Sectoral Banking Tax: Risks, Impacts, and Possible Consequences for the Czech Economy

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Sectoral tax, i.e. higher taxation, which affects only selected sectors of the economy (such as banking, insurance, energy, telecommunications, or the information technology segment) is considered to be an effective tool for increasing state budget revenues. However, the new proposals put forward in the Czech Republic discuss only additional tax revenues, whilst totally neglecting the additional social costs in the form of unintended impacts caused by the imposition of a sectoral tax on selected segments of the national economy.

The imposition of a sectoral banking tax involves risks of interrupting continuous development by disrupting steady market growth, and forcibly seeks for a new equilibrium with negative implications for the confidence of clients. Given the importance of the banking sector on strong economic development, the abovementioned changes may cause national economic fluctuations and could potentially jeopardize competitiveness. As many foreign experiences have shown, the sectoral banking tax can bring with it a number of negative consequences; costs of which were borne not only by savers or other bank clients, but also by taxpayers.

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> THE IMPOSITION OF A SECTORAL BANKING TAX INVOLVES RISKS OF INTERRUPTING CONTINUOUS DEVELOPMENT BY DISRUPTING STEADY MARKET GROWTH

Moreover, such a serious intervention in the economy increases the risk of market uncertainty. The sectoral banking tax can become a dangerous precedent for other sectoral taxes, such as the energy sector or telecommunications. Significant changes in the market environment are also a negative signal for foreign investors.

WHAT THE SECTORAL BANKING TAX MIGHT LOOK LIKE?

Experiences around Europe offer a wide range of forms of sectoral banking tax, which differ mainly in the concept of the tax base on which the tax determination is derived. The tax base may be, for example, total liabilities minus equity and insured deposits (Austria, Belgium, Slovakia) or total liabilities, excluding all deposits but including derivatives (Germany) or total assets (Hungary, Poland)[1]. Sectoral banking taxes may, of course, differ in the size or in its progression (tax rate depends on the size of the bank's balance sheet items).

In some cases, the main reason for the implementation of the banking tax was the foundation of financial reserves to be used for the possible remediation of the banking system in further economic recessions, as was during the global financial and economic crises in 2008-2009; some governments were forced to remediate insolvent banks from the state budget. The Czech banking sector emerged unscathed from financial and economic turmoil, and did

[1] CYRRUS (2017) *Analýza dopadu sektorového zdanění bank*. [in Czech]

> SECTORAL BANKING TAX CAN BRING WITH IT A NUMBER OF NEGATIVE CONSEQUENCES; COSTS OF WHICH WERE BORNE NOT ONLY BY SAVERS OR OTHER BANK CLIENTS, BUT ALSO BY TAXPAYERS

not require any financial injections while its lending activity significantly helped the Czech economy return to economic prosperity.

According to the Czech Social Democratic Party (ČSSD), as a leading supporter of such instrument, the sectoral banking tax might take the form of a levy on the volume of total assets, while the tax rate is expected to grow progressively from 0.05% to 0.3%[2], depending on the total amount of assets. The aim of the sectoral banking tax is simple – bring more finances into the state budget without any negative social or economic consequences. Party leaders argue that higher costs will not fall on bank clients, because the high rate of competitiveness in the Czech banking sector will absorb all possible price increases of financial products. The current proposal of sectoral banking tax also calculates additional state revenues of CZK14 bn (EUR 0.56 bn). That is basically it, no more arguments from proposers or relevant economic analysis about risks and related effects. Can such a fiscal tool really be so innocent? Let us see how some negative aspects might look like, and who will pay these costs in the end.

NEGATIVE IMPACTS OF A SECTORAL BANKING TAX

In order to fully understand the consequences of implementing the sectoral banking tax in the Czech Republic, estimating its impact is crucial. Therefore, the following estimates are based on real variables, market indicators, and research results.

1) PRICE INCREASE OF FINANCIAL PRODUCTS

The rational response to the increased cost in the industry, and to the threat of decreasing profitability, is naturally a rise in final product prices. Financial institutions are tied up by their financial plans and performances of which their management is responsible to the owners of their shares. The economic theory postulates that increasing costs are usually divided between the company and its customers (part of the cost is borne by the company and the other part is passed on to the customer through rising production prices). The ratio in which the additional costs are divided depends mainly on the elasticity of demand for the good.

A very common argument of the Czech Social Democrats' is that the increased costs of banks will not be felt by clients, but by the banks themselves. However, as foreign studies show, the overall cost increase

[2] https://www.ceskenoviny.cz/zpravy/bankovni-dan-podle-cssd-ma-mit-podobu-odvodu-z-aktiv/1752027 [in Czech]

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across the sector is always passed on to the end customers. Research about effects of sectoral taxation in the euro area has shown that banks are able to pass on the raised costs (caused by banking tax) to their clients, from 45% in the short term (i.e. immediately after implementation), to 80% in the long term[3]. Results of further research indicate that the pass-through of the additional costs generated by the sectoral tax to clients of banks might be up to 90%[4].

In this context, an increase in the price of financial products means, in particular, an increase in interest rates on loans or a decline in interest rates on deposits. Moreover, foreign experience (e.g. Hungarian, Polish and Slovakian) shows how much on average banks raised interest rates in order to partially eliminate the financial losses caused by the imposition of a sector tax.

A rise in interest rates is strongly dependent on the sector's level of market concentration. In EU countries (where the sectoral banking tax is implemented) with a high sectoral market concentration, interest rates on loans increased by up to 0.77 percentage points[5]. This conclusion undermines the Czech Social Democrats' argument about the "competitive dissolution" of the burden of sectoral tax on clients. The above analogy might be used correctly for Czech conditions, where the banking sector is a highly concentrated market.

Impact on Households

The conclusions of foreign studies confirm that the risk of passing on costs to consumers through increased interest rates is real, and should be taken into account when considering the introduction of a sectoral banking tax. According to the Hungarian experience, it is partially predictable to which group of consumers the tax burden would most likely be passed on. The introduction of a sectoral banking tax in Hungary has led to an increase in interest rates for consumers with the lowest demand elasticity, i.e. for households who are repaying mortgage loans[6]. Households are, therefore, those customers who just have to accept higher interest rates because they have nothing else to do if they do not want to lose their homes.

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[3] Chiorazzo, V. and C. Milani (2011) "The Impact of Taxation on Bank Profits: Evidence from EU Banks", [in]: *Journal of Banking and Finance*, Vol. 35, pp. 3202–3212.

[4] Albertazzi, U. and L. Gambacorta (2010) "Bank Profitability and Taxation", [in]: *Journal of Banking and Finance*, Vol. 34, pp. 2801–2810.

[5] Capelle-Blancard, G. and O. Havrylchyk, O. (2013) *Incidence of Bank Levy and Bank Market Power,* CEPII Working Paper No. 2013-21.

[6] Capelle-Blancard, G. and O. Havrylchyk (2014) "The Ability of Banks to Shift Corporate Income Taxes to Customers", [in]: *Taxation and Regulation of the Financial Sector*, MIT Press, pp. 253–278.

The sectoral banking tax would probably also have similar consequences in the Czech Republic. Low-income families are very often characterized by rational ignorance due to lower levels of education (approximately 427,000 low-income households are characteristic for primary or lower secondary education)[7], which makes their demand elasticity of financial products even lower.

Impact on Business

As the sectoral banking tax entails serious consequences in the form of price increases for banking products, i.e. an increase in interest rates on credit loans, it is also necessary to consider the possible impacts on the business sector. It is not only small and medium enterprises (SMEs) that are considered as key sources of employment and innovative activities. Small entrepreneurs are also often dependent on available services in a healthy financial sector that is able to provide enough capital for their operating and investment activities (non-financial corporations hold 35.6% from the total amount of loans, households hold 49.3%; small entrepreneurs hold 1.4%)[8].

An increase in loans to entrepreneurs can seriously jeopardize the operating and investment activities of enterprises. The borrowers took the loans with some expectation about the future development of interest rates, which could change due to the shock caused by the banking tax, and this would depreciate their business plans. The increased cost of loan financing will then necessarily be reflected either in the final output prices of companies for which their customers pay, or, in the reduction of production capacities and thus a reduction in the number of employees (or in a wage reduction).

> THE PASS-THROUGH OF THE ADDITIONAL COSTS GENERATED BY THE SECTORAL TAX TO CLIENTS OF BANKS MIGHT BE UP TO 90%

2) SLOWDOWN OF ECONOMIC GROWTH

GDP Growth

At the same time, all the abovementioned impacts of the sectoral banking tax are also key determinants of the development of a very important performance indicator of the banking sector – the dynamics of credit lending. Credit growth in the economy is also strongly linked to other macroeconomic indicators, including GDP growth.

The sectoral banking tax may weaken credit growth in the economy, as the IMF pointed out to the Polish government in its analysis in 2016. The conclusion of this analysis predicted a decline in lending activity by 2-3 percentage points[9]. Moreover, we can expect a slowdown in the growth of credit lending in the Czech Republic during the upcoming period mainly due to increased interest rates by the Czech National Bank, which, among other things, determine the level of interest rates on loans. The period of cheap mortgages past behind Czech consumers and mortgage loans are now

[7] Czech Statistical Office (2019) *Main Macroeconomic Indicators.*

[8] Czech National Bank (2019) *Main Indicators (ARAD).*

[9] IMF (2016) *Republic of Poland, Selected Issues.*

Table 1: Estimation of the impact of sectoral banking tax on GDP growth rate in the Czech Republic

	Expected decline in the credit growth rate	**Expected decline in the GDP growth rate**	**Deviation from projected state budget revenues**	**Decrease in state budget revenues (absolute amount)**
1st scenario (optimistic)	-1 pp	- 0.43 pp	-0.39 pp	CZK -5.715 mn (EUR 228 mn)
2nd scenario (realistic)	-2 pp	- 0.87 pp	-0.78 pp	-CZK 11.429 mn (EUR 457.2 mn)
3rd scenario (pessimistic)	-3 pp	- 1.3 pp	-1.17 pp	-CZK 17.145 mn (EUR 685.8 mn)

Source: Own calculation

not only less affordable, but also more expensive. Implementation of the sectoral banking tax and the associated consequences would thus further exacerbate the current slump in lending activity.

The relationship between credit growth and GDP growth has been addressed in a number of international studies, and their conclusions confirm the strong dependence of both variables[10]. The decline in lending activity by 3 percentage points may cause a GDP growth slowdown by 1.3 percentage points[11]. The impact of the sectoral banking tax on the Czech economy can also be partially estimated from this relationship. The calculation of the three possible scenarios is illustrated in Table 1.

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THE INTRODUCTION OF A SECTORAL BANKING TAX IN HUNGARY HAS LED TO AN INCREASE IN INTEREST RATES FOR CONSUMERS WITH THE LOWEST DEMAND ELASTICITY, I.E. FOR HOUSEHOLDS WHO ARE REPAYING MORTGAGE LOANS

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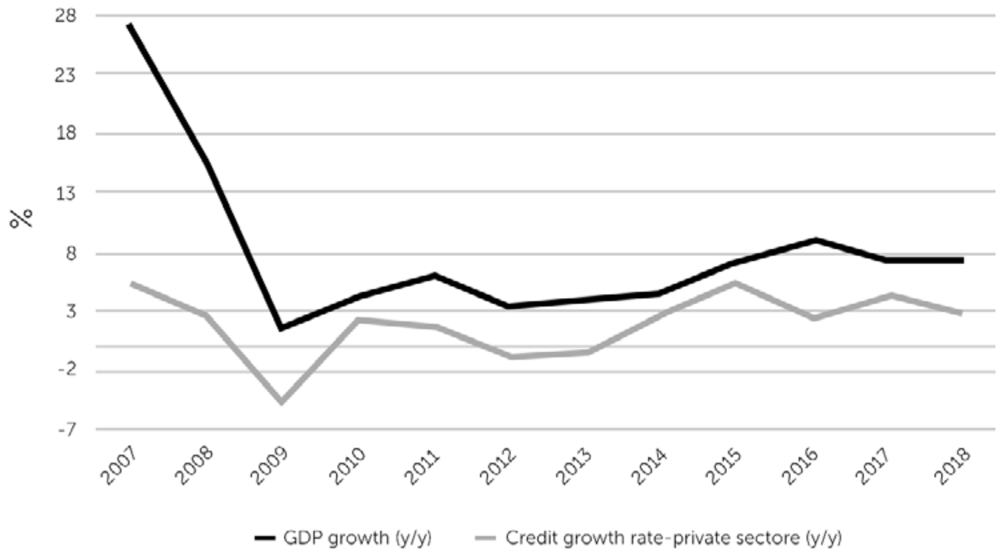
[10] A 2.5 percentage point decline in capital adequacy may cause a 1.5 percentage point slowdown in GDP growth. See: Bayoumi, T. And O. Melander (2008) *Credit Matters: Empirical Evidence on US Macro-Financial Linkages*, No. 8-169, International Monetary]). A 4 percentage point decline in lending activity (credit growth) will cause a 0.8-1.4 percentage point slowdown in GDP growth [See: MMF (2008) *Global Financial Stability Report, April 2008: Containing Systemic Risks and Restoring Financial Soundness*.

[11] Greenlaw, D., Hatzius, J. Kashyap, A., and H. Shin (2008) *Leveraged Losses: Lessons from the Mortgage Market Meltdown*, a draft paper prepared for US Monetary Policy Forum Conference.

Figure 1: GDP growth rate and Credit growth rate in the Czech Republic



Source: Czech Statistical Office, Czech National Bank

Alternatively, the estimation of fiscal impact can be calculated using the results of studies that examine the relationship between actual and predicted GDP growth values and their fiscal revenues dependent on them. Based on the forecast for GDP growth in the following year, the Czech Ministry of Finance also predicts its future state budget revenues. If the sectoral banking tax causes an unexpected decrease in the GDP growth rate, the actual state budget revenues will also deviate from the expected ones. The conclusion of the study examining the deviations of the state budget revenues in the EU countries states that the decrease of the actual GDP growth rate by 1 percentage point compared to the expected one will cause the actual state budget revenues to decline by 0.9 percentage points compared to the expected amount[12]. Based on this relationship, Table 1 also illustrates the calculation based on the planned revenues of the state budget for 2019, amounting to CZK 1,465.36 bn (EUR 58.6 bn)[13].

The current proposal of sectoral the banking tax calculates with additional state revenues of CZK 14 bn. After taking into account the unintended impacts from the first scenario, the final balance of revenues and costs of the sectoral banking tax would be CZK +8.285 bn (EUR 0.33 bn). If the second scenario is fulfilled, the final balance will amount to CZK +2.56 bn (EUR 0.1 bn). If the consequences of the third scenario are fulfilled, the state budget will ultimately lose CZK -3.145 bn (EUR -0.13 bn).

[12] Afonso, A. and R. Carvalho (2014) *Revenue Forecast Errors in the European Union*. Department of Economics, ISEG-UL, Working Paper, (02).

[13] Ministry of Finance of the Czech Republic (2019) *State Budget 2019*.

The Risk of a Deep Economic Recession and the Bank System's Remediation

Unlike many other EU countries (but also the USA, for example), Czech banks were in good shape at the time of the 2008/2009 financial and economic crises, and their stable lending activity helped bring the Czech economy out of a recession. As Figure 1 illustrates, the credit growth rate to the private sector over the whole period exceeds the GDP growth rate, and banks thus contribute significantly to the growth and prosperity of the Czech economy.

Future security of stable lending activity may be jeopardized by the implementation of a sectoral banking tax, as one of its possible impacts is an increase in interest rates on loans, which may reduce the dynamics of lending to the private sector and thus change the trend. This fact would then be very destructive in the next economic recession, when banks will not have the necessary financial resources to support and quickly resume growth in the Czech economy.

> AN INCREASE IN LOANS TO ENTREPRENEURS CAN SERIOUSLY JEOPARDIZE THE OPERATING AND INVESTMENT ACTIVITIES OF ENTERPRISES

> THE SECTORAL BANKING TAX MAY WEAKEN CREDIT GROWTH IN THE ECONOMY

The weakening of the banking sector's stability will not be immediately apparent. It is likely to be most visible only in times of economic crisis or economic recession. For this reason, some EU countries had to help effected banking institutions with money from public budgets during the 2008-2009 financial and economic crises. These unplanned government expenditures, which could have been used differently, have only increased public budget deficits. In order to avoid this unpleasant experience, it is essential to maintain the stability of the banking sector at least at its current level, and not burden it with additional taxes. The consequences of doing so may aggravate not only banks, but also the economy as a whole.

3) FINANCIAL SECTOR SECURITY

As past foreign experience shows (see below), the implementation of a bank sector tax entails a number of risks that can significantly shake stability in the banking sector. The latest results of the stress test of Czech banks, which are regularly published by the CNB, indicate currently stable banking with sufficient capital equipment[14].

[14] Czech National Bank (2018) *Rizika pro finanční stabilitu a jejich indikátory.* [in Czech]

THE PERIOD OF CHEAP MORTGAGES PAST BEHIND CZECH CONSUMERS AND MORTGAGE LOANS ARE NOW NOT ONLY LESS AFFORDABLE, BUT ALSO MORE EXPENSIVE

The Polish Experience

The Polish experience with the sectoral banking tax shows relatively substantial impacts on the financial sector. The first was the immediate downgrading of Poland's rating, along with the prediction of the negative outlook (S&P downgraded both short and long-term domestic ratings from "A- / A-1" to "A / A-2", Moody's downgraded "A2" from stable to negative). The rating, and its changes, is one of the essential pieces of information for domestic and foreign investors. Any subsequent reaction of investors is immediately reflected in the entire economy via the exchange rate. The immediate reaction to the downgrading of the rating was the fall in prices of Polish shares, and the depreciation of the Polish zloty[15].

After the implementation of the sectoral banking tax in Poland, Polish banks' profitability soon declined, but it was temporary. Banks' profitability fell by more than 11% between 2016 Q1 (PLN 3.2 bn) and 2017 Q1 (PLN 2.8 bn). Profitability decline was deepened by the obligation to finance recapitalization of saving cooperatives, as well as financial difficulties with loans held in Swiss francs. Polish banks, after the imposition of the tax burden, recorded the lowest gains since 2010, when the local economy was still torn by the effects of the global financial and economic crises[16]. In order to compensate financial losses, interest rates on loans and interest rates on deposits were

SOME EU COUNTRIES HAD TO HELP EFFECTED BANKING INSTITUTIONS WITH MONEY FROM PUBLIC BUDGETS DURING THE 2008-2009 FINANCIAL AND ECONOMIC CRISES

[15] https://www.ft.com/content/f7ea634e-d72d-32ea-bbd9-8c2f1cfc44cd

[16] Narodowy Bank Polski (2018) *Annual Report 2017.*

raised, and the lending was redirected from low margin investment and mortgage credit toward consumer credit, thus increasing the net interest margin. Banks also partially offset the negative impact of increased costs by reducing their personnel costs and reducing the number of employees. In the end, the burden of the tax was shifted on to their customers.

The link between the banking sector and the rest of the financial sector also shows the negative impact of the sectoral banking tax on the financial results of more than half of all Polish insurance companies, whose investment activities declined. Another direct consequence was the immediate decline in the value of banks listed on the Warsaw Stock Exchange, as their price-to-book value ratio dropped to low levels from the 2008-2009 global financial and economic crises[17].

The Hungarian Experience

Hungary also has an experience with the sectoral banking tax. Empirical studies show that a banking tax in Hungary caused an increase in the net interest and fee margin, especially for large banks compared to small banks. For large banks, the net interest and fee margin increased by 0.84 percentage point[18]. The increase in this indicator shows that banks have passed the costs associated with bank tax to their clients, mainly through higher interest rates on loans.

Interest rates increased the most for clients who have already been repaying house loans, not new loans generated. The rate on these mortgage loans increased by 108 basis points after the introduction of the tax.

> AFTER THE IMPLEMENTATION OF THE SECTORAL BANKING TAX IN POLAND, POLISH BANKS' PROFITABILITY SOON DECLINED, BUT IT WAS TEMPORARY

The Slovakian Experience

Slovakia imposed a sectoral banking tax in 2012. The basis for calculating the tax is the volume of deposits, with the tax rate set at 0.4%. One year after the introduction of the tax, banks experienced a decline of almost 25% in profitability. Three years later, the tax rate was reduced to 0.2% because of its destructive effects[19]. According to the Slovak National Bank, banks' profitability has been significantly reduced[20], which threatens the stability of the banking sector, weakens banks' ability to finance the growth of the domestic economy, and worsens the competitiveness of banks in the European market[21]. Thus, the Slovak government

[17] CYRRUS (2017) *Analýza dopadnu sektorového zdanění bank*. [in Czech]

[18] Capelle-Blancard, G. and O. Havrylchyk (2013) *Incidence of Bank Levy and Bank Market Power*.

[19] https://www.novinky.cz/ekonomika/430719-slovaci-varuji-cechy-pred-dani-pro-banky-maji-zkusenost.html

[20] https://www.nextfuture.sk/banky/sadzba-bankoveho-odvodu-zostava-do-roku-2020-nezmenena/

[21] https://ekonomika.sme.sk/c/20207470/bankovy-odvod-sa-neznizi.html#ixzz5nR7EZL00

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THE SECTORAL BANKING TAX COULD SUBSTANTIALLY DEEPEN THE CURRENT DECLINE IN CZECH BANKS’ LENDING ACTIVITY

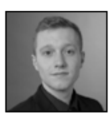
finally approved its complete abolition, effective from the beginning of 2021.

CONCLUSIONS

The analysis of the effects of the sectoral banking tax has revealed a number of negative consequences and extensive risks, which are undoubtedly connected with the implementation of this selective fiscal instrument. The short but rich experience of a sectoral banking tax in European countries proves that its costs are not only incurred by the banks themselves, but also by citizens, not only as bank clients, but also as taxpayers. The impact on the citizens is therefore cumulative.

Immediate consequences of the sectoral banking tax can be demonstrably seen in price increases of financial products, and a disruption of the natural development on the financial market, which weakens the dynamics of the banking sector and is also reflected in the long-term stability of economic growth. Moreover, many of the consequences of a sectoral banking tax do not need to necessarily take effect immediately after its implementation, but later at times when it is least appropriate – in times of economic crisis or economic recession.

The proposal of Czech Social Democrats to introduce a bank tax is insufficiently analyzed. Implementation of a banking tax, however, entails a number of undesirable and unintended impacts, which will ultimately also effect the overall balance of fiscal revenues. The sectoral banking tax could substantially deepen the current decline in Czech banks’ lending activity, which will also be reflected in the revenue side of the state budget through a decline in GDP growth rates.



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