

Summing up for the opening of final plenary session, on “looking forward” (session 15)

**Mr. Carlo Cottarelli, Director, Fiscal Affairs Department
International Monetary Fund (IMF)**

It is for me a pleasure and an honor to chair this concluding panel. We have five distinguished panelists:

- Allen Kagina (Commissioner General, Revenue Authority, Uganda)
- Dave Hartnett (Permanent Secretary for Tax, from the UK)
- Jeffrey Owens (Director, Center for Tax Policy and Administration, OECD)
- Lyse Ricard (Deputy Commissioner, of the Canada Revenue Agency)
- Ashraf Al Arabi (Deputy Minister for Tax Policy and Commissioner, Egypt)

Our sessions over the last two days have examined several key issues relating to the role of taxation in the financial sector.

What are its objectives?

What are the features of a financial taxation system that aims at neutrality?

To what extent is it appropriate to deviate from neutrality?

How can the tax system support a vibrant financial sector?

What are the challenges in collecting revenues from the financial sector?

What are the implications of Islamic finance?

We have examined these questions in many respects: technical design, administrative constraints, the current financial and economic context, the various types of financial institutions, the various financial instruments, and also from the perspective of both developed and, importantly, developing countries.

So, if these are the questions, what have we learned? Of course, we cannot expect conclusions that are valid for all countries in all circumstances. Nevertheless, I believe some points of consensus have emerged.

I think there was first of all broad consensus on the objectives, the *vital* objectives that the taxation of the financial system has to achieve. One is, of course, to ensure that the sector provides a fair and proper contribution to government revenues. But an equally important objective is to have in place a tax system that supports, rather than hinders, strong performance of the sector. The evidence tells us that this is critically important for long-term economic growth and development, through efficient channeling of capital to its best uses, and effective management of risk.

Second, I think we can all agree that the tax system, and particularly in relation to capital income, is full of well-known *asymmetries* which mean that, often, the principle of tax neutrality is not achieved. As you all know, a "neutral" tax system is one that leaves private decisions as they would be in the absence of taxation. Well, when it comes to financial taxation, we observe in practice key deviations from neutrality:

- First, in the tax treatment of *debt and equity*. This is important in the financial sector itself--remembering the discussion of the taxation of banks, the regulation of Tier 1 capital, and the prescription of loss provisions--but also in respect of incentives for investors in non-financial corporations. As we heard, there may be lessons to be drawn from the Australian TOFA experience in the area of debt and equity.

- A second critical deviation from neutrality arises from the requirement of *realization* before tax is imposed in some cases--capital gains, versus "ordinary" dividend or interest income, being the most important one, although we've also seen that even this standard is not uniform--with financial institutions increasingly being subjected to current—"mark-to-market"—taxation on their trading gains.
- Third, there are the deviations from neutrality arising from the application of different *tax rates*, including in the case of investors, an important portion of which are tax-exempt, as well as of types of income. These may be particularly stark where the differences are between a derivative and its reference asset.

There are other imperfections arising also from *non-linearities*, such as imperfect loss carryforward and carrybackward provisions; from our inability to correct well for *inflation*; and, not least, from the possibilities for *tax arbitrage* across jurisdictions. Many participants have raised the current challenges posed by recent financial sector losses, and the possible value of a framework of principles for addressing tax arbitrage between the financial systems of different countries.

Much of our discussion has focused on the nature and implications of these non-neutralities. The good news is that we understand quite a lot about them, and how, in principle, they could be addressed. The bad news is that, in practice, eliminating these asymmetries has proved to be difficult. This may reflect policy inertia. It may also mean that we, on the technical side, need to work more in strengthening our efforts to be more convincing and understand better the nature of the difficulties preventing reform, including

possible reasons to deviate from tax neutrality. In this respect, the crisis may act as a catalyst for taking steps to reduce distortions, including through increased international dialogue on both policy and tax administration.

This brings me to my third conclusion, which relates to the relevance of the concept of *neutrality* itself as a benchmark for assessing tax policies for the financial sector. I think it is fair to say that neutrality can only be a benchmark—not an absolute criterion from which any deviation is a mortal sin—but yet, it is a *very important* benchmark. By this I mean that there could in some cases good reasons to suppose that deviations from neutrality are justified, including the fact that financial markets do not in fact work perfectly. Whatever their merits, this is the motivation of recent proposals to introduce financial transactions taxes. Indeed recent events have made clear that there are powerful externalities at work in the sector: for instance, the distress of one financial institution can prompt distress in others, with powerful effects on the real economy and, not least, tax revenue. When private decisions can have these large social consequences, there may be a case—and I stress the “may”—for an intentional distortion introduced through the tax system to offset existing distortions or externalities.

But introducing tax distortions to deviate from neutrality is like a box that needs to be “handled with care”. In particular, one would have to ask whether the tax system is the most effective instrument to use in correcting these externalities, or whether some form of regulation would be better. In any event, care must be taken to ensure that interventions do not ultimately make matters worse—and as we've heard from the distinguished experts

assembled here, there is ample room for greater collective understanding of these problems, both in terms of the operation of the financial system itself, and of the effects of taxation upon it.

A fourth and final conclusion emerging from the conference is the difficulties of administration, and potentially of compliance too, of even the best system for financial sector taxation--this is the "elephant in the room," the shadow cast over the best theoretical solutions. One of the plenary sessions was appropriately devoted to this issue, but the questions arose, too, in most of the parallel sessions addressed to specific topics or institutions. Even the most sophisticated revenue administrations have problems in dealing with the financial sector, and the problems become even more acute for developing countries which may not yet have the capacity to hire and train the specialists needed to effectively administer such complex issues.

Luckily, steps are being taken, in some cases on an international basis, to improve the implementation of appropriate tax policies for the financial sector. The most prominent example is of course the work on transparency and international exchange of information, begun by the OECD but now being carried forward on a much broader basis through the expanded and strengthened Global Forum on Tax Transparency, under the auspices of the G-20. There is now a renewed determination in many countries to maximize the benefit of increased information flows through well designed voluntary compliance strategies.

But of course, in the arena of administration, the financial sector is not merely a problem, it also forms a substantial part of the solution to tax enforcement, through information reporting, withholding, and receiving taxpayer payments. And this is even more important, often, in developing countries than in industrial ones. All countries will benefit hugely from building capacity to keep abreast of financial sector developments and learning from the expertise of others.