Bank levy in South Australia: Doing as the Treasurer says, doing as the Treasurer does

The impact of the South Australian bank levy.

Discussion paper

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Summary

The announcement of a new state level bank levy in South Australia has upset the big banks. This is not surprising and the big banks along with their lobby group the Australian Bankers Association have launched a self-interested campaign to stop the levy. Like most industry political campaigns it relies on exaggerated claims about the impact of the bank levy on ordinary people and the South Australian economy.

The South Australian bank levy is designed in the same way as the federal bank levy. Banks cannot avoid the levy by not banking or investing in South Australia. The proposed levy will therefore not disadvantage South Australia compared to any other state or territory.

The South Australian bank levy is proposed at 0.0036 per cent or 0.36 basis points. That is $36 in every $1,000,000 of determined liabilities. It is expected to raise about $90 million per year over the next four years. Together the five CEOs of the big banks make about half of what the levy is expected to raise each year. The amount the levy is expected to rise also represents just 0.2 per cent of the $44 billion in pre-tax profits the big five made last year.

The bank levy is not a new idea and has been implemented in many other countries around the world, particularly in Europe. This along with the size of the levy means it will have no material impact on sovereign risk.

The bank levy also represents a good opportunity for the federal government to encourage state governments to raise more of their own revenue. The federal government has recently complained that the states are too reliant on it for their revenue. When the states want more revenue they have in past suggested the federal government increase the GST. This means the states get all the revenue and the federal government suffers all the political pain of increasing a tax.

The federal government should take this opportunity to encourage the state governments to follow South Australia's lead and implement their own bank levies. This means state governments would be more reliant and responsible for their own taxes. The federal government should use the COAG process to encourage this to happen.

Introduction

South Australia has announced in its budget that it will be implementing a bank levy that mimics the federal bank levy.[1] The levy will be set at a rate of 0.0036 per cent or 0.36 basis points, imposed on most of the liabilities of any deposit-taking institution with total assets above $100 billion. This means the levy will be just $36 in every $1,000,000 of defined liabilities.

As with the federal bank levy it will only impact the big four banks (Commonwealth Bank, Westpac, ANZ and NAB) as well as Australia's largest investment bank Macquarie Bank. The rate of the levy is set so it will raise from SA the same amount as the federal levy that comes from South Australia. This is achieved by calculated the ratio of South Australia's Gross State Product and Gross Domestic Product. At the moment this is about six per cent of the total levy. This effectively means the South Australian bank levy is the same size as the federal levy in South Australia.

The banks are as unhappy with the announced South Australian levy as they were unhappy with the federal government's bank levy. This is not unexpected as it opens up an additional tax on the banks and if the South Australian government is successful, it could see other states follow suit. The South Australian bank levy is only tiny in size but the ferocious reaction of the banks is in part because they are concerned that other states will follow South Australia's lead.

As is increasingly the case in Australia, the reaction has been over blown with exaggerated claims of sovereign risk and lost investment opportunities for the South Australian economy. Such exaggeration needs a closer examination.

BANK PROFITABILITY

The big five banks are very profitable. The most recent figures show that they earned before tax profits of $44 billion dollars.[2] That represents about three per cent of Gross Domestic Product. Or to put it another way of every $100 of income generated in Australia, $3 went to the owners of the big banks.

[1] South Australia Department of Treasury and Finance (2017) *State Budget 2017-18, Budget paper 5*

[2] Author's calculations from latest annual reports and shareholder circulars. Fiscal years ending June 30 2016 for Commonwealth Bank; Sept. 30 2016 for Westpac, ANZ, and NAB; and March 31 2017 for Macquarie.

Australian banks are the most profitable in the world.[3] Bank profits as a percentage of GDP are two and half times larger than the United States and three times larger than the United Kingdom. The profitability of the banks is somewhat surprising when you consider that banks are just a utility; they provide a payments system and are intermediaries between savers and borrowers. They do not actually build or produce anything themselves.

Banks high rates of profit are derived from a number of factors. The first is that the big four banks make up an oligopoly. They represent about 80 per cent of the market and such a high market shares means they have a large amount of market power. This market power allows them to earn large profits. They also operate in an environment that is highly regulated and they benefit from that regulation. They are largely protected from being taken over by foreign banks.

They are also implicitly guaranteed by the government because they are deemed too big to fail. This comes about because the collapse of a major bank would impose enormous economic, social, and fiscal costs on the economy, and the federal government quite rightly would want to ensure that this doesn't happen.

The government has the power to protect banks from collapse through various measures including the injection of emergency liquidity (often facilitated through the central bank), regulatory changes (eg. controlling deposits to limit capital flight), deposit guarantees to stabilize confidence (like those introduced by the Rudd government in 2008), or public equity investments and even outright nationalization as happened in the UK during the Global Financial Crisis.

This means that the large banks are perceived as safer than the smaller banks and this brings two benefits. First people are more likely to bank with them. And secondly they face smaller borrowing costs because capital markets feel more confident they will be able to pay their debts.

IMPLICIT GUARANTEE

IMF researchers suggest the implicit guarantee given to large banks by the government ranges in value from at least 20 basis points of their total balance sheet, to 100 basis points or more (during times of instability).[4] The RBA estimated the value of the guarantee at 20-40 basis points on average since 2000.[5] During a financial crisis the

[3] Farr (2016) *Australian banks top global list as Labor persists in demands for a royal commission*

[4] International Monetary Fund (2014) *How Big is the Implicit Subsidy for Banks Considered Too Important to Fail?*

[5] Hughes (2015) *Do large Australian banks receive an implicit public subsidy?*

guarantee is worth much more than this. During the 2008-09 crisis the support given the large banks by the Australian government allowed them to absorb smaller, more fragile institutions – hence the banks emerged even bigger and stronger.

The cost to the banks of the levy is small relative to the private benefit of the implicit guarantee. The federal levy is six basis points and South Australia is proposing a levy that is six per cent of that or 0.36 basis points. That's 0.0036 per cent or $36 in every $1,000,000 of defined liabilities. So the total bank levy in Australia would increase to 6.36 basis points.

Even if every state implemented the same levy as the South Australian government then this would only add another six basis points for a total of 12 basis points. This is far less than the lower bound of the estimated value of the implicit guarantee of 20 basis points.

BANK LEVIES IN OTHER COUNTRIES

Bank levies are common in other countries, particularly in Europe. There are at least 14 countries in Europe which imposed bank levies after the GFC, on the advice of the IMF. The IMF recommended a maximum levy of 20 basis points.[6] So even with the South Australian move, the combined total state (0.36 basis points) and federal (6 basis points) is less than a third of the IMF's recommended safe maximum.

SOVEREIGN RISK

There have also been claims that the federal and South Australian bank levies will impact on sovereign risk in Australia. These claims are exaggerated. As noted above there have been many other developed countries that have imposed bank levies, many of which are set at higher rates than Australia. These countries remain attractive places to invest. The bank levy is not a controversial idea in Australian policy circles. The Reserve Bank of Australia was in favour of a bank levy in its submission to the Murray Financial systems inquiry.[7]

Claiming that a new government tax or a change in an existing tax will cause sovereign risk is often employed by opponents of a tax when there are few other arguments. The impact on sovereign risk of a new tax is almost impossible to measure. Tax changes are

[6] International Monetary Fund (2014) *How Big is the Implicit Subsidy for Banks Considered Too Important to Fail?*

[7] Reserve Bank of Australia (2014) *Submission to the Financial System Inquiry*

quickly absorbed into business calculations and it is important to remember that Australia is consistently rated as one of the safest countries to invest.

It is also important to remember that the South Australian bank levy is expected to raise about $90 million each year over the next four years. This represents just 0.2 per cent of the banks pre-tax profits of $44 billion last year. As shown in Table 1, the CEOs of the big five banks earnt $45 million last year. This means that just five CEOs made about half of the expected cost of the levy.

Table 1 – Big bank CEO's remuneration

Bank	CEO	Remuneration
Commonwealth Bank	Ian Narev	$8,768,352
Westpac	Brian Hartzer	$6,752,017
NAB	Andrew Thorburn	$6,709,667
ANZ	Shayne Elliott	$5,069,657
Macquarie Group	Nicholas Moore	$18,159,292
Total		**$45,458,985**

Source: CBA, Westpac, ANZ, Nab and Mac Bank annual reports

For this reason it is surprising that anyone would think that that a 0.0036 per cent tax on defined banking liabilities will have any significant impact on sovereign risk for Australia or South Australia.

LEVY WILL NOT IMPACT SOUTH AUSTRALIAN ECONOMY

The levy is based on bank liabilities from all states not just those in South Australia. This means that banks can't reduce the size of the levy by restricting lending to South Australia since the levy is based on liabilities in all states and territories. This creates no incentive for the banks to reduce business in South Australia. If it is profitable to do business in South Australia then banks will continue to do so.

There have been threats by one bank to not set up a team in South Australia but rather set it up in another state.[8] The bank has claimed this will cost South Australia 150 jobs. This decision is clearly not based on economics since the South Australian bank levy will not impose any additional cost of setting up a team in South Australia compared to any other state.

Rather this seems to be a punitive measure that is designed to put political pressure on the South Australian government not to introduce the levy. While such actions may happen during the period before the bank levy is legislated they are not likely to be an

[8] Harmsen et al. (2017) *SA budget: BankSA steps up protest against bank levy*

ongoing issue. After the bank levy is part of the tax system there will be no incentive for banks to make these decisions on anything other than the economics of each of the cases.

GST EXEMPTION ON FINANCIAL SERVICES AND EXTENDING THE LEVY TO OTHER STATES

Financial services have been exempt from the GST since it was introduced in 2000. This exemption is estimated to be worth $3.7 billion in 2017-18.[9] The result of this exemption means that the banks pay less tax than they otherwise would. The premier of South Australia has previously suggested that the GST be extended to financial services[10] but the federal government was reluctant because all the additional revenue would go to the states while the federal government would feel the political pain of increasing the GST.[11]

Rather than increase the GST the federal government suggested the states should rely less on them for revenue and instead raise their own taxes. At the time there was talk that the federal government would hand back some responsibility for income tax to the state governments.[12] State governments could then change the rates of income tax in their own state. This would mean that each state would be less reliant on the federal government and would also be politically responsible to the voters for any change in the tax rate.

The decision of the South Australian government to impose a bank levy should therefore please the federal government. The revenue from the South Australian bank levy will go directly to the South Australian government and any political fallout for the levy will also be borne by the South Australian government. Also since the federal government has just implemented the same kind of levy then it is reasonable to assume that they're generally happy with this kind of taxation measure.

It would seem prudent for the federal government to encourage other state governments to follow the South Australian government's lead and implement bank levies in other states. This would increase state government revenues without the federal government having to hand over additional money. COAG would seem to be the best forum to coordinate this exercise and the federal and state governments should consider working together to create a state government bank levy in all states

[9] The Treasury (2017) *Tax Expenditures Statement 2016*
[10] Tingle (2015) *South Australia's Jay Weatherill moves GST debate to financial services*
[11] Turnbull (2016) *Doorstop Penrith*
[12] Kildea (2016) *Turnbull's plan to fix the federation is bold – but can he deliver?*

and territories. There have been reports already that the Western Australian government is considering a bank levy of its own.[13]

[13] Laschon (2017) *SA-style bank tax 'attractive option' to relieve debt, WA Treasurer Ben Wyatt says*

Conclusion

While the campaign of the big banks and their lobby group the Australian Bankers Association might want people to believe differently, the proposed South Australian Bank levy is tiny at 0.0036 per cent or $36 in 1,000,000. It is proposed to raise about $90 million per year which is only about twice as much as the five CEOs of the big banks got paid last year.

These kinds of self-interested campaigns have become far more popular since the success of the campaign against the mining tax. While it is not surprising that industries would wage such campaigns it is surprising that the general public would be influenced by them.

The campaign is clearly designed to exaggerate the impact of the South Australian bank levy. The reality is that the bank levy will have no real impact on ordinary South Australians and its design means that it will not disadvantage South Australia compared to any other state or territory. It will raise revenue for the South Australian government and will mean either more services or less taxes paid by other South Australians.

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