Comment

Ireland's taxpayers must take their share of the pain

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The principle of "no taxation without representation" should work both ways. If taxpayers have the right to share in decision-making, they must also accept the consequences. But in Europe this relationship between taxpayers and the financial system is not working.

In the years before the crisis several countries, like Ireland and the UK, took decisions aimed at ensuring a more benign environment for their financial sectors. These included favourable taxation for banks, and less stringent self-regulation, rather than thorough inspections and reports. As a result, their banks grew larger and more profitable, increasing leverage and lending to risky sectors such as real estate. But taxpayers also benefited: bank profits filled up state coffers, as tax revenues rose sharply – financing higher public spending and reducing the pressure on taxpayers.

When the crisis erupted, however, the sector abruptly turned into a heavy burden. Irish taxpayers, for instance, now find themselves faced with both the collapse of tax revenues and the losses incurred by the banks themselves. In principle, the costs of restructuring these banks should mainly be passed on to shareholders and managers, and thus subsequently on to bondholders. Only in a systemic crisis should taxpayers be involved. The question is, how should we judge if a crisis is truly systemic, and therefore whether taxpayers should rightly bear some of the costs of resolving the situation?

But here we encounter a problem. In a closed economy, taxpayers invest their savings in domestic financial instruments. There is therefore a strong incentive to vote for a strong regulatory framework to prevent banks taking excessive risks – an incentive that coincides with

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the interests of investors, who bear the costs in the event of a bank crisis. In this case a regulator accountable to taxpayers is best able to judge whether a crisis is systemic.

In an integrated financial area such as Europe, however, the issue is more complex. Here, some discretion is exercised at the national level in applying common EU regulations, and also when implementing prudential supervision. The taxpayers' incentive to vote for a tougher, hands-on approach is also weakened if their bank's liabilities are held abroad, and therefore the burden of adjustment can be shifted to non-residents.

If the decision on whether a crisis is systemic or not is in the hands of the authorities of the country where the troubled banks are located, their authorities will have an incentive to underestimate the systemic dimension of the crisis, and thus shift the burden to other European taxpayers. However, those other countries will rightly consider that, as long as supervision remains national and accountable to the taxpayers of the country with indebted banks, those taxpayers should, in the first instance, assume responsibility for any failures.

In a single market, such conflicts of interest considerably complicate bank crisis resolution. They also intensify the correlation between banking risk and sovereign risk, thus undermining financial stability, especially in the euro area. One way to reduce the burden on taxpayers arising from these perverse incentives is to minimise the degree of discretion enjoyed by national regulators.

Ultimately this would mean the integration of independent prudential supervision at the European, or at least euro area, level – to match the way burdens are shared when a systemic crisis strikes. Such a move may seem politically unpalatable, as taxpayers around the eurozone fear having to bail out the banks in other countries. But these taxpayers would at least have the assurance that banks in different countries would henceforth be subject to uniform and independent supervision, and that there would be no incentive to tolerate excessive risk-taking by individual nations.

Recent events have shown that, as long as the accountability of supervisors to taxpayers is primarily a national affair, and discretion in the implementation of national financial regulations and supervision is allowed, then there is a high risk that taxpayers will foot most of the bill. They should not complain when it actually happens.

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