

03.09.2018

Welcome address

Second Annual Research Conference of Banco de España
3 September 2018

Pablo Hernández de Cos
Governor

Good morning.

I would like to welcome you to the second Annual Research Conference, which this year is jointly organised by Banco de España and the Institute for Fiscal Studies.¹

Let me start by thanking our colleagues from IFS. The IFS is a benchmark for rigorous policy analysis, far-reaching influence and frontier academic research, and it is indeed an honour for us to collaborate with them.

This meeting has become our flagship research conference with the main goal of bringing together leading scholars and policy-makers to discuss frontier research on recent economic developments and the policy options to address them.

Last year the conference focused on macro, monetary and macroprudential policies. This year we want to turn our attention to tax and transfer systems.

After several years of sustained recovery, the Great Recession has left a legacy of high public debt ratios, low potential output growth and rising inequality in some countries. For instance, the euro area aggregate public debt

¹ I would like to thank Olympia Bover and Roberto Ramos for their contributions to this speech.

stands at close to 90% of GDP, almost 25 percentage points up on its pre-crisis level. Also, the IMF estimates that potential output growth in the major advanced economies has been declining since the early 2000s, this trend being further aggravated by the global financial crisis. Currently, potential output for this group of economies is thought to be at around 1.5%, a significant drop from the 2% growth estimated in the pre-crisis period.² At the same time, the percentage of wealth held by the richest 10% of the population of the United States, France or the United Kingdom has risen by between 5 pp and 9 pp in the last 25 years.³

Moreover, far-reaching transformations such as globalisation, the digital revolution and demographic trends are all shaping the world economy today, and will continue to do so in the years to come.

Against this backdrop, tax and transfer systems can play a crucial role in providing sound public finances, increasing potential output and delivering sustainable and inclusive growth. However, meeting these goals poses some significant challenges. And not only because of the intrinsic distortionary nature of taxation and the different existing trade-offs among these three dimensions, but also because

² See Chapter 3 of the April 2015 World Economic Outlook.

³ See Alvaredo, F., L. Chancel, T. Piketty, E. Saez and G. Zucman (2018), World Inequality Report 2018, Harvard University Press.

some of these global phenomena, in particular globalisation and the digital revolution, can adversely affect the capacity of governments to collect taxes. As recently stressed in a newspaper article, the challenge is to define a system where taxes target rents, preserve incentives and are hard to avoid.⁴

Let me highlight some avenues of research that I consider relevant in this context.

First, the well-known equity-efficiency trade-off of taxation has given rise to a fruitful literature on the mechanisms driving the behavioural response of taxpayers and the size of such reactions.⁵

While the initial focus of this literature relied on labour supply responses⁶, some recent contributions have emphasised the importance of accounting for additional mechanisms, such as tax avoidance or rent-seeking activities by top earners. For example, one such contribution finds that the incentive to bargain for more compensation in an environment of low top tax rates drives the bulk of the behavioural reaction of

⁴ See "Taxation. Stuck in the past", *The Economist*, 11th August 2018.

⁵ In this regard, it is worth noting that the early empirical literature found a very large elasticity of taxable income with respect to the marginal net-of-tax rate, while the subsequent research, part of it based on non-US experiences, has lowered this number to around 0.05 and 0.4; see Saez, E., J. Slemrod, and S. H. Giertz (2012): "The elasticity of taxable income with respect to marginal tax rates: A critical review," *Journal of Economic Literature*, 50 (1), pp. 3-50; and Kleven, H. J., and E. A. Schultz (2014): "Estimating taxable income responses using Danish tax reforms", *American Economic Journal: Economic Policy*, 6 (4), pp. 271-301

⁶ See, for example, the discussion in Feldstein M. (1995), "The effect of marginal tax rates on taxable income: A panel study of the 1986 Tax Reform Act.", *Journal of Political Economy* 103 (3), pp. 551-572.

top earners, while the reaction of the labour supply is modest.⁷

For policymaking, it is crucial to know the direction and extent of these behavioural reactions. On one hand, because they inform the need for policy evaluation frameworks that go beyond the simple estimation of morning-after effects. On the other, because behavioural responses are at the root of the optimal design of the tax and transfer system. As a consequence, accounting for them is central to addressing a host of current policy debates, such as the optimal level of progressivity.

Second, one influential avenue of research has documented a consistent trend of income concentration at the top of the distribution in some OECD countries in the last few decades. One explanation behind this pattern points to the concurrent fall in top marginal rates, whereby some authors have established a causal link. For example, it has been documented that the top 1% income share in the US has increased from around 8% in the early 1960s to 18% in recent years, this trend having been accompanied by a dramatic fall in the top marginal tax rate from 85% to 35%.⁸ Nonetheless, other economists suggest that skill-biased technological change - by favouring top earners relative to

⁷ See Piketty, T., E. Saez, and S. Stantcheva (2014): "Optimal taxation of top labor incomes: A tale of three elasticities," *American Economic Journal: Economic Policy*, 6 (1), pp. 230-271.

⁸ See, Piketty T., E. Saez and S. Stantcheva (2014), *op. cit.* p. 245.

average earners - is at the root of this income concentration pattern.⁹ This debate has by now reached the public arena.

Third, from a macro perspective, a growing segment of the literature advocates a move from the standard new Keynesian framework, based on representative agents, to models that account for household and firm heterogeneity, in order to better understand the transmission channels of monetary and fiscal policy. This literature speaks directly to central bankers, since it challenges some of the basic tenets of our traditional understanding of monetary and fiscal policy.

For example, a heterogeneous household framework is crucial to assess the extent to which additional revenue can be raised by making income taxes more progressive. In this regard, a recent paper emphasizes that the revenue impact of a more progressive tax schedule in the US should be assessed in light of the reaction of agents along the income distribution, and the aggregate changes triggered as a result.¹⁰

And fourth, the emergence of the digital economy poses significant challenges and opportunities for tax systems

⁹ See, for instance, Card, D. and J. E. DiNardo (2002): "Skill-biased technological change and rising wage inequality: Some problems and puzzles," *Journal of Labor Economics*, 20 (4), pp. 733-783.

¹⁰ See Guner, N., M. Lopez-Danieri and G. Ventura (2016): "Heterogeneity and government revenues: Higher taxes at the top?" *Journal of Monetary Economics*, 80, pp. 69-85.

around the globe. For instance, research for the US suggests that profit-shifting to low-tax jurisdictions reduces the tax bill of US-owned companies by about 20%.¹¹ Thus, globalisation and the growing reliance on intangible assets demand new ideas to limit the erosion of corporate income tax. In this situation, the international dimension of tax design emerges at the forefront of the policy debate. Against this backdrop, for instance, the OECD has launched a welcome initiative, known as the Base Erosion and Profit Shifting Project (BEPS), which brings together 115 countries with the aim of ensuring that profits are taxed where the economic activity takes place and where value is created.¹²

As you can see in the conference programme, we have an excellent menu of papers covering a large amount of topics, related to these and other issues. They will provide new and valuable insights in the realm of fiscal policy, and will therefore improve our understanding of this field, both from a theoretical and an empirical perspective.

Why are all these questions relevant for central banks? In my view, there are sound reasons to argue that the research effort of a central bank need not necessarily be confined to the traditional fields of macro and monetary policy. On the contrary, the deeper and broader our understanding of the

¹¹ See Gabriel Zucman (2014), "Taxing across Borders: Tracking Personal Wealth and Corporate Profits", *Journal of Economic Perspectives*, volume 28 (4), pp. 121-148.

¹² See <http://www.oecd.org/tax/beps/>. See also the Chapter 2 of the April 2018 Fiscal Monitor of the IMF.

economy is, the better we will be able to fulfil our task of producing good analyses in monetary and financial matters.

In the particular case of tax and benefit systems, they have sizable effects on investment, labour-force participation and productivity, and hence on potential output growth and the level of the natural rate of interest. In addition, apart from potential discretionary decisions, tax and benefit systems are the main ingredient of automatic fiscal stabilisers in advanced economies. A deep understanding of tax and benefit systems is therefore crucial to anticipate aggregate demand and inflation dynamics and to assess the appropriate stance of monetary policy and, more generally, of the overall policy mix.

From the standpoint of Banco de España, the foregoing arguments in favour of a wide view on our research activities are even more compelling since our responsibilities include providing advice to the Spanish government on economic policies. In so doing, we have not remained indifferent to the transformations referred to above and the avenues of research inspired by them.

Consistent with this broad perspective on central bank research, our economists engage in an extensive variety of topics, some of which go beyond the more traditional focus

of central banks. For example, we have recently placed emphasis on the study of the aggregate effects of structural reforms in product and labour markets, the distributional consequences of tax policies, the evolution of income inequality and the assessment of the financial competences of the population, to name but a few.

More generally, we believe that high-quality theoretical and empirical analyses are necessary to fulfil one of our core mandates: understanding and monitoring developments in the euro area and Spanish economies. We see high-quality research as an indispensable tool to adopt sound policy-making decisions.

In this regard, in recent years Banco de España has aimed to further improve the standard of its research activity and to strengthen collaboration with other institutions. Overall, these endeavours reaffirm our commitment to research, as the fundamental basis for good policy decisions, and I hope they will enhance our research output in the future.

I would not like to miss this opportunity to underline the importance of relying on accurate and available statistics for economic analysis and research. It is my view that allowing independent researchers to access high-quality data is a necessary step to advance in the knowledge of the issues referred to above.

In this regard, over the years more and more countries are easing the requirements to work with the micro and administrative data produced by the public sector.¹³ I believe that Spain should not lag behind in this endeavour.

In keeping with this assessment, Banco de España provides researchers with the micro data of some of the surveys it conducts, such as the Survey of Household Finances and the Survey of Financial Competences. But more needs to be done. In this regard, we are committed to extending the availability of micro data to other products, such as the balance sheet data of non-financial corporations and some banking data. In this respect, Banco de España has recently joined INEXDA, a network of central banks whose aim is to exchange experiences in the management of granular data in order to facilitate their use by external researchers.

Also, we must strive to have other public institutions join us in this initiative. Although the Spanish public sector currently provides samples of administrative data regarding, among others, tax returns and social security records, there is ample room for improvement in this area.

¹³ See Arellano, M. (2018), "El acceso a los microdatos administrativos públicos: la nueva frontera de la investigación económica y social", presentation at XVIII Aula de Verano Ortega y Gasset, UIMP, Santander, 20-21 Agosto 2018, <http://www.cemfi.es/~arellano/arellano-presentacion-uimp-2018.pdf>

In this respect, enlarging the number of available datasets, enabling access to the universe of observations and allowing for the merger of different databases are measures that would, for sure, deepen our understanding of the Spanish economy and help design better public policies. In this connection, the experience of the Nordic countries is a success story, and could be used to guide our efforts in the future.

Let me conclude.

Tax and transfer systems around the world face significant challenges to provide inclusive growth and fund the public policies that the population demands. Meetings such as this conference provide an excellent opportunity to enhance our understanding of these fascinating issues and to strengthen the links between central bankers and academics.

Allow me to recall in this regard the figure of Sir James Mirrlees, who has recently passed away. His groundbreaking academic contributions and deep involvement in public policy design provide an outstanding example of intellectual achievement and commitment to improving the society. He rightly gave his name to the influential Mirrlees review, which has become an essential guideline for policymakers involved in tax design. I would like to convey my sympathy to our colleagues of the IFS,

who had the opportunity to work in close collaboration with him, and to the academic community in general for this loss.

Finally, let me express my gratitude to the organisers for making this conference possible and to all of you for attending.

I wish you a very productive meeting and a pleasant stay in Madrid.

Thank you very much for your attention.