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Banks want you to pay less tax on interest, but why?

Abstract

Australia's big banks want the government to give their customers tax breaks on interest income, having told the Financial Systems Inquiry it would encourage more savings. In turn, the banks will have access to greater deposits to lend as the economy recovers.

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Banks want you to pay less tax on interest, but why?

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Banks are asking former CBA chief David Murray, now heading the Financial Systems Inquiry, to consider tax breaks on interest income. AAP/Dean Lewins

Australia's big banks want the government to give their customers tax breaks on interest income, having told the Financial Systems Inquiry it would encourage more savings. In turn, the banks will have access to greater deposits to lend as the economy recovers.

But this isn't selfless concern for their customers. Deposits from savings are by far the cheapest source of lending capital for banks. The winners will be taxpayers who have money to place in a bank deposit, and the banks themselves.

The loser is the government, especially at a time when it would appear to need every tax dollar it can obtain.

A long time coming

The 2010 Henry Tax Review recommended that income tax treatment of household savings could be improved by applying a 40% discount to most interest income.

The review identified the fact inflation erodes the real return on interest paid to deposit holders, and that income tax would further reduce the real return, would be a disincentive for savings.

For instance, if \$10,000 is placed in a term deposit with a bank and the interest rate paid on the deposit is 4%, then the return is \$400 per year. With inflation at 2% and income tax at 20%, the real return is 80% of \$200, \$160 or a 1.6% return. This isn't a great incentive for

taxpayers to deposit money with banks.

A 40% discount on tax payable on interest would place the taxpayer in a position where the return on their investment would be adjusted for the effects of inflation.

But if the Australian Bankers' Association had its way, the interest would be tax free and investors would have an incentive to deposit money with the banks. The government could also adopt the Henry Tax Review's less generous recommendation, which would also provide taxpayers with an incentive.

Short lived tax savings measures for bank deposits were introduced by the Howard government, but at present, the only tax benefit for saving is with first home buyers saving deposits with banks where the government co-contributes up to a certain level.

These earlier attempts to attract savings failed because of a combination of restrictions on the amount deposited and competition from shares and property as an investment option.

A question of capital

Australian banks are finding themselves borrowing from overseas to have sufficient capital to lend. They pay interest on those funds at the LIBOR rate plus a margin depending on their credit rating, which by world standards is very high. The current borrowing rate for one year is approximately 2.7%. This money is then lent to domestic customers at various interest rates which reflect the risk associated with the customer and the project to be undertaken.

And the process is expensive, far more so than simply lending capital raised through bank deposits made by Australians, where the rate is approximately 2.6%. So if the Australian Bankers' Association's proposal is taken on board by the government, banks could save a great deal of money.

Still, there are a number of issues to be considered. First, the amount of revenue collected by the government in the form of income tax will be reduced and this could be substantial if many people deposited money with banks and no tax was paid on the interest.

Reserve Bank figures show Australian households have around \$700 billion in directly held interest-bearing deposits. This would make yearly interest around \$17.5 billion (at a rate of 2.5%). A very rough calculation shows that if the assumed tax rate was 30%, then the revenue loss would be around \$5 billion a year. This may be a hard sell when the budget is in deficit.

Second, non-taxpayers such as self-funded retirees and those investors earning less than \$18,200 will obtain no direct advantage from the tax free interest.

And third, would the banks be prepared to compensate the government for the loss of revenue by paying a super profits tax on the economic rent gained from this extra money that has been deposited into their bank accounts? Probably not.

All of the recommendations made by the Henry Tax Review deserve to be considered by all governments in Australia. A tax incentive to save money is a very worthwhile objective. Giving Australian banks access to the best form of capital available to them, namely bank deposits, is again a worthwhile objective.

But why not require the banks to give something back to the community and the investors by imposing a rent tax on their super profits along the lines of a resource rent tax, another worthwhile recommendation by the Henry Tax Review.

Could it be that big Australian banks are just blatant rent seekers and this is another method by which they can extract even more "super profits"?