year period, while the positive effect on employment will be around 3,000 jobs. In the case of the coordination centres, there are signs that employment has contracted, but there has been a partial shift towards other companies within the group. Nonetheless, the fall in employment would in any case have been larger without the introduction of the risk capital allowance. Moreover, some jobs are being created, albeit on a limited scale, in the new finance centres being set up by multinational groups.

Finally, the study assessed the impact on the budget of the risk capital allowance and the other measures laid down by the law of 22 June 2005. In order to conduct this assessment, it is necessary to distinguish between the gross tax advantage represented by the risk capital allowance for Belgian companies and the net impact of that measure on public revenues.

The gross tax advantage for companies increased considerably owing to the marked rise in equity capital. The gross cost of the reform was already around 2.4 billion euro in 2006, on the basis of the tax returns. However, the net impact on the budget is much smaller. It is limited by the proceeds of the compensatory measures, the main one being the amendment of the definition of tax-exempt capital gains. Furthermore, the inflow of foreign capital does in principle not mean any reduction in corporation tax revenues for the Belgian government, but quite the contrary. Nor is that the case in regard to the application of the risk capital allowance by the companies which have taken over the activities of the coordination centres. On the basis of data which are still provisional and taking into account wide uncertainty margins, the net cost to public finances in 2006 of the measures introduced by the law of 22 June 2005 is estimated at between 140 and 430 million euro.

Macroeconomic analysis also shows that the measures introduced by the law of 22 June 2005 have so far had at most only a limited negative effect on corporation tax revenues. Both the movement in these tax revenues and the absence of any decline in the implicit rates indicate that there has so far been no significant negative effect on public revenues.

However, the conclusions of the analysis of the risk capital allowance's impact on public finances must be considered provisional, since the measure's dynamic effects are not yet fully apparent.

In that regard, it is reasonable to expect future years to bring a further increase in the gross tax advantage which Belgian companies enjoy. Some of the factors behind that increase are unlikely to depress public finances, and could even prove positive if they lead to an expansion of the corporation tax base in Belgium, particularly as a result of the process of allocating profits between the various companies in the same international group. The positive influence of the macroeconomic payback effects on public revenues could also increase slightly.

Conversely, various other factors could depress corporation tax revenues. These include the increase in the rate used to calculate the risk capital allowance, the use of the previously unused part of the risk capital allowance, and the changes made to the structure of companies or groups of companies in the context of tax optimisation techniques. Some of these factors could have a considerable impact. It is therefore possible that the public revenues generated by corporation tax could suffer a substantial adverse effect in the future.

It is not yet possible to estimate accurately the effect that the risk capital allowance will have on public finances in the future. It will depend, in particular, on what happens regarding the various factors mentioned above, the economic context and the latter's influence on the operating surplus of companies, and the movement in interest rates. In this regard it should be noted that the cost to the budget may increase, particularly in a situation where the operating surplus of companies declines significantly and interest rates rise. Finally, the impact of the tax reform will depend on the degree to which companies resort to tax optimisation techniques and the application of the relevant rules.