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Italy: Banking on the wrong tax

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Executive Summary

- On August 7, Italy's right-wing Government led by Giorgia Meloni announced a controversial windfall tax on the allegedly "excess profits" of the country's banks.
- The intervention was partly justified by the low benefits from higher interest rates that Italian banks have passed on to their depositors compared to their European peers, and by the need to raise fiscal resources to shield poorer households from the inflation crisis.
- However, the haphazard modality with which it was introduced has created turmoil for markets and required substantial modifications, which ultimately limited its scope.
- Both the ECB and the Italian Banking Association (ABI) have criticised the measure. Even within Meloni's right-wing coalition, Forza Italia has advocated for changes to exclude smaller lending institutions from the measure.
- As a result, the tax is now estimated to generate a fraction of the original resources, but the government's move has blemished Italy's risk perception in the markets and foreshadows the political and economic challenges the government will face in the upcoming months.

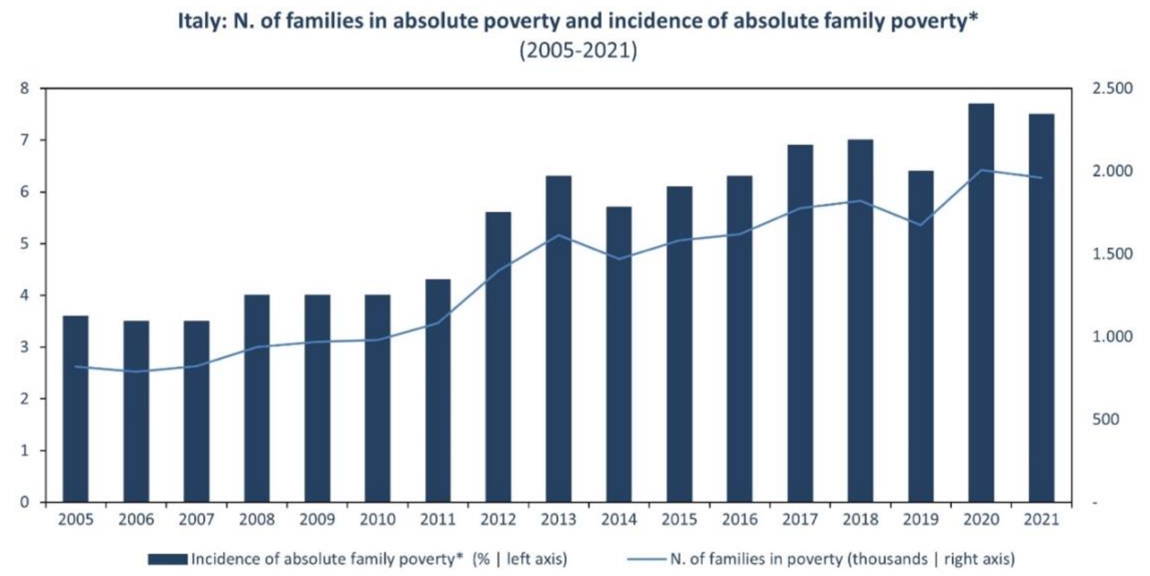
Policy Analysis

The Italian executive set forth a proposal for a tax on banks' windfall profits applying to those banks which have increased the interest rate they charge on loans disproportionately more than the rate at which they remunerate their depositors. The original proposal envisaged a retroactive 40% levy on the increases on banks' "interest margins" greater than 3 percentage points (for 2022 vs 2021) and 6 percentage points (2023 vs 2022). To be a one-off payment in 2024, the tax was originally estimated to raise up to €5bn. Soon after the announcement, however, the turmoil in financial markets prompted the government to revise the proposal by raising the thresholds to 5% and 10%, respectively, and by capping the maximum impact to 0.1% of a bank's assets and 25% of its equity.

While there are some justifications for the decision, the policy design and method were controversial. There are at least three arguments that may justify the government's move.

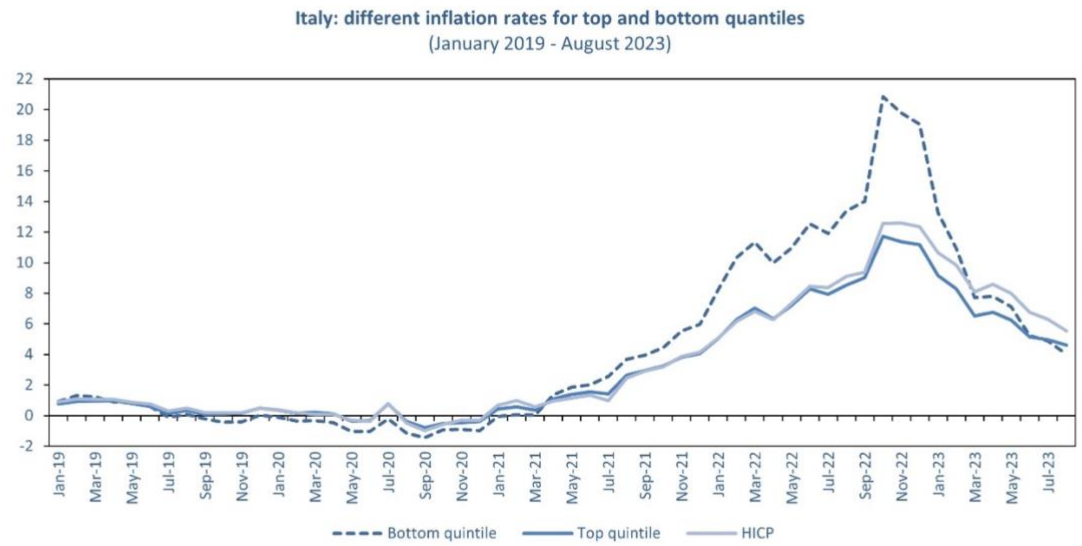
1. Italians have experienced a significant rise in both inequality and the cost of living in the years since the pandemic (figures 1.a and 1.b). In particular, poorer Italians have experienced higher inflation as the costs of basic goods have risen the most. In this context, a redistributive policy is both economically and politically sensible. Targeting banks for these types of interventions is justified in voters' view, given that the sector is perceived to have benefited from state rescues during and in the aftermath of the Global Financial Crisis (see the case of Monte dei Paschi di Siena).

<u>Figure 1.a: Italy’s households in absolute poverty have risen to unprecedented levels since the pandemic</u>



Source: <u>ISTAT</u> | *The share of families living in a condition of absolute poverty across all Italian families.

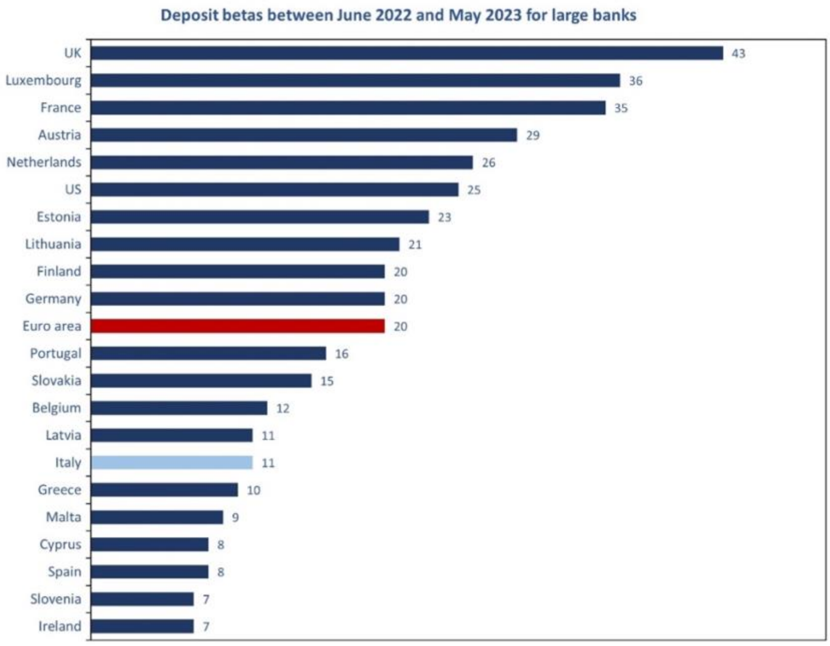
<u>Figure 1.b: Poorer households have experienced higher inflation</u>



Source: <u>Bruegel</u>

2. Italian banks have been particularly "slow" at passing on the benefit of the ECB's higher rates to their depositors. At 11%, Italian banks' "pass-through" rates[1] are among the lowest in Europe, well below the Eurozone average of 20% (see Fig. 2).

Figure 2: Italy's banks have passed on a smaller proportion of interest rates to depositors



Source: Financial Times based on S&P Ratings data.

3. Other EU countries with governments from across the political spectrum (Spain, Hungary, the Czech Republic and Lithuania) have already implemented analogous measures.

However, the policy as designed by the Italian government showed several flaws.

1. *It was unequal*, penalising smaller banks most. By focussing only on the interest margin, it taxed only one line of banks' income statement. Those that rely most on traditional credit activity were thus disproportionately affected, while larger banks that have other sources of income (e.g., fees on financial and insurance products) saw

[1] Pass-through rates are defined as the proportion (%) of interest rates passed on to customers' deposits in the face of higher interest rates set by the ECB.

a relatively smaller impact. Moreover, this approach ignored the loan default costs banks incur, which would instead be reflected in their net income.

2. It constituted a *discretionary and asymmetric government intervention* in a competitive market. The state would tax banks today, when interest rates are high, ignoring years of very slim margins when interest rates were close to zero, but banks could not charge customers negative interest rates on their deposits. This type of one-off measure can increase the perception of uncertainty for operators and investors. The oscillations of the Italian stock market in the week following the announcement and the rush to amend the proposal show the costs of this unpredictability.

3. The tax could be *counterproductive*. It risked increasing the difficulties for Italians to access bank credit at a moment of economic slowdown and in a context where SMEs are already struggling to obtain credit. The policy could lead banks to tighten credit further during the rest of 2023 to maintain their capital buffers. This could impact private borrowers as well as Italian treasury bonds, of which Italian banks are large holders, at a time when the ECB is starting to reduce its purchases.

While these specifics of policy design are a matter of debate, there is little doubt that the government's method was controversial. The absence of coordination led to more-than-necessary confusion.

On the one hand, the government did not attempt any pre-emptive concertation with banks. In particular, it did not engage Abi (the Association of Italian Banks). On the other hand, the days following the announcement made it clear that, even within the government, there was no consensus on the merits and risks of the tax. The result was immediate backtracking after the announcement, a vehement backlash from industry representatives, and an ongoing public discussion about the appropriateness and feasibility of the measure, even among government representatives.

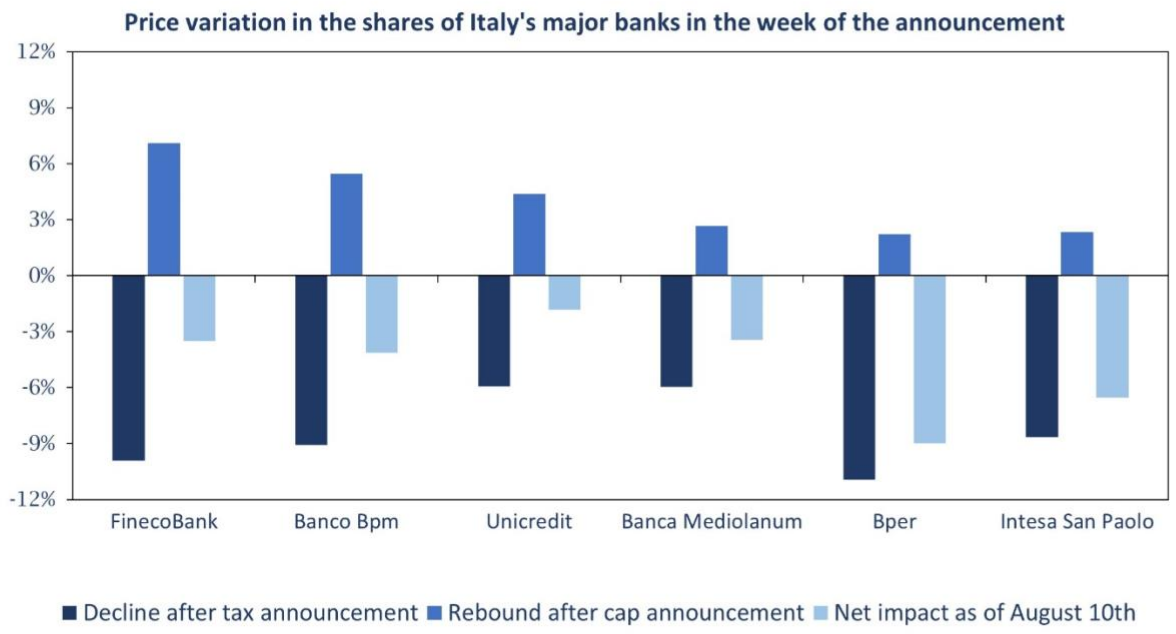
All in all, the move led to a chaotic situation that gave the impression of an improvised policy process. This is particularly detrimental as the executive will now need to gain market confidence for a 2024 budget law that includes higher deficits and slower growth forecasts.

Immediate effects and reactions

The measure caused major concerns across financial markets and immediately set off a debate on how to modify it.

Within the first day of trading after the announcement, the Italian stock market (FTSE MIB) lost €27bn of capitalisation, €9bn directly from banks' share price fall. Even after the Minister of Economics and Finance attempted to reassure financial markets by introducing a cap on banks' prospective total costs, none of Italy's major banks' shares recovered their value (Figure 3).

Figure 3: The announcement of the windfall tax hit Italian banks' shares



Source: Open, WeWealth

Neither did the introduction of the cap put an end to the debate. Since then, several criticisms and adjustment proposals emerged about the definition of the tax base and the types of banks that should be spared. The European Central Bank also voiced its concerns in an official, non-binding opinion. It explained that the tax's impact on banks' capital base risked reducing the resilience of financial institutions and thus increasing financial instability in case of recession.

As the law underwent parliamentary conversion, parties from the majority applied drastic changes that watered down the tax's impact. The cap was changed to 0.26 percent of risk-weighted assets and the interest margin calculation now excludes interest profits from government bonds. Banks also have the option to avoid the levy altogether by allocating 2.5 times its value to their capital reserves.

All in all, the government had to backtrack on several aspects. Now the likely financial impact of the measure will fall short of original expectations, raising less than €3bn. In the meantime, however, Italy's reputation vis-à-vis international investors has been impaired, and observers will be monitoring Meloni's fiscal stance in the upcoming budget law.

Economic and Political Implications

Aside from the financial impact that the final version of the measure will ultimately have, the episode provides at least five insights as to what to expect from the government's economic policy and Italian politics in the months to come.

1. The government feels the *pressure to approve policies that appear to redistribute wealth*. This is to avoid social tensions and balance its position on other dossiers that risk weakening Meloni's support among poorer social classes. During the summer, the government scaled back the citizens' income program (*Reddito di cittadinanza*) – a poverty relief scheme – at a time when economic growth was slowing down and gasoline prices increasing. Meloni is also rejecting the opposition's proposals for a national minimum wage and for increased spending on public healthcare. In this

context, targeting banks' "undeserved profits" sends the message that the government is trying to distribute the costs of the difficult economic moment.

2. *Fiscal constraints* will characterise the upcoming budget law. The introduction of such a one-off tax is a sign of the challenges the government is experiencing in finding the resources to fund its fiscal agenda for next year. With the cost of debt rising and economic growth slowing down, the negotiations over the budget law are already forcing the majority to find areas where to cut spending. This has been confirmed on several occasions by Finance Minister Giancarlo Giorgetti and by Meloni's request that ministers enact a "spending review."

3. The government is prone to an *interventionist and ad-hoc approach* to economic policy. The tax was consistent with the government's preference so far for piece-meal interventions in specific sectors of the economy rather than system-wide and horizontal reforms. The same method can be seen in the measure that limits the use of algorithms by airlines to set prices (originally in the same decree), in last year's extension of special tax regimes to specific categories of taxpayers, and in the fiscal reform currently in the making.

4. *Ms Meloni still has a strong hold* on the government. The PM supported the measure and pushed it through the Cabinet despite some internal opposition; Mr Giorgetti, who had previously reassured the sector against this type of intervention, was absent during the announcement. Ms Meloni instead defended it publicly despite the controversies. She thus remains the undisputed leader of Italy's right-wing coalition, notwithstanding mounting problems (e.g., the steep rise in illegal immigration numbers) and the League's leader Salvini's effort to exploit them for his campaigning. Recent polls confirm this.

5. *Forza Italia (FI)'s was weakened by Berlusconi's passing* and is struggling to find a new role in the political system. The measure was approved despite being against both the party's direct interests (affecting Mediolanum, the bank owned by Berlusconi's family) and those of its middle-class electorate. The party did not have the strength to impede its approval. However, it became the main proponent of modifications to the law in parliament, in particular by defending the interests of smaller banks. This activity foreshadows what might be the party's emerging role in the coalition: a more moderate partner which uses its golden share of votes in both chambers to fight battles that help it retain the centre-right of the Italian electorate.

3 Key Takeaways

1. The controversy around the windfall tax foreshadowed the challenges lying ahead for the government's budget law, which will require a difficult search for resources to deliver at least part of the ambitious electoral campaign promises.
2. The financial impact of the tax was ultimately reduced, but the episode is revealing of the government's interventionist approach in economic policy, which so far has increased complexity through ad-hoc and unpredictable measures.
3. Ms Meloni is still the undisputed leader of Italy's right, but tensions within the coalition are rising and might contribute to other episodes of non-linear policy processes.