The Cyprus crisis in the mirror: the 'small deposit tax' as historical faux-pas

Fischer, Justina A.V.

University of Oradea, Univerity of Mannheim

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Justina A.V. Fischer

Abstract

Taxing small deposits used to be a taboo in European politics – but why? This contribution re-assesses the protection of small deposits from an angle that has not received much attention in the current debate: the politico-philosophical, ordo-liberal, and social-political perspectives, arguing that protection of the ordinary saver is a fundament of our civil societies.

Keywords: Eurocrisis; Cyprus; financial markets; banking sector; market power; market failure; Hobbes; Locke; Rawls; social contract; trust; rule of law; social capital; democracy

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Contact: Department of Economics, University of Mannheim, L7, 3-5, 68131 Mannheim; University of Oradea, Department of International Relations, Oradea, Romania. E-mail: mail@justinaavfischer.de

Protection of property as fundament for a stable society

The Cyprus crisis and the public discussion has stimulated re-thinking the fundaments on which our democracies are built, and reflecting on to what extent a tax on small deposits puts these fundaments into danger. According to Hobbes (1647, 1651) protection of property serves to maintain internal peace in society. That the protection of property constitutes a key duty of any government is a direct consequence of the original state of nature, which was characterized by a fight of atomistic human beings against each other – fighting for obtaining resources, fighting for keeping those resources and, finally, fighting for life. In this state of nature human beings enjoyed the right to property only to the extent to which they were physically able to defend it by themselves. In order to overcome this miserable and anarchic state, people consented on the ‘social contract’ that established a political authority which was given the means to make laws and to enforce them. It follows from that that the ‘rule of law’, the equality before the law and the subjection of all to the law (including the ruler), implies protecting the weak against the strong – in the case of the EU crisis, it implies the protection of the property of the weak against expropriation/exploitation by the stronger (any person or institution, like banks, the EU, or the government itself).

Cypriot government failed to protect its citizens

Altogether, political philosophy reveals the strong linkage between obeying the basic principles ‘rule of law’, ‘protection of property’ and social and political stability in a country – it was Locke (1690) who argued that if a government failed to comply with its duties, the people had a right to revolt and to choose a new government. In that respect, it would have been the obligation of the Cypriot government to protect its ordinary, not overly wealthy citizens against expropriation efforts by the EU or other institutions; as Locke would have predicted, not having done so resulted in citizens’ protest on the streets and their loss in trust in their current government, and the EU. In this light, already bringing the faux-pas word ‘deposit tax’ into play during the EU negotiations can be regarded as putting into question the basic principles on which our modern societies are built.

Why should governments safeguard small deposits?

But do we have economic reasons to argue that small deposit owners are the ‘weak’ in society who are in need government protection? The theory of market perfection to achieve global efficiency may provide some answers (e.g. Musgrave, 1959): small depositors might be put at a disadvantage compared to large investors because of a) market power of local banks, caused by b) restricted access of ordinary people to financial markets, aggravated by c) an information asymmetry between financial product sellers and those who buy them (Modigliani and Miller, 1958; notably, the latter market failure caused the first financial market crisis in 2008). While economic theory assumes that also small savers had a choice between several ways of investing their money, they are, in reality, entirely depending on the financial products the local banks as financial intermediaries offer them and the information they provide (Diamond, 1984): This ‘no choice’ situation forces ordinary savers to bear the bank’s business risk that might be, in the case of Cyprus, higher than the one they would have preferred. In sum, due to financial market imperfections the speculation of local banks creates (unwanted) negative spill-overs on the ordinary deposit holder.

Safeguarding as result of justice considerations

Economic theory proposes various solutions to internalize negative spill-overs (e.g. Musgrave, 1959); however, most of these are not applicable to our case because a) financial intermediaries work in national, segmented markets, while b) capital itself is mobile across countries. This calls for international cooperative solutions to restrain bank’s risky behavior that are insufficient and difficult to achieve (e.g. the agreements Basel I and II). In addition, in the case of Cyprus, the government colluded with the local banks and showed no interest in regulating the banking sector in order to prevent excessive speculation (offered savings rates were between 4% and 6%, while world growth rate was about 3% to 4%). In this light of missing means to internalize negative externalities, safeguarding deposits, while not constituting a remedy, can be regarded as a consumer protection mechanism against the negative effects of this externality on their savings. If we view ‘global efficiency’ as the result of justice and fairness in market processes (in the tradition of Rawls, 1971), the principle to safeguard small depositors can be seen as a compensating and redistributive policy that establishes a socially fair outcome.

The faux-pas word 'deposit tax' and public trust

We can conclude that the announcement of a tax on small deposits was rightly perceived by the European public as unjustified expropriation effort because of its contradiction to the 'rule of law' and to the principle of fairness. Simply enunciating this policy idea on Saturday night (to which the Cypriote delegate had agreed to) was not only disastrous for Cypriots' consent to their government and the EU as such; also the fact that implementation of this tax was, in some instances, on Sunday, prior to the vote of the national parliament on Monday added to its trust-destructive effect – according to public choice theory, the parliamentary vote represents people's consent, ensuring that policies serve the 'common good' and not group interests (e.g., Mueller, 2003). Hence, the clumsiness with which the Cypriot government tried to introduce this tax equally contradicted and undermined the principles of democracy.

These arguments show the importance of discussing the EU crisis and the policy response for Cyprus not solely under aspects of banking sector stability; besides negative macroeconomic consequences for the whole EU-region (Fischer, 2013), people's trust in the national government (Fischer, 2012), but also in banks, and in the EU has been substantially eroded, as recent polls also in Germany suggest. Trust, however, is the fundament on which the EU is built, which we need to restore; otherwise we risk trading off EU's future and that of our democracies for the Euro.

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