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EUROPE

European Investment Bank Leaders Prefer Lending to Their Own Region

Senior managers' personal histories play a key role in the European Investment Bank (EIB) lending process, with loans for financing large infrastructure projects being more likely to flow into a region where one or more members of the EIB's Board of Directors come from, while regions not represented on the Board are less likely to receive loans. This is the result of a recent study by ZEW, which has evaluated all EIB loans since its foundation in 1958, comparing them with the respective careers of its Board members.

The probability for a European region to receive a loan from the EIB increases by 17 percentage points if at least one person from that region sits on the Bank's Board of Directors. The researchers cannot rule out the possibility that this lending practice leads to a misallocation of resources and to economic inefficiency. The observation shows that the beneficiary regions coincide strikingly often with regions where a member of the EIB Board of Directors either currently holds or will hold a position in the future.

Nevertheless, the researchers stress that Board members who tend to favour their region of origin when granting loans should not necessarily be accused of harbouring self-interested motives. It is possible that Board members simply decide in favour of their own region due to prevalent social connections, for example. Exclusive knowledge of the local conditions in the home region could just as well be a decisive factor in their choices, insofar as the staff responsible for granting a loan would have greater certainty that financial support from the EU is necessary and therefore justified. Through this practice, Board members would minimise information gaps between the EIB and beneficiaries, reducing the risk of potential misallocation of European funds.

The researchers have observed, however, that when members of the Board of Directors are in the process of relocating to another region during or after their term at the EIB, they increasingly lend to the region where they will be working. This connection is only weakly pronounced. But it is hard to imagine that they have an information advantage about the new region, because up until now, the respective Board members have not been personally connected to the region. Also worth noting is the fact that this phenomenon of preferential treatment occurs exclusively in connection with very large infrastructure projects. In comparison with small, less tangible measures at a local level, it is highly likely that the overall conditions for large and costly construction projects can be assessed without specific local knowledge.

The EIB Board of Directors is one of the Bank's three decision-making bodies and is responsible for strategic management. It is solely responsible for the final decision on granting loans. The Board of Directors consists of 29 full members, each representing an EU Member State and the European Commission for five years. As the new lending decision panel meets only occasionally at the EIB headquarters in Luxembourg, being a Board member is not a full-time position.

A loan is approved by the EIB when at least one third of the members of the Board of Directors vote in favour of it, and when these members represent at least 50 per cent of the capital registered with the EIB. Each country's share of the EIB's total capital is determined by the relative size of its gross domestic product (GDP) in the EU at the time of attaining EU membership.

Majority of EIB Board members from economically strong regions

The study examined all EIB loans in terms of volume, purpose, and contract date at the regional level between 1959 and 2015, bringing together up to 5,000 projects with a total loan volume of almost 500 billion euros. The EIB makes such information publicly available on its homepage, while its Board members' regions of origin can be found in their CVs and annual reports. This way, the researches collected data on a total of 254 full members and 216 deputy members of the EIB's Board of Directors. 435 of these members come from regions where the capital of their EU Member State is located, while 109 representatives work in regions where per-capita GDP is below 90 per cent of the EU Community average and which are therefore eligible for funding from the EU Cohesion Fund.

The EIB is the world's largest multilateral credit institution, financing projects in line with Europe's integration and economic policy objectives while promoting innovation, small and medium-sized enterprises, as well as infrastructure and environmental projects. The EIB operates globally but lends mainly to the EU Member States, which are also shareholders. Loans can be applied for by all levels of government, as well as private and public companies. A significant part of the capital flows to poorer regions in the form of cohesion funds, which facilitates a balance of living standards within the Union. Since the EIB's creation in 1958, its annual sum of signed loans has grown steadily from 34 million euros to around 77 billion euros in 2015.

The study is available to download at: *www.zew.de/PU81151*

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Digital Tax Poses Risk to Competitiveness and Profitability If Poorly Implemented

Last year, the EU Commission proposed Europe-wide directives for the taxation of digital companies. Capital markets reacted vigorously, causing the market value of many digital companies to plummet in the short term to the tune of billions. In the long term, the proposed digital taxation directives could harm the profitability and competitiveness of digital enterprises. These are the findings of a study conducted by ZEW together with the University of Mannheim.

The study examines how capital providers investing in digital companies react to the planned introduction of a digital tax in Europe. The researchers evaluated data from 222 potentially affected digital companies and examined their stock returns both on 21 March 2018, when the EU Commission published the draft directives, and on the following day. The result shows a significant decrease in the market value of digital enterprises that would be affected by the directive. Due to the proposal, the overall market value of digital companies fell by at least 52 billion euros beyond the normal market movement. Around 40 per cent of the companies affected are based in the USA.

Most affected by the extraordinary market reaction are EU-based companies with higher profits. Capital markets are also reacting more strongly to companies actively engaging in tax avoidance, as well as companies with higher potential for profit shifting. It seems that some digital companies are currently still able to largely avoid taxation in the EU. According to investors, this would probably be much more difficult in the future once the proposed digital taxation comes into force, and this is why they react accordingly.

The EU Commission has proposed two directives for digital taxation. The first – conceived of as an interim solution – introduces a tax of three per cent on the gross revenue of certain digital services. This concerns companies with a worldwide turnover of more than 750 million euros within a financial year and a turnover of more than 50 million euros from digital services within the EU. The second directive seeks a longer-term solution to the digital tax problem, creating a new taxable link for companies with a non-physical but significant digital presence in one or more EU Member States.

Investors are expecting negative effects on the profitability and competitiveness of digital companies. This may also translate into less willingness to invest in digital businesses, which could mean fewer growth opportunities. In light of the current shortcomings in the design of the draft directives and their potentially harmful impact on digital enterprises, the researchers are therefore advising caution when introducing digital tax measures. The latter should be carefully checked in advance with regard to their exact effect.

The study is available to download at: *www.zew.de/PU81189-1*

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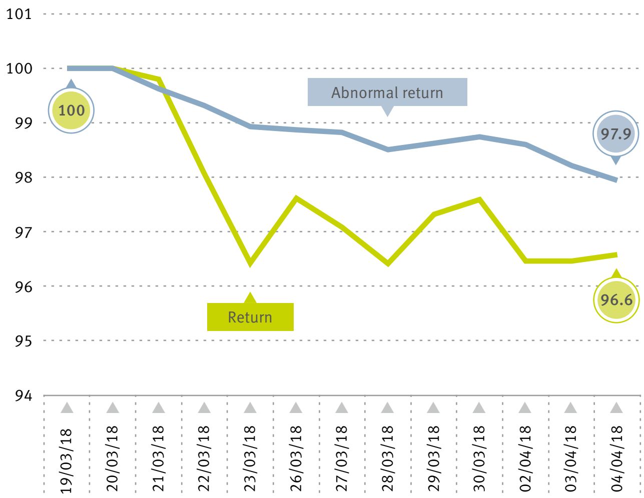
PORTFOLIO RETURN ON PURCHASES MADE BEFORE PUBLICATION OF THE DRAFT DIRECTIVES ON 20 MARCH 2018



The figure displays the buy and hold return of an equally-weighted portfolio of all potentially affected firms. The blue line controlls for the regular market return. Source: ZEW

Green Debt for the "Green Deal"?

The new Commission has chosen a compelling leitmotif for its term of office. The "Green Deal" is to kick-off the transition of Europe towards a climate-neutral continent. The objective is highly ambitious and will absorb substantive financial resources. Hence, it is not surprising that the potential role of higher public debt is discussed to provide finance for climate policies. The discussion has started to challenge existing rules and institutions of European monetary and fiscal governance. The ECB is increasingly requested to provide green finance through its asset purchase programmes. In the reform discussion of the Stability and Growth Pact one of the prominent green ideas is to exclude national investments in CO_2 emission reduction from the deficit calculation. Similar suggestions are made in national debates, for example, with respect to a possible lenient treatment of 'climate bonds' in the German constitutional debt brake.

But does an ambitious climate policy really provide compelling arguments for higher public debt? As plausible as the basic idea of ecological debt sounds, it nevertheless contains several logical fallacies. Its first mistake is to use ethical obligations to justify the accumulation of public debt. The state carries out many functions that society regards as moral imperatives: from health care and poverty reduction to help for refugees, disaster relief, and development aid. But an ethical obligation cannot be served by funding the costs of its fulfilment with debt. We might pat each other on the back today, but others, the future generations, would have to pay for our good deeds. This is not what we would usually call an ethical behaviour.

Green public debt not necessarily sustainable debt

The second mistake is the idea that measures against climate change are profitable investments that ultimately pay for themselves. It is true that the benefit they produce is the slowdown of global warming and the cost savings that result. But this idea fails to recognise the key problem of climate policy: mitigating climate change is a global public good. While reducing global warming is highly profitable for the world as a whole, an isolated European approach won't see much benefit from its own action. This is even more true for uncoordinated action of EU Member States. Hence, with respect to its impact on debt sustainability, debt-financed climate policy is hardly more favourable than debt-financed welfare spending. It puts a strain on debt sustainability because the debt increase is unlikely to have a directly positive effect on growth and tax revenues. To some extent, the political debate seems to mix up the morality of public spending with its sustainability. Any debt sustainability analysis must simply ask to what extent future tax revenues will be sufficient to cover public spending. An increase in spending that does not reliably raise a country's growth rate and tax potential will therefore damage its creditworthiness. This applies regardless of whether the analysis is carried out by monitors in central banks, international organisations or rating agencies.

It is true, however, that Europe's climate change efforts can be part of a strategy to influence the behaviour of other global players in international climate negotiations. In that case, European efforts to fight global warming may have an indirect impact on the world's climate and thus yield an indirect benefit that may also be of a fiscal nature. But this calculation is fraught with many uncertainties. If the strategy fails and ultimately ineffective European climate policies are funded by debt, future European taxpayers will face a double burden: additional costs due to climate change and restricted fiscal leeway to adapt to climate change due to a higher national debt.

The profitability argument appears in the debate in another variant. EU Member States have agreed to share and trade the burden of reducing emissions, so that countries that have exceeded their reduction target can sell their excess capacity to countries that have not met their target. If a single country like Germany fails to meet its target, the federal government may have to buy excess capacity for CO_2 emissions from other EU partners. From a European perspective, however, this is a zero-sum game. Individual states may have a financial advantage if they exceed their goals. For the EU as a whole, however, burden and relief cancel each other out. Thus, the argument that climate policy is fiscally profitable falls apart as soon as one regards it at the European level.

Overall, fighting climate change is thus hardly a convincing justification to open new loopholes in European debt rules and fiscal or monetary institutions. Today's generation has the obligation to make sure global warming is limited to a responsible level. And it is precisely today's generation that has to bear the costs. Everything else is ethically as well as fiscally irresponsible.

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A longer version of this article first appeared in the German business weekly "Wirtschaftswoche" on 10 January 2020.

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