Inflation and the excessive taxation of savings Bill Hearn B.Sc, Ph.D.

I wish to consider the effect of inflation regarding "Enhancing the taxation of savings …. Terms of reference 3.3". I propose that the inflation component of interest-income be exempt from taxes and means tests. The commonsense reason is that the inflation component of interest-income from savings is not real-income. Such tax relief on interest-income will encourage individuals and businesses to be self-sufficient by saving for a rainy day (or for a drought) rather than beating inflation by spending and borrowing now. It should also assist local banks to build up larger stable saving deposits thus making Australia less dependent on expensive and volatile foreign credit, which should also assist borrowers. Savings will tend to be longer term, which ought to enhance the stability and trustworthiness of Australian banks.

There is another way of viewing this matter. It is axiomatic that every government should relentlessly protect the reputation of their money to encourage trade which increases their country's wealth and tax base and improves the wellbeing and loyalty of their citizens. They have done this in past millennia by zealously ensuring that gold and silver coins met a standard of purity, weight, and authenticity. For example Sir Isaac Newton directed the Royal Mint for about thirty years with the utmost extent of his intellect, position and the law, including the vigorous prosecution of wrongdoers which lead to executions in some cases (http://en.wikipedia.org/wiki/Isaac_Newton).

Since World War 2 governments have tolerated a little inflation, perhaps because it is preferable to deflation. But, this modern form of currency-debasement can be as destructive as in Newton's days. For instance, in Australia inflation during the past 40 years has increased by 10 times. Nevertheless, savers can be justly treated if their interest-income is sufficiently high to both compensate for inflation and allow for a rent for the present use of the money. However, this is negated by the present practice of governments taxing and means testing interest–income as if it was all real. For example, presently the inflation rate is 4.5% and the official interest rate is 6.0%. For a tax rate of 41.5% (including the Medicare levy) the net interest rate after inflation is negative, i.e. $[(1.06-0.06x0.415)/1.045] - 1 = - 0.95\%$. It is worse for higher rates of tax, means test and inflation. For a lower inflation rate of 3.0 % the return after inflation is positive, but still only a meager +0.50%. No wonder Australians tend to borrow rather than save.

For large amounts, interest-rate details should be provided in tax returns to allow estimation of the proposed tax relief. However, for administrative efficiency with moderate amounts, the fraction of tax exempt interest-income could be set annually. For example, presently it might be set at 60% for interest-income less than $5,000. In this scheme savers (particularly retirees) would feel secure when inflation and interest rates are increasing because the tax exempt fraction would also increase. As with superannuation, a fixed 15% tax on interest-income might be an option, but its disadvantage is that it does not track inflation and interest rates as they vary.

With this scheme I have not addressed the implications for means tests, which are quite complex. However, some forms of government assistance may even be unnecessary if everyone has an incentive to save. For example, tax exempt drought bonds, which are far too bureaucratic and restrictive anyway.

To be consistent, the inflation component of interest on business expenses could be excluded as a tax deduction. Certainly, claiming deductions on both interest costs and interest earned should be disallowed, i.e. no double dipping. However, I do not wish to investigate inflation accounting here, as I believe it is secondary to enhancing the reputation of the Australian dollar and giving savers a fair go.