The Fiscal Theory of the Price Level When *Interest* Income is Taxed*

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**Abstract**

In this paper we analyze the consequences of taxing interest income from bond holdings for price stability in an endowment economy where the central bank follows a Taylor rule and the fiscal authority takes the level of debt into account when deciding the tax rate. In this environment the demand for government liabilities explicitly depends on fiscal policy so that the evolution of inflation rates and real bonds are not independent of each other. This new feature drastically changes the fiscal and monetary requirements for price stability. The steady state value of inflation and real bonds crucially affect the speed of convergence. Moreover, the parameter space consistent with locally determinate equilibria is much larger compared to that of Leeper (1991). In addition, we show that if the government taxes *interest* income and the fiscal authority sets taxes taking into account the level of debt, then the economy can exhibit multiple steady states. Thus, the traditional prescriptions for price stability given by the Fiscal Theory of the Price Level are not robust to taxing interest income from bond holdings. Thus ignoring this feature present in the U.S. tax code is not as innocuous as it may seem.

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