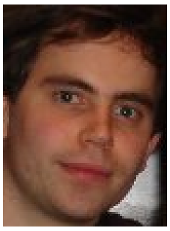
If it is to survive, the eurozone can no longer hold private creditors as sacrosanct above taxpayers, and must crack down on the fiscal black hole of the EU's tax havens.

by Blog Admin



Who benefits from the EU's bailouts of crisis stricken countries? **William Oman** *writes that international bondholders – the richest five per cent of people – are the true beneficiaries of bailouts, which amount to fiscal transfers from taxpayers to private creditors. He argues that the Greek precedent suggests orderly sovereign debt restructurings are possible, and that key steps towards solving the eurozone crisis should include imposing losses onto bondholders and cracking down on the EU's tax havens through policy coordination at the EU level.*

What does the ECB bond purchase programme announced by Mario Draghi in September have to do with French billionaire Bernard Arnault's application for Belgian citizenship only a few days later? Both reflect a Gordian knot at the heart of the European Union that makes relatively straightforward solutions to the crisis elusive. This Gordian knot is, in turn, the consequence of two forces at the heart of the EU's functioning – or rather, its epic dysfunctions: a creditor protection dogma and a fiscal black hole. In a word, private creditors and investors are systematically being put before taxpayers, with disastrous long-run economic, social and political consequences.

Repudiating the creditor protection dogma would allow distressed eurozone countries to solve the problem of unsustainable public debt burdens (a stock problem), while tackling the fiscal black hole would help reduce fiscal deficits (a flow problem). Given the powerful vested interests at stake, however, the prospects of policymakers identifying and grappling with these forces are depressingly dim.

The creditor protection dogma has distorted the way we think about crisis exit options

One of the most striking and least well recognised facts about the crisis is that those who have ultimately benefited from public EU bailout funds are not the governments or citizens of periphery countries but international bondholders. The degree of financial concentration in the world today is unprecedented; bondholders belong to the richest five per cent of people in the world. Yet public bailout money has been used first and foremost to ensure that bondholders are paid in full or with minimal losses. This amounts to a fiscal transfer from taxpayers to private creditors. The cost for the rest of society is enormous: austerity measures in distressed countries have caused unemployment to surge and decades of welfare achievements to be scrapped.

Mario Draghi, Credit: European Parliament (Creative Commons BY-NC-ND)

The conventional wisdom that bondholders must not bear losses is a key reason why the crisis has escalated so dramatically. Fear of a systemic banking crisis has ensured that European leaders have consistently ruled out sovereign restructurings as a way to deal with unsustainable debt burdens. So far, despite large and rising debt burdens across most of the eurozone, the only sovereign default that has occurred is the timid Greek restructuring. In fact, one of the aims of the ECB's bond purchase programme is to make sovereign restructurings as unlikely as possible. (The plan entails potentially "unlimited" sovereign bond purchases by the ECB in exchange for policy conditionality.) Precisely for this reason, the plan is mostly seen (outside of Germany) as a step in the right direction.

But is this really the correct way of thinking about crisis exit options? There are good reasons to think not. If we accept the principle that many eurozone countries have real solvency issues that mean that they will eventually have to restructure their sovereign debt, the question of who is to bear these losses becomes crucial. Though the notion that even orderly default would cause a systemic banking crisis is widely accepted, it is highly debatable. As Harald Hau and Ulrich Hege note: "The Greek example has shown how sovereign debt can be restructured without the market upheaval and contagion predicted by many". There are two broader issues with the ECB's programme. First, because the ECB will remain de facto senior to other bondholders, this will inevitably add a premium to the yields of the bond it purchases for fear of default. Hau and Hege point out that: "Ironically, rather than reducing the risk of sovereign default, the ECB's bond buying will eventually produce the opposite effect. The larger the scale of sovereign debt transfers from domestic investors to the ECB, the less will there be domestic resistance against default. ECB policy might delay sovereign default, but does not make it less likely."

Second, not only is the sacrosanct treatment of private creditors socially unfair and economically inefficient (as Willem Buiter noted back in 2008), it threatens the EU's democratic legitimacy and credibility. Putting the taxpayers of solvent countries on the hook for the debt of insolvent ones and forcing countries to submit to policy conditionality in exchange for bond purchases are not politically tenable propositions.

What is the alternative to transferring losses to eurozone taxpayers? Impose losses on bank shareholders and bondholders by allowing orderly sovereign restructurings to take place sooner rather than later, and forcibly recapitalise banks, notably by using the new European Stability Mechanism. To be sure, bank and investor lobbies will fight tooth and nail against this solution. Yet what is at stake is nothing less than the eurozone's survival. Either private creditors are made whole, or the eurozone survives. Europe must choose. Even if early sovereign debt restructurings do take place, they would only address part of the problem (the stock) and leave the flow problem unaddressed. On this front, the binding constraint is the fiscal black hole.

Bernard Arnault and Europe's fiscal black hole

The fiscal black hole guarantees the continued prosperity of tax havens at the heart of the EU – from Luxembourg and Belgium to Austria, Ireland and the UK. These deprive EU countries of vital tax revenue and create destructive competition among them. David Cameron's promise to "roll out the red carpet" for French tax exiles is a case in point.

Arnault's (France's – and Europe's – richest man) application for Belgian citizenship last week (Belgium has a bank secrecy policy and very low inheritance taxes) is a shocking illustration of the ease with which the wealthiest people in Europe evade national fiscal authorities – without even having to leave the EU. Individuals who have benefited the most from European integration are using the extensive means at their disposal to shirk their social and moral responsibilities in the midst of an historic fiscal crisis. Tax havens are helping exiles evade taxes, and the EU is helping tax havens evade scrutiny.

This fiscal black hole creates a tilted playing field and prevents EU countries from coordinating on corporate and other tax rates. With countries scrambling to cut their deficits, and enormous wealth (which mostly belongs to high net worth Eurozone citizens) sitting – hidden – at the very heart of the EU, an EU-level crackdown on tax havens would be a powerful tool to raise substantial tax revenues without significantly hurting economic growth. These new tax revenues would significantly reduce the need for growth-killing and self-defeating fiscal austerity, which affects the average citizen far more than the well off, creating social unrest and feeding political disenchantment and the rise of populist, anti-EU parties.

How big is this fiscal black hole? By all accounts, it is gigantic. According to an edifying 2012 study by Gabriel Zucman, "The Missing Wealth of Nations", around 8 per cent of global household wealth is held in tax havens. As of the end of 2008, this amounted to about $6 trillion. A 2012 study by the Tax Justice Network puts this number at $21 trillion by the end of 2010. According to the study, this offshore fortune belongs to fewer than 10 million people, and almost half of it belongs to fewer than 100,000 people. After taking unrecorded offshore wealth into account, it appears that Europe as a whole is a net creditor – which makes sense given that it is a rich, old, ageing region with a relatively high savings rate. If these hidden sources of wealth can be tapped, the fiscal equation changes dramatically.

National and EU policymakers' lack of will and coordination in cracking down on offshore centres has for decades allowed – and encouraged – extremely wealthy individuals to break the law. If politicians and regulators decided to put serious pressure on offshore centres to end bank secrecy in a coordinated way, the secrecy would likely end, the amounts being hidden would be revealed, thereby making it possible to raise large amounts of new tax revenue. Wealthy individuals would no doubt find other schemes to hide their wealth, but it would become much harder for them to do so.

The importance of cutting the Gordian knot

The challenges faced by the EU are Herculean. The sums involved are huge and rising. They range in the hundreds of billions, if not trillions, of euros. Yet straightforward options do exist. A new perspective – a gestalt shift – would bring new options to the table. Eventually, something is going to have to give. Although anathema to policymakers (and even more so to private creditors), it is hard to envisage a solution that does not involve orderly sovereign debt restructuring. Clearly, the public debt dynamics of several large eurozone countries are not sustainable. Passing on the buck of these restructurings to eurozone taxpayers is not only unfair and inefficient, it risks jeopardising the entire euro project by weakening its democratic legitimacy. If European citizens feel that they are being cheated repeatedly and losing their ability to influence decisions that affect them in a big way, notably through politics and the democratic process, their support for Europe will wane.

Schopenhauer wrote that: "All truth passes through three stages. First, it is ridiculed. Second, it is violently opposed. Third, it is accepted as being self-evident." The need for early and orderly sovereign debt default – with losses imposed on private creditors rather than taxpayers – is one such idea. The need to finally crack down on tax havens at the European level is another. Either or both of these ideas may have reached the point of transition between the first and second of Schopenhauer's stages. Let us hope they reach the third stage before it is too late. Then again, as John Galbraith quipped: "The enemy of the conventional wisdom is not ideas but the march of events."

This post first appeared here. Global Policy is an innovative and interdisciplinary journal bringing together world class academics and leading practitioners to analyse both public and private solutions to global problems and issues. Alongside the print journal, Global Policy's website features a range of e-content including videos, blogs and regular columns by experts in their fields.

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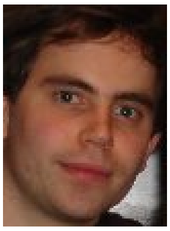

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