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HOUSEHOLDS WILL BEAR BANKS' BURDEN

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The Treasurer has neglected the basic laws of economics

Since Treasurer Morrison announced the bank levy last Tuesday night, wildly different claims have been made about who will actually bear the cost. However, the evidence is clear: as basic economics and common sense would suggest, the cost will be shared between banks and their customers, but customers (particularly households) will bear the biggest burden.

Both proponents and opponents of the levy have made claims that just aren't true. Proponents should acknowledge that bank customers will bear some of the cost, while opponents should acknowledge that they won't bear all of it.

The 0.06 per cent levy is on our big four banks and Macquarie Group's relatively high-risk liabilities. For example, it applies to funds raised in the wholesale market, but not to customer deposits under $250,000.

In defending the levy, Morrison has displayed great naivety about how markets work. For example, he said the levy was "not on mortgage holders, so if banks tell you they're changing their pricing because of this on your mortgage … they're not telling you the truth". He's correct that the levy is imposed on bank liabilities, not on bank assets like mortgages. However, as first-year economics students learn, the incidence of a levy — who really bears the cost — can be very different. That depends on the price-sensitivity of customers' demands for bank products.

As intermediaries, banks raise funds and use them to supply lending products to customers. As the levy increases the cost of banks' key input (funds), it raises the cost of supplying those products. When supply costs rise, the proportion of the additional costs passed on to price depends on customers' demand price-sensitivities. Only in the extreme and unrealistic case that all customers' demands are infinitely sensitive to price would Morrison's wish that the banks pass on none of the cost come true.

The evidence clearly shows Morrison is dreaming.

Eleven European Union member countries introduced levies on bank liabilities after the global financial crisis. Multiple studies have analysed the effects of these levies and produced remarkably consistent results.

The evidence shows that a considerable proportion of levy costs were passed through to borrowers, as banks supplied fewer loans and raised lending interest rates. This is the standard response of firms when marginal costs rise: quantities supplied fall, prices rise. Lending interest rates rose by at least 0.15 per cent. One study found that the volume of mortgage lending fell by 3 per cent.

On the other hand, depositors gained. As deposits were largely exempt from the levy, banks sought more deposits. Levies caused EU deposit rates to rise by about 0.15 per cent.

However, households experienced bigger lending rate increases and smaller deposit rate increases than business customers did as competition for, and demand price-sensitivities of, business customers were higher.

In any case, depositors' gains were small compared to borrowers' losses. Net interest margins rose by about 0.05 per cent. Borrowers bore the majority of the cost, bank shareholders bore a minority.

Interest rates may well rise by more on loans and by less on deposits, in Australia. Morrison's 0.06 per cent levy is higher than in most EU countries. In Germany (where the highest marginal levy rate was 0.06 per cent), lending rates rose by at least 0.33 per cent. Furthermore, the banking sector is more concentrated in Australia than in EU countries. It would be great if our banking sector wasn't so concentrated, but we're stuck with it because previous governments were too soft on bank mergers. More concentration means less competition and hence lower the demand price-sensitivities for individual banks' products. One study found that lending rates rose by more in more concentrated markets and that at a concentration level equivalent to Australia's, lending rates would rise by up to 0.7 per cent. Nevertheless, Australian borrowers won't bear all of the cost. The post-Budget hit to banks' share prices is clear evidence of that.

Morrison argued that as the levy only applies to five banks, customers should "shop around" if those banks raise their lending rates. But this won't stop the rises. Even with more competition and greater ability to shop around in the EU, lending rates still rose. In addition, the EU levies even caused lenders that were exempt from levies to raise their lending interest rates (although by less than the big banks subject to the levies), because they lessened competitive pressures from the big banks.

Morrison also said that the ACCC will "keep a close eye" on the banks' pricing. However, while the ACCC will conduct an inquiry into mortgage pricing, it won't report for a year. In the meantime, the ACCC's monitoring-only role won't stop rate rises.

The prime rationale for EU bank levies was to give large banks (which might be "too big to fail") incentives to reduce risk and hence avoid future taxpayer-funded bailouts. It's a "good" tax. That's why I support a bank levy.

Nevertheless, the EU experience demonstrates other ways (apart from pricing) in which banks can minimise the impact of levies. A recent study found that levies did reduce the overall riskiness of bank capital, as banks switched funding from taxed liabilities towards equity-financing and deposits. However, lower capital risk raised banks' appetite for riskier assets. About half the reduction in liabilities risk was offset by higher asset risk. Banks shifted risk from one side of the balance sheet to the other, although overall risk still went down.

Rather than risk reduction, Morrison's prime rationale for his levy is "budget repair". We should indeed be doing much more on the budget repair front. However, the EU evidence raises questions about whether Morrison is over-estimating levy revenues and whether the levy might rise in future.

Levies have raised much less-than-expected in the EU, partly because banks cut loan volumes (hence funding requirements) and switched funding from taxed liabilities to equity and deposits. When the UK Chancellor introduced a levy in January 2011, he said it would raise £2.5 billion a year ($4.4bn). As revenues fell well short, the levy rate was raised a number of times. By April 2015, the rate had tripled.

The bank levy is a "good" tax and a strong case can be made for it, even though bank customers will bear much of the cost. However, by neglecting the basic laws of economics, Morrison has presented a flawed defence of the levy and damaged his own credibility.Paul Kerin is Adjunct Professor, School of Economics, University of Adelaide.

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