The Impact of the FairTax on Interest Rates

Interest income, like all other income, will not be taxed under the FairTax Bill. Furthermore, there will no longer be any need to track interest paid on loans for the purpose of mitigating income tax liability. Under our current income tax system a deduction, when applicable, allows taxpayers to make interest payments from pre-tax dollars *to the extent* of their marginal tax rate. Under a sales tax, people will make all interest payments from 100% pre-tax dollars.

Interest rates will fall 25-35 percent under a consumption tax like the FairTax.[1] Rates will drop immediately and quickly toward the current tax-exempt rate. Investors will no longer need to receive a tax premium to achieve a particular after-tax rate of return. The impact of eliminating this "tax wedge" or tax premium on interest can be seen every day in the *Wall Street Journal*. Tax-exempt municipal bonds tend to yield about 30 percent less than taxable corporate bonds of similar term and risk.

As shown in Figure 1, the demand for loans at any given interest rate will decrease. This effect would be brought about by the increase in cost due to the elimination of interest deductibility. In other words, for any particular interest rate, fewer loans will be demanded since the cost of paying a particular interest rate will have risen. Conversely, since interest is no longer taxable, the availability, or supply of loans will increase. Market equilibrium will be achieved at a lower interest rate (i_1) and, in the short run, the same amount of capital will be supplied.[2] **A borrower will not be able to deduct interest but will pay a much lower interest rate. A lender will receive a lower interest rate but will not pay taxes on his interest income.**

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1 For a more detailed discussion of the impact a national sales tax would have on interest rates, see John E. Gobb, *Economic Review*, Federal Reserve Bank of Kansas City, "How Would Tax Reform Affect Financial Markets?", Fourth Quarter, 1995. He estimates a 25-35 percent drop in the tax rate (p. 27). See also, Martin Feldstein, "Effect of a Consumption Tax on the Rate of Interest," National Bureau of Economic Research, Working Paper No. 5397 (December, 1995).

2 The actual amount of loans may vary somewhat if today borrowers and lenders have different income tax rates.

Short-Run Impact of the FairTax on Interest Rates

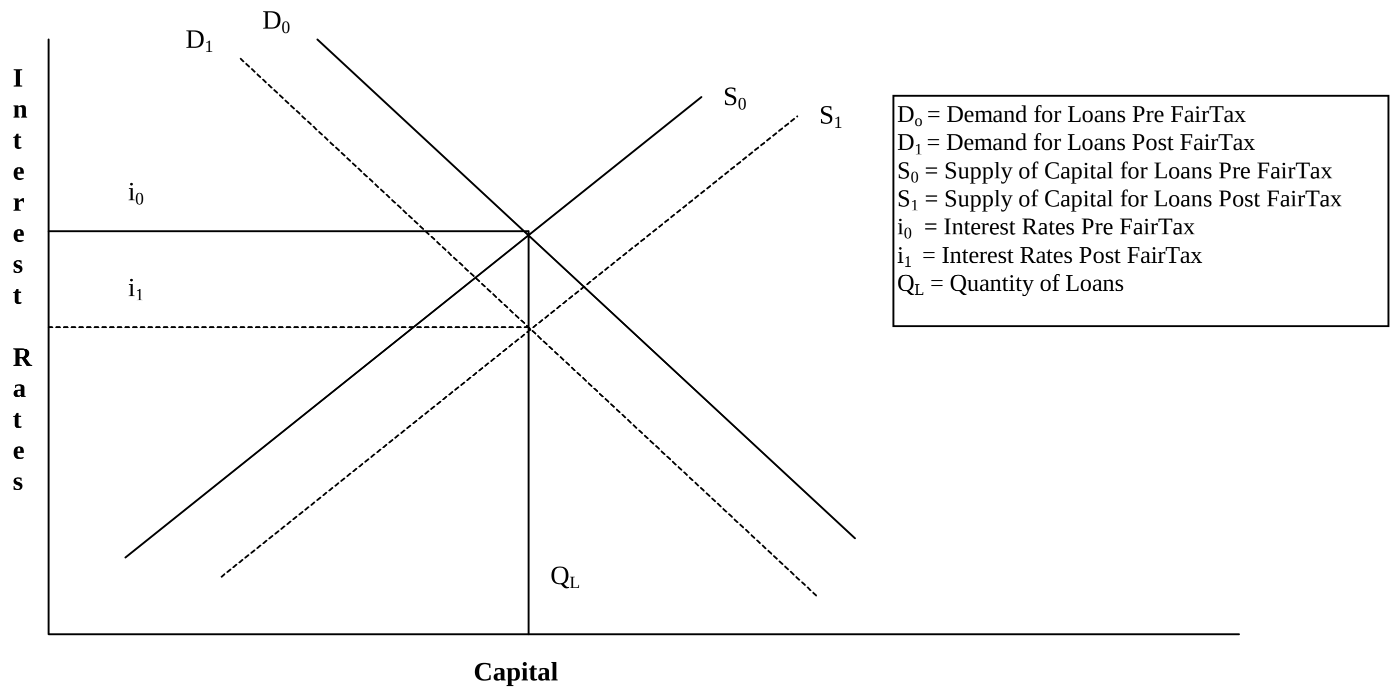

Figure 1: This figure illustrates the downward shift of interest rates after passage of the FairTax Bill. Higher cost of loans due to the lack of interest rate deductibility will drive the demand for loans down, and the supply of loanable capital will increase.

Because the sales tax is neutral toward savings and an income tax is not, the attractiveness of savings relative to consumption will increase. The income taxes savings two, three and often four times, whereas the FairTax will tax savings only once. Economic studies show that savings are responsive to changes in tax treatment and that savings rates are closely correlated to the return on savings.[3] The chart found in Figure 2 illustrates the close connection between savings rates and the return to savings. After having fallen steadily for almost two decades U.S. savings rates – the U.S. supply of capital – will improve under the FairTax because the return to savings will increase.

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3 See Gary Robbins and Aldona Robbins, "Eating Out Our Substance: How Taxation Affects Savings," Institute for Policy Innovation, Policy Report No. 131, September, 1995. Mr. Robbins is the former Chief of the Applied Econometrics Staff at the U.S. Treasury Department. This paper updates the work of Stanford University economist and former Council of Economic Advisors Chairman Michael J. Boskin, "Taxation, Saving and the Rate of Interest," *Journal of Political Economy*, Vol. 86, No. 2, Part 2, April 1978, pp. S3-S28.

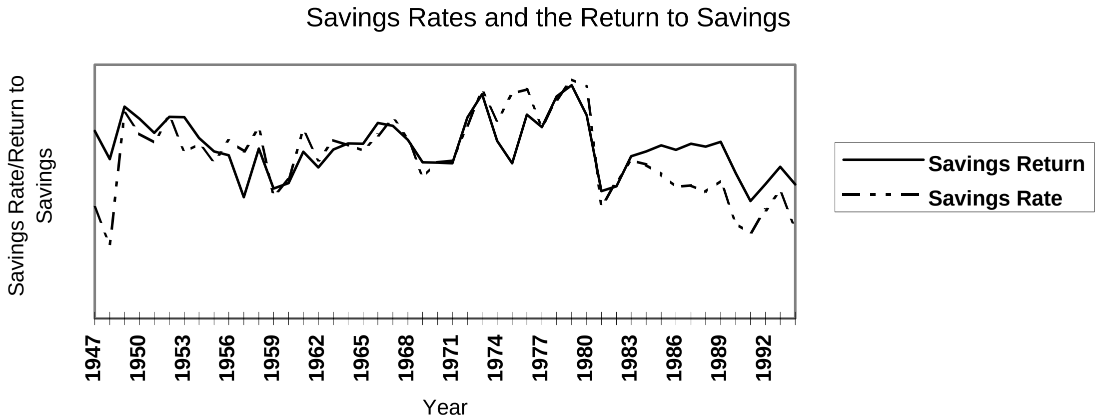

Figure 2: This figure illustrates the high level of correlation between U.S. savings rates and the savings rate of return to savings between the years of 1947 and 1991.

As the supply of capital increases over time, the return to savings will decline. The new, larger capital stock will make the U.S. economy more productive, more competitive in international markets, and will increase real wages.

The attractiveness of investment and the demand for capital will improve as well. After repeal of the income tax, the U.S. will be perhaps the most attractive place to invest on earth. The combination of a highly attractive tax system, stable political and legal institutions, a relatively well-educated workforce, relatively good infrastructure and a large domestic market will make American-based operations highly attractive. Foreign firms can be expected to build manufacturing plants here. The U.S. demand for capital may well increase more than the U.S. supply (savings).

In the absence of international capital, an excess of demand for capital (investment) over the supply of capital (savings) can be expected to place upward pressure on interest rates. In modern capital markets, however, interest rates are set internationally. Foreign investors will provide some of the capital needed to fund the investment here. This impact of international capital markets on the U.S. economy is one of the major reasons why the U.S. government's budget deficit has had a relatively small impact on U.S. interest rates.[4]

The capital flowing into the U.S. as a result of the FairTax will be used to build productive plants and equipment here, as well as to fund job creation. The impact on interest rates due to both new demand for investment and increases in savings supply will be greatly dampened by the flow of international capital into the U.S. (apart from the large effect due to elimination of the tax wedge on interest).

4 See, e.g., "Government Deficit Spending and Its Effects on the Prices of Financial Assets," May 1983, Department of the Treasury, Office of the Secretary, Office of the Assistant Secretary for Economic Policy. This is not a surprising result because changes in the U.S. budget deficit are small when compared to the worldwide capital stock.

International capital flows have one other important implication. The FairTax will dramatically reduce the tax bias against work and, therefore, people will work more. Thus, the economy and individual incomes will be larger and there will be more resources available for both consumption and savings. In a closed economic analysis, domestic investment must come from domestic savings, and savings must come from reduced consumption. Consumption and savings can both increase if people choose to work and produce more, thereby creating more personal income. Under the FairTax, people will choose to work more because the marginal tax rate on labor will be much lower. Under this type of analysis, the increased amount of work effort people would choose to undertake may or may not result in consumption increases as great as the consumption deferred by higher savings and investment. In the real world, however, our economy is not closed. Foreign capital can meet some of the demand for investment capital. Higher investment does not need to come at the expense of domestic U.S. consumption. The investment will create jobs, enhance productivity and increase real wages. This improved standard of living will be reflected in higher consumption levels.