The Heritage Foundation

ISSUE BRIEF

No. 4465 | SEPTEMBER 30, 2015

# An Alternative Way to Treat Interest Properly in Tax Reform

*Curtis S. Dubay*

Achieving the proper tax treatment of interest is critical to any effort in reforming the tax code. Specifically, it is important to keep tax policy regarding interest—and all tax policy—neutral. Neutrality holds that tax policy should not influence the economic decisions of individuals or businesses in either a positive or negative way.

Neutrality is the guiding principle of tax reform because, if a tax system is not neutral, it will influence economic decisions and therefore cause families and businesses to allocate resources inefficiently. That results in less economic growth and fewer jobs and lower wages than would have occurred had taxes not interrupted the free market and those resources went to their most productive uses.

The federal tax code currently taxes most forms of interest income and provides a deduction to borrowers. When interest income is taxable, this maintains neutrality.[1]

Alternatively, the tax reform can achieve neutrality by exempting the interest income of lenders and not allowing borrowers to deduct their interest cost. This is an equally acceptable method for arriving at the neutral tax treatment of interest.

This paper, in its entirety, can be found at
**http://report.heritage.org/ib4465**

**The Heritage Foundation**
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

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## Neutral Treatment of Interest Is Vital for Maximizing Growth

It is vital that the tax code treat financial flows, such as interest, properly because there are significant negative ramifications if it does not. If the code treats them wrongly it will artificially raise the cost of borrowing, which will reduce investment (law of supply and demand). Less investment lowers economic growth and suppresses wages and job creation over time because less investment reduces productivity.

It works like this: If interest income of lenders is taxed, they raise the interest rates they charge borrowers. This is done because those lenders are seeking a certain *after-tax* return when deciding whether it is worth the risk to make a loan.[2]

There is also real-world evidence that lenders change the interest rates they demand from borrowers when the interest they earn is taxed. For example, lenders demand lower rates for tax-exempt municipal bonds than for similarly risk-rated taxable corporate bonds.[3]

All else being equal, because taxes cause lenders to raise the interest rates they charge, borrowers would take fewer loans on the margin. Interest rates are the price people and businesses pay for borrowing money. Like anything else, when the price of borrowing rises, customers tend to borrow less, all things equal. Left unaddressed, such a policy would negatively influence the amount of borrowing in the economy and thus violate the principle of tax neutrality. That violation would cause harmful economic effects.[4]

## Exempting Interest Is Neutral

The deleterious effects of reducing investment can be avoided, and tax neutrality maintained, by

not taxing lenders on the interest income they earn from making loans. In that case, lenders would not raise the rates they charge borrowers because of tax interference. Therefore, taxes would not alter the lending-borrowing decision and the level of investment in the economy would be unchanged by taxes.

Since borrowing costs would not increase, there would be no need to provide an interest deduction for borrowers' interest expenses.

Although likely to be seen as an alternative treatment of interest compared to the current system of taxing most lenders and allowing a deduction for most borrowers, not taxing lenders on their interest income is a feature of existing tax-reform plans such as the traditional flat tax,[5] a national-retail-sales tax, and a business-transfer tax.

The New Flat Tax[6] taxes interest income of lenders and makes interest deductible for borrowers. But in the case of mortgages, it gives homebuyers the option of retaining their deduction, or not claiming it and paying a lower interest rate from their lender, which would not be taxed on its interest income. Either treatment is neutral.

## Tax Base Key to Tax Reform

As the push for tax reform continues, it is important that Congress remember that establishing the proper tax base is as important for instituting pro-growth tax reform as is lower rates.

The proper tax treatment of interest is an integral part of the tax base, and Congress can achieve it by exempting all interest income from tax and denying a deduction to all borrowers.

*—**Curtis S. Dubay** is Research Fellow in Tax and Economic Policy in the Thomas A. Roe Institute for Economic Policy Studies, of the Institute for Economic Freedom and Opportunity, at The Heritage Foundation.*

1. Curtis S. Dubay, "Taxation of Debt and Equity: Setting the Record Straight," Heritage Foundation *Issue Brief* No. 4463, September 30, 2015, http://report.heritage.org/ib4463.
2. The after-tax interest rate that lenders charge equals their pre-tax required rate of return divided by one minus the tax rate.
3. For instance, the spread, or tax wedge, of interest rates between similarly rated non-taxed municipal bonds and taxable corporate bonds of equal maturity is roughly equal to their differing tax treatment: "Composite Bond Rates," http://finance.yahoo.com/bonds/composite_bond_rates (accessed September 23, 2015).
4. For instance, businesses would forego certain investment opportunities because the cost of making them would no longer allow them to meet the return they require for making the investment. Families would buy fewer homes, cars, invest less in education, and buy fewer things for which they typically borrow to pay. Entrepreneurs would launch fewer new enterprises. The combined result of each of these actions would reduce the size of the economy.
5. Robert Hall and Alvin Rabushka, *The Flat Tax*, 2nd ed. (Stanford, CA: Hoover Institution Press, 1995).
6. J. D. Foster, "The New Flat Tax: Easy as One, Two, Three," Heritage Foundation *Backgrounder* No. 2631, December 13, 2011, http://www.heritage.org/research/reports/2011/12/the-new-flat-tax-easy-as-one-two-three.