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

You earn Interest Income = $100,000 \times 0.09 = $9,000$

If the tax on interest income is 25%

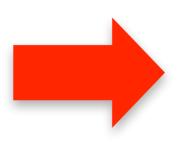
Tax you owe	$$9,000 \times 0.25 = 2,250$
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If the tax on interest income was charged on the Real interest

Tax you really owe $$4,000 \times 0.25 = 1,000$

You earn	Real Interest Income = $100,000 \times 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

2,250 ----x 100 = 56% effective tax! 4,000



