Briefing Note:

Of Levies, Profits, and Backstops: The Bank Tax in Context

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The Australian government's surprising decision to impose a new tax targeted precisely at the biggest financial institutions in the country continues to generate public debate. We have reviewed the structure, likely effects, and economic and regulatory context of the proposed 0.06% levy on selected liabilities of the 5 largest financial institutions in Australia. Here are some points to keep in mind as the debate unfolds:

Structure of the Levy

The bank levy would consist of a 6 basis point (0.06%) tax imposed annually on most of the liabilities of any deposit-taking institution with total assets above $100 billion. (That threshold will be indexed to inflation) This means the levy (by design) will apply only to the 4 largest retail banks (Commonwealth, NAB, Westpac, and ANZ) plus Macquarie Group (the large investment bank). Foreign banks are excluded.

The levy will exclude consumer deposits covered under the Financial Claims Scheme (that is, up to $250,000 per depositor per institution) and deposits related to mortgages. The government expects to collect $1.5-$1.6 billion per year in net revenue from the tax. The government claims this is *after* adjusting for the ability of the banks to deduct the cost of the levy from their taxable income and hence reduce their company income taxes, but it is not clear if this claim is valid (see below).

The 5 institutions have total liabilities in excess of $3.6 billion, so the levy would seem to apply to about three-quarters of their total liabilities. (If it applied to all of their liabilities, it would raise around $2.2 billion per year.)

Precedents for a Liabilities Levy

At least 15 countries around the world (mostly in Europe) introduced bank levies broadly similar to this one in the years following the Global Financial Crisis of 2008-09.[1] These taxes were justified as a means of requiring large institutions – those deemed

[1] Michael Kogler, "On the Incidence of Bank Levies: Theory and Evidence," University of St. Gallen, School of Economics and Political Science, Economic Working Paper 1606, https://ideas.repec.org/p/usg/econwp/201606.html.

"too big to fail" – to pay something toward the ultimate cost presumably borne by government of keeping the banks in business in the event of a financial crisis.

In Australia, the outgoing Rudd government proposed a 5 basis point levy in its pre-election budget of 2013 (which was never implemented). Other organizations in Australia – including the RBA itself in a 2014 submission to the financial system inquiry headed by David Murray[2] – have also supported the idea.

Value of the Implicit Guarantee

The collapse of a major bank would impose enormous economic, social, and fiscal costs on any economy, and governments quite rightly want to ensure that doesn't happen. They have 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.

These measures have a cost, and some argue that it is fair for large banks which benefit from these protections to "pay" toward that cost, such as through a levy. Some progressives might also propose other mechanisms to help ensure a "fair return" on this public support for the banks – such as democratic oversight over the actions of the banks, the capacity to direct bank credit to better reflect social priorities (rather than private speculation), or even public ownership to reflect the "social license" which banks are granted through these protections. On the other hand, some free-market purists argue that banks (even big ones) should just be allowed to collapse, as the ultimate "discipline" over bad management; but this would cause huge damage to the economy and workers.

IMF researchers suggest the implicit guarantee given large banks by the government backstop ranges in value from at least 20 basis points of their total balance sheet, to 100 basis points or more (during times of instability).[3] The RBA estimated the value of the backstop as 20-40 basis points on average since 2000.[4] Of course, during a financial crisis the 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 emerging even bigger and stronger.

[2] Reserve Bank of Australia, "Submission to the Financial System Inquiry," March 2014, http://www.rba.gov.au/publications/submissions/financial-sector/financial-system-inquiry-2014-03/pdf/financial-system-inquiry-2014-03.pdf.

[3] International Monetary Fund. "How Big is the Implicit Subsidy for Banks Considered Too Important to Fail?" *IMF Global Financial Stability Report*, 2014, Ch. 3, http://www.imf.org/External/Pubs/FT/GFSR/2014/01/index.htm.

[4] David Hughes, "Do large Australian banks receive an implicit public subsidy?", Reserve Bank of Australia, 23 January 2015, http://www.rba.gov.au/information/foi/disclosure-log/pdf/151609.pdf.

It is clear that the costs paid by the banks through this levy are small relative to the private benefits they gain as a result of the implicit public guarantee of their businesses. Using the RBA estimates, they are being asked to "pay back" as little as one-sixth of the ongoing value they receive from the guarantee.

A Timely Reminder

The exclusive benefits captured by the large banks because of their "too big to fail" status was reafirmed dramatically recently, when the ratings agency Standard and Poor's downgraded its credit rating for 23 Australian banks and other financial institutions – but *not* for the 5 large banks that are being targeted with the 6-basis-point levy.[5] The downgrade reflected the growing precarity of the household credit and mortgage market, given Australia's housing bubble and soaring personal debt levels. That situation is mostly the result of the actions of the 5 *large* institutions (who control over 80 percent of mortgage lending), yet only the *smaller* banks will pay higher borrowing costs because of the downgrade. S&P explained this decision by pointing out that the big banks cannot collapse: the government will bail them out.

Bond rates for borrowing by the smaller banks affected by the downgrade will rise as a result – by 10 basis points or more, according to financial analysts. Ironically, then, the competitive position of the smaller banks has gotten *worse* since the budget: the small relative advantage they received by being exempted from the 6 basis point levy, is overwhelmed by the higher borrowing costs they will now face as a result of their downgrades.

Costs per Bank

Table 1 After-Tax Cost Per Bank Per Year	
Westpac	$260 m
NAB	$245 m
ANZ	$240 m
Commonwealth	$220 m
Total	**$965 m**
Source: Bank circulars, as reported in Thomson (2017), op. cit.	

[5] Carrington Clarke, "S&P downgrades banks' credit rating on property crash risk but big four escape, *ABC News Online*, http://www.abc.net.au/news/2017-05-22/sp-downgrades-banks-credit-rating-on-property-crash-risk/8548218.

The four large banks have issued statements to investors indicating how they think their after-tax profits will be reduced by the levy.[6] They estimate they will pay $1.4 billion per year in total on the levy, but the after-tax impact will be smaller (just under $1 billion in total – see table). This suggests that the government may be overestimating its net revenue from the levy. The government claims that the $1.6 billion per year estimate took account of the offsetting decline in company income tax from the same banks (since the levy will be tax-deductible), but the banks' own statements suggest otherwise (see Table 1).

The impact of the tax is uneven, based on the differing composition of the banks' businesses. Commonwealth is the largest bank measured by assets, but will pay the smallest in levy because its business is more concentrated in smaller-scale retail savings and lending – much of which is exempted from the levy.

The Levy in Perspective

The five affected institutions together hold total assets of over $3.6 trillion – more than twice as large as Australia's entire GDP (see Table 2). Their total annual revenue exceeds $160 billion per year. Their combined before-tax profit (in the latest fiscal year) was $44 billion; they reported $31 billion in after-tax net income.

Table 2
Assets and Profits of Major Australian Banks

	Assets ($b)	Revenue ($b)[1]	B-T Profit ($b)	A-T Profit ($b)	Rtrn. on Equity (%)	A-T Levy Cost ($m)	As % Assets	As % B-T Profit
Comm.	$933	$41.5	$13.1	$9.2	16.2%	$220	0.02%	1.68%
ANZ	$915	$35.4	$8.2	$5.7	10.0%	$240	0.03%	2.93%
Westpac	$839	$37.7	$10.6	$7.5	14.0%	$260	0.03%	2.45%
NAB	$778	$32.8	$9.0	$6.4[2]	12.1%[2]	$245	0.03%	2.72%
Macquarie	$183	$13.3	$3.1	$2.2	15.2%	?		
Total	$3,648	$160.6	$44.0	$31.0		$965[3]	0.03%[3]	2.36%[3]

Source: 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.
1. Gross revenue. 2. Adjusted to exclude special charge for discontinued operations. 3. Big four only.

As a share of total assets, the levy's net impact on the four largest banks equals just 0.03%. That is only half as much as the supposed 6 basis point rate of the levy; the lower effective rate reflects the exclusion of many liabilities from the tax, as well as the

[6] James Thomson, "Bank Levy to Hit Dividends as Banks Reveal Profit Hit," *Australian Financial Review*, May 22 2017, http://www.afr.com/business/banking-and-finance/bank-levy-will-cost-westpac-260m-a-year-20170521-gw9zqk.

partial recouping of its cost through reduced company income tax payments. As a share of before-tax profits, the net cost of the levy is equivalent to just over 2 percent.

Why Do Banks Make So Much Money?

Private banking in general is a business with unique capacity to generate profits. The industry operates by literally creating new money in the form of loans issued to borrowers. (The repayment of credit, meanwhile, represents the destruction of money.) Banks do not require initial deposits from customers in order to conduct this lending (as implied in the mistaken stereotype that banks serve only an "intermediary" function).[7] Loans can be issued, and spending power created by the banking system, whenever bank managers determine that the likely profits from issuing a new loan (with its concomitant interest revenues) exceeds the risk of non-payment. If individual banks require more cash to meet net demand for actual currency (which is small relative to gross payments, all the more so given the expansion of electronic transfers), they borrow it from other banks (through the huge inter-bank lending market).

So on one level, it is hardly surprising that banking is a profitable business: this industry, unique among others, makes money through its legal power to *create* money. Australia's major banks, however, take this power a step further to generate consistent above-normal profits thanks to their dominant, protected position within a relatively small market. The state's guarantee of their business plays an important supporting role, as we have seen, as does effective protection against foreign takeover of Australian banks. The major banks have leveraged these advantages into a dominant position in Australian financial markets: based on their size (which provides various efficiencies and economies of scale), their combined market share (over 80 percent), their capacity to undertake more complex, higher-margin activities (including investment banking, derivatives, foreign trading, etc.) than their smaller rivals, and other advantages.

The rich profit margins consistently earned by banks reflect their ability to mark up revenues well above their costs of business through higher fees and net interest income. This is why the banks consistently earn rates of return on equity far higher than typical of other businesses: averaging *15 percent per year* in recent years. Their competitive dominance will not be significantly affected by this levy; in fact, as we have seen, they are gaining an *increasing* advantage over their smaller rivals as the growing fragility of Australian mortgage lending results in higher borrowing costs for smaller banks (but not for the big ones).

Only if the dominant pricing power of the large banks in the overall banking industry were somehow curtailed, or if the overall lending market turns down (so that fewer new loans are being issued, and more customers default), would we expect bank profit

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[7] The dominant role of new bank lending in creating new money in a credit money system is now acknowledged by mainstream economists; see, for example, Michael McLeay, Amar Radia and Ryland Thomas, "Money Creation in the Modern Economy," *Bank of England Quarterly Bulletin*, Q1 2014, http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2014/qb14q1prereleasemoneycreation.pdf.

margins to be eroded. The latter is a distinct possibility as Australia's debt-fueled property bubble starts to contract; the former, however, is not likely at all. The Coalition government has announced various measures aimed at supposedly tightening competitive discipline on the big banks (including a Productivity Commission investigation, special ACCC powers, etc.). These announcements are mostly aimed at allowing the Coalition to rebuff demands for a Royal Commission into banking. It is hard to believe that they would have any measurable impact on the large banks' market dominance in the foreseeable future.

Can the ACCC Stop Banks From Passing the Levy On to Customers?

Prime Minister Turnbull has suggested that oversight from the ACCC would prevent the banks from passing on the cost of the levy to customers in the form of higher fees or lower interest rates on deposits. "The ACCC will be watching them very, very carefully indeed," he said.[8] This threat is utterly hollow. The ACCC has the authority to monitor and punish outright collusion or price-fixing among companies. But it does not have any authority to regulate banks' pricing decisions. And as we have seen, it is their general market dominance – not illegal collusion – that allows the banks to collect extra-large profit margins on their activities.

The head of the ACCC, Rod Sims, has been put in an awkward position by the government's appointment of him as a phony "cop" to monitor the banks' activities. He has acknowledged that the ACCC's role is limited to monitoring bank responses and publicizing its findings. It has no ability to stop the banks from recouping the new costs from consumers.[9]

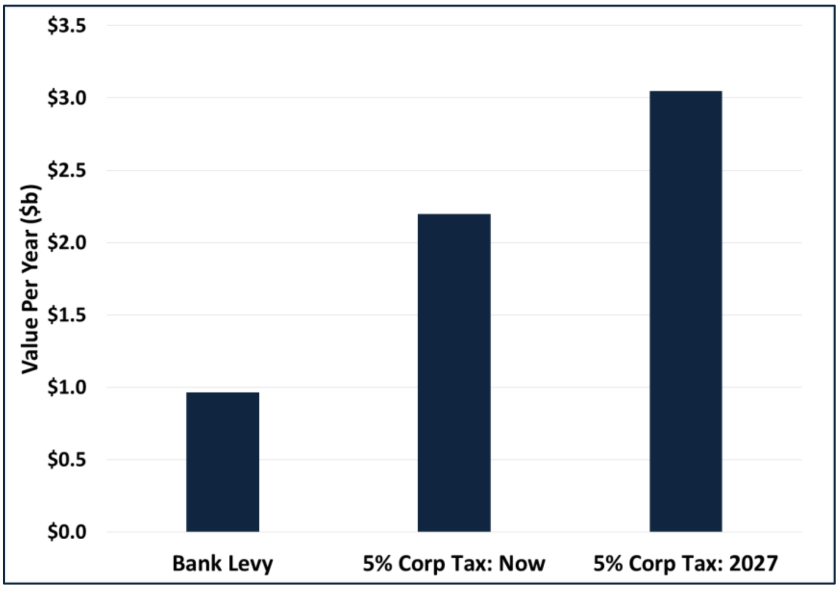
The Bank Levy and Company Tax Cuts

The banks' complaints about the new levy are hard to take too seriously, when we remember that they will be by far the biggest beneficiaries of the proposed across-the-board cuts in company income tax rates which are planned by the Coalition. Starting in 2023-24, and then phased in over the subsequent years, the banks' income tax rates would fall by 5 percentage points of before-tax profit. If this lower rate had been in place in the last fiscal year, the five institutions would have saved *$2.2 billion – more than twice their net (after-tax) cost of the bank levy* (see Figure 1). By 2027 (when the lower rates are to be phased in, under the Coalition's plan) that amount would likely swell (along with the banks' general income) to over $3 billion per year.

[8] Sky News, "Banks Would be 'Unwise' to Pass on Levy Costs," May 10 2017, http://www.skynews.com.au/news/top-stories/2017/05/10/coalition-backed-on-budget-bank-levy.html.

[9] Peter Ryan, "Bank Tax: Regulator Doesn't Have the Power to Stop Banks Passing On Costs, says ACCC Boss," ABC News Online, May 18, 2017, http://www.abc.net.au/news/2017-05-18/accc-doesn27t-have-the-power-to-stop-banks-passing-on-tax/8536614.

Figure 1
Taking With One Hand, Giving With The Other



The major banks are the last companies which should be receiving government fiscal assistance (whether through a company tax cut or other measures). They will not leave Australia because of the company tax: to the contrary, Australia has been one of the most consistently profitable jurisdictions in the world for banks. They enjoy a protected, lucrative, government-supported business environment here. In particular, the government's implicit guarantee, no matter how far they over-stretch their lending, is an enormous public gift. Giving up $3 billion per year in needed revenues to further reward their concentrated private profit is truly scandalous.

The banks know full well that they will be much better off, by a ratio of at least 2-to-1, from the promised company tax cuts, compared to the net burden of this levy. (In fact, assuming they pass most of it on to consumers, this levy will have almost no impact on their profits.) That's why their campaign against the Coalition government will be essentially token: going through the motions of outrage, but knowing full well they are being looked after by this government.

A Better Way to Tax the Banks

The banks' complaints about the unfair "burden" of this levy are not at all convincing, and progressives should support the general principle that these lucrative private institutions should make a larger contribution to public revenues. But there are other, more efficient ways for a fair amount of taxes to be collected from the banks.

In particular, an excess profits tax on the banks – levied on bottom-line profits – would have less risk of being passed along to bank consumers. A strong argument can be made that banks should indeed pay a higher tax rate than other businesses, possibly on a graduated basis (so that the tax rate rises as the return on equity soars above normal rates). They enjoy a uniquely powerful, protected, and lucrative economic position;

they are subsidized by public actions; and their economic role (supplying credit to the economy) is akin to that of a utility. If banks are going to be given the license to use this power (to the private benefit of their owners), then it is certainly reasonable to expect them to pay higher rates of tax as a repayment to society for their right to operate.

In October 2016 the Australia Institute conducted an opinion poll to test public opinion on the idea of a "super-profits tax" on banks. 61 percent of respondents approved of the idea (25 percent strongly), while only 19 percent disapproved – a more than three-to-one ratio in support of the tax.[10]

Conclusion

The proposed levy on banks is an extraordinary policy measure from a government which normally rails against taxes on business of any kind – and against targeted, arbitrary, supposedly "punitive" measures like this one in particular. The government's action reflects both its weak political positions, and its realization that Australians have become disillusioned with the logic of "trickle-down" economic policy (according to which anything that enriches powerful private interests will spark investment, job-creation, and widespread prosperity). There is an enormous cognitive dissonance between this policy, and the government's general policy approach, and it is little reason so many Liberals are painfully uncomfortable with the measure.

That being said, the design and implementation of this levy leave much to be desired. Large foreign banks, which are also profiting immensely from the indebtedness of Australians, are exempted. Imposing the levy on deposits rather than bottom-line profits enhances the extent to which it is passed on to consumers. The government's claim that it will raise a net $1.5 billion or more per year is suspect, in light of the banks' own estimates of the after-tax cost to them of the new measure.

Initial public opinion research suggests the levy is popular with Australians, and rightly so. Indeed, this policy opens the door to other revenue-raising measures which should also be targeted at the private businesses which have profited extraordinarily from our recent, lopsided economic trajectory (such as resource companies, electric utilities, and others). And it certainly undermines the logic of the much larger company tax cuts which this same government is intent on implementing. The precedent set by this measure should now be seized on by progressives to argue that all business (not just the big banks) should pay a fairer share toward maintaining the society which allows them to make such profits: by rejecting company tax cuts, strengthening tax compliance and closing loopholes, and increasing taxes in specific sectors (like banks) which consistently earn above-normal profits.

[10] Australia Institute, "Australian Support a Super Profits Tax on Banks," October 6 2016, http://www.tai.org.au/content/australians-support-super-profits-tax-banks.