

CAPITAL MARKETS FOR A MORE COMPETITIVE EUROPE

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1. Key Messages

The Confederation of Swedish Enterprise supports the aim of the Capital Markets Union (also referenced as the Savings and Investment Union) (in the following the "CMU") to create a single market for capital. Strong, well-functioning capital markets are critical for businesses and are key to achieving the EU's long-term goals, such as the twin transition and increased competitiveness. As shown in the Draghi report¹, the EU has the foundations in place for a highly competitive economy but must urgently focus on increasing productivity growth. Therefore, investment levels need to increase across the EU in the coming years. The following paper details our views on how the CMU can best support the goal of meeting businesses' investment needs.

If the CMU is to aid in raising investment levels, any actions to reinforce and implement the CMU should be designed to strengthen EU companies' access to finance by identifying their unmet needs, areas of potential improvement and by facilitating financial market innovation. This is especially important when it comes to complex, transformative and technology intensive investments where banks, which dominate corporate lending in the EU, are less suited to provide financing. The long-term goal should be to make the EU more attractive both to foreign and domestic investors, in order to increase investment in the areas that will drive future productivity growth.

Our key messages regarding the CMU are the following:

- Any actions taken to reinforce and implement the CMU should strengthen EU companies' access to
 finance by identifying their unmet needs, areas of potential improvement and by facilitating financial
 market innovation, thereby supporting the aim of increasing investment in the EU.
- Focus on competitiveness and improving business conditions to attract and increase investment.
 Financial market outcomes are greatly driven by the real economy. Do not overestimate the role of financial regulation.
- Increase the size and liquidity of EU capital markets by encouraging a shift of household savings to the capital markets. This can be done via attractive savings accounts and reformed pension systems at the member state level.
- Leverage the diversity in the EU by improving each individual market through a structured process. Be
 careful when attempting to harmonize financial market rules across the EU. Many issues are more
 effectively resolved by an inter-governmental approach, where the EU has an important leadership
 role.
- Focus on enhancing the coordination and exchange of information between ESMA and national authorities. Centralized supervision would be difficult to implement effectively and would bring limited benefits, if any.

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¹ The Future of European Competitiveness, Draghi, September 2024

2. The Business Environment Matters for Financial Market Outcomes

When analysing EU capital market outcomes, it is important to understand the role of the broader business environment. As is pointed out in the Draghi-report, the lack of viable investment opportunities and barriers to innovation and growth in the EU are likely holding back the demand for capital. This is reflected in the value of stock markets and IPO activity.

A recent paper by ESMA² points out certain facts regarding the current state of EU capital markets. For instance, at the end of 2023, the EU27 share of global equity market capitalization was 11%, which is quite low compared with 45% for the US, given the relative size of the economies. The EU27 share has also been in decline since 2009. There is also a substantial gap between the number of IPOs in the EU and in the US. Between 2014 and 2023, the value of IPOs even declined in the EU, as a share of GDP³.

Capital is internationally mobile, and investment decisions are primarily driven by expected returns. The functioning of a country's capital market is important, but it is only one among many parameters. The differences in capital market outcomes between the US and the EU are probably to a great degree explained by general business conditions which lead to the formation of valuable firms. As pointed out in the Draghi-report, only four of the world's top 50 tech companies are European.

In the Letta-report, it is claimed that the EUR 300bn net outflow of capital from the EU⁴ is caused by financial market fragmentation. This is unlikely, as the net outflow of capital is mirrored by a current account surplus, which is caused by a complex set of factors. On an individual level, savers and investors are driven to invest abroad by the pursuit of returns and need for portfolio diversification. More attractive investment opportunities in the EU would likely contribute to reversing the flow of capital.

It would be a mistake to attribute the above outcomes primarily to financial market regulations. Such a view leads to unrealistic expectations regarding what can be accomplished through financial market reform and integration in the EU, and risks ultimately leading to policies that do not achieve their aims. Instead, and to have maximum impact, the CMU initiatives should focus on targeted, effective measures alongside much needed competitiveness reforms within the EU.

3. Strengthen EU Capital Markets via National Reforms

In the discussion about the future of EU capital markets, it must be recognized that the EU does not yet have a single market for capital, but rather 27 individual eco-systems. Since these different markets differ greatly in terms of their development, size and broader national context, it is unlikely that any single set of policies will be appropriate for all member states.

It is also important to keep in mind that in the context of capital market reform, not all issues are best solved from the top down by EU level legislation. Many issues are more effectively resolved by an inter-governmental approach, where the EU has an important leadership role, not least because many relevant policy areas are under the exclusive control of member states.

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² Building More Effective and Attractive Capital Markets in the EU, ESMA, 2024

³ Searching for Growth: The Future of EU Capital Markets, New Financial, September 2024.

⁴ Much More than a Market, Letta, April 2024

For example, there is a large scope for EU household savings to be more extensively deployed in capital markets, but the relevant policy areas, such as taxation and pensions, are controlled by member states. Therefore, measures in this area need to be taken at national level. Such policy changes can also be implemented more swiftly than legislation at the EU level. Examples of potential areas for reform at the national level include savings accounts, taxation, pension systems and capital market regulation.

Harmonization of capital market rules, which is sometimes proposed to varying degrees, has proven to be difficult to achieve in practice, for valid and legitimate reasons upon which this paper elaborates below. Identified barriers to the internal movement of capital should preferably be removed by focusing on facilitating cross-border activities. One example where room for improvement remains and where the current structures create unnecessary complexity is the system of withholding tax, which is discussed further below.

We encourage the EU to leverage the diversity within the union by aiding member states to learn from each other. This is most effectively done when member states study reforms and outcomes in other member states and adapt the most successful ones to their own particular circumstances. The EU has a crucial role to play in this context by facilitating structured coordination between member states, but ultimately member states must take ownership of their own reforms.

It should be explored whether it would be possible to create a formal process within the EU, inspired by the European Semester, with the aim of evaluating the capital market in each member state and making recommendations on how to improve them. The objective should be to drive reform at the national level by enabling peer support and peer pressure, addressing identified challenges and learning from successful practices from within and beyond the EU.

Knowledge-sharing initiatives should be prioritized to foster market development, while maintaining respect for national specificities. Regulatory changes should be guided by the principles of better regulation, subsidiarity, and proportionality. Building on the work already initiated by the Eurogroup+, the introduction of country-specific recommendations could provide a new impetus to the process and serve to strengthen the governance framework.

4. The Swedish Capital Market

The Swedish capital market is often mentioned as one of the top performers in the EU, with a growing capital market and a high level of retail investment. The development of the Swedish capital market was not a rapid process; it rather progressed gradually over a long period of time. Policy probably played some role in shaping this outcome and we therefore choose to highlight a few notable reforms in Sweden, which have been beneficial in this regard:

- The pension system was reformed in 1994. Since then, 2.5% of an individual's salary is invested in a mix of mutual funds of their choice, with a default option for those who don't make an active choice, with a comparatively large weighting toward equity. This reform means that every Swedish citizen born after 1938 automatically invests a share of their income into mutual funds.
- The number of listed companies in Sweden has increased sharply over the past quarter century, contrary to the global trend. At the same time, the importance of family foundations as control

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⁵ A little-known fact is that the first Swedish mutual fund, which was founded in 1958 used a legal structure inspired by the West German legal model which had been introduced in 1956.

owners has diminished and been replaced by wealthy private individuals who own control stakes via holding companies. This reversal can be seen in light of several reforms, including changes of taxation of different types of owners and the reduction and subsequent abolition of inheritance and gift taxes, which previously prevented a generational transfer of large shareholdings. The decline in real taxation through falling inflation (also the abolition of the individual wealth tax, even though Sweden was among the very last countries abolish this tax) has also strengthened the incentives to build up new business assets. However, taxation of regular capital income on e.g. dividends and capital gains are still high in Sweden compared to other countries.

- The investment savings account (Sw: ISK or "investeringssparkonto") was created in 2012, for the use of private individuals. Instead of taxing returns on investments directly, the investor is taxed based on the average value of their investment portfolio each year. Since the tax is based on the value of holdings throughout the year, there are no complex reporting requirements for the account holder. Only a few data points regarding the value of the account at certain points in time are needed, and these are collected automatically. There are also no tax costs related to buying and selling securities, making it easy to move money in and out of the account and to rebalance a portfolio. The simplicity of the ISK has attracted a large number of private investors, and today more than 3.7 million, out of Sweden's 8 million citizens over the age of 20, invest through an ISK account. It is important to note that the success of the ISK is not explained by the level of taxation, which is not favourable compared to other capital taxes. It is more likely that the popularity of the ISK is explained by its ease of use and that no taxes are incurred when buying and selling securities.⁶
- It is our firm belief that an important factor in the success of the Swedish stock market is a general corporate governance framework that creates trust and allows due flexibility and proportionality for individual companies, making the market work for different types and sizes of businesses, while safeguarding investor interests where it matters the most. The general corporate governance framework includes among other things fundamental rules regarding shareholder rights and engagement, board and auditor election, board structure and composition, directors' duties, disclosure rules, division of competence, etc. and include well calibrated rules that can be revised on an as needed basis through the collaboration between legislators and self-regulatory bodies (such as the Swedish Takeover Panel, the Swedish Corporate Governance Board, and the Stock Market Self-regulation Committee). If there is not a clear need for regulation, regulation is avoided, and when regulation is deemed necessary, rules are tailor made for the specific situation and adapted to the general Swedish legislative landscape, with great care not to interfere with the effectiveness of the general corporate governance framework.

As explained above, much of what has made Sweden successful in the capital markets area is due to policies which are controlled at the member state level, such as taxation and pensions. This implies that a significant share of the reforms that can aid the EU in achieving its capital market goals are to be found at the member state level.

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 $^{^{6}}$ Är skatten på investeringssparkonton för låg?, Ekonomisk Debatt, nr 6, 2023.

5. Challenges With Harmonizing EU Capital Markets

To achieve the overarching aims expressed under the framework of the CMU, any rules must be flexible enough to give room for and incentivize continued innovation in capital markets. Self-regulation on the stock market, where business and stakeholders are engaged in defining what is good practice on the stock market, has proven efficient and well-functioning for the Swedish market. Under self-regulation, experts with practical experiences from the market have an important role, which leads to high trust and compliance on the market. In addition, self-regulation is flexible and allows quick adaptation of the rules where changes or clarifications are needed. By default, national legislation is not as flexible and making changes or adaptations to harmonized rules on the EU level makes the lead times for adaptation even longer, and sometimes politically impossible. Therefore, the value of further convergence at the EU level and detailed and comprehensive regulation is questionable, as this would decrease the much-needed flexibility on the market.

Harmonization should be sought only where necessary to achieve the aims of the CMU. It is crucial that any harmonization does not come at the expense of well-functioning systems in member states. Regulatory systems often exist within a broader national context and have evolved over a number of years. It is not possible to simply transpose successful regulations from one country to another expecting the same results. However, where good practices exist, these should be highlighted and it should be explored to what extent these can be used, adapted, and implemented in other member states, taking due account of market particularities. The principle of "do no harm" should guide such processes, with respect for subsidiarity and proportionality. Otherwise, the ambitions for increased harmonization risk causing more harm than good, impeding opportunities for member states to improve and develop their capital markets. Reforms at the national level can also be implemented much more quickly than EU legislation. Inspiration could also be drawn from the OECD Capital Market Reviews, and it should be considered if OECD involvement could be beneficial to get an international perspective.

6. Centralizing Supervision Would Not Benefit EU Capital Markets

Centralized supervision of financial markets within the EU, particularly the idea of transferring supervisory responsibilities to the EU level through ESMA, naturally only makes sense in areas with a great degree of regulatory harmonization across the EU. As we have already expressed, the Confederation of Swedish Enterprise is skeptical to harmonization in this area since it risks overlooking important national differences and creating a rigid regulatory framework that is ill-suited to the unique conditions prevailing in various member states.

Even in areas where there is some degree of rule harmonization, centralizing supervision of national markets presents significant challenges as this risks creating a supervisory framework detached from local market conditions, lacking the understanding needed to address specific circumstances in different member states. Understanding the local conditions and historical and structural factors relevant to the market is key for well-functioning supervision. It is highly unlikely that a central supervisor would have all relevant insights, which in turn would lead to inefficient supervision that fails to respond adequately or swiftly to local challenges. Moving towards centralized supervision therefore risks ultimately undermining the credibility and effectiveness of supervision across the EU.

When it comes to overseeing regulations that are not harmonized, the challenges of centralization become even more pronounced. A central authority responsible for supervising a variety of national regulatory frameworks would likely struggle with accurately interpreting and applying these diverse rules. This could result in supervision that is both ineffective and disconnected from the practical realities within each member

state. The potential for confusion, inefficiency, and increased costs for all stakeholders makes it difficult to justify such an arrangement.

Central supervision is likely to become costly and administratively heavy and the lack of adaptability not only threatens the effectiveness of supervision but also undermines trust in the market as a whole.

Flexible and effective supervision, contributing to good market practices and regulatory development, is particularly crucial in the context of the twin transition – encompassing both the green and digital transitions – that is key to ensuring Europe's future competitiveness. To effectively support these transitions, supervisory authorities must be able to swiftly adapt and innovate, ensuring that both the enforcement of existing regulations and the development of new ones are responsive to the rapidly changing needs of the market. Centralized supervision, with its inherent rigidity, risks obstructing this process by disconnecting the regulatory framework from local realities and stifling the flexibility needed to lead in these critical areas. By limiting the ability of supervisory authorities to tailor regulations and enforcement to specific local conditions, centralization could undermine the EU's capacity to remain competitive in a quickly evolving global landscape.

Rather than moving towards centralization of supervision, we believe that the current collaborative model between ESMA and national supervisory authorities provides a solid foundation for efficient supervision. By further enhancing the coordination and exchange of information between ESMA and national authorities, while respecting the unique insights and expertise of local regulators, the EU can maintain both the benefits of a unified framework and the flexibility needed to address specific market conditions. This approach would avoid the rigidity and inefficiencies that full centralization could bring, while continuing to foster a balanced, adaptable supervisory environment.

7. Channel Household Savings Toward the Capital Market

Data from Eurostat shows that there are clear differences regarding the level of engagement with capital markets for households in different parts of the EU⁷. This indicates that there is potential to shift household savings into the equity market, which would increase access to types of financing other than bank lending (a point also made in the Noyer-report⁸). Returns on savings for households may also increase through such a shift, easing the burden on national pension systems.

We encourage the EU to explore various options for member states to mobilize household savings, and an EU savings product could potentially be an option, as mentioned in the Mission Letter to Commissioner Albuquerque. Drawing on the Swedish experience and the success of the ISK, it may be advisable to explore whether a similar model could generate the same positive effects in other member states if implemented there. We believe that the following criteria would help making such product attractive to savers:

- **Simple**, with as little administration as possible and simple taxation.
- **Liquid**, meaning that using the product should not necessitate locking in capital for long periods of time. Moving capital into and out of the account should not entail any taxation.
- **Flexible**, with no restrictions on portfolio composition, aside from what is strictly necessary (e.g. no forced allocation to EU assets or requirement that funds be managed in a certain way).

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⁷ Unleashing retail investors' potential - the key ingredient for enhancing the EU's investment funds and capital markets, Lannoo and Thomadakis, European Capital Markets Institute, 2023

⁸ Developing European Capital Markets to Finance the Future, 2024

This approach is quite different from the idea presented in the Noyer-report, which would require that savers' capital be locked in for long periods of time and be invested primarily into European assets, in exchange for a favorable tax treatment. It is our view that such a product could prove to be unattractive to households.

Member states may also use the pension system as another viable tool for channeling household savings into productive investment. Pension capital is currently concentrated to just a few member states, led by the Netherlands, Denmark and Sweden which account for around two thirds of all assets. This indicates that there is scope for other members of the EU to gradually transition toward a pension model which relies more on funding rather than pay-as-you-go. Any such national reforms should be informed by the experiences of other members that previously performed this transition successfully, and it must be respected that pensions are exclusively controlled by the EU member states.

8. Improve the System for Withholding Tax

Withholding taxes on dividends on cross-border portfolio investments may have a negative effect on liquidity and constitutes a major obstacle to an integrated capital market in the EU. The current withholding tax refund system is time-consuming and costly. Taxpayers are confronted with an unreasonable administrative burden having to collect different forms of evidence, responding to various questionnaires in different languages and are subject to a protracted withholding tax procedure. It is urgent that the withholding tax refund procedures within the EU are simplified, harmonized and digitalized.

The proposal for a Directive on Faster and Safer Relief of Excess Withholding Taxes (FASTER) constitutes a step in the right direction but has its shortcomings. A system based solely on relief at source would however improve efficiency in tax processes. Further, the proposed Directive does not address the potential discrepancies across the EU regarding the definition of "beneficial ownership" to a sufficient extent. This is especially important, as the Directive requires the Certified Financial Intermediaries to perform several tests to identify situations that might impair beneficial ownership. This not only contributes to legal uncertainty but also increases the administrative burden on the Certified Financial Intermediaries.

9. The Need for Efficient and Proportional Reporting Requirements

The EU should strive for simplifying and streamlining all reporting, in line with the Commission's target to reduce the reporting burden on companies of all sizes by 25%. Administrative costs for corporations must be given greater weight when proposing and implementing future reporting requirements.

For example, the EU taxonomy and the broader sustainable finance framework has the potential to become a useful instrument in the transition toward a sustainable economy, create a competitive advantage and become a distinguishing feature of EU capital markets. However, the current sustainable finance reporting requirements are costly and complex. Measures need to be taken to reduce complexity as well as inconsistencies and overlaps. Ensuring interoperability between the leading sustainability reporting frameworks is an effective way to both reduce the reporting burden and facilitate investment by increasing comparability.

10. Recommendations

Drawing on the Swedish experience and the current state of EU capital markets, we recommend the following measures to create a CMU which supports the EUs long term goals of increased productivity growth and succeeding in the twin transitions. By implementing these strategic actions, we believe that the EU can create a robust and competitive CMU that enhances market efficiency, encourages sustainable growth, and supports the diverse economic needs of all member states:

- 1. Focus on companies' access to finance: All CMU initiatives should be tailored to strengthen EU companies' access to capital by focusing on unmet financial needs and ensuring access to diverse and innovative financing sources. Emphasis should be placed on supporting transformative and technology intensive investments which will be critical to achieve the EUs long-term goals such as the green and digital transition, while also enhancing access to public equity markets to broaden capitalraising opportunities. To support these objectives, the regulatory environment must be predictable, proportionate, and responsive, enabling companies to raise capital efficiently while allowing for innovation and adaptability in financing models. In order to enhance cross border capital flows, it is urgent that the withholding tax refund procedures within the EU are simplified, harmonized and digitalized.
- 2. Encourage household savings in equity markets: Encourage member states to incentivize household participation in equity markets by introducing simplified, low-burden investment schemes. Inspiration could be drawn from the Swedish ISK model and such schemes should be designed to minimize administrative requirements and avoid capital lock-ins, while maintaining flexibility in asset allocation in terms of different types of assets and geography. The goal should be to channel more household savings into equity markets, enhancing capital supply and returns for savers.
- 3. Promote pension capital engagement: Promote engagement of pension capital in the capital markets by encouraging member states to gradually transition toward a pension model which relies more on funding rather than pay-as-you-go. A shift toward funded pension systems could provide sustainable capital flows to the markets and relieve pressure on national pension budgets. This should be done with strict adherence to the principle of subsidiarity in the area of pensions.
- 4. Foster a competitive investment environment: To attract both foreign and domestic capital, the EU should focus on creating a favorable and innovative investment climate. This includes reducing unnecessary barriers, promoting proportionate regulation and supporting financial innovation across member states. In addition to general improvements to the business environment, simplifying and streamlining reporting requirements is crucial to reduce the regulatory burden on companies, in line with the Commission's target to cut the reporting burden by 25%. Administrative costs to corporations must be given greater weight when proposing and implementing future reporting requirements. Further efforts should target reducing other regulatory burdens where they hinder market efficiency and competitiveness, ensuring that the EU remains both an attractive market for investors and a supportive environment for businesses.
- 5. Improve financial market outcomes through an enhanced process of peer review: Encourage member states to improve the efficiency of their respective financial markets by establishing an enhanced peer review process at the EU level, enabling peer support and peer pressure to drive reform at national level by addressing identified challenges and learning from successful practices

from within and beyond the EU. Knowledge-sharing initiatives should be prioritized to foster market development, while maintaining respect for national specificities. Regulatory changes should be guided by the principles of better regulation, subsidiarity, and proportionality. Building on the work already initiated by the Eurogroup+, the introduction of country-specific recommendations could provide a new impetus to the process and serve to strengthen the governance framework.

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