Italy's Bank-Profits Tax Plan May Become Model For Eurozone

By **Cris Cicala** (September 28, 2023)

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Last month, as most Italians were preparing for Ferragosto, the festival that kicks off the traditional August holidays, Prime Minister Giorgia Meloni and Deputy Prime Minister Matteo Salvini proposed a one-time, 40% tax on bank profits.

Although Meloni, a member of the Brothers of Italy party, and Salvini, a member of the Lega Nord per l'Indipendenza della Padania party, had floated the idea earlier in 2023, they seemed to lose interest as the year progressed, and the Aug. 7 announcement came with little notice to European financial markets.

Meloni, Salvini and their right-leaning coalition government have associated robust Italian bank profits with the expanding gap between high interest rates for borrowers and significantly lower interest rates for savers and depositors.

Per the Italian cabinet's calculations, the so-called windfall tax could bring in as much as €4 billion ($4.3 billion). Meloni and Salvini have proposed using this revenue to assist first-time home buyers struggling with high mortgage rates and to subsidize tax incentives for consumers with high-interest consumer debt, including credit cards.

The redistributive nature of the proposal has led many to view the proposed tax as a populist political maneuver to curry favor among Italian voters, positioning Meloni and Salvini's coalition government as the defender of Italians feeling the pinch of rising interest rates.

Of course, Italian banks are subject to borrowing costs set by the European Central Bank, not the Italian central bank, Banca D'Italia. As the ECB has steadily increased the benchmark interest rate, Italian banks have passed the cost on to Italian borrowers.

Although the Italian government has representation on the governing body of the ECB, the ECB is ultimately beyond their control and regulation. This multitiered representative structure means Italian banks are the only entities within the reach and regulation of the Italian government — and the only outlets for the government to impart its frustration.

Accordingly, the proposed windfall tax puts Italian banks squarely in the middle of a dispute between the populist and euroskeptic.

Italian government and the ECB.

Immediate Walk-Back

By its own admission, the Italian government's communication to both financial markets and the public leading up to the announcement of the tax left a lot to be desired. The rollout was clumsily orchestrated and lacking in detail, causing an immediate and substantial drop in the stock value of both Italian banks and European banks more broadly.

The ECB immediately voiced concern for the stability of the Italian banking system as a whole, arguing that a 40% tax on profits could destabilize certain Italian banks by depleting their assets.

As alarm bells sounded across the continent, Meloni's government quickly recalibrated. On Aug. 10, just three days after the initial announcement, Salvini told reporters that while the tax would remain at 40% of profits, the tax imposed could not exceed 0.1% of a bank's assets.

The walk-back resulted in a short-term, partial recovery in the stock prices of major Italian banks that held during the holiday recess.

However, the 0.1% cap was not enough to satisfy the ECB, which is preparing a complaint against the Italian government to be brought before the European Union. And now that Italians have returned from their summer vacations, concerns about the windfall tax proposal have amplified.

Major Italian banks and bank advocacy groups, such as the Associazione Bancaria Italiana, have already threatened legal action to challenge the proposed one-time tax on the grounds that it violates Italian constitutional law. At a minimum, they argue the one-time tax should be deductible in some form from the bank's ongoing tax liability.

The Italian government's official position is the proposed tax is a tool to be used to rebalance the basic inequities it believes have risen between the banking system and Italian borrowers.

Members of Meloni and Salvini's coalition have come out publicly and in numbers to defend the proposed tax as both fair and necessary, and those lawmakers have been quick to point out that the tax will pass the Italian Parliament and become law.[1]

Fight Over Future Investment

The likelihood that Meloni's tax plan will pass has not stopped Italian banks and their defenders from attacking this redistribution of wealth. They argue that the windfall tax places the burden solely on Italian banks, with none on the ECB.

At the same time, they want to hold Italian borrowers accountable for spending habits that have slowed Italy's economy, such as increased reliance on credit cards and consumer loans. Of course, the Italians who stand to benefit most from Meloni's plan are also the very voters upon whom the coalition government will likely rely to remain in power.

If one is calling sour grapes on the Italian banks right now, it is worth noting that they are the largest private purchaser of government bonds. This may be the critics' strongest argument, and indeed they have argued vociferously on practical rather than legal grounds that the proposed tax will deter future investment in Italy.

The government's surprise intervention may be sending the dangerous message to potential investors that the ground rules could change with little to no warning.

Italian banks have heavily implied that they would be less likely to invest in government bonds if they are to be taxed 40% on profits. This would almost certainly drive down prices and drive up yields, widening the spread between interest rate yields on Italian 10-year bonds and German 10-year bonds.

This difference in yields, colloquially referred to as lo spread in Italy, is seen as a major indicator of economic health, and closely followed by investors and the public alike. Simply put, lo spread has become a gauge by which to measure the government's stewardship of the economy.

Italian politicians are keenly aware of lo spread and are sensitive to its implications. Members of the Forza Italia party, a center-right component of Meloni's coalition, have said that profits earned on Italian bonds should be exempt from the proposed tax.

This week, Meloni's government announced that banks could strengthen their capital reserves in lieu of paying the tax, at least partially in response to Forza Italia's concerns. However, the large Italian banks have indicated they would rather pay the tax.

Ramifications in the EU and the U.K.

Aside from macro-level philosophical and political arguments surrounding equity, fairness and whether it is right or wrong to hold the banks accountable, European market observers are wondering how far this dispute between the Italian government and the ECB will go.

There is speculation that the passage of such a tax could spark a trend across the eurozone and even in the U.K.

Windfall profit taxes are not necessarily a novel concept in Italy or in Europe. Prior to Meloni's tenure as prime minister, Italy imposed a windfall tax on energy companies in March 2022 that remains in place.

Additionally, Spain, the Czech Republic and Lithuania have imposed windfall profit taxes on banks somewhat similar in structure to that proposed in Italy, though for considerably smaller economies.

Hungary has experimented with a hybrid windfall profit tax on banks under which Hungarian banks can largely avoid the tax if they increase their Hungarian bond purchases by 50%, a solution that could calm fears about lo spread in Italy.

Despite windfall taxes in smaller economies and on smaller scales, the current attention on Italy's proposed tax asks whether the imposition of such a broad and unexpected tax in Europe's third-largest economy — the eighth largest in the world, per the International Monetary Fund — will change the status quo in the eurozone.

Officials in Germany, Europe's largest economy, have stated that a windfall tax similar to the one proposed in Italy is off the table, as it is prohibited by their current coalition government agreement.

The same cannot be said for France. French President Emmanuel Macron, while not having commented on the Italian tax directly, has publicly indicated a desire to see a more equitable distribution of income derived from the higher interest rate environment.

Macron's statements have some observers speculating that France may follow Italy's lead and propose a windfall tax on French banks.

Perhaps most intriguing of all is the possibility the U.K. could implement some form of a windfall profit tax on its banks. Like Meloni and Salvini, U.K. Prime Minister Rishi Sunak has been described as an euroskeptic and continues to support Brexit.

After Italy implemented its windfall tax on energy profits, the U.K. government followed suit in May 2022 with a stated aim of using the tax revenue to assist Brits struggling with increased costs of living and inflation. Accordingly, many observers believe Sunak is closely monitoring how the proposed windfall tax battle in Italy plays out.

If Meloni can curry favor with voters by navigating safe passage of her tax, Sunak may well introduce his own version.

A proxy battle with the Bank of England vis-à-vis a tax on English banks would have far-reaching consequences, given the U.K.'s importance as an international banking center. And it would have a very different tenor than in Italy.

Whereas most Italians are skeptical that the ECB is looking out for their interests, the Bank of England functions more like the U.S. Federal Reserve, purporting to deliver monetary and financial stability for its citizenry. As such, Sunak would not be pushing back against the eurozone but the entire concept of central banking.

What to Watch For

Expect Meloni and Salvini's proposed windfall tax on banks to take a prominent place on both the political and economic stages in the coming weeks, as Parliament must approve their proposal within 60 days of its introduction on Aug. 7.

It will pass, likely easily, and then the legal challenges promised by the ECB, Italian banks and bank advocacy groups will begin. Opponents will use the Italian press to bemoan potential damage to the Italian economy, while the dynamic and steadfast Meloni doggedly pursues the windfall tax in the name of protecting the Italian public from the Eurocentric policymaking of the ECB.

Squarely and unwantedly in the middle will be the Italian banks themselves, left waiting to see if the image of Italy as an attractive and stable market will survive. Meloni, Salvini and others in the governing coalition will no doubt be tracking lo spread alongside market watchers and the Italian public.

But if this windfall tax helps keep Meloni's coalition government in power, it may only be a matter of time before other European politicians counter central bankers' playbooks with populist moves of their own.

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[1] The proposed tax will still need to pass a larger vote in the Italian Parliament in order to become law. As Meloni's coalition enjoys a comfortable majority, all indications at the moment lead political observers to believe it will pass with little change or debate.