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THE SOUTH AUSTRALIAN MAJOR BANK LEVY: ARBITRARY, UNJUSTIFIED, AND HARMFUL FOR SOUTH AUSTRALIA AND THE REST OF THE COUNTRY

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Introduction

In the South Australian state budget 2017-18, South Australian Treasurer Tom Koutsantonis announced that the state government intended to introduce a South Australian Major Bank Levy, one of two revenue measures "to help us meet the cost of our significant support for driving economic growth and creating more jobs".[1] Treasurer Koutsantonis made clear that this levy was explicitly modelled on the Commonwealth government's Major Bank Levy, which was announced in the May 2017-18 Commonwealth budget and passed the Commonwealth parliament in June.

Banking is a key sector in a modern economy. Banks and the financial markets they serve work to allocate capital across the economy to its most efficient purpose. The health of the banking sector is closely related to the health of the economy in general; likewise, an unstable and inefficient banking sector often causes, or is at least a leading indicator of, turmoil in the general economy. The centrality of banking and financial markets to economic prosperity and recession throughout history is reason to subject public policy proposals that affect banking markets to particular scrutiny.

This paper is an examination of the South Australian Major Bank Levy. The South Australian Major Bank Levy is intended to exactly replicate the Commonwealth Government's Major Bank Levy but at the state level. Accordingly, it applies an *additional* 0.015% tax on South Australia's share of the total value of bank liabilities that are subject to the Commonwealth Major Bank Levy Act 2017. That levy consists of a tax introduced on a range of liabilities held by the five of Australia's largest banks – the Commonwealth Bank, the ANZ, the National Australia Bank, Westpac and Macquarie Bank. While these banks are not explicitly named in legislation, they are subject to the levy because they each have total liabilities greater than $100 billion – raising the prospect of new banks being added or of existing banks dropping off the list.

Both levies apply to the total liabilities held by each bank with the exception of that bank's additional Tier 1 capital, its deposits protected by the Financial Claims Scheme (that is, its government guaranteed deposits), an amount equal to the lesser of the derivative asserts and derivative liabilities of each bank, and its exchange settlement account held with the Reserve Bank of Australia.[2]

This paper finds that the South Australian Major Bank Levy:

- will be economically harmful to a state that has seen a rise in unemployment and a decline in business investment,
- lacks serious justification in either taxation or banking policy,
- represents a rollback of the GST compact of 2000 which required South Australia to remove state taxes on banking and financial services,
- harms the stability of banking in South Australia and Australia more generally,
- increases 'regime uncertainty' for investors, and
- there are reasons to believe it has already done harm to the South Australian economy.

Not only should the bank levy be rejected by the South Australian parliament, but parliament needs to work to ensure that markets and investors have certainty that such an arbitrary and harmful intervention could not occur in South Australia in the future.

1 Tom Koutsantonis, Budget Speech 2017–18, 22 June 2017 http://servicesa.cdn.on.net/budget201718/pdfs/budget/2017-18_budget_speech.pdf

2 Major Bank Levy Bill 2017 and Treasury Laws Amendment (Major Bank Levy) Bill 2017, Explanatory Memorandum

South Australia's economic situation is dire

The South Australian economy substantially underperforms the rest of the country on some significant margins. The economic data paints a picture of a state that is facing significant economic challenges, and the need for public policy to prioritise investment and growth.

As Figure 1 shows, South Australian unemployment is the highest in the country and significantly higher than the national average.

Figure 1: Unemployment Rates (15+), National and by State and Territory, May 2017

Jurisdiction	Licences (and sub-classes)
Northern Territory	3.2 per cent
Australian Capital Territory	3.5 per cent
New South Wales	4.8 per cent
Western Australia	5.5 per cent
Victoria	6.0 per cent
Queensland	6.1 per cent
Tasmania	6.1 per cent
South Australia	6.9 per cent

ABS Labour Force Data

State headline rates hide some significant regional variation. The Australian Bureau of Statistics breaks down unemployment rates by region. While some South Australian regions are below the national average in unemployment – for example, the Barossa/Yorke/Mid North region has just 5 per cent unemployment – unemployment in the Adelaide North region has a rate of 8.2 per cent and Adelaide West has an unemployment rate of 7.9 per cent. While these two regions have the sixth and seventh highest unemployment rates in the country, they are also among the most heavily populated.

The unemployment rate is also trending badly for South Australia. As Figure 2 shows unemployment has been on an upward trend since the Global Financial Crisis.

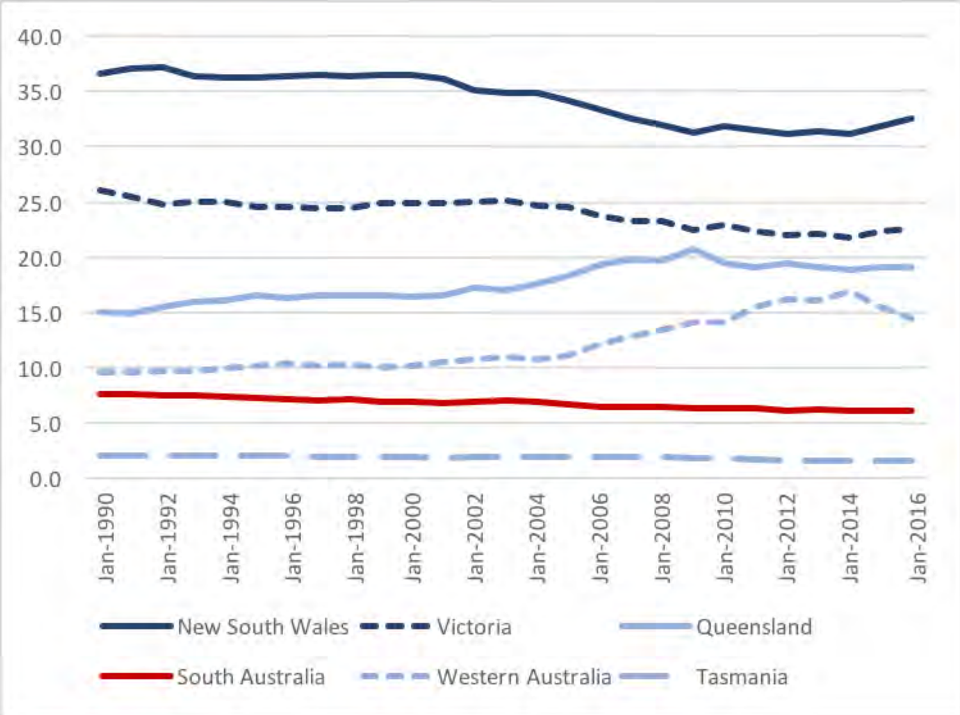
Figure 2: South Australian unemployment, 1978-2017

ABS Labour Force Data SA4 - Summary Data, May 2017

Reflecting this decline, South Australia's share of national employment has reduced from 7.3 per cent in 2007 to 6.7 per cent in 2017.[3] Population growth in South Australia is also substantially slower than the rest of the country. While population growth in Australia increased by 1.6 per cent in 2016, the increase in South Australia was just 0.6 per cent, the second lowest (equal with Tasmania) in the country.[4]

South Australia is a declining part of the national economy. Figure 3 shows that South Australia's share of the national economy has declined from 7.6 per cent in 1990 to 6.1 per cent in 2016.

Figure 3: State share of the national economy

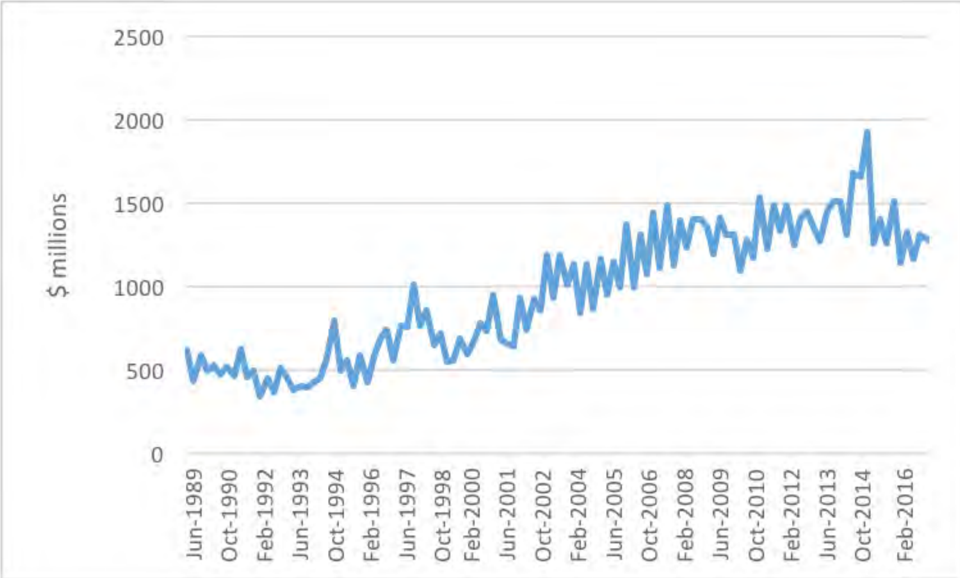


South Australia has low levels of business investment. Undermining the willingness of banks to undertake business in that state can only further reduce business activity in South Australia. The importance of the banking system is that it allocates finance to investment projects. Those economies that have underdeveloped banking systems tend to be poorer and have lower levels of business investment.

3 ABS 6291.0.55.003 Labour Force, Australia, Detailed, Quarterly May 2017

4 ABS 3101.0 - Australian Demographic Statistics, Dec 2016

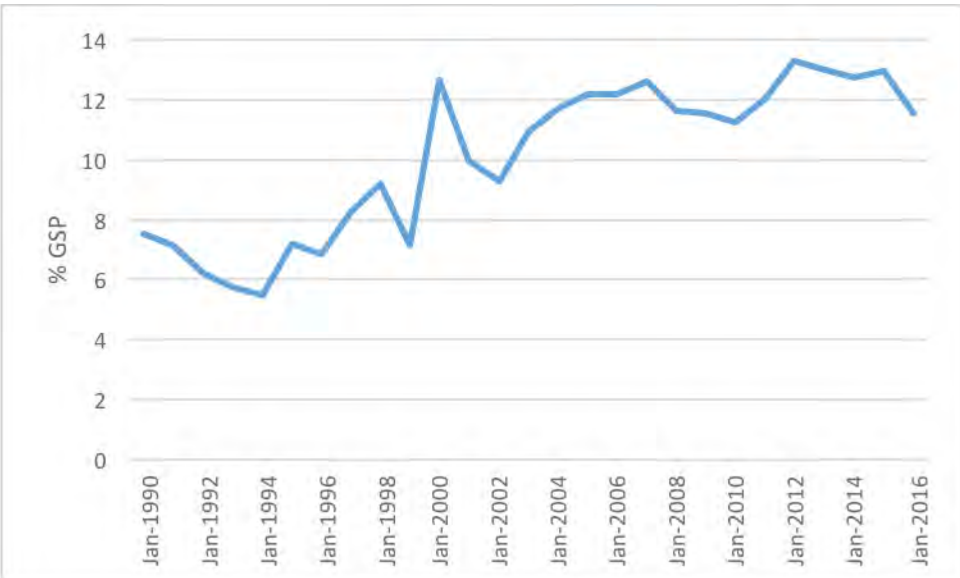
Figure 4: New Capital Expenditure in South Australia



Source ABS Cat 6525.0 Table 9B.

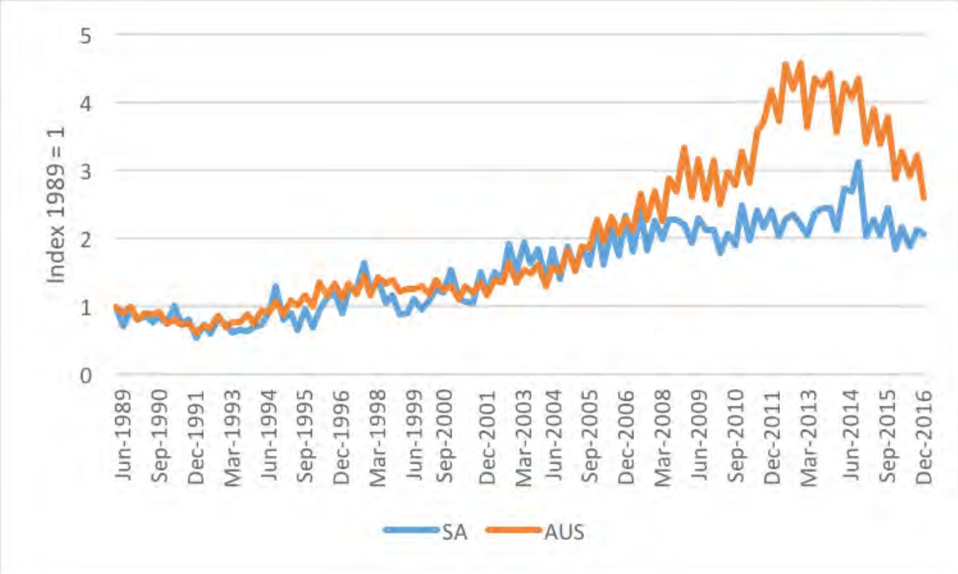
Apart from a spike in 2014 South Australia has not enjoyed growth in new capital expenditure since the financial crisis in the mid to late 2000s. Looking at Capital Formation (private investment) as a percentage of Gross State Product (GSP) we observe a similar pattern in Figure 5 and Figure 6.

Figure 5: Private Capital Formation as a percentage of Gross State Product



Source ABS Cat. 5220.0 Table 5.

Figure 6: Index values of New Capital Expenditure in South Australia and Australia



Source: ABS Cat. 5625.0 Tables 1A and 9B.

The two data series divert in the mid-2000s – before the onset of the financial crisis. To the extent that capital expenditure decisions are determined by business responses to poor public policy settings it appears that South Australia has been long regarded as poor investment destination. In recent years Australia as a whole has seen a decline in capital expenditure both as a result of the end of the mining boom and also as a result of poor policy making. In such an environment it becomes very difficult to justify a new tax on what is a successful industry and also an industry that finances business investment.

The bank levy lacks serious justification

Treasurer Koutsantonis has raised a number of justifications for the South Australian bank levy in addition to those the Commonwealth Government has proposed for its bank levy. As Daniel Wild from the Institute of Public Affairs and Michael Potter from the Centre for Independent Studies have argued, the rationale presented by the Commonwealth government for its imposition does not hold up to scrutiny.[5] If the major banks have unfair advantages due to current Australian policy settings, these advantages should be directly tackled. Similarly, if the bank levy is necessary to remedy weaknesses in Australian competition policy, then it is economy-wide competition policy that needs remedying. The Commonwealth Bank has further pointed out that the Commonwealth levy does not apply to large foreign banks – rather than 'levelling the playing field' for small Australian banks, it puts the Australian industry at a disadvantage relative to its foreign competitors.[6]

We do not propose to re-examine the arguments for a Commonwealth bank levy here. Treasurer Koutsantonis' additional justifications for his state levy are even weaker than those proposed by his federal colleagues. Furthermore, many of the most plausible rationales for the Commonwealth levy do not stand up when applied to a state tax.

The regulation and control of banking is the responsibility of the Commonwealth government. Section 51 (xiii) of the Commonwealth Constitution gives the Commonwealth power over banks and state banking that crosses state borders. Until the 1990s, financial regulation in Australia was divided into two jurisdictions: the Commonwealth regulated banks, and the states regulated other non-bank financial institutions (NBFIs) such as building societies, credit unions, and hire-purchase firms. In the wake of financial deregulation, the weaknesses of this regime became apparent. The states began to unify regulation on NBFIs in the 1990s, and in 1998 control of all 'authorised deposit institutions' – banks and NBFIs alike – was taken over by the Commonwealth and vested in the Australian Prudential Regulation Authority.[7] Consequently, under the current regulatory regime, state governments have no direct or implied role in controlling the banking sector, and their role in financial markets in general is minimal.

Will it substitute for a GST on financial services?

One of the key arguments presented by Treasurer Koutsantonis for the levy is that it is intended as a replication or 'shadow' GST on financial products. In his Budget speech he stated that:

> The State Government and the Premier have advocated to address the under taxation of the banking sector at the national COAG for many years ...
>
> Reports show that financial services are significantly undertaxed by more than $4 billion per annum because their GST treatment differs from other industries.[8]

It is certainly the case that the South Australian government has been advocating including the

5 Daniel Wild, Submission to the Inquiry into the Major Bank Levy Bill 2017 and the Treasury Laws Amendment (Major Bank Levy) Bill 2017, Institute of Public Affairs, 16 June 2017; Michael Potter, *The Major Bank Levy: We're all going to be hit*, Centre for Independent Studies, 19 June 2017

6 Commonwealth Bank, Submission to Treasury on Proposed Australian bank levy, 15 May 2017.

7 For a detail exploration of this history see Chris Berg, *Safety and Soundness: An economic history of prudential bank regulation in Australia, 1893-2008*, PhD thesis, RMIT University, 2016.

8 Tom Koutsantonis, Budget Speech 2017–18, 22 June 2017 http://servicesa.cdn.on.net/budget201718/pdfs/budget/2017-18_budget_speech.pdf

GST on the financial services. Through horizontal fiscal equalisation South Australia receives $1.42 for every $1 it sends to the Commonwealth in GST. It is unsurprising that the state would like a tax which it disproportionately benefits from to be raised. Financial services were explicitly excluded from the GST when the tax was introduced.

There are many reasons to be sceptical about putting GST on financial services. First, there are serious problems with valuing what the GST would be levied upon. For example, while a bank receives the difference between the interest on borrowings and loans, this is not a pure service fee. It also includes what could be described as input charges: risk compensation and payments of the time value of money. Unlike other firms in the economy, valuing financial transactions for the purposes of GST would require banks to disclose their margins on transactions.[9] Second, the GST is intended to be a tax on consumption. Most financial services do not represent consumption, they represent savings which are eventually used for downstream consumption. It is for these reasons that most GST systems internationally are not levied on financial services.

Even if a GST on financial services was desirable, the bank levy looks nothing like a GST on financial services. The appeal of a GST is that it is a tax on consumption, not savings, and has efficiency properties that are appealing. But the bank levy is not related in any way to consumption. The cost of ideal GST is born solely by the end consumers of a good or service. By contrast, the incidence of the bank levy is likely to complex and diffuse. Indeed, the Commonwealth and South Australian government have specifically argued that consumers will not be the ultimate payers of the levy.

Are Australian banks excessively profitable?

Treasurer Koutsantonis stated in his Budget speech that the banking sector is "very profitable and a Major Bank Levy is a fair and reasonable approach to ensuring the sector contributes its fair share".[10] In separate comments he has referred to the "super profits" of the banks.[11] But at the first instance, bank profitability is not something to be regretted. As the economist Ludwig von Mises wrote:

> There would not be any profits but for the eagerness of the public to acquire the merchandise offered for sale by the successful entrepreneur, but the same people who scramble for these articles vilify the businessman and call his profit ill-got.[12]

In this sense it is hard to understand what 'contributing its fair share' would constitute; the contribution of a bank is measured by how well it serves its customers and community, not how much of its profits are expropriated by the state.

Treasurer Koutsantonis has focused his claim that the $30 billion profit earned by the five biggest banks (as a group) represent "super profits". Of course profitability is only relevant insofar as it is related to size. In this context, it is true that Australian banks perform very well globally, with a return on equity of 14 per cent. Canadian banks, however, earn a higher a return on equity of

9 Kavita Benedict, "The Australian GST regime and financial services: How did we get here and where are we going?", *eJournal of Tax Research*, vol 9, no. 2, 2011, pp. 174-193; Kerrigan, Arthur, "The Elusiveness of Neutrality - Why Is It So Difficult To Apply VAT to Financial Services?", *International VAT Monitor*, March/April 2010.

10 Tom Koutsantonis, Budget Speech 2017–18, 22 June 2017 http://servicesa.cdn.on.net/budget201718/pdfs/budget/2017-18_budget_speech.pdf

11 Tom Koutsantonis, "Major Bank Levy to support thousands of small businesses", 27 June 2017 https://www.premier.sa.gov.au/index.php/tom-koutsantonis-news-releases/7677-major-bank-levy-to-support-thousands-of-small-businesses

12 Ludwig von Mises, *Planning for Freedom*, Libertarian Press, St Holland Illinois, 1974, p. 122.

14.6 per cent. Yet this is not necessarily a black mark against the banks. First, different industries in different countries are likely to significantly differ in profitability depending on where they are in the economic cycle and the prevailing micro and macroeconomic conditions of the jurisdiction.[13] Second, any measurement of profitability by return on equity will be upwardly biased by high levels of debt. Other measurements show Australian banks doing well but not excessively so in comparison to their international counterparts. Figure 7 shows the return on assets for Australian banks in comparison to the rest of the world.

Figure 7: Bank profitability: net income as a percentage of total assets

Country (number of major banks)	2012-14 (Average)	2015	2016
Japan (5)	0.61	0.60	0.52
United States (10)	1.12	1.40	1.36
France (4)	0.25	0.42	0.42
Germany (4)	0.12	-0.12	0.03
Italy (4)	-0.46	0.29	0.67
Spain (6)	0.06	0.57	0.53
Australia (4)	**1.24**	**1.25**	**1.17**
Canada (6)	1.05	0.97	0.97
Sweden (4)	0.73	0.80	0.78
Switzerland (3)	0.23	0.17	0.11
United Kingdom (6)	0.26	0.27	0.22
Brazil (3)	1.57	0.67	1.99
China (4)	1.65	1.50	1.34
India (2)	1.67	1.57	0.56
Korea (5)	0.62	0.60	0.63
Russia (3)	1.79	0.63	1.86

Source: Bank of International Settlements, Annual Report 2016-17, 25 June 2017, p. 80.

The Reserve Bank of Australia has repeatedly explained the causes of Australia's relatively profitable banking sector since the Global Financial Crisis. For the RBA, Australia's banking reflects a healthy banking sector and supports prudential management. In 2008 the Deputy Governor Ric Battellino told a House of Representatives Standing Committee that

> When we look at bank profitability, we find that Australian banks are around the top of the international range. On the surface, this could indicate a lesser degree of competition than elsewhere. But when we look a bit deeper it seems that an important reason for the high profitability of Australian banks is their unusually low bad debt experience. Over the past decade or so, bad debts of Australian banks have been about half the long run average, and also around half the experience of overseas banks. This has been the result of the very strong domestic economy. It is also worth noting that other Australian industries have been very profitable over this period. If we adjust for the unusually low bad debts of recent years, the profitability of Australian banks falls back to around the middle of the international range.[14]

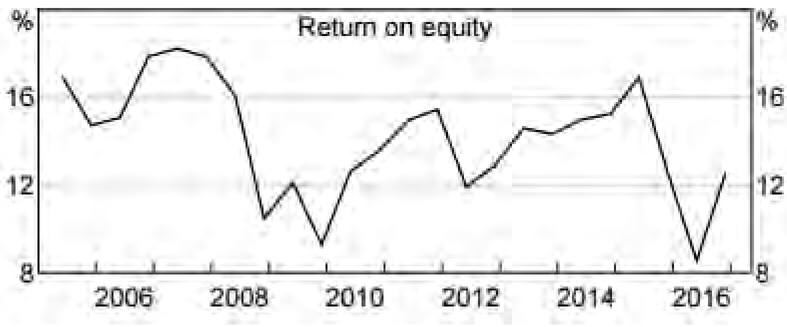
The RBA's *Financial Stability Review* has repeatedly discussed the significance of high profitability. For the RBA, profitability and resilience are closely related. The April 2017 *Review* emphasised

13 Sinclair Davidson, Submission to the Senate inquiry into Competition within the Australian Banking Sector, Institute of Public Affairs, 2011

14 Commonwealth Parliamentary Debates, House of Representatives Standing Committee on Economics, Reference: Competition in the banking and non-banking sectors, 14 August 2008, ECO 2-3

that while bank profits are significant, Australian banks are not *increasingly* profitable. As Figure 7 shows, the return on equity for (all) banks is in fact currently below the historical average of 15 per cent.

Figure 8: Bank return on equity



Source: Reserve Bank of Australia, Financial Stability Review, April 2017, p. 40

It is noteworthy in Figure 7 that the rates of return on equity in 2016-17 are now closer to where they were during the Global Financial Crisis, reflecting both the slowdown in growth and the banks' relative success in that period.

The RBA's September 2014 *Review* contained a discussion about the significance of the banks internationally high profitability. The RBA noted that the profitability of the major banks "appears to partly reflect operational efficiencies". It continued:

> Over recent years, the Australian major banks' returns on equity have been well above those recorded by large banks in many other advanced economy banking systems ... This partly reflects the relatively stronger asset performance of the Australian major banks. Another factor is their lower cost-to-income ratios than large banks in Europe and the United States, with the disparity having increased since the onset of the financial crisis ... The reduction in the major banks' aggregate cost-to-income ratio has been an offset to the decline in their net interest margin over the past couple of decades.[15]

Finally, even if it was demonstrated that the banks were earning excess profits (or even super profits) however defined, it is unclear what the taxation significance of this would be. In the wake of the debate about the mining tax, some commentators have proposed a bank 'super profits' tax. The South Australian government is obviously using this language deliberately. We were highly critical of the mining tax at its introduction.[16] Nonetheless, the mining tax at least sought to reduce its economic burden on the Australian economy and had a rationale (if not a particularly compelling one) in the fact that the state governments own the rights to mineral resources. The bank levy lacks even these questionable justifications.

Other jurisdictions have done it

The South Australian budget papers list 12 other jurisdictions around the world that have introduced "bank levies" since 2009: Austria, Belgium, France, Germany, Hungary, Iceland, Netherlands, Poland, Portugal, Slovakia, Sweden and the United Kingdom. Unfortunately for the South Australian government, this list goes to demonstrate how little policy justification there is for

15 Reserve Bank of Australia, Financial Stability Review, September 2014, p. 25.

16 Sinclair Davidson, "The fatally flawed Resource Super Profit Tax", *Tax Policy Journal*, vol. 6: p. 21 – 2; Sinclair Davidson, "Rudd's other great big new tax", The Drum, 30 April 2010; Sinclair Davidson, "Mining tax risks spooking investors", The Drum, 6 May 2010; Sinclair Davidson, "Resource tax blundering has the government digging itself into a deeper hole", The Age, 8 July 2010; Chris Berg, "Big Business In Full Flight Is The Clarion Cry Of Democracy", *The Age*, 1 May 2011

the levy. As Judith Sloan wrote in the Australian:

> the list only contains national governments, not sub-governments such as state or provincial governments. And most of these countries have done so with a specific purpose in mind: to claw back the monies that were handed over to bail out their banks during the global financial crisis. There is no such rationale for South Australia, or indeed for Australia.[17]

Unlike South Australia, these national governments have responsibilities for the regulation of their banking sector, and consequently are responsible for considering the effect of levies on that sector's stability. It is no surprise that (with one exception) all of these levies were introduced between 2009 and 2012 and as Sloan writes, deeply related to those countries' Global Financial Crisis experience.

The single exception in this list is Poland, which introduced a 0.44 per cent levy on bank and insurance assets in 2016. However the structure of the Polish banking sector is significant different to Australia, and the bank levy has a significantly different purpose. Poland's banking sector is mostly foreign owned and comes in the context of a foreign bank push by the conservative Polish government. The government is pursuing the renationalisation of the foreign banking sector.[18] The list of national foreign jurisdictions that have introduced bank levies provides no useful guide for South Australian policy.

17 Judith Sloan, "SA's bank levy even dumber than Morrison's", *The Australian*, 4 July 2017

18 Marcin Goclowski, "'Re-Polonisation' puts banks under government scrutiny", *Reuters*, 26 September 2016

The bank levy represents a rollback of the GST compact

The South Australian bank levy represents the state's abandonment of the GST agreement that required South Australia to remove a number of state taxes on banking and financial services. Treasurer Koutsantonis admitted as much in his budget speech, stating that "States previously applied taxes to banks and the financial sector, yet gave those revenue streams up as part of the introduction of the GST".[19]

The GST was introduced to provide the states with a more efficient, nationally harmonised, and more administratively simple revenue stream than the sales taxes, duties and stamp duties that were levied by both state and Commonwealth governments prior to its introduction. Two of the key taxes were the financial institutions duty (FID) and the bank accounts deposits (BAD) tax. The FID was levied on the value of financial institution receipts (and liabilities of short term money market dealers) at a rate of 0.00065 per cent in South Australia. The BAD tax, also known as the Debits tax, was levied on the basis of account debits on a progressive scale.[20]

A commitment to repealing the FID and BAD tax was part of the Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations, which was agreed to by South Australian Premier John Olsen on 25 June 1999. That agreement stated the FID would be removed in all states and territories by 1 July 2001 and the BAD tax would be removed by 1 July 2005. Furthermore, each state and territory "will not reintroduce them or *similar* taxes in the future" [emphasis added].[21] South Australia proceeded with their removal in 2001 and 2005 respectively.

The reasons for removing the FID and BAD tax were uncontroversial. These taxes were highly inefficient, regressive, and distorted economic activity. The Howard government's *Tax Reform: not a new tax, a new tax system* paper outlined their consequences:

> The taxes on bank transactions unfairly burden the less affluent in our community. For example, those undertaking smaller transactions often pay relatively more tax than those who make large transactions because debits tax rates are specified as fixed dollar amounts per transaction. Further, large firms minimise their FID liability by bundling their transactions to take advantage of the cap on the maximum amount of FID payable per transaction. Individual consumers therefore bear a disproportionate tax burden ... Some consumers and business can also avoid FID by conducting their financial transactions in areas that do not impose a FID.[22]

The South Australian government likewise recognised the harmful nature of the FID and BAD tax:

> Aside from wholesale sales tax, many of the more inefficient and inequitable taxes levied on Australia are those imposed by the States. These include financial institutions duty, debits tax and various stamp duties.[23]

19 Tom Koutsantonis, Budget Speech 2017–18, 22 June 2017 http://servicesa.cdn.on.net/budget201718/pdfs/budget/2017-18_budget_speech.pdf

20 For an explanation about how these taxes worked, see David Kehl, "Bank Account Transaction Taxes: 'FID' and 'BAD'", Australian Parliamentary Library Research Note, 18 September 2001.

21 Revised Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations, June 1999 http://www.austlii.edu.au/au/legis/vic/consol_act/ntrpa2000552/sch1.html

22 Treasury, *Tax Reform: not a new tax, a new tax system paper*, Commonwealth of Australia, p. 74

23 Cited in Treasury, *Tax Reform: not a new tax, a new tax system paper*, Commonwealth of Australia, p. 76

The South Australian bank levy is not a levy on transactions and will consequently have different economic effects for analytical purposes, for the purposes of the GST agreement it is clear that the bank levy is substantially similar to the FID and BAD tax. This places the GST compact at risk. At the very minimum it demands interrogation by the Council of Australian Governments.

The bank levy harms banking stability

Any tax creates an incentive to move economic activity into activities that are not liable to the tax. This incentive effect is explicitly used in sin taxes to dissuade certain activity. Introducing a tax on certain bank liabilities and not others creates an incentive for banks to rely more heavily on some liabilities more than others. It is here that there are many serious problems with the bank levy.

The business of banking trades on risk and banking is therefore an inherently 'risky' industry. The Australian government regulates the banking sector to ensure that banks hold enough capital and liquidity to prevent bank runs and collapses. Under the Basel Accords, Australian banks are required to hold both 'Tier 1' and 'Tier 2' capital to promote resilience and stability. Capital is available to absorb losses in the event of a bank crisis. Tier 1 is the highest quality capital, which can be dipped into to avoid bankruptcy. Tier 2 capital is of lesser quality – or less available – and is typically only available during a bankruptcy to make depositors whole.

The Australian Prudential Regulatory Authority has informed the Commonwealth government that it does not believe the levy will have a "material impact on the resilience of the banking system".[24] The Commonwealth Treasurer told the parliament that the Commonwealth levy "will work in tandem with APRA reforms".[25] Nevertheless the Commonwealth (and subsequently South Australian) levy is applied to Tier 2 capital instruments, creating an incentive to reduce capital holdings in that form.

The Commonwealth Bank has argued that the inclusion of Tier 2 capital and total loss absorbing capacity securities in the levy "creates a disincentive for the banks to hold more than the minimum amount of capital to absorb losses and protect the Australian banking system from bank failures".[26] The ANZ has cautioned that Commonwealth levy could have unintended consequences for banking stability, and called for an investigation into its effects:

> To address the risk that the additive impacts of the levy and prudential changes unintentionally affect credit availability in the economy, bank soundness or financial stability, we would emphasise the importance of assessing bank regulation and the levy cognisant of the impact and operation of the other ...
>
> While we respect the conclusion of APRA that the levy does not harm its prudential policy objectives, there is interest in the cumulative impact of recent and proposed capital requirement increases, including TLAC, and the levy.[27]

The National Australia Bank has outlined similar concerns about the Commonwealth levy's effect on prudential controls:

> The inclusion of funding for high quality liquid assets and double counting of internal intercompany balances (essentially securities such as residential mortgage-backed securities which support liquidity and funding) in the calculation of the levy payment creates a systemwide disincentive to further improve liquidity buffers. This runs contrary to a recent APRA letter to ADIs encouraging the further build-up of liquidity buffers.
>
> In addition, covered bonds, which are also impacted by the double count of inter-company balances,

24 Clancy Yeates and Patrick Hatch, "APRA says bank levy won't have 'material' impact on stability" *Sydney Morning Herald*, 30 May 2017.

25 Commonwealth Parliamentary Debates, House of Representatives, 30 May 2017, p. 5556.

26 Commonwealth Bank, Submission to Treasury on Proposed Australian bank levy, 15 May 2017.

27 ANZ, Submission to Senate Economics Legislation Committee on Major Bank Levy Bill 2017, 15 June 2017

> support the banks in raising stable and diverse funding, especially in times of market stress. This is critical for the system given Australia's high reliance on wholesale funding.[28]

Finally, the regulatory disconnect between South Australia and the Commonwealth banking regulatory system means that operating in South Australia will bring further risks in a downturn. A number of the targeted banks have recommended that the Commonwealth government suspend the bank levy in times of economic crisis in order to ensure the stability of the financial system. With taxation comes responsibility. If it proceeds with the levy, the South Australian government is going to have to reinvolve itself in supervising the financial sector; a task which after the State Bank of South Australia debacle it should be reluctant to assume.

28 National Australia Bank, Submission to Senate Economics Legislation Committee on Major Bank Levy Bill 2017, 15 June 2017

The bank levy will harm the South Australian economy, not support it

Treasurer Koutsantonis stated that the bank levy was intended to "help us meet the cost of our significant support for driving economic growth and creating more jobs".[29] The headline measure in the 2017-18 South Australian budget is a Future Jobs Fund, totalling $200 million over four years "to support the growth of industries that will create the jobs of the future following the closure [South Australia's] car industry". The Fund consists of a program of grants, low interest loans, subsidies to firms in the automotive supply chain, and marketing campaigns. It is targeted at five favoured industries: Shipbuilding and defence, Renewable energy and mining, Tourism, food and wine, Health and biomedical research, and Information technology and advanced manufacturing. It is notable that the financial sector does not appear on that list, despite its vital role in funding job creation.

The fallacy that governments can sustainably create jobs is a very old one. Governments can obviously create jobs but the question is whether they can do so sustainably. In his *Wealth of Nations*, Adam Smith distinguished between productive and unproductive labour. Productive labour adds to the wealth of a country and unproductive labour is consumed – and has to be financed off the back of productive labour. The bank levy makes it clear that the $200 million for the Future Jobs Fund is a direct transfer from one sector of the economy to other favoured sectors. The privileged recipients are likely to be more economically marginal than the productive sector from which the tax was raised.

There are already a number of signs that the bank levy is harming the South Australian economy. BankSA, now a division of Westpac and subject to the bank levy, has announced that it has put a plan to expand 150 jobs in South Australia on hold.[30] But of course banks do not simply create jobs in banking – they exist to move capital through an economy. More important than specific employment decisions they make is how the levy will affect funding and allocation decisions. Of some significance is the fact that BankSA is considering rising its variable mortgage rates in order to pass the cost of the bank levy on.[31] The bank levy could also harm the funding of the South Australian government. Major banks, including Commonwealth and the ANZ, have begun to offload state government bonds.[32]

29 Tom Koutsantonis, Budget Speech 2017–18, 22 June 2017 http://servicesa.cdn.on.net/budget201718/pdfs/budget/2017-18_budget_speech.pdf

30 BankSA expansion shelved in budget response, *SkyNews*, 24 June 2017.

31 Isabel Dayman, BankSA examines variable mortgage rate rises after South Australian bank levy announcement, *ABC News*, 26 June 2017.

32 James Eyers, Jonathan Shapiro, and James Frost, "ANZ offloads South Australian government bonds", *Australian Financial Review* 29 June 2017; Simon Evans and James Frost, "CBA follows ANZ in SA bond punishment", *Australian Financial Review*, 30 June 2017

The bank levy increases investment uncertainty in South Australia and across the country

The medium and long-term consequences of the South Australian bank levy are more significant than its immediate consequences. The bank levy increases significantly regime uncertainty in South Australia and to a lesser extent the wider Australian economy. Regime uncertainty refers to uncertainty about future regulatory or taxation changes that might affect firm or individual decisions to invest. For example, a state or country which rapidly changes its taxation and regulatory frameworks is seen as a more uncertain jurisdiction for investment than a state or country which has had long term stability.

The concept of 'regime uncertainty' was most prominently described by the historian Robert Higgs in his exploration of the slow return to prosperity after the Great Depression in the United States.[33] As he found, the Great Depression was extended by uncertainty about the security of the property rights of investors. The Roosevelt administration brought significant change to the regulatory and taxation framework under which firms had invested in the United States. Strong claims by members of the administration and by others in the public space that these were part of a larger institutional change to the United States' capitalist economic system made investors fearful for their investments and reluctant to expand. Only with the Truman administration did that uncertainty abate, and the subsequent boom underpinned the prosperity of the 1950s and 1960s. Regime uncertainty is now widely seen as a important explanatory factor for differences in economic development.[34] For example, in the wake of the Global Financial Crisis, the United States' Federal Open Market Committee noted that "widespread reports from business contacts that uncertainties about health-care, tax, and environmental policies were adding to businesses' reluctance to commit to higher capital spending".[35]

While the Commonwealth bank levy was ill-advised and is likely to have deleterious consequences, it is at least clearly within the Commonwealth's regulatory and constitutional purview to impose. The South Australian bank levy is clearly not. It lacks any form of rudimentary justification – apart from the claim of banking 'super profits' and that the Weatherill government would like the GST reformed – and the government seems uninterested in further elaborating its rationale. It violates South Australia's pre-existing commitments to not introduce anything similar to the FID and BAD tax. The South Australian government has done little to assure investors that the bank levy is anything but an opportunistic grab for money off the back of a Commonwealth policy initiative that it had no part in designing.

These factors make the South Australian bank levy a particularly concerning policy for regime uncertainty. As one of us wrote in the *The Advertiser*,

> Imagine being an international investor looking at Treasurer Tom Koutsantonis's Budget. You wouldn't be interested in his infrastructure spend and "future jobs fund".

33 Robert Higgs, "Regime Uncertainty: Why the Great Depression Lasted So Long and Why Prosperity Resumed after the War", *The Independent Review*, vol. 1, no. 4, Spring 1997.

34 See Scott R. Baker, Nicholas Bloom and Steven J. Davis, "Measuring Economic Policy Uncertainty", *The Quarterly Journal of Economics*, vol. 131, no. 4, pp. 1593-1636.

35 Minutes of the Federal Open Market Committee, December 15-16, 2009, https://www.federalreserve.gov/monetarypolicy/fomcminutes20091216.htm

> You'd immediately hone in on the fact that the South Australian government has doubled down on the Federal Coalition's bank levy by introducing its own state bank levy.
>
> And you'd immediately understand that this makes SA the riskiest state to invest in, in a country that is looking like an increasingly risky place to invest.[36]

The consequences of regime uncertainty go beyond the South Australian borders. The states' bank levy harms Australia's investment climate across the country. Further deepening the regime uncertainty consequences of the Commonwealth and South Australian bank levy is the fact that the West Australian government immediately expressed an interest in introducing its own levy. The WA Treasurer Ben Wyatt also said he assumed "that all state treasurers are looking at this now".[37] It is also important to note that the regime uncertainty engendered by the South Australian policy is unlikely to be limited to banking related policy. Political turmoil in Australia's energy markets – particularly in South Australia - and mining industry – particularly in the wake of the politics surrounding the Adani coal mine - mean that the investors looking at any industry in Australia might fear that industry would be the next target of opportunistic politics.

There are some signs that the South Australian bank levy has already made investment in Australia more uncertain. For example, one London-based fund manager said in response to the South Australian bank levy that "I have reduced my investment exposure further. Politicians are running riot and appear to have absolutely no concern about the damage being done to the country's reputation". The Commonwealth Bank CEO Ian Narev has described a perception of "significantly elevated levels of sovereign risk" in Australia following the announcement of both bank levies.[38]

In this context, if the parliament rejects the bank levy, it ought to immediately work to ensure investors that South Australia is not a risky place to invest in. This may necessitate some sort of formal rule preventing such imposts from being imposed by this or future governments.[39]

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36 Chris Berg, "State Government bank levy makes South Australia riskiest place for investment in Australia", *The Advertiser*, 3 July 2017

37 Phillip Coorey, "WA threatens to follow SA with bank tax", *Australian Financial Review*, 23 June 2017.

38 Simon Evans, James Eyers and John Kehoe, "Ian Narev warns sovereign risk soaring after 'unprincipled and reckless tax grab'", *Australian Financial Review*, 25 June 2017.

39 The notion of fiscal rules around taxation and spending is discussed in the Australian context in Mikayla Novak, *Next Generation State Budgets: Stronger Fiscal Rules for Better Budgetary Outcomes* and More Prosperous States, Institute of Public Affairs, April 2011; Robert Carling, *Fiscal Rules for Limited Government: Reforming Australia's Fiscal Responsibility Legislation*, Centre for Independent Studies, July 2009; Stephen Kirchner, *Strengthening Australia's Fiscal Institutions*, Centre for Independent Studies, December 2013.

Conclusion

When asked why he robbed banks, the bank robber Willie Sutton reputedly answered "That's where the money is".[40] As Charles W. Calomiris and Stephen Haber show in their 2014 book *Fragile by Design: The Political Origins of Banking Crises and Scarce Credit*, historically governments have taxed, regulated and controlled the banking sector in order to deliver funds and power to politically-favoured groups.[41] Calomiris and Haber argue that it is this deeply embedded relationship between banks and governments that in large part causes instability in the financial sector. The South Australian government fits this pattern exactly.

Rather than working to improve the investment and economic climate in the state, The South Australian government has exploited the opportunity of a Commonwealth bank levy to impose an arbitrary and highly political tax on a key sector in order to transfer wealth to politically-favoured sectors like renewable energy and defence. While this might temporarily satisfy a political demand for redistribution, the consequences of the South Australian bank levy are likely to be severe, both for South Australia and Australia as a whole.

40 Garson O'Toole, "I Rob Banks Because That's Where the Money Is" Quote Investigator, 10 February 2013 http://quoteinvestigator.com/2013/02/10/where-money-is/

41 Charles W. Calomiris and Stephen Haber, *Fragile by Design: The Political Origins of Banking Crises and Scarce Credit*, Princeton, 2014.

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