A FairTax[SM] White Paper

The impact of the FairTax on interest rates

Interest income, like all other income, is not taxed under the FairTax plan. Furthermore, there is no longer 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 the FairTax, people make all interest payments from 100 percent pre-tax dollars.

Interest rates will fall 25 to 35 percent under a consumption tax like the FairTax.[1] Rates drop immediately and quickly toward the current tax-exempt rate. Investors 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 decreases. This effect is 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 increases. Market equilibrium is achieved at a lower interest rate (i_1) and, in the short run, the same amount of capital is supplied. *A borrower is not able to deduct interest but pays a much lower interest rate. A lender receives a lower interest rate but does not pay taxes on his interest income.*

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

Short-run impact of the FairTax on interest rates

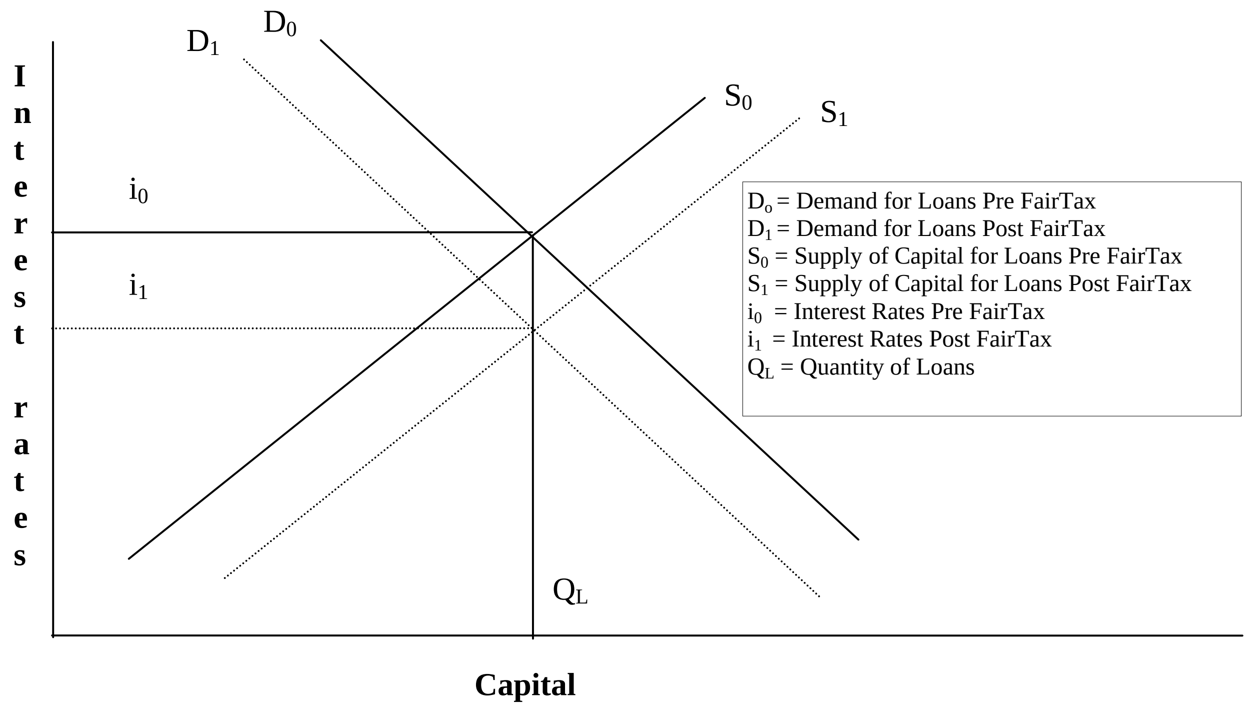

Figure 1: This figure illustrates the downward shift of interest rates after passage of the FairTax. The higher cost of loans due to the lack of interest rate deductibility drives the demand for loans down, and the supply of loanable capital increases.

Because the FairTax is neutral toward savings and an income tax is not, the attractiveness of savings relative to consumption increases. The income tax taxes savings two, three, and often four times, whereas the FairTax taxes 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.[2] 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 – improves under the FairTax because the return to savings increases.

[2] See Robbins, Gary and Aldona, "Eating Out Our Substance: How Taxation Affects Saving," Institute for Policy Innovation, Policy Report No. 131, September 12, 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.

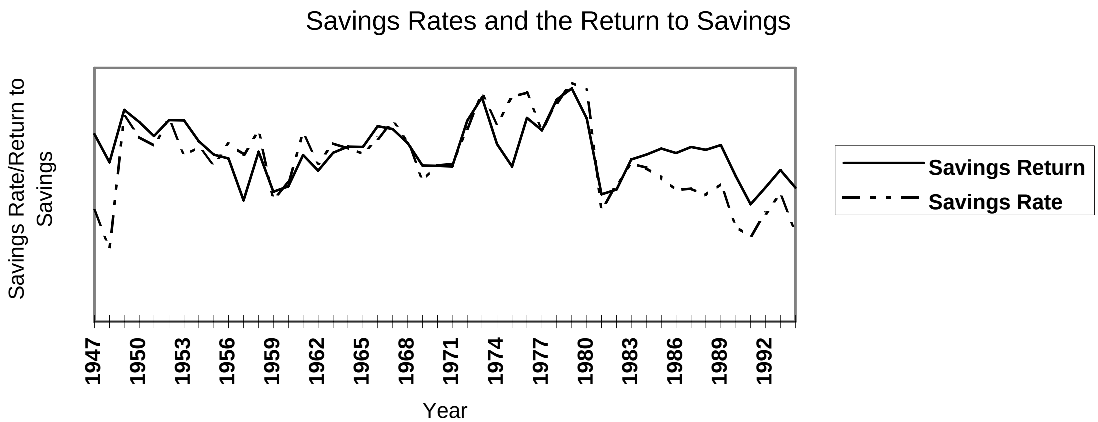

Figure 2: This figure illustrates the high level of correlation between U.S. savings rates and the rate of return to savings between the years of 1947 to 1991.

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

The attractiveness of investment and the demand for capital improves 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 makes 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.[3]

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).

[3] See, e.g., "Government Deficit Spending and Its Effects on the Prices of Financial Assets," Department of the Treasury, Office of the Secretary, Office of the Assistant Secretary for Economic Policy, May, 1983. 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 dramatically reduces the tax bias against work and, therefore, people will work more. Thus, the economy and individual incomes are larger and there are 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.

What is the FairTax Plan?
The FairTax Plan is a comprehensive proposal that replaces all federal income and payroll based taxes with an integrated approach including a progressive national retail sales tax, a prebate to ensure no American pays federal taxes on spending up to the poverty level, dollar-for-dollar federal revenue replacement, and, through companion legislation, the repeal of the 16th Amendment. This nonpartisan legislation (HR 25/S 1025) abolishes all federal personal and corporate income taxes, gift, estate, capital gains, alternative minimum, Social Security, Medicare, and self-employment taxes and replaces them with one simple, visible, federal retail sales tax – administered primarily by existing state sales tax authorities. The IRS is disbanded and defunded. The FairTax taxes us only on what we choose to spend on new goods or services, not on what we earn. The FairTax is a fair, efficient, transparent, and intelligent solution to the frustration and inequity of our current tax system.

What is Americans For Fair Taxation (FairTax.org)?
FairTax.org is a nonprofit, nonpartisan, grassroots organization solely dedicated to replacing the current tax system. The organization has hundreds of thousands of members and volunteers nationwide. Its plan supports sound economic research, education of citizens and community leaders, and grassroots mobilization efforts. For more information visit the Web page: www.FairTax.org or call 1-800-FAIRTAX.

(H:\FILES\AFFT Documents\Papers on a specific subject\The impact of the FairTax on interest rates)