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The Major Bank Levy: We're all going to be hit

Michael Potter

The government is proposing to impose a levy on Australia's major banks, forecast to raise $1.5–$1.6 billion per year, applied to certain bank borrowings. The levy will be paid by five Australian banks: Commonwealth, ANZ, Westpac, NAB and Macquarie, and is scheduled to start from 1 July 2017.

Who pays the levy?

The banking levy will most likely be passed on as increases in mortgage and business interest rates. This expectation is based on overseas experience, including in research cited by the government, and analysis by Australian experts.

As a result, the levy will essentially act as a tax increase on households who are already afflicted by flatlining real wages growth and ongoing increases in personal tax — including through bracket creep. The ratio of personal tax to GDP has been increasing by about 0.3 percentage points per year, cumulative, since the GFC.

An increase in business borrowing rates will dampen business investment, which is already at near-record lows as a share of the economy and is forecast to decline further.

Based on an IMF study, Australia's levy could reduce GDP by about $1.7 billion per year, a substantial impact compared to the revenue raised of $1.5–$1.6 billion.

Refuting arguments in favour of the levy

Balancing the budget & maintaining Australia's credit rating

The government's stated goals of the levy include improving the budget and maintaining the government's AAA credit rating.

However, the levy does not change the year the budget moves into surplus, or materially change the size of the surplus, based on government projections. Therefore the levy will have a negligible impact on Australia's AAA credit rating.

It is also inconsistent to increase bank funding costs through the levy in order to reduce those costs by maintaining Australia's AAA rating. In addition, a flawed policy measure that improves the budget bottom line may be worse than a larger deficit or smaller surplus.

Nevertheless, if the primary purpose of the levy is for budget repair, then the justification for the levy ends when the budget returns to surplus, and the levy should automatically end when surplus is reached.

Addressing alleged unfair advantages of big banks

The largest banks are said to receive several privileges, including an implicit government guarantee which arguably reduces funding costs, and less strict capital requirements. The levy is argued to address these privileges, however it is an inferior solution — it is far better to remove the unfair advantages directly.

The extent of privileges is also debatable. The RBA has found the large bank funding advantage has fluctuated considerably over time, and in 2014 was not statistically different from zero.

The government implies the larger banks have substantial market power. However, if this is true the banks could just use this power to ensure the levy is fully passed on to customers. Regardless of its impact on competition in the financial market, the levy is very likely to have an adverse impact on households and business as noted earlier.

And if the levy is designed to address 'unfair' advantages, this prejudges and devalues a separate Productivity Commission (PC) inquiry that should determine if the big banks have any

unwarranted advantages. The whole point of the PC inquiry has been compromised before it has even started.

If the government wishes to ensure the PC inquiry is seen as genuine, it should commit to removing the levy if the PC does not specifically recommend the levy.

International comparisons

The government cannot use international experience to justify the levy, as many other developed countries have chosen not to implement a levy on bank borrowings.

In addition, the government support for banks in many other developed countries has been much larger than in Australia, as these other countries have engaged in quantitative easing and bank bailouts during the GFC.

Impact is small

The impact of the levy is small relative to the economy, but this does not mean the harmful effect of the levy can be ignored. Many small bad decisions, each the size of the bank levy, become a much larger problem. Each bad decision should be rejected on its merits. In addition, the levy once introduced could easily be increased to be at much more harmful levels given the levy's broad political support.

Furthermore, the government has rightly criticised the ALP's proposal to increase the top marginal tax rate, a tax increase raising about the same revenue as the bank levy. If this type of small, but bad, decision can be criticised, the bank levy can be criticised on the same terms.

Process concerns

The process for developing the levy breaches numerous government requirements for best practice regulation and consultation, including:

- Full public consultation on proposals unless there is a 'compelling case'.
- Wide consultation must occur.
- Consultation should not make unreasonable demands.
- Timeframes for consultation should be realistic, between 30 to 60 days.
- Papers, such as draft regulation impact statements, should wherever possible be made available to stakeholders.
- It is best to use a discussion paper process before embarking on a substantial reform.
- Consultation should not occur after a decision instead of before a decision, with minimal exceptions.
- If a proposal impacts on competition, the government should show there are no feasible alternative options that do not restrict competition, and the proposal has a net benefit.
- A proposal that increases regulatory burdens should be offset by other reductions in the burden of regulation.

The government has either not complied with these requirements, or failed to show why it should be exempt from these requirements.

Increased financial market risks

The levy will increase risks because it:

- Discourages banks from using long-term wholesale borrowings that have smaller risks to banks and taxpayers.
- Will encourage banks to make greater use of guaranteed deposits, which will increase taxpayer risk and moral hazard because the government has guaranteed these deposits.

These incentives will likely reduce bank resilience, despite the government's arguments. The Australian levy is unlikely to lead to banks increasing capital levels, also contrary to the government's arguments.

The levy likely has broader adverse effects on financial market and systemic risk:

- Customers may move to smaller financial institutions, which are more risky (as shown in the lower credit ratings given to these institutions), and to shadow banks, which are substantially more risky.
- The sudden imposition of this tax without warning increases regulatory risk or sovereign risk. This is heightened by the substantial risk of future increases in the levy.
    - o The Coalition criticised the ALP's mining tax as increasing sovereign risk, but the Coalition's bank levy can be criticised on the same basis.
    - o The levy heightens the risk that any sector of the economy could suddenly be hit with a tax when the government considers profits are 'too high'.
    - o Increased sovereign risk and an uncompetitive tax system are likely reasons for Australia's historically low levels of investment.
- The levy might encourage the view that the largest five banks are Too Big To Fail (TBTF), meaning they are more likely to be bailed out by the government. However, this would be counter to efforts by the RBA, APRA and global regulators to ensure the big banks are not classified as TBTF. The Financial System Inquiry (the Murray Inquiry) emphasised the problems of banks being classified as TBTF, including increased moral hazard and financial market risks.

The levy will encourage use of foreign banks, which may reduce systemic risk — but government policy should not be deliberately driving activity to foreign owned businesses.

Conclusion

Given these flaws in the levy, it should be abandoned in its entirety.

However, if the levy is not abandoned, it should be subject to a much more detailed inquiry over the coming year, with a consequent delay in the start date. This detailed inquiry would enable the government to meet its own guidelines for best practice regulation, ensure unintended consequences are known, if not addressed, and allow interactions to be considered — including interactions with bank prudential regulations, and the inquiry by the PC into competition in the financial sector.

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Research Report 29 (RR29) • ISSN: 2204-8979 (Printed) 2204-9215 (Online) • ISBN: 978-1-922184-93-1 • Published June 2017