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The Safety of Deposits in EU Banks in View of Cyprus's *Bailout Tax*

Cyprus has been a member of the EU (European Union) since 2004. In 2008 this country joined the Euro Zone and adopted EUR as its currency. From 2001 up to 2011 the Cypriot economy was almost constantly growing – the average GDP (gross domestic product) increase in those year amounted to 2,6% with 2009 being the only year with a negative GDP of minus 1,9%¹. However, in 2012, Cypriot GDP decreased by 2,4% and the estimated GDP for 2013 amounts to minus 8,7%. The above-mentioned decreases are the result of a serious crisis in the Cypriot economy. This crisis includes the serious problems of Cypriot Banks which suffer from bad debts and lack of capital. In addition, it is partially caused by the restructuring of Greek debt which severely affected Cypriot Banks.

On 25th March, 2013, Cyprus obtained a €10 billion bailout package. To gain it, the Cypriot Government was obliged to freeze and tax bank assets, in particular in Laiki Bank which suffered most during the crisis. What is worth mentioning is that before the crisis, it was the second largest banking group in Cyprus. As a result of the agreement between the EU and Cyprus, deposits above € 100 k (the amount which is guaranteed under EU law) have been frozen. Part of the funds are currently being used to resolve Laiki Bank debts, others were used to recapitalize the Bank of Cyprus (the biggest Cypriot Bank, the one to which deposits under € 100 k were moved)².

In addition, a *bailout tax* was imposed. At first it was meant to affect all depositaries in Cyprus³. However, in the end it was decided that only the deposits in Laiki Bank would suffer as well as a part of the deposits in the Bank of Cyprus. 37,5% of assets held

1 Eurostat, GDP and main components – volumes [online]. Eurostat Home [access: 2013-08-03]. Available at: <<http://appsso.eurostat.ec.europa.eu>>.

2 M. Kambas, K. Tagaris, *Cyprus banks remain closed to avert run on deposits*, Reuters, 2013-03-25.

3 J. Weisenthal, M. Boesler, *Cyprus Agrees To New Plan To Tax Deposits*, Business Insider, 2013-03-23.

in the Bank of Cyprus were deducted from depositors' accounts and another 22,5% were frozen⁴. Owners of deposits in Laiki Bank are expected to lose even more than that. However, as their loss is dependent on the result of the currently on-going liquidation proceedings of Laiki Bank, the exact amount of losses is not yet known.

The so called *bailout tax* imposed on deposits in Laiki Bank and the Bank of Cyprus raised serious doubts about the safety of deposits across the European Union. Formally, under Directive 94/19/EC of the European Parliament and of the Council of 30th May 1994, country-level deposit-guarantee schemes shall cover up to ECU 20 000 in the event of deposits being unavailable⁵. However, the situation in Cyprus raised questions about the certainty of this protection and as a result the safety of money deposited in Euro Zone Banks.

It should be noted that confidence in banks is one of the most important conditions for the proper running of national bank systems. This is because currently most of the developed countries run their banking systems under the fractional reserve scheme. To understand the importance of bank confidence this term should be explained. Generally, when a customer deposits money in a bank, the funds become the property of the bank. In return, customers receive assets in a form which is receivable from the bank. The bank uses the deposited money to grant loans. Thus, only a small amount of the deposited money is saved as a reserve (e.g. currently in Poland the obligatory reserve rate amounts to 3.50%⁶, which means that a bank may use 96,5% of the deposited money for granting loans). As the party receiving the loan usually uses it to pay for certain assets, another party receives the funds from the loan. If this party deposits this money back into a bank account, after deducting the obligatory reserve, the bank may use it to grant further loans. As a result, €100 of the initial deposit, depending on the level of the obligatory reserve rate, can result in e.g. €900 of granted loans in the national banking system⁷. Taking the above into account, any changes in the level of bank deposits automatically affect the country's economic system.

It is also worth mentioning that, as a result of granted loans and low reserve rates, banks usually do not hold enough reserves to cope with all deposits being taken out at once. In other words, banks suffer from a constant mismatch of liquidity as the bank's liabilities are more liquid than their assets (e.g. granted loans). Thus, a banking system

4 A. Granitsas, *Central Bank Details Losses at Bank of Cyprus*, The Wall Street Journal, 2013-03-13.

5 Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes.

6 *Podstawowe stopy procentowe NBP [online]. NBP [access: 2013-08-03]. Available at: <<http://www.nbp.pl/Dziennik/Stopy.htm>>.*

7 The exact amount may be calculated by using the formula: $m = 1 / R$, where m – is the maximum amount of money which may be created from a deposit and R is the obligatory reserve rate.

works only as long as investors forecast that banks will survive. If customers expect problems with bank liquidity their actions may cause severe problems. In particular, there is a risk that a bank will not be able to close its investment (e.g. sell loans) fast enough to meet the demands of depositaries. Thus, a crisis of confidence in bank liquidity may be perceived as a kind of self-fulfilling prophecy.

During a bank run, depositors rush to withdraw their deposits because they expect the bank to fail. In fact, the sudden withdrawals can force the bank to liquidate many of its assets at a loss and to fail. In a panic with many bank failures, there is a disruption of the monetary system and a reduction in production⁸.

Many of the global economic problems were caused by the loss of confidence in banks and subsequent bank runs which ruined local banking systems, and subsequently countries' economies. This had echoes of the great depression. One of the European legs of this crisis was the failure of Creditanstalt in Austria. Creditanstalt not only granted loans but also invested in various companies⁹. In the 1930s this bank expected serious problems with liquidity. The Austrian government's policy, aimed at guaranteeing its deposits, resulted in putting the government's own creditworthiness into question¹⁰. In today's language Credit-Anstalt was too big to fail, but too big to save¹¹. Even though the bank was saved in the end, the lack of confidence spread, leading to serious economic turmoil across Europe. The following recession indirectly cleared the path for the Nazis to come to power¹².

The above example shows that a crash of the banking system caused by lack of confidence may lead to unexpected events of great and tragic influence for millions of people. Taking that into account, the Cyprus bailout tax could be perceived as a dangerous idea – especially if such a way of handling bank problems spreads across the Europe. However, looking at the bank's deposits from a different perspective, taxing such deposits is a relatively easy way to get rid of growing government debts. For example, it is said that a tax rate of 15 percent on financial assets in Italy would push Italian debt below 100 percent of GDP¹³. Bearing that in mind, deposits located in banks may attract political attention, especially in the current times of serious debt problems for many countries.

8 D.W. Diamond, P.H. Dybvig, *Banks Runs, Deposit Insurance, and Liquidity*, Federal Reserve Bank of Minneapolis Quarterly Review, Winter 2000, p. 14.

9 P. Coy, *Lessons from the Credit-Anstalt Collapse*, Bloomberg Businessweek, 2011-04-20.

10 *Ibidem*.

11 A. Schubert, *The Credit-Anstalt Crisis of 1931*, Cambridge 1991.

12 M. Mcardle, *Why Should You Be Freaked Out About Greece? Remember, The Great Depression Had Two Parts*, Business Insider, 2010-04-28.

13 D. Newer, *The myth of the clammy crisis states*, Handelsblatt, 2013-03-15.

Are deposits safe then in the Euro Zone? To analyse this issue, we should take a closer look at the history of certain European countries. Germany, which is currently said to be the country leading Europe, has used emergency financial instruments several times in its modern history. In the years before World War II, there were several situations in which Germany used its citizens' capital to finance government affairs:

- in 1919, as a result of huge government debt amounting to 180 percent of gross domestic product, a special tax was introduced¹⁴. Taxpayers' assets were taxed with progressive rates beginning at 10% and ending at 65%. Generally, the taxes were to be paid in installments over a 30 year period. Even though the tax rates were very high, huge rates of inflation affected the taxed amounts and devalued the installments;
- in 1922/23 Germany introduced a forced loan for all individuals holding assets worth at least 100 k. marks. The rates were progressive, with persons holding wealth worth 1 m. marks obliged to grant a loan of 10%. In this case also the repayments were seriously devalued by German hyperinflation¹⁵.

Germany also used similar instruments after the Second World War. In 1949, a capital levy was introduced. The tax rate was generally 50% with a tax allowance set at 5000 marks (at that time the average annual pensionable income was 3,850 deutschmarks)¹⁶. The installments were to be paid over a 30 year period and were collected until 1979. A few years later, in 1952, entrepreneurs were forced to provide loans for investment in certain industries. The companies had to pay a total of 1,4% of German GDP and the exact rate of taxation was dependant on the company's profits¹⁷. The forced loan was analyzed by the Federal Constitutional Court which ruled that it did not breach the German constitution¹⁸.

The last attempt to introduce a forced loan in Germany took place in 1982. The government decided to introduce one-off forced loans to promote the housing industry. The taxable amount was based on income from previous tax years and was meant to be paid back without interest. However, in 1984, this tax was declared unconstitutional. In its ruling the German constitutional court stressed that the government had exceeded its rights as it only had the possibility to impose taxes but not obligatory loans. The German constitutional tribunal also defined some requirements for a special levy, claiming that there has to be a group-specific financial interest and corresponding use of funds for such a tax to be introduced.

14 S. Bach, *Capital Levies—A Step Towards Improving Public Finances in Europe*, DIW Economic Bulletin, no. 8, 2012, p. 5.

15 *Ibidem*.

16 *Ibidem*.

17 *Ibidem*.

18 *Ibidem*.

Capital levies were also popular in the 1920s'. They were introduced, for example, in Italy where the rate of *extraordinary tax on capital* graduated from 4,5% to 50% with the payment stretched out over 20 years¹⁹. A similar tax was also introduced at that time in Czechoslovakia. Its progressive rates ranged from 3% to 30%. The tax collection took place during a 3 years period²⁰. In the 1920s, similar taxes were also introduced, with various effects, in Austria and Hungary.

Looking at more modern times, the Italian example can be mentioned. In 1992 the Italian Government introduced a 0,6% one-off levy on bank accounts. Even though the tax was successfully introduced it didn't helped Italy as the Lira had to be devalued in the same year. One year later the Prime Minister of Italy was forced to resign.

The above-mentioned examples show us that the one-off deposit account tax which was introduced recently in Cyprus may also be introduced in any other country. There are several reasons why implementation of such taxes is probable:

- implementation of a deposit tax is easy – it requires only the freezing of bank accounts and deduction of a certain amount of money from each depositary;
- it is hard to evade such a tax –introducing a capital tax usually results in a so – called capital war (people trying to evade the tax and transferring their assets). As national banks are heavily controlled it is relatively easy to order them to freeze assets and subsequently deduct amounts from accounts, however;
- it is fast – a bank account tax may be introduced in just a few days and the budget gains the profit almost immediately;
- it is cheap – imposing such a tax does not require any complicated calculations or valuations.

On the other hand, there are also some negative aspects of such a tax. Firstly, and probably most importantly, is the problem that the community is likely to object to such a tax. Thus, politicians are rather cautious about introducing such an idea as it would probably mean political suicide for them. The second problem is that constitutional problems may arise as regards the legality of such a tax.

Looking more closely at the constitutional problems relating to a bank tax it should be said that the provisions of constitutions regarding the prerequisites for establishing taxation vary significantly between particular countries. In addition, in each case, it is important to also take into account the rulings of constitutional courts which often play a great role in the interpretation of national constitutions. The length of this article does not allow an in-depth analysis of constitutional problems relating to the establishment of a deposit tax. However, based on the Polish constitutional example, I would like to point out some problems which may arise in the case of establishing such a levy.

19 B. Eichregan, *The capital levy in theory and practice*, Nber Working Papers, no. 3096, 1991, p. 20.
20 *Ibidem*.

According to the article 84 of the Polish Constitution, *everyone shall comply with his responsibilities and public duties, including the payment of taxes, as specified by law*²¹. However, according to a ruling of the Polish Constitutional Tribunal dated 7 June 1999 (K 18/98), the imposition of a tax may not result in the confiscation of property. In addition, taxation may not infringe upon the essence of other constitutional rights. According to the Constitutional Tribunal²², the government may impose taxes where the value exceeds income from property. However, such a possibility is limited – the taxation may violate the right to property and become a hidden form of confiscation.

Taking the above considerations into account, the possibility of imposing a deposit tax may be disputable. It could be argued that the legality of such a tax would depend on the circumstances in which it were imposed. In particular, in my view, imposing a deposit tax with a comparatively high rate in normal economic conditions could be perceived as confiscation of property. However, in the case of serious national economic problems (e.g. the risk of bankruptcy) one could argue that imposing such a tax would be acceptable. In particular, in such circumstances, a serious conflict between constitutional values could exist. In cases where the government has to choose between freedom of property and the stability of the country (the possibility of securing other constitutional rights) a deposit tax could be claimed as proportional infringement of liberty.

It should also be noted that the freedom of property may be limited during a state of emergency (polish: *stan wyjątkowy*). Such a state may be announced in situations in which there is a threat to the constitutional order of the state, to the security of its citizens or public order²³. The risk of a country's bankruptcy may be perceived as a threat to all of the above. However, constitutionally, an emergency state is temporal²⁴. In my view, introducing it only to adopt some one-off measures would go against the constitutional reasons for having the emergency state in the first place.

Looking at deposit taxes from the perspective of EU Law, it should also be stated that imposing such a tax is not contrary to Directive 94/19/EC of the European Parliament and of the Council of 30th May 1994 on deposit-guarantee schemes. As was already mentioned, this Directive states that when deposits are unavailable, part of them is guaranteed by the country.

However, taxation of deposits does not activate the guarantee. This is because taxed deposits are not *unavailable* – they are simply no longer owned by the depositary. Thus, the Directive guarantees do not work in the event of deposit taxation.

21 Dz. U. No. 78, item 483.

22 Ruling of The Polish Constitutional Tribunal of 8 October 2007; K 20/07.

23 Article 230 of The Constitution of the Republic of Poland of 2nd April 1997; Dz. U. No. 78, item 483.

24 Limit of maximum 150 days exists.

To conclude, it should be stated that deposits in banks are never completely safe. Certain exceptional political and economic events may cause depositors to lose part or even the full amount of the deposited money. Thus, to safeguard one's funds, one should consider not only diversifying one's assets between banks but also between different countries. On the other hand, taxing deposits is a last-ditch regulatory action. In normal economic circumstances, its introduction is highly unlikely. In particular, in some countries, introducing such a tax could infringe constitutional rights (e.g. freedom of property).

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SUMMARY

The safety of deposits in European Union banks in view of Cyprus's bailout tax

The aim of the study is to evaluate the right to property in the context of the safety of bank deposits in the European Union. In order to present that topic the author focus on the example Cyprus's bailout tax concluding that it should be stated that deposits in banks are never completely safe.

KEYWORDS: bank deposit, Cyprus's bailout tax, tax law

