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The Proper Tax Treatment of Interest

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Abstract

There is frequent talk of Congress abolishing interest deductions like the mortgage interest deduction (MID) either as a way to pay for lower marginal tax rates in a tax reform package or through loophole closing to raise taxes so the government can spend more. The desire to abolish interest deductions is usually rooted in a widely held misbelief that they are subsidies for borrowing. In fact, they are not subsidies, but an integral part of a neutral tax system, meaning that they neither encourage nor discourage particular activities. Interest deductions maintain neutrality by establishing symmetry between lenders and borrowers. By abolishing them, Congress would create a disincentive to invest that would reduce job creation and wages. Congress should keep interest deductions including the MID.

Key Points

- Congress is under pressure to reform the broken tax system and raise taxes. Those who favor these approaches frequently target interest deductions like the mortgage interest deduction (MID) to help to achieve their aims.
- The desire to rid the tax code of interest deductions usually grows out of a mistaken belief that they are subsidies for borrowing.
- Properly understood, interest deductions like the MID are not subsidies, but an essential component of a neutral tax system.
- Interest deductibility establishes a symmetry between lenders and borrowers that prevents taxes from creating a disincentive to invest.
- The principles supporting the MID are the same as those underpinning the business interest deduction, which is supported by many who want to abolish the MID. This is inconsistent.
- Without interest deductions, investment would fall, and job creation and wage growth would suffer.

Treating interest properly in the tax code is essential to maintaining neutrality. Neutrality should be the guiding principle of tax reform. It holds that taxes should not influence—positively or negatively—the economic decisions of families, investors, entrepreneurs, or businesses. A neutral tax code is the most conducive to economic growth.

In debates about tax reform or closing loopholes, many argue that deductions for interest, like those for mortgage interest and business interest, should be curbed or eliminated altogether to raise more money for the government to spend. However, deductions for interest expense, whether for individuals or businesses, preserve neutrality because they establish symmetry between lenders and

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borrowers when tax is levied on the interest income of lenders. Eliminating those deductions would both violate neutrality by discouraging investment and inflict serious damage on the economy. Congress should maintain interest deductions as long as it taxes the interest income of lenders.

Maintain Neutrality by Establishing Symmetry

The mortgage interest deduction (MID) is the deduction that it is most commonly suggested Congress should eliminate or curtail. As such, it provides a useful and understandable example of how an interest deduction establishes symmetry and maintains neutrality in the lending/borrowing decision.

The MID is a deduction from taxable income for taxpayers that itemize deductions on their federal tax returns and pay interest on a mortgage. For instance, if a family paid their mortgage lender $100 in interest in a given year and itemized their deductions, they would subtract that $100 from their taxable income.[1] The deduction would reduce their tax bill by $100 multiplied by their marginal tax rate. Assuming they pay the 35 percent rate, the deduction lowers their taxes by $35.

The deduction has been in the tax code since the income tax began in 1913[2] because it is essential to maintain the neutrality of the tax code. In fact, the original tax code allowed a deduction for all personal interest expenses, not just mortgage interest. This is sound policy because all interest expenses should be deductible to borrowers if the interest income is taxable to the lenders.

Thus, properly understood, the MID is not a subsidy for taking a mortgage as some suggest, nor are other varieties of interest deductions as long as interest income is taxable to lenders. Interest deductions like the MID prevent taxes from raising the cost of borrowing and therefore altering the decision to take loans. Stopping a disincentive to invest is not the same as creating an incentive or providing a subsidy.

The MID and other similar interest deductions maintain neutrality by establishing symmetry between lenders and borrowers, thereby preventing taxes from creating a disincentive to take a mortgage. Sound policy should seek to maintain and expand that symmetry for all interest expenses.

Lenders pay tax on the interest earned from loaning money to borrowers. Today, lenders pay a 35 percent federal corporate tax rate on their interest earnings—the highest corporate tax rate in the world. The tax imposed on the lenders causes them to raise their interest rates higher than they would without the tax. Lenders set rates based on the *after-tax* rate of return they require, which is a function of their cost of capital, the risk involved in making a particular loan, the time value of money, and their tax rate, among other factors. Because lenders seek a certain after-tax return for taking the risk of making loans, they build the cost imposed on them by taxes directly into the interest rates that they charge.

The difference in interest rates between municipal bonds and corporate bonds with similar risk characteristics is proof that lenders raise the interest rate that they demand to reflect taxes. Lenders demand lower rates for tax-exempt municipal bonds than for taxable corporate bonds. That spread, sometimes called the tax wedge, is almost entirely the result of their different tax treatment.

Interest rates are the prices that lenders charge borrowers to borrow money. Like the price of any other good or service, when the price of an item rises, customers—in this case, borrowers—buy less of it. All else equal, because the taxes cause lenders to raise interest rates, borrowers take fewer mortgages. This would violate tax neutrality because taxes would negatively influence the amount of investment in housing. However, the higher interest rate does not deter borrowers from taking a mortgage, because the MID reduces borrowers' tax liabilities by the exact extra amount that their interest expense rises because of the tax on lenders.

For example, if a lender requires a pre-tax 5 percent return to lend a particular borrower $100 for

1. Taxpayers can itemize their deductions when their total deductions are greater than the standard deduction ($6,100 for single filers and $12,200 for married filers in 2013).
2. For the original 1040 form for federal income tax, see U.S. Internal Revenue, "Form 1040," 1913, esp. p. 3, http://taxfoundation.org/sites/taxfoundation.org/files/docs/86626fd2c93c905f88f2668d09b19b28.pdf (accessed November 26, 2013).

Flat Tax Is Neutral; Progressive Taxation Is Not

Taxpayers face higher tax rates as they earn more income under the tax code today. Those higher rates harm the economy because they impose a disincentive for families to work and save more. Progressive tax rates also make it harder to maintain neutrality when it comes to interest deductions.

In the foregoing example with the MID, the lender and the borrower are assumed to pay the same tax rate. However, under the current tax code, they could pay different rates. Lenders most likely would pay the top corporate tax rate of 35 percent, but individuals' rates would vary from a high of 39.6 percent to as low as 10 percent, although taxpayers paying the lowest rates are more likely to take the standard deduction than they are to itemize their deductions.

In cases in which the borrowing individual pays a higher rate than the lender, the MID reduces that individual's taxes slightly more than the extra interest expense due to taxes on lenders, creating a small incentive to take out a mortgage. In cases in which the borrower pays a lower rate than the lender, the deduction reduces taxes less than the extra interest expense, creating a small disincentive to taking a mortgage.

About 80 percent of mortgage interest deductions are claimed by taxpayers with tax rates below the corporate tax rate of 35 percent, so the vast majority of those claiming the deduction experience a disincentive.[4]

A proper income tax should have only one rate, so the deductibility of interest is perfectly consistent with the principles of an income tax. The disparities in the current system, which result from the progressive individual income tax, are an argument not for abolishing interest deductions, but for establishing a flat tax that applies only one rate to individuals and businesses.

one year, the 35 percent tax forces the lender to charge the borrower 7.7 percent to meet the original 5 percent return it requires.[3] The higher interest rate raises the interest cost to the borrower by $2.70 over what he would have paid in interest if the tax had not been levied on the lender. Assuming the borrower was willing only to pay up to 5 percent interest on the mortgage, he would not take the loan because he would not be willing to pay the extra amount, but because of the MID, the borrower is willing to pay the higher interest rate. The borrower's total interest expense is $7.70, which, once deducted from his taxable income and multiplied by his tax rate (also assumed to be 35 percent), reduces his tax liability by the same $2.70. The MID cancels out the higher interest cost.

This symmetry leaves the amount of investment in housing unaffected by tax, preserving neutrality. The lender is willing to make the loan because he receives the required after-tax return, and the borrower is willing to take the mortgage because, after accounting for the MID, he effectively pays the amount of interest he was originally willing to pay. Symmetry and neutrality are similarly established and preserved in all lending and borrowing scenarios as long as lenders are taxed on their interest income and borrowers receive a deduction for their interest expense.

Neutrality and symmetry could also be achieved for lending and borrowing decisions by not taxing the interest that lenders earn from making loans and denying borrowers a deduction for the interest they pay. In this case, taxes do not raise the interest rate the lender charges, so no deduction is necessary. Just as in the case in which lenders are taxed on their interest income and borrowers receive a deduction for their interest expense, taxes do not alter the borrowing decision.

3. The after-tax interest rate that lenders charge equals their pre-tax required rate of return divided by one minus the tax rate. In the example, 5 percent/(1 – 35 percent) = 7.7 percent.

4. See U.S. Internal Revenue Service, "Individual Complete Report (Publication 1304)," Table 2.1, http://www.irs.gov/file_source/pub/irs-soi/11in21id.xls (accessed November 15, 2013).

Investment Would Decline Without MID

Preserving neutrality is not simply a textbook exercise. Violating it causes real economic damage. Continuing with the example of the MID, if Congress abolished it and continued to tax lenders' interest income, for instance, it would destroy the symmetry that the MID creates. As a result, families would take fewer mortgages to buy houses because the price of mortgages would rise artificially because of a non-neutral tax code.

For families that pay cash for their houses, the lack of a MID would not affect their decision to invest in housing. Other families would still take a mortgage at the higher rate if there was no MID, although they would have less money to spend or invest elsewhere. Without the deduction, however, a segment of home buyers at the margin would no longer invest in housing because artificially high interest rates would price them out of the market.

Taxes matter at the margin. Creating a disincentive for some families to invest in housing by denying a MID would lower investment, which would decrease economic growth and opportunity for Americans at all income levels because less investment reduces job creation and suppresses wages. A similar process would occur in any sector where Congress decided to deny an interest deduction to borrowers and continued taxing the interest income of borrowers and would create similar deleterious economic impacts.

Same Principles Apply to Business Interest Deduction

Many also favor scrapping the deduction for businesses' interest expense, but it is based on the same principles of neutrality and symmetry as the MID and should similarly remain in a neutral tax code. The economy would suffer if Congress eliminated either deduction, because investment would fall.

In the case of the business interest deduction, businesses are the borrowers and families are the lenders. The tax code taxes the interest that families earn from making loans to businesses, and businesses deduct the interest that they pay to families.

Families require a higher rate to make loans to businesses when they pay tax on their interest income because, similar to mortgage lenders lending to families, they require a certain after-tax rate of return. However, businesses are willing to pay the elevated rate because the interest deduction reduces their tax bill by the same amount that the tax families pay on the interest they earn from lending to businesses raises businesses' interest expense. Neutrality is preserved because the tax falls out of the lending and borrowing decision the same as with the MID.

In contrast to those who want to abolish both the MID and the interest deduction for businesses, there are those who want to eliminate the MID but keep the interest deduction for businesses. This is an inconsistent position. A person who favors the businesses interest deduction should also favor the MID because they are predicated on identical principles.

Others see the deduction for business interest expense as a subsidy that favors debt financing over equity financing. This is also a mistake. The deduction is not a subsidy to take on debt.[5] Debt enjoys a tax advantage as compared to equity not because of the interest deduction, but because equity is double-taxed, first at the business level through the corporate income tax and then at the shareholder level through capital gains and dividends taxes.

The correct way to equalize the tax treatment of debt and equity is to eliminate the double taxation of equity, not to add another disincentive to investment by taking away the interest deduction for businesses. As the old adage says, two wrongs do not make a right.

Interest Deductions Not Tax Expenditures

Since the MID is often incorrectly called a subsidy, it is usually wrongly grouped with "tax expenditures," which are policies that deviate from a subjectively defined normal, or ordinary, income tax.[6] Often other interest deductions, such as the one for student loan interest, are referred to as subsidies too and therefore also wrongly included as tax expenditures.

5. J. D. Foster, "The Big Choice for Jobs and Growth: Lower Tax Rates Versus Expensing," Heritage Foundation *Backgrounder* No. 2810, June 19, 2013, http://www.heritage.org/research/reports/2013/06/the-big-choice-for-jobs-and-growth-lower-tax-rates-versus-expensing.
6. J. D. Foster, "Eliminating Tax Expenditures: Beware the Third Wave of Tax Hikes," Heritage Foundation *Backgrounder* No. 2480, October 21, 2010, http://www.heritage.org/research/reports/2010/10/eliminating-tax-expenditures-beware-the-third-wave-of-tax-hikes.

A normal income tax has a proper tax base, but there is not a universal standard for defining a proper base. Hence, a normal income tax is in the eye of the beholder. The MID is essential for neutrality regardless of how a normal income tax is defined, and like other similarly necessary policies, it should not be included in the poorly named tax expenditures list.[7]

Nevertheless, because of its frequent inclusion in the list, analysts also often look at the distribution of the MID—in other words, how much the families that take the deduction earn in income and pay in taxes. Regrettably, these data are often used to craft arguments in favor of repealing the MID that are based on class warfare. While distributional information is interesting because it shows who takes mortgages and itemizes deductions, the distribution of a deduction—MID and others—is irrelevant to its inclusion in the tax base if it is necessary to maintain neutrality.

Interest Expenses Should Be Deductible

Setting a neutral tax base is essential to pro-growth tax reform, and keeping the right deductions is just as important as lowering tax rates to reduce tax-imposed disincentives against productive activity. This basic fact is too often overlooked in the tax reform debate because of the strong desire to lower tax rates as much as possible. Of course lower rates are good, but they must be paired with a proper tax base to maximize their benefit. Similarly, those who are ravenous for more revenue to spend too often judge a loophole by how much revenue they could raise by eliminating it while failing to consider how eliminating it, in addition to the resultant tax hike, would damage the economy.

Congress should not fall prey to either mistake. Abolishing interest deductibility either to pay for lower tax rates or to raise revenue would make the tax code less neutral and lower investment. Less investment would reduce opportunity for families struggling in a sluggish economy.

Congress should never eliminate tax deductions simply to raise revenue. If it decides to reform the tax code, it should establish a neutral tax base. This means that as long as it taxes interest income to lenders, it should keep interest deductible to borrowers.

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7. There is tax preference for housing, but it is not the MID. The rental income that owners of houses could earn by renting their houses instead of living in them, known as imputed rent, is a form of income included in national income accounting. Theoretically, this income could be taxed, but for reasons of practicality, it is not.