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You lend $100,000 at 9% Nominal interest in 2020 to be repaid in 2021

The borrower pays back = 100,000(1.09)=109,000

CPI = 210

2020

CPI = ?

2021

You want to earn a 4% Real interest rate

Interest Income = 100,000 x 0.09 = $9,000

If the tax on interest income is 25%

$9,000 x 0.25 = 2,250

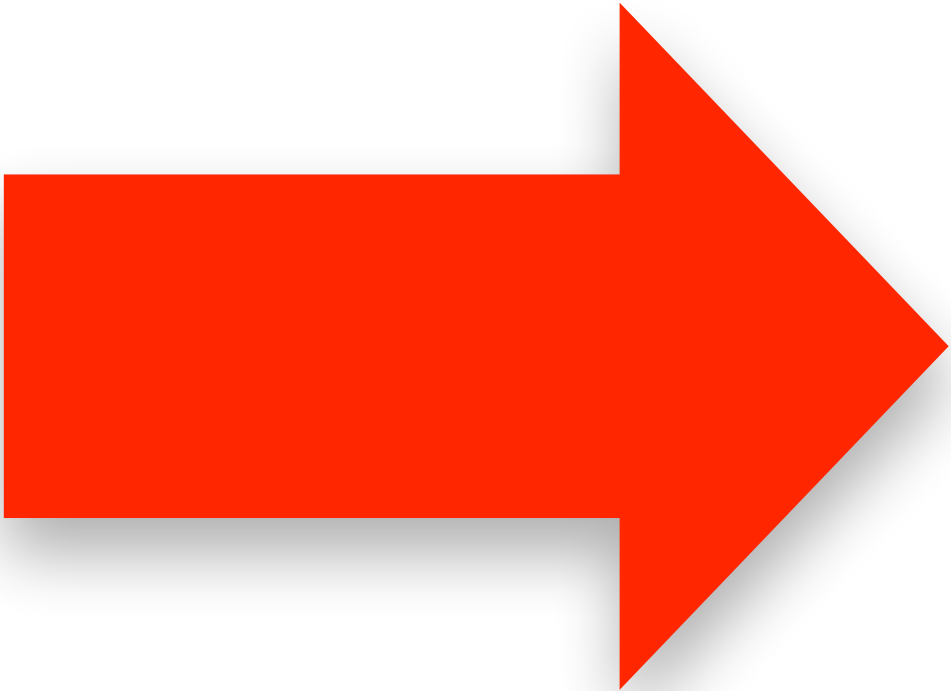
If the tax on interest income was charged on the Real interest

Tax you really owe $4,000 x 0.25 = 1,000

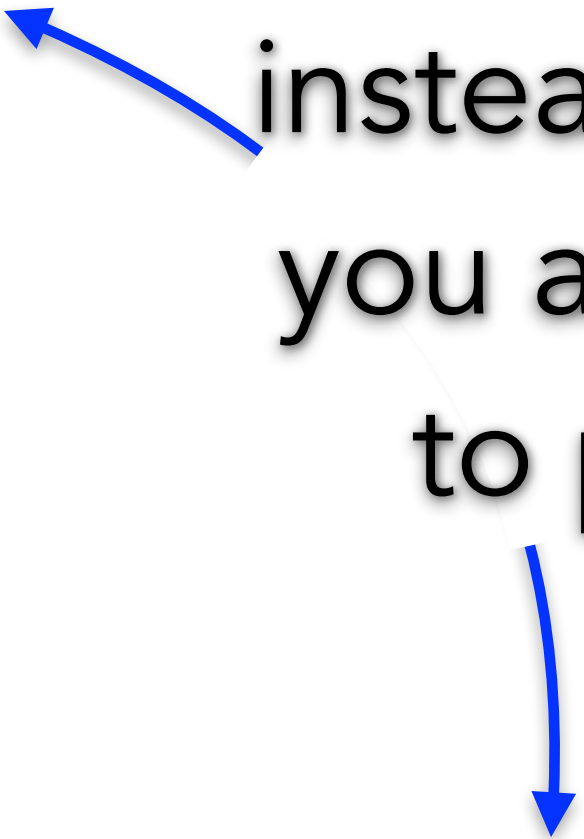
Real Interest Income = 100,000 x 0.04 = $4,000

Even though your Real Income was only $4,000

the government still makes you pay $2,250



You pay 56%
instead of the 25%
you are supposed
to pay by law



$$\frac{2{,}250}{4{,}000} \times 100 = 56\%$$ effective tax!


If you guessed right and inflation was 5%

CPI = 210

2020

CPI = ?

2021

If you guessed right and inflation was 5%

You want to earn a 4% Real interest rate

You lend $100,000 at 9% Nominal interest in 2020 to be repaid in 2021

The borrower pays back = 100,000(1.09)=109,000

You earn → Interest Income = 100,000 x 0.09 = $9,000

If the tax on interest income is 25%

Tax you owe → $9,000 x 0.25 = 2,250

You pay 56% instead of the 25% you are supposed to pay by law

You earn → Real Interest Income = 100,000 x 0.04 = $4,000

Even though your Real Income was only $4,000 the government still makes you pay $2,250

$$\frac{2{,}250}{4{,}000} \times 100 = 56\%$$ effective tax!