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## BANKING TAX PROPOSAL: WILL IT RUIN THE ECONOMY?

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**The clash between unlimited needs and limited resources forces the government to seriously consider the tax on banks.**

**Government says banks' profits are unjustified while banks threaten to cut lending in response to higher tax. None of them is right.**

**Banking tax is actually a well-designed tax measure. What is not is the use of proceeds.**

**The clash between the unlimited needs of the government and the limited resources is playing out in the Czech Republic.** As recently as in December 2018, the Minister of Finance was boastful that its 2019 budget was very good one, claiming, as she (Alena Schillerova) did, that *"the times when this country had bad budgets are gone"* ↗. Only couple of months later, once first 2019 numbers came in and revenues fell short of expectations, the clear proof of budgetary manic depression was on clear display: at the beginning of February 2018, PM Babis and Schillerova said ↗ that *"we must start saving"*, that *"we cannot increase the expenditures"* and that some of the public sector employees, whose salaries the same government increased by some 30% in last three years, may need to be laid off...

**This glimmer of fiscal prudence proved short-lived as well.** As soon as the February 2019 budget data came in (in early March), the government spending appetite was back with vengeance. One could be forgiven for expecting a little bit of the spending moderation, with Eurozone slowdown and VAT revenues undershooting the projections (plan is +6,8% y/y, the reality for first four months is +2,5% y/y), but there would have to be a different government for that to happen. So, in March 2019 alone, government promised another CZK 40 bn. in additional spending (higher pensions, higher

maternity allowance, although the latter wasn't settled until May when it finally emerged that another CZK 8-9 bn. will be needed to pay for that). Just a few days ago, the government promised to increase the salaries of the teachers further, with Schillerova ↗ *"guaranteeing that the average salary of the teacher will rise to CZK 45 000"* from 2018 average of about CZK 35 000. And no, this certainly is not the end of it.

**The question that dawned even on government so amateurish as this one was where to get the money to pay for all of this.** Obviously, you can borrow, but the problem is that PM Babis spent last four years boasting of lower indebtedness. You could in theory also made the government more efficient or use those CZK 200 bn. that Babis said in 2013 were *"being lost annually on corruption"* ↗ but apparently 6 years were not enough to stop this apparent bleeding... Or you can tax. Babis may have been repeating ad nauseam that he would never do higher taxes, but the desire to keep budget in relative shape and still hand money to people left and right forces his hand.

**But who to take the money from?** Corporate income tax is hard because a) not only it is relatively high here already, but b) it would have to also be paid by Agrofert, i.e. the company that PM Babis still de facto owns despite having ostentatiously put it in a trust. Labor is already taxed pretty heavily as well, and if you are a populist trying to please everyone, it is hard to be handing money with your right hand and taking it back with your left one. Same goes for VAT: it ain't much good to raise the pensions if it is followed by VAT hike (that pensioners are very sensitive to).

**So, how about some sectoral taxes?** You know, taxing those companies that no one likes like banks or telecoms, companies the size of profits of which defy the understanding of the ordinary populace and that seldom get many advocates in the local pubs' discussion. **Enter the banking tax.**

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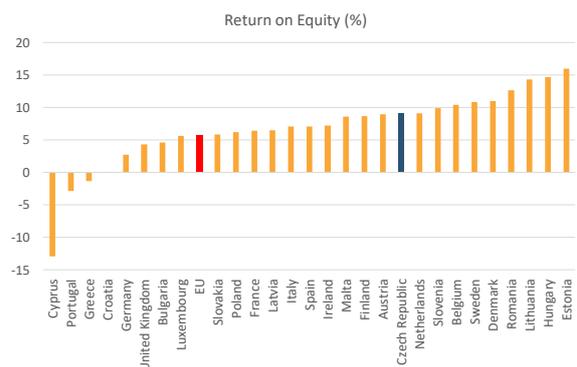
**This**, originally in a bigger package of sectoral taxes (i.e., taxes not only on banks, but utilities or telecoms) **has been Social Democrats' obsession for years now**. In previous government or ANO and CSSD, run by PM Sobotka, this **was met with resolute disagreement of Babis**, understandably so considering that he still de facto (if not de iure) owns Agrofert, company that is dependent on banks' financing. However, as said above, with those hundreds of billions of CZK that we've been supposedly losing annually due to corruption not materializing and with money to fund the bribes to the population not elsewhere available, **Babis has gradually been warming up to the idea and coming to accept that this may be the least of the evils if he doesn't want to blow the king-size hole in the budget**. Combine that with rising star of CSSD, Jana Malacova, currently minister of labor and social affairs, and her appetite for social spending (she is nicknamed "Venezuela" here), and it looks like local banks won't dodge this bullet this time.

**But that does not mean they will not put up a fight**. Malacova said banks, predominantly owned by foreigners, make inordinate amount of money in what she called "Eldorado" for them, and so it is OK if they are taxed more [↗](#). She did not even pretend to have any economic rationale (like, say, with telecom operators who are regularly accused of fixing the market, keeping prices artificially high, but who are conspicuously absent from sectoral tax proposal) other than finding someone to give her money for her spending plans. **Banks don't exactly like the idea**. As counterargument, they said [↗](#) that if they are taxed more, their ability to extend credit to the real economy will be curtailed, that the whole economy will suffer as a consequence, and that budget revenues will actually decline. **Yeah, a lot of passion in the whole discussion**.

**Let us separate the feelings from the reality**. Before we begin, we need to dispense with the question of whether it is actually moral to tax some specific sector at higher rate. Here, it is simple. If one accepts that it is government's prerogative to tax its subjects (within limits, i.e. no expropriation) then there is no argument against setting different tax rates according, for example, the ability to pay. The modern optimum tax theory

holds that the taxes should fall more on those that are better positioned to pay (while abiding by so-called horizontal equity, i.e. that those of same ability to pay should pay the same) and should be designed such as to minimize distortions. Selecting a sector to pay relatively more in taxes certainly is not something that would be Czech-specific. As Deloitte report [↗](#) shows, many countries tax bigger companies more (Albania, for instance) or specific sectors more (Gibraltar, for instance).

Now, onto the Eldorado that Malacova says previous politicians created to enable banks to generate outsized profits at the cost of general population. Is it really so? There are many ways to look at this, one being to look at the return on equity (ROE) in the financial sector: one would expect this to be off the chart if Czech Republic is indeed such an Eldorado for banks. But look at the following picture:



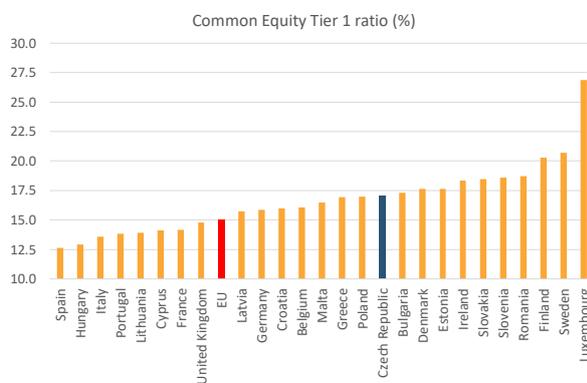
SOURCE: Statistical Data Warehouse ECB [↗](#)

Yes, Czech banks are fairly profitable, but not only is the Czech banks' ROE not off-the-chart one when compared to EU countries, but it is not much different from ROE in other sectors of the economy. As the regular report of the Ministry of industry and trade [↗](#) shows, ROE in, for instance, industry is about 16% (see page 17 in the report). **So, no, the banks are nor extraordinarily profitable here**.

**But they are also very unlikely to restrict lending**. **First**, they have **lots of capital**: Czech banks are among the best-capitalized in the EU, with common equity tier 1 capital ratio at almost 17.5%. **Second**, they have **incredible amounts of unused liquidity** that they deposit at repo facility at CNB, a testimony to the fact that they cannot

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find better use for it – and haven't been able to for a long time now. **Both of these facts**, demonstrated in the pictures below, **make it very unlikely that the banks, even if hit with the additional tax** (that should raise about 8 bn., i.e. about 1/10<sup>th</sup> of the annual profit of the sector), **would restrict lending**: their problem is with demand, not with capital or liquidity. Further on the liquidity / capital point, banks have been consistently saying in last years that liquidity or capital are the least of their problems – see the Bank Lending Surveys of CNB ↗ for a proof.



SOURCE: Statistical Data Warehouse ECB ↗

To repeat, no, the banks will not restrict lending here because of the tax.

From this perspective, taxing banks is relatively cost-free and is surprisingly good tax policy measure. Indeed, they may transfer some of the additional tax costs onto the clients, but the competition here is pretty tough (there are more than 30 banks here) so it is not unreasonable that, with ROE high, some banks may try to use this opportunity to get market share by not doing so. Banks will not leave and, as shown above, will not

restrict lending. In other words, if you really need to, tax the banks. That is the least of evils.

What is much, much worse than the tax itself is the use of the proceeds. See, Czech Republic is already taxing its population fairly heavily, and there are not many pockets of unused revenues to be tapped. In other words, raising rates across the board / meaningfully is not really possible as it will bump into Laffer curve constraints, and new sources of untaxed revenues are few and far between: basically, it is only wealth taxes that are non-existent here that can be tapped in the future.

In such a situation, one should be really careful about what one does with the additional revenues. But what does this government want to do with banking tax proceeds? It will give them away to make parents stay home for longer, via increasing maternity allowance! This at the time when, with economy growing nicely and strong generation born in 1970s and 1980s in their prime economic careers, all the economy can pay the average pensioner is CZK 13 000 / month.

And so the nagging question appears. Shouldn't the money raised be used to pay, for instance, for the transition from the current PAYG pension system to something more sustainable, to prepare us for the future when those born in 1990s and 2000s, far less numerous than the previous generation, need to support them? Is little long-sightedness too much to ask of this government? I fear the answer.

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