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Liberals, tax your brains and drop the bank levy

Illustration: Eric Lobbecke

HENRY ERGAS THE AUSTRALIAN 12:00AM May 20, 2017

Let's be clear: increasing taxes is not necessarily bad. After all, if we are genuinely unwilling to curb public spending, then we ought to pay for it rather than passing the bill to future generations.

But if taxes must be raised, let it be done sensibly. Unfortunately, the proposed levy on banks does not meet that test.

True, so little is known about the levy's design as to make it hard to evaluate. In fact, Scott Morrison's lack of clarity is reminiscent of the partygoer in Woody Allen's *Annie Hall* who says of his latest brainwave, "Right now it's only a notion, but I think I can get money to make it into a concept — and later turn it into an idea."

With tax, however, it is not merely the devil but the dollars that are in the detail. If virtually every aspect of the levy is still a work in progress, how could Treasury sensibly estimate the levy's revenue?

Ask Labor: as careful thought was not given to the design of its ill-fated minerals resource rent tax, the MRRT ended up costing more to collect than it raised.

Even so, this much seems likely, both from what has been said and from overseas experience: as far as taxes go, the levy will be shockingly inefficient.

It isn't difficult to see why. In essence, these levies are a tax on an input used in supplying banking services, namely wholesale deposits — they are, in other words, typically calculated as a percentage of the amounts the banks borrow, mainly from global capital markets, to fund their loans. Those borrowings are a substitute for the deposits banks obtain from retail customers, in the sense that banks can finance their operations from one or the other. And banks have other funding options too, including drawing on liquidity provided by the Reserve Bank.

As a result, a tax on wholesale borrowings does not only increase banks' costs in aggregate, it also skews their funding decisions, leading them to turn from what otherwise would be a lower-cost source of funds — loans from capital markets — to higher-cost sources of funds, such as retail deposits.

Just as a tax on steel, but not on the alternatives it competes with, would drive firms that use steel to shift to other materials (say aluminium) that may be costlier to produce, a tax on wholesale borrowings will distort the input mix the banks choose, making banking services costlier to produce.

That means such a levy is likely to be an order of magnitude more inefficient than, say, a GST-type tax that raised similar revenues. For all its defects, the GST-type tax would have what economists call marginal effects: faced with the tax, a few consumers would decide not to purchase services they otherwise would have consumed, but the cost of supplying banking, calculated in terms of the scarce resources it absorbs, would not rise.

In contrast, the levy will have an infra-marginal effect, making every unit of banking output costlier to produce. And the fact the levy is being imposed only on the larger banks, exempting their smaller rivals and the capital markets that provide services that compete with those of the major banks, compounds the distortion.

To justify levying a tax on banking and on banking alone, the Treasurer has suggested that it compensates taxpayers for insuring banks' retail deposits. But this argument, which many commentators have echoed, is hard to accept.

It may be that banks are undercharged for the deposit guarantee, even taking account of the many regulatory burdens that come with it. If so, the government should charge a premium that reflects the risk the community bears from providing that guarantee.

Banks then would find those deposits more expensive, and so would decrease their reliance on them, reducing taxpayers' exposure — much as charging properly risk-reflective premiums for insuring dangerous activities such as skydiving reduces the extent to which they are undertaken.

Seen in those terms, the levy is positively perverse. In effect, the levy will induce banks to rely to a greater, rather than lesser, extent on retail deposits, as it makes them cheaper compared to wholesale borrowing.

Far from reducing or offsetting the social costs of deposit insurance, the tax is therefore likely to do the opposite, as banks replace wholesale borrowings with insured deposits, increasing the risk taxpayers bear. At the same time, the more intense competition for retail deposits will force interest rates up.

Ultimately, the best that can be said for this tax is that it will be popular. Why that would be the case is a puzzle: only those who believe in the tooth fairy would think that you can increase an industry's costs without eventually increasing its prices. But the enduring attraction of bank-bashing is that it is the political equivalent of picking a dead man's wallet — it is easy to get away with it.

That hardly means it is praiseworthy. Indeed, those with ivy-clad memories will remember that the Liberal Party made its name by standing up for the banks when Labor proposed to nationalise them in 1947.

The banks were certainly not loved then — on the contrary, the tight constraints they imposed on access to credit meant they were detested. And the labour movement's assault on the "money power" didn't hesitate to fan the flames, with the unions issuing, barely two years after the liberation of Auschwitz, a pamphlet demonising the "great chain of Jewish banking houses" as "the most powerful financial Empire the world has ever known".

Little wonder Robert Menzies, in a hard-fought but ultimately successful election campaign, denounced the attacks on the banks as "a farrago of allegations which are based on inaccuracies and which proceed from false premises".

Those were, of course, different times. But on the 70th anniversary of the "battle for the banks", the Liberal Party would do well to remember its heritage. And on that score if no other, it should reconsider a tax that will do more harm than good.