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

Michael Potter

Research Report | June 2017

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1. Executive Summary:

- The bank levy is likely to feed through to higher mortgage and business lending rates. This will hit many households already facing tax increases through bracket creep, reduce GDP and constrain business investment in a time when investment is set to be falling to near record lows.
- Based on government projections, the levy does not change the year the budget moves into surplus, or materially change the size of the surplus. Therefore the levy will have a negligible impact on Australia's AAA credit rating.
  - The increased revenue from the levy has also been more than fully spent in other spending decisions.
  - It is inconsistent to increase bank funding costs through the levy in order to reduce those costs by maintaining Australia's AAA rating.
- The levy is an inferior way to deal with any supposed unfair advantages bestowed on the big banks — it is far better to remove the unfair advantages directly.
  - 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 this separate inquiry has been compromised before it has even started.
- If the big banks have substantial market power — as the government implies — the banks could just use this power to ensure the levy is fully passed on to customers.
- The government cannot use international experience to justify the levy, as many other developed countries have chosen not to implement a levy on borrowings.
- The levy will help mortgage customers only if they switch to smaller banks and then those smaller banks cut mortgage rates. The government has provided no evidence this will occur.
- The process for developing the levy breaches numerous government requirements for best practice regulation and consultation.
- The harmful impact of the levy appears small, but this in no way justifies the levy. A bad policy is bad no matter what its size, and the levy rate could easily be increased in the future to have a larger adverse impact.
- The levy causes a mispricing of risk, encouraging banks to increase the use of more risky borrowings while discouraging the use of some less risky borrowings, particularly long-term wholesale borrowings.
  - This will reduce bank resilience, despite the government's arguments.

- The levy will encourage greater use of smaller financial institutions and shadow banks, which may increase financial market risk.
    - o 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.
- The sudden imposition of this tax without warning increases regulatory risk/sovereign risk. This is heightened by the substantial risk of future increases in the levy.
- The levy might encourage the view that the largest five banks are Too Big To Fail (TBTF), or more likely to be bailed out. However, this would run counter to efforts by regulators to ensure the big banks are *not* classified as TBTF.
    - o In addition, classifying banks as TBTF increases moral hazard, financial market risks, and the risks of another financial crisis.

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

If however 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.

There are two primary reasons given in support of the levy as noted above: budget repair, and addressing supposed advantages given to the large banks. Given this:

- The levy should automatically end when the budget returns to surplus.
- The levy should be abandoned if the PC inquiry into financial sector competition does not recommend the levy be imposed. This condition will ensure the PC inquiry is seen as genuine and the outcomes of the inquiry have not been prejudged.

2. Introduction

The 2017–18 Budget proposed the introduction of a levy on certain borrowings of Australian banks with total liabilities of over $100 billion.[1] This threshold means the levy is imposed on five Australian banks: Commonwealth, ANZ, Westpac, NAB and Macquarie (henceforth called the 'big five banks'). The levy is due to start from 1 July 2017, less than two months after its announcement.

The levy is 6 basis points on the bank's liabilities, or borrowings, with some exclusions. For example, if a super fund lends $1m to a big five bank, the bank will be required to pay a levy of $600 per year on that borrowing. The main exclusion from the levy is bank deposits covered by the government bank guarantee, which applies to bank deposits with a value below $250,000 per customer.[2]

The government estimates the levy will raise $1.5–$1.6bn per year,[3] although some have questioned whether the government will be able to achieve these revenue targets.[4]

The banks were not aware of the levy before the 2017–18 Budget and the announcement of the levy took them completely by surprise. The levy comes on top of other new regulatory burdens on banks, such as substantial new regulatory requirements for senior bank executives.[5]

3. Who pays the levy?

There has been significant debate about who will bear the cost of the levy. While the banks pay the levy to the government, ultimately it will be borne by shareholders, customers, employees or suppliers in some combination.

The levy is already having an impact on shareholders, though the exact impact is not clear because share prices fluctuate constantly for many reasons. According to one estimate, bank shares have declined by $43.4bn since the levy was announced,[6] while another estimate is a price decline of $32bn.[7] Several superannuation funds have noted the negative impact on fund returns.[8]

However, in the longer term, the levy will largely feed through to higher mortgage and business interest rates, according to most analysis cited by the government.[9] Professor John Freebairn of Melbourne University reaches a similar conclusion,[10] also noting the big five banks are unlikely to be able to pass the levy on to wholesale borrowings, and the history of these banks passing on RBA interest rate changes suggests the costs of the levy will likewise be passed on to household and business mortgages. Fabrizio Carmignani and Ross Guest from Griffith University also argue the levy will be largely borne by customers,[11] as does Richard Holden from UNSW.[12]

Any increase in lending rates due to the levy will hit most households with mortgages and put a further brake on business investment which is already at historically low levels (see Section 6.3). An initial estimate from PricewaterhouseCoopers is the levy could reduce GDP by around $2.5 billion over four years with approximately 6,200 fewer jobs.[13] Based on an IMF study, the levy would permanently reduce the level of Australia's GDP by 0.1% or about $1.7 billion per year.[14]

- The government has argued the impact of the levy is expected to be 'negligible'. However, they have not provided more detail of this estimate,[15] in sharp contrast to the considerable detail they provided in modelling the impact of a corporate tax cut.[16] The government also cannot dismiss 'negligible' economic impacts of the levy, as argued in Section 4.5.

Professor Freebairn also examines the potential pass-through of the levy to employees.[17] He argues that any adverse impact on workers is likely to be primarily focussed on low wage employees, as banks may react to the levy by increasing the automation of routine tasks. He notes the impact on higher wage employees is likely to be small, as the market for banking talent is often global and Australian banks may have only limited market power for employees.

The empirical evidence suggesting the levy won't be borne by shareholders in the longer term is consistent with logic and theory. If investors did feel a long-term impact, they would effectively be accepting a *permanently* lower rate of return on their investments in the banks. This is very unlikely as most investors can choose a large range of assets to invest in other than the big five banks. Banks may have market power for loans (see Section 4.2) but are likely to have little or no market power in the market for capital.[18]

If a bank tried to maintain a permanently lower rate of return on equity (ROE), investors would sell shares, driving down the price and increasing the ROE until it returned to its previous level. Those who own shares when the levy is announced make a loss, but later owners do not. In addition, the bank would not be able to issue new equity at a permanently lower rate of return.

- The levy is likely to change bank risk, as argued in Section 6.1, which will in turn change bank ROE. However, it is not clear whether the levy will result in banks being classified as more risky (see Section 6.1) or less risky (Section 6.4).

By contrast, the same argument cannot be made for customers, suppliers and employees: the levy will impact on some combination of these stakeholders rather than on shareholders (in technical terms, the supply of equity to banks is very elastic[19] while the supply of other bank inputs are not).

4. Response to arguments in favour of the levy

There are a number of arguments stated in support for the levy, reviewed below.

4.1. Restoring budget to surplus & maintaining government credit rating

The government has argued the bank levy will help improve the federal government budget position, and this budget improvement may help the Australian government maintain its AAA credit rating.[20] However, there are a number of flaws in this argument:

- If the levy were not imposed and no other changes were made to the budget, the budget would still return to surplus in exactly the same year (2020–21), based on current forecasts.[21] The change in the surplus would also not be substantial. Therefore, the levy is likely to have a negligible impact on Australia's AAA rating.
  - In addition, every dollar raised by the levy has been spent on new measures in the 2017–18 Budget. The net increase in spending in the budget is more than the bank levy in each of the next four years.[22] Arguably, the levy is paying for new spending, rather than repairing the budget. The budget spent all of the money from the levy, and then some more.
- A policy that improves the budget is not automatically good. A policy does not automatically pass a cost benefit test just because it improves the budget balance.
  - A flawed policy measure that improves the budget bottom line may be worse than a larger deficit or smaller surplus.
- The government has argued the levy will lower bank funding costs by enabling Australia to maintain its AAA credit rating.[23] However, it is inconsistent to increase bank funding costs through the bank levy in order to reduce these costs by maintaining the AAA credit rating.
  - The levy may result in an increase in financial system risk as noted in Sections 6.1 and 6.4, while maintaining an AAA credit rating is likely to be an indicator of reduced risk, which is also inconsistent.
- The Budget already contains large automatic tax increases through fiscal drag and bracket creep.[24] Since the GFC, there has been an increase in personal tax as a share of GDP of about 0.3 percentage points per year, cumulative, and this is forecast to continue into the future.[25] Tax revenue as a share of GDP fell after the GFC, but has grown since then and is set to be around its historical average in 2017–18, and projected to go grow quickly to be well above these averages in later years.[26] As a result, the need for the tax to GDP ratio to grow even more quickly through the bank levy has not been demonstrated.
  - Other arguments for an increasing tax burden are flawed, as argued in recent CIS research.[27]

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. As a consequence, the legislation for the levy should be amended to bring the levy to an end when surplus is reached.

4.2. Addressing pricing power and unfair advantages

The largest banks in Australia are argued to receive a number of regulatory privileges, including:

- An implicit guarantee of the entire bank, meaning the bank is seen as Too Big To Fail (or TBTF, see Section 6.4).
- An ability to borrow from the Reserve Bank at discounted interest rates.[28]
- APRA having less strict capital requirements for housing loans for the big five banks.[29]
- APRA urging banks to limit growth in some types of lending, which has arguably encouraged the larger banks to increase lending rates and hence profitability.[30]

In addition, it is argued the larger banks supposedly have significant pricing power due to their substantial market share.[31]

The Treasurer has argued the large bank funding advantages are worth 20 to 40 basis points,[32] and the bank levy will reduce these advantages.[33]

The extent of these supposed privileges is debatable. For example, the relevant regulators (APRA and RBA) are trying to prevent the big banks from being considered as TBTF, as discussed in Section 6.4. There is great uncertainty about the supposed bank funding advantage: the Treasurer argues the potential advantage could be anywhere between 20 to 40 basis points.[34]

In addition, detailed research by the RBA indicates the major banks' funding advantage has varied considerably over time and in 2014 was not statistically significant.[35] The RBA also notes some issues with these results, for example some of the apparent funding advantage may be due to larger banks having greater diversification, economies of scale and liquidity of issued bonds.[36]

Hence using these results to justify the levy is a particularly fragile argument.

The lack of conclusive evidence for the supposed advantages provided to the big five banks means the levy cannot be specifically designed to respond to these alleged advantages. If the levy addresses any regulatory privileges, it will do this entirely by accident rather than by intent.

Given this flimsy evidence, an independent inquiry would be best to determine the extent of any 'unfair' privileges received by the big banks. In fact, the government has done exactly this: the recently announced Productivity Commission (PC) inquiry into competition in the financial system[37] is ideally placed to estimate the extent of any regulatory privileges for the largest banks.

However, the government has not waited for the outcomes of this PC inquiry to determine if, in fact, the big banks have any privileges; instead it has prejudiced this inquiry and devalued its outcomes. If a levy is needed to address competitive problems, the PC would be able to come to this conclusion — but the government has effectively announced its view on the issue before the PC has been able to analyse the facts. As a result, the PC's inquiry has been compromised before it has even begun.

If it is *demonstrated* that the big banks have unfair advantages, the better solution is to remove those advantages. In particular, if the big five banks are protected from competition or if existing regulations unfairly increase costs on their competitors, these regulations should be reformed to remove the bias towards the big five banks. In particular, the extent of explicit and implicit bank guarantees should be limited so that the big five banks are not seen as being TBTF, as discussed in Section 6.4.

Further, the levy is likely to harm consumers, regardless of the benefit to any businesses in the financial market. The evidence suggests in the longer term the bank levy will largely be passed through to consumers as higher mortgage rates, as explained in Section 2, with the pass-through likely to be greater in more concentrated banking markets, arguably including Australia. The impact of this price pass-through on the banking sector depends on whether the levy results in customers shifting to smaller banks:

- If customers shift to the smaller banks, these smaller banks may leave prices unchanged, or even increase prices, meaning the levy provides no benefits to consumers, just higher profits for smaller banks. If the smaller banks reduce prices in response to the levy, customers will benefit; however, the government has not presented evidence to suggest this unexpected price cut would occur.
    - If customers shift to smaller banks, this won't have a clear impact on financial system risks, as smaller banks are inherently more risky (see Section 6.2) but are less likely to be classified as TBTF (see Section 6.4).
- If customers do not shift to smaller banks, the levy will harm consumers and will not provide any competitive benefit.

There are several other problems with the argument that the levy reduces an 'unfair' advantage for the big banks:

- There are already a number of taxes and regulations that disproportionately target larger businesses, including land tax and payroll tax.[38] The bank levy will simply add to this existing burden on large businesses.
- If the levy is designed to level the playing field, it isn't clear why foreign banks are exempt from the levy: some foreign banks have a global size much larger than the major Australian banks. According to Standard & Poor's data on the 100 largest global banks by assets,[39] Bank of China, JP Morgan, HSBC, BNP Paribas, and Citigroup all have a global size more than three times the size of Australia's largest bank, the Commonwealth Bank of Australia.
    - However, extending the levy to foreign banks would be problematic as it may involve double taxation if these banks are already subject to equivalent taxes overseas. The levy may also encourage these banks to leave Australia altogether, reducing competition with no benefit to the budget.
- If the big banks do have substantial market power, they could simply use this market power to ensure the full cost of the levy is transferred to customers, consistent with the argument in Section 2. The evidence suggests this will occur: in other countries, the imposition of a bank levy caused a greater increase in mortgage rates where the banking industry is more concentrated.[40]
- The levy can't be seen as a charge for regulatory privileges for the whole banking sector, such as the explicit government bank guarantee and the GST exemption for financial services, unless those privileges unduly benefit the larger banks, and this has not been shown. Again the PC inquiry (discussed above) would be best placed to analyse this issue.
- In addition to the advantages listed at the start of the section, it could be argued the big five banks have an advantage caused by economies of scale. However, this type of advantage is in no way 'unfair'. If larger banks are more efficient and productive because of scale economies, this is good and should be encouraged. If the levy is designed to discourage economies of scale, it will harm productivity and economic growth.

4.3. A super profits tax

The levy is not a super profits tax, as some have argued,[41] because it has no link to profits — banks will be liable for the levy regardless of profit levels. The case for this justification for the levy has been weakened by the recent decline in profitability of major banks relative to listed smaller banks.[42]

4.4. Other country comparisons

The government has argued Australia's proposed bank levy will bring us into alignment with other developed countries that impose a bank levy.[43]

However comparisons with these other countries are flawed:

- The Australian context of the levy is quite different from many other countries where expensive 'bail outs' have been provided to private banks, such as in the United Kingdom. In contrast, Australia's banking system did not require any bail out.
  - o In addition, comparisons to Europe are flawed because quantitative easing (QE) by the European Central Bank arguably provided substantial subsidies to banks in that continent,[44] and Australia has not engaged in QE.
- Other countries with a levy tend to impose an insurance premium on guaranteed bank deposits,[45] while Australia does not. In fact, the current Australian government explicitly rejected the case for an insurance premium on guaranteed deposits.[46]
- Despite the government's arguments, many developed countries have not implemented a levy on bank borrowings. According to one paper,[47] 11 countries in the European Union (EU) implemented a levy on borrowings over the period 2009–2011. The explanatory memorandum on the Australian legislation lists fewer countries with a levy on borrowings.[48] Three countries — France, Hungary and Slovenia — implemented a bank levy on a substantially different basis from the rest.[49] By implication, the remaining 14 members (50%) of the EU did not impose a bank levy on borrowings.[50] The USA does not impose a bank levy according to Macquarie Bank.[51]
  - o This means the assertion by the government that the levy "brings Australia's taxation arrangements for ADIs [banks] into alignment with other advanced countries"[52] is not correct.

4.5. Impact is small

The government and regulators have argued the impact of the levy on the economy, bank profits, and financial market risk is small[53] at just under 0.1% of GDP.[54] However, this small size does not mean the levy is good. A bad impact is still bad even if the impact can be obscured in an economy of Australia's size.

Although small bad decisions can be easily ignored as individually having a negligible impact, many small bad decisions, each of the size of the bank levy, become a much larger problem. Each bad decision should be rejected on its own merits, rather than being ignored on the basis of an insignificant impact.

Most decisions of the government are small, such as each decision over individual social security recipients, so dismissing analysis of all these small decisions would result in a rapid loss of government control of the economy and the budget.

In addition, the levy may not remain at its current rate, and could easily increase to levels that have a much greater impact on the economy. This is the experience in the United Kingdom, which has seen numerous increases in its bank levy — one report stated the levy in the UK has been increased nine times.[55] In Australia, the broad political support for the levy makes an increase in the levy fairly easy, even though the levy rate is included in legislation. The levy is more likely to increase if the levy fails to raise as much money as forecast — and these revenue forecasts have been questioned as being too optimistic.[56]

The ALP is proposing an increase in the top personal tax rate, a decision the government has rightly criticised.[57] If this type of small, but bad, decision can be criticised, the bank levy can be criticised on the same terms. Notably, the ALP's policy would raise around the same amount as the proposed bank levy: $1.55bn in 2019–20 compared to $1.5bn for the bank levy in that year.[58]

4.6. Improving resilience

The Treasurer has argued the bank levy will make the financial system more resilient by "making stable and secure funding sources relatively less expensive".[59] Many aspects of this argument are incorrect. One of the most 'stable and secure' funding sources for a bank is long-term wholesale bonds, and the levy makes this funding source more expensive. The levy also makes government guaranteed at-call deposits relatively less expensive, and these deposits are less stable and secure because they are at call.[60] The levy does make equity funding relatively less expensive in the longer term, but this change in relative costs is unlikely to have a large impact because bank equity is already much more expensive than bank borrowings.[61] Therefore changes in equity funding are more likely to be caused by changes in prudential rules than changes in funding costs.

In addition, if the levy promotes resilience, it clearly should be applied to all financial institutions, ensuring all receive the 'benefit' of this improved resilience.[62]

5. Process concerns

The public process for developing this levy has been very poor. Consistent with the approach of National Competition Policy, the onus of proof should be on those wishing to expand or add regulation.[63] As a consequence, the process for substantial new regulations and taxes, including the bank levy, should include the following steps, similar to the approach taken by the PC in relation to many reviews:

- Public announcement of the intent to develop the policy;
- Public release of an issues paper, requesting submissions;
- Public release of draft proposals in response to submissions and analysis, and calling for additional submissions; and
- Public release of final proposals in response to submissions and analysis.

The public consultation process should have involved, at the start, the presentation of the full case for the levy, a Regulation Impact Statement, and modelling of the levy's impact. The government's explanatory memorandum on the levy[64] attempts to present these arguments but only well after the decision to implement the levy was made.

None of these steps were taken. In fact, recent reviews of the tax system and the financial system (the Financial Systems Inquiry and the Henry Tax Review) did not recommend the adoption of a bank levy.

In addition, the timetable for the levy (less than two months) is extraordinarily rushed. Regardless of public image, no industry should find out about a major new levy or tax in such a short time before they are made liable for it.

5.1. Breaching government's own regulation guidelines

In numerous ways, this levy does not meet the government's own regulation development guidelines.

The breaches of the guidelines for best practice consultation include the following (in the text below 'you' refers to the government):[65]

- Full public consultation is the appropriate level of consultation for all proposals unless you [the government] make a compelling case for a limited form of consultation.
- You [the government] must consider the scope of the proposed regulatory changes and consult widely to ensure that consultation captures the diversity of stakeholders affected by the changes.
- It is important not to make unreasonable demands of people you [the government] wish to consult or assume that they have unlimited time to devote to your consultation process.
- Timeframes for consultation should be realistic to allow stakeholders enough time to provide a considered response.
- Information or issues papers—such as draft assessments of compliance costs or draft regulation impact statements…should, wherever possible and appropriate, also be made available to stakeholders to enable them to make informed comments on proposals and proposed legislation.
- It is best to use a discussion paper or white paper process before embarking on substantial reform to ensure that only necessary legislation and regulations are drafted.
- Agencies should provide realistic timeframes for participants to contribute [in consultations].
- Depending on the significance of the proposal, between 30 to 60 days is usually appropriate for effective consultation.
- Post-decision consultation should:…not be undertaken [instead of pre-decision consultation] unless it can be demonstrated that extreme confidentiality is needed and that consultation before the decision would undermine the effectiveness of the policy.

While the government may consider some of the above guidelines do not apply to the bank levy, they have not provided a case explaining why the guidelines should not apply.

There are additional requirements for regulation that adversely affects competition. These requirements apply to the levy because the levy raises the cost of production for some businesses, specifically the big five banks, relative to others. As a result, Australian Government Guide to Regulation[66] and the COAG Best Practice Regulation Guide[67] require the levy to meet the following competition tests:

- there are no feasible alternative options that do not restrict competition; and
- the proposal has a net benefit.

The government has so far failed to demonstrate the levy passes either of these tests. No modelling has been released to show the proposal has a net benefit, and we have seen no publicly detailed explanation for the rejection of other options, including reducing any regulatory preferences for the big five banks.

At time of writing, there also was no indication of any regulatory offsets to the increased regulatory burden due to the bank levy.[68]

On this basis, at a minimum, the Senate Inquiry should recommend a delay in the start date for the levy by one year so a full public inquiry can be conducted.

6. Financial market risks

The design of the bank levy is likely to have a number of harmful effects on bank risk and the risk of the financial system as a whole. The government and regulators argue the impact of the levy on risk is small, but this is not a reasonable basis for accepting the levy as discussed in Section 4.5.

6.1. Mispricing risk

According to the 2017–18 Budget,[69] the bank levy will apply to most bank borrowings, except those that are currently subject to the explicit bank guarantee.

- The explicit government guarantee currently applies to bank deposits of value below $250,000 per customer.[70]

On the face of it, this is the exact opposite of the pricing that should occur. If there is to be a charge for a bank guarantee,[71] it should be on guaranteed borrowings instead of unguaranteed borrowing. The bank borrowings that are being levied should be exempt, and the bank borrowings that are exempt should not be.

- Note that the Financial System Inquiry (Murray Inquiry) specifically rejected the imposition of a charge for the bank guarantee.[72] The current Treasurer announced the government had accepted this recommendation in October 2015.[73]

These two effects mean the guaranteed bank borrowings are undercharged — if a charge is to be levied at all — while the non-guaranteed borrowings are overcharged.

Guaranteed bank borrowings present greater risks to taxpayers, as the government has made an explicit promise to bail out the borrowings if a bank becomes insolvent. By contrast, unguaranteed borrowings crate smaller taxpayer risk, because there are no explicit promises of bailout (implicit promises of bailout are considered in Section 6.4).

Government guarantees encourage banks to take more risks, a problem known as moral hazard. This makes the financial system as a whole more risky, increasing the likelihood of another financial crisis. The proposed bank levy makes this problem worse: it is imposed on the bank borrowings that cause less moral hazard, and exempts the borrowings which have a greater risk of moral hazard.

The levy applies equally to short and longer term wholesale bonds, hence discouraging those types of financing. The discouragement of long-term bonds caused by the levy seems particularly inappropriate, as those bonds are less risky than many other bank funding sources. This is because long term bonds are not government guaranteed — reducing moral hazard —increase bank funding certainty and reduce refinancing risks, because funds have to be rolled over less frequently.

To the extent banks reduce the use of unguaranteed borrowings, particularly longer term bonds, and increase the use of guaranteed borrowings, this will increase moral hazard, the risks to taxpayers, and financial system risks, including the risks of another financial crisis. The government has noted that the levy encourages the use of guaranteed borrowings, arguing this increases bank funding stability, but failing to acknowledge the negative impacts of increased use of guaranteed borrowings, in particular increased moral hazard and risks to taxpayers.[74]

Even a small increase in financial system risk is troubling, given the large financial costs of financial crises. The government and community devote substantial government resources to reducing this risk, imposing detailed prudential regulations to limit the likelihood of a crisis. This indicates the importance the government and community place on minimising risk, and why any increase in this risk, no matter how small, should be of substantial concern.

6.2. Other reasons the levy may increase financial market risk

The proposed levy does not apply to any financial intermediary outside the big five banks. If the levy encourages customers to move to the unlevied smaller financial institutions (see Section 4.2), this will likely increase financial market risk. The smaller financial institutions are likely to be more risky, as shown in their bond ratings, because they are less diversified and more regionally focussed (the argument that the riskiness of the big five has been artificially reduced because they are TBTF is considered in Section 6.4).

In addition:

- Some bank customers may move to the unregulated 'shadow banking' sector, which would more substantially increase financial market risks.
- If banks pay the levy from retained profits this will reduce bank capital buffers. This would also run against proposals for the banks to increase these buffers.
- The levy does not vary with bank profit — it has to be paid whether or not a profit is made. As a result bank profits may become more volatile, increasing bank risks.
- Fabrizio Carmignani and Ross Guest from Griffith University argue the levy may trigger a higher probability of bank default by reducing profitability.[75]

The government notes bank levies in European countries have encouraged increases in bank capital levels, and this may have promoted financial stability in those countries.[76] However, the implied comparison with Australia's proposed levy is false, as other European countries tend to have an insurance levy on guaranteed deposits[77] and Australia does not — so Australia's levy will likely encourage increased funding from guaranteed deposits as much as from equity, raising taxpayer and systemic risk rather than reducing it.

6.3. Regulatory risk or sovereign risk

The bank levy has also increased Australia's regulatory risk because it has involved the imposition of a tax on an industry without warning or consultation. This is also sometimes called country risk or sovereign risk.

The levy means the government has effectively expropriated some of the existing investments in the big five banks with no compensation, as shown by the share price falls after the levy was announced. The levy, once introduced, will be fairly easy to increase as it has broad political support, as discussed in Section 4.5. The potential for an increased levy also means heightened regulatory or sovereign risk.

Building on the regulatory risks created by the first version of the mining tax, the bank levy more broadly raises the question of who is next to be taxed. If the government can launch an unwarranted attack on disliked business without warning, then it could easily do the same for other businesses. Several members of the business community have raised this as an important concern:[78]

- Alan Joyce, the CEO of Qantas, asked rhetorically, "are we going to just start having an imposition on any profitable businesses out there and a policy for more taxes when businesses do well?" and said the Government faces capital flight "unless it better explains the $6.2 billion bank levy and reassures investors that other profitable sectors won't be hit."[79]
- Don Argus, former CEO of NAB, said: "Business would now be starting to think, 'well am I next?'"[80]
- Andrew Papageorgiou, Managing Partner of Real Investment House, argued "regulatory risk for the [financial] sector has never been higher."[81]

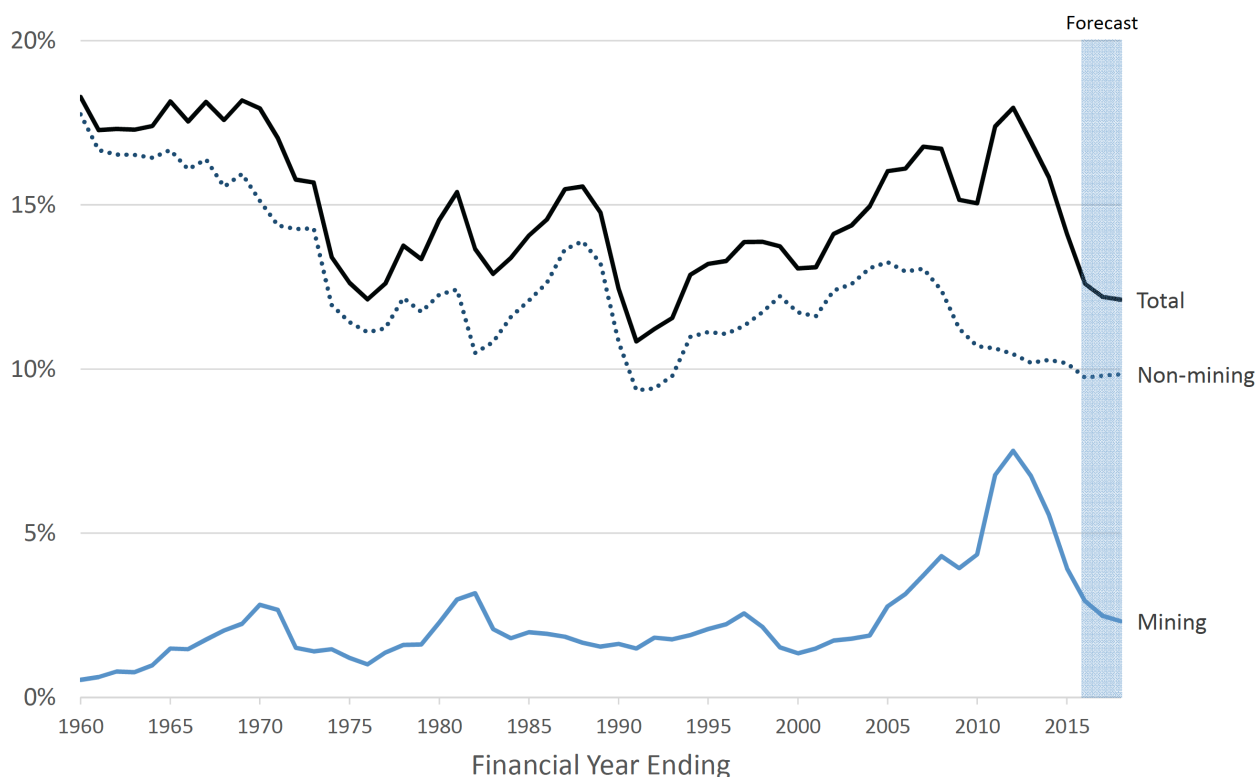
The Coalition rightly criticised the Rudd Government's mining tax as creating regulatory risk or sovereign risk,[82] because it expropriated some existing investments in mining; but exactly the same criticism can be raised about the Coalition's own bank levy.

This levy heightens the risk that industries experiencing periods of above average profitability will have these profits suddenly taxed, as happened with the mining tax. This will curtail upsides without offsetting benefits (profit subsidies) on the downside.

Increased regulatory risk, combined with other factors such as an increasingly uncompetitive corporate tax rate,[83] has resulted in declining Australian business investment as shown in Figure 1 below, with non-mining investment at historically low levels and not forecast to recover despite the end of the mining boom. Total new business investment is currently at near-record lows as a share of the economy and set to decline further.

Australia is also falling in various international competitiveness rankings, including in the World Economic Forum Global Competitiveness Report, the International Institute for Management Development's World Competitiveness Yearbook, the Heritage Foundation Index of Economic Freedom and the Fraser Institute's Economic Freedom of the World.[84]

Figure 1: New business investment as share of GDP



Sources: ABS, 2017–18 Budget.[85] Figures for 2016–17 onwards are forecasts based on the Budget.

The banking levy will only make this declining business environment worse.

6.4. Too Big To Fail (TBTF)

It has been argued[86] that the levy indirectly confirms the big five banks are TBTF — broadly meaning the government would step in to ensure a bank continues in operation if the bank would otherwise become insolvent. This could mean the current guarantee of retail deposits of up to $250,000 per customer[87] would effectively be extended to cover most or all of the banks' (supposedly) unguaranteed borrowings.

The government has implied the levy is connected with the funding benefit from large banks being classified as TBTF,[88] and several commentators have drawn this connection, arguing this is beneficial because it reduces bank funding costs.[89] However, any implicit extension to the bank guarantee should raise major concerns. Effectively guaranteeing most or all the borrowings of the big five banks would substantially increase financial market risks and moral hazard. The big banks would be encouraged to take on excessive risks, making a financial crisis more likely at great cost to taxpayers and the economy.

Australian banking regulators have argued that a broad government guarantee would greatly increase the risk of moral hazard. In a memo released under Freedom of Information, the RBA and APRA argued a bank guarantee covering deposits up to $1m created substantial moral hazard,[90] so clearly a guarantee covering *even more* bank borrowings would increase this problem even further.

Former RBA governor Glenn Stephens reportedly argued at the time of the introduction of the bank guarantee that "not only must there be a cap [on the guarantee], but the lower the better".[91]

Other criticisms of classifying banks as TBTF, or increasing the scope of bank guarantees, include:

- Former US Federal Reserve chairman Ben Bernanke said in 2010: "As the crisis has shown, one of the greatest threats to the diversity and efficiency of our financial system is the pernicious problem of financial institutions" that are deemed TBTF.[92]
- The UK Office of Fair Trading has said: "One consequence of the implicit guarantee by Government to rescue banks that are 'too big to fail' may be the creation of a moral hazard in banking."[93]
- The Financial System Inquiry (the Murray Inquiry) argued:[94]
  - o "… implicit guarantees create market distortions, altering the risk-reward equation and conferring a funding cost advantage on financial institutions perceived as guaranteed… Removing perceptions of these guarantees will reduce Government's contingent liability and improve the efficiency of the financial system and economy." (p33)
  - o "Government should not generally guarantee the ongoing solvency and operations of individual financial institutions." (p38)
  - o The cap on the explicit guarantee (of $250,000 per person) is 'relatively high' compared to other countries (p37).

- "Implicit guarantees create inefficiencies by:… Weakening the market discipline provided by creditors [and] Potentially creating moral hazard that encourages inefficiently high risk taking." (p45)

- The regional banks, in a submission to the Financial Systems Inquiry, argued classifying institutions as TBTF can "increase systemic risk through moral hazard, and create resource allocation distortions."[95]

In addition, a pre-GFC article argued government guarantees in the US of Freddie Mac and Fannie Mae substantially increased financial market risk,[96] and Freddie and Fannie's operations were arguably key causes of the GFC.[97]

The relevant regulators, APRA and RBA, have noted the problems with banks being classified as TBTF. The RBA has said "A key [international] reform area since the financial crisis has been 'ending too big to fail'", and the RBA cites several Australian regulatory changes in accord with this global reform goal including increasing loss-absorbing and recapitalisation capacity.[98] One of the stated objectives of the Financial System Inquiry (Murray Inquiry) was to "Reduce perceptions that some banks are subject to an implicit Government guarantee to lessen market distortions created by this perception and improve competition in the banking sector."[99]

Therefore, implicitly or explicitly classifying the big five banks as TBTF, or expanding the size of bank guarantees, would be particularly ill-advised. Instead, the scope of bank guarantees should be reduced. This may increase the risk of individual banks, but the risks to the financial system as a whole will be mitigated.

6.5. Other concerns with TBTF argument

Even if the levy is meant to charge for banks being classified as TBTF, it fails in that goal. This is because it applies only to unguaranteed liabilities (see Section 6.1). A TBTF bank may have the government bail out all of its borrowings, so any levy for the TBTF guarantee should apply to all borrowings. Instead, the proposed levy applies only to borrowings with a hypothetical (TBTF) guarantee and omits the borrowings with an actual, explicit guarantee.

There are other concerns with the TBTF argument:

- The unguaranteed bank borrowings were left unguaranteed for a reason. If banks become classified as TBTF, this makes it unclear why this distinction remains, as the government is broadly guaranteeing all the borrowings of a TBTF bank. The distinction between guaranteed and unguaranteed debt becomes less relevant, or even meaningless, so why continue to use those terms?
- The premise of this specific argument is that only the largest five banks are TBTF. However, several commentators have argued it is unclear why Macquarie Bank is TBTF, but not Bendigo/Adelaide Bank, Suncorp or Bank of Queensland.[100]
- Arguably, increased bank capital requirements are meant to address the TBTF issue. So if the proposed levy is a charge for banks being classified as TBTF, this is double funding.[101]

7. Conclusion

The major bank levy is particularly ill-conceived. The evidence highlighted in this paper indicates the levy will largely — or entirely — be passed through to higher mortgage rates, harming households who are already facing substantial tax increases through bracket creep. It will also hit business investment which is at near-record low levels.

None of the arguments used in favour of the levy stand up to scrutiny:

- The levy will not have a material impact on the projected budget surplus, and is therefore not essential to budget repair.
- The evidence that the major banks have significant unfair advantages is flimsy at best, and it would be better to remove any unfair advantages directly.
  - In any case, if the banks have major pricing power they could just use this power to ensure the levy is fully passed on to customers.
- The levy will not bring Australia into alignment with other developed countries, as many do not have a bank levy imposed on borrowings as is proposed for Australia.
- The levy will not improve financial sector resilience. Instead, it is likely to increase risks to banks by encouraging the use of guaranteed deposits and discouraging the use of long term borrowings.

If the levy indirectly confirms the big banks are Too Big To Fail, this directly contradicts efforts of the main regulators to prevent banks receiving this classification, and would increase systemic risks facing the financial sector as a whole.

The levy also breaches multiple regulation guidelines and increases systemic or regulatory risk because it was a sudden attack on banks with no warning, and the substantial risk that the levy rate will increase in the future.

Therefore, the levy should be abandoned. However, if it is not abandoned, it should be postponed for a year with a consequent delay in the start date to allow a detailed inquiry into the levy to occur. The benefits of the inquiry are that it would:

- Allow the government to meet its own guidelines for best practice regulation;
- Enable all the issues raised in this paper, and others, to be investigated; and
- Allow interactions to be considered, including with the Productivity Commission inquiry into competition in the financial sector and bank prudential regulation.

In addition, given the supposed aims of the levy noted above:

- If the levy is primarily aimed at budget repair, it should end when the budget returns to surplus.
- If the levy is primarily aimed at addressing unfair competitive advantages, it should be removed if the levy is not specifically supported by the PC inquiry into competition. This condition will ensure the PC inquiry is seen as genuine and has not been prejudged.

8. Endnotes

1 2017–18 Budget, p24. See also Explanatory Memorandum on Major Bank Levy Bill 2017.

2 The guarantee is called the Financial Claims Scheme. It applies to deposits of up to $250,000 per account holder, and applies to banks, building societies and credit unions that are incorporated in Australia and authorised by APRA. For details see: https://www.fcs.gov.au/about-apra

3 The estimated revenue from the levy is $1.6bn in 2017–18, $1.5bn in 2018–19, $1.5bn in 2019–20 and $1.6bn in 2020–21. Source: 2017–18 Budget, p24.

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5 See 2017–18 Budget, p160, and http://budget.gov.au/2017-18/content/glossies/factsheets/download/FS_Banking.pdf

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9 Explanatory Memorandum on Major Bank Levy Bill 2017, pp39–40.

10 John Freebairn (2017) "Budget Forum 2017: Who Will Wear the Bank Levy?" Austaxpolicy: Tax and Transfer Policy Blog, 18 May.

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12 Richard Holden (2017) "Budget 2017: bank populism will be paid for by Australians" *The Conversation*, 9 May.

13 PricewaterhouseCoopers (2017) "Budget 2017 - Government goes 'all in' for growth", press release, 9 May.

14 A permanent 20 basis point bank levy is estimated to reduce real GDP by 0.3%. Assuming a linear response, this means a 6bp levy would reduce GDP by about 0.1%. Source: Stijn Claessens, Michael Keen & Ceyla Pazarbasioglu (2010) *Financial Sector Taxation: The IMF's Report to the G-20 and Background Material*, p59.

15 Explanatory Memorandum on Major Bank Levy Bill 2017, p36.

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18 See Treasury (2008) *Architecture of Australia's tax and transfer system*, Table 8.1, p269 and Liangyue Cao, Amanda Hosking, Michael Kouparitsas, Damian Mullaly, Xavier Rimmer, Qun Shi, Wallace Stark, and Sebastian Wende (2015) *Understanding the Economy-Wide Efficiency and Incidence of Major Australian Taxes*, Treasury Working Paper 2015-01, April.

19 See endnote 14.

20 See Explanatory Memorandum on Major Bank Levy Bill 2017, p5 and p26.

21 The budget would return to surplus (on an underlying cash basis) in 2020–21 based on forecasts from the 2017–18 Budget, regardless of whether the levy is in place or not. With the levy, the surplus will be $7.4bn in 2020–21; without the levy the surplus in that year will be about $5.8bn, assuming the cash receipts from the levy are similar to accrual revenue from the levy in that year.

Without the bank levy, deficits and public debt would be slightly higher — in particular, debt would be around $4.6bn higher in 2020–21. As a result, interest payments would also be slightly higher in 2020–21, but not by enough to cancel out the projected surplus in 2020–21.

22 2017–18 Budget, Budget Paper 2, p24 & p60.

23 Explanatory Memorandum on Major Bank Levy Bill 2017, p26.

24 Fiscal drag and bracket creep are the automatic increases in personal tax as a share of the economy because of a failure to index personal tax thresholds. For further discussion see Robert Carling & Michael Potter (2015) *Exposing the Stealth Tax: the Bracket Creep Rip-off*, CIS Research Report 8, 13 December.

25 2017–18 Budget.

26 The tax to GDP ratio is forecast to be 22.2% in 2017–18, equal to the 30 year average and just above the 40 year average of 22.1%. Source: 2017–18 Budget, Statement 11, Table 3. While tax will shortly be above the 30 and 40 year average, it will be below the average for the period between 2000 and the GFC, but comparison to this shorter period is flawed as argued in Michael Potter (2016) *The case against tax increases in Australia: The growing burden*, CIS Research Report 15, Box 1.

27 Michael Potter (2016) *The case against tax increases in Australia: The growing burden*, CIS Research Report 15.

28 Through the Committed Liquidity Facility, as discussed here: RBA (2011) *The RBA Committed Liquidity Facility*, Media Release, 16 November.

29 This is because the big five banks are able to use internal risk models to assess credit risk for housing, which generally results in reduced capital requirements compared to the standardised approach used by other smaller banks. For more details of the differences between the internal and standardised approach for risk weighting, see Reserve Bank of Australia (2015) *Financial Stability Review*, October, Box C: The Regulatory Capital Framework for Residential Mortgages.

30 APRA has requested banks limit the growth in investor lending and interest only lending. This arguably benefits the larger banks more than the smaller banks. See Duncan Hughes (2017) "Big banks getting 'free kick' from regulator crackdown, says MyState" *Australian Financial Review*, June 8.

31 Scott Morrison (2017) *Major Bank Levy Bill 2017, Second Reading speech, Parliament House, Canberra*

32 Scott Morrison (2017) *Interview with Barrie Cassidy, ABC Insiders*, 14 May.

33 Scott Morrison (2017) *Major Bank Levy Bill 2017, Second Reading speech, Parliament House, Canberra*. The Treasury Secretary, John Fraser, also made similar arguments at Senate Estimates. See Philip Coorey (2017) "Treasury boss John Fraser defends bank tax, impact on rates will be 'trivial'" *Australian Financial Review*, 29 May.

34 Scott Morrison (2017) *Interview with Barrie Cassidy, ABC Insiders*, 14 May.

35 RBA (2016) *RBAFOI-151609 Documents Released*.

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37 See http://www.pc.gov.au/inquiries/current/financial-system

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46 Australian Government (2015) Improving Australia's financial system — Government Response to the Financial Systems Inquiry.

47 Michael Devereux, John Vella & Niels Johannesen (2013) *Can taxes tame the banks? Evidence from European bank levies*, Oxford University Centre for Business Taxation Working Paper 1325, Table 1.

48 Explanatory Memorandum on Major Bank Levy Bill 2017, p37–38, which does not include a bank levy from Cyprus, Latvia, Romania or Slovenia. These countries are listed as having a levy in Devereaux, Vella & Johannesen (2013) Can taxes tame the banks?

49 Devereaux, Vella & Johannesen (2013) Can taxes tame the banks?, Table 1.

50 The 28 members of the EU minus 11 imposing a levy on borrowings and 3 imposing a levy on a different basis.

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53 Explanatory Memorandum on Major Bank Levy Bill 2017.

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57 Malcolm Turnbull (2017) *Keynote address at the CEDA 2017 State of the Nation Conference*, 31 May.

58 Increase in top personal tax rate: Parliamentary Budget Office (2017) *Post-election report of election commitments*, p21. Banking levy: 2017–18 Budget, Paper 2, p24.

59 Scott Morrison (2017) *Major Bank Levy Bill 2017, Second Reading speech, Parliament House, Canberra*.

60 The government guarantee is not a guarantee that withdrawals won't occur. Customers can withdraw from at-call deposits for any reason, whether or not a guarantee exist.

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70 The guarantee is called the Financial Claims Scheme. It applies to deposits of up to $250,000 per account holder, and applies to banks, building societies and credit unions that are incorporated in Australia and authorised by APRA. For details see: https://www.fcs.gov.au/about-apra

71 The government has not explicitly argued the bank levy is a charge for a bank guarantee, but it has linked the levy to privileges the banks receive worth 20 to 40 basis points; this potentially includes the bank guarantee. See Scott Morrison (2017) *Interview with Barrie Cassidy, ABC Insiders*, 14 May.

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77 See endnote 41.

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79 Patrick Durkin (2017) "Bank 'tax grab' will spook investors: Don Argus, Alan Joyce, Andrew Thorburn", *Australian Financial Review*, 11 May.

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87 See Section 5.1.

88 The Treasurer cited a supposed funding benefit to the big banks as a reason for imposing the levy, see Scott Morrison (2017) *Interview with Barrie Cassidy, ABC Insiders*, 14 May, and this funding benefit may include the benefit of being classified as TBTF, see Section 3.2.

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