

PRESIDENT'S MESSAGE

Scaling Back Debt Subsidies

As individuals, we love debt and we hate it. More precisely, we love what it enables us to do — use tomorrow's income to pay for something we want today — while we don't like the burdens it places on us, especially if we haven't managed it well or we've been financially unlucky.

Private debt has constructive uses, such as allowing households to pay for large purchases like housing or education over time and allowing owners of firms to borrow against future earnings to finance projects. Meanwhile, lenders enjoy a steady stream of interest payments, which is attractive to more risk-averse investors. But private debt can be very costly as well. As we saw during the financial crisis of 2007-2008, highly leveraged balance sheets made it very difficult for households and firms to adjust to the unexpected shock to the housing market. Many households were unable to keep up with their mortgage payments and were forced into foreclosure or bankruptcy. Financial firms that had taken on large amounts of short-term debt to finance long-term investments found themselves under significant stress when credit markets suddenly dried up.

Why did those households and firms become so highly leveraged in the first place? One contributing factor is that the United States — like many other countries — encourages the use of debt through its tax code. For example, households are able to deduct the interest payments on their home mortgages from their taxable incomes. While this policy has remained in place to encourage greater homeownership, it is likely not the most effective way of achieving that goal. It encourages households that do decide to purchase a home to take out larger mortgages than they otherwise would, leaving them more vulnerable to adverse movements in housing prices. Another criticism is that the tax break is regressive, since it mostly benefits more affluent households that can afford to buy homes in the first place.

Private firms also enjoy favorable tax treatment for debt. The interest they pay on debt is considered a deductible business expense — unlike dividends paid out on equity. Economic research suggests that firms do respond to this incentive. As their marginal tax rate increases, so does their ratio of debt to assets. And even though banks are subject to minimum capital requirements, research by economists at the International Monetary Fund suggests that they also increase their leverage as a result of this tax distortion. By encouraging financial and nonfinancial firms to take on greater leverage, these tax policies increase the risk of insolvency in the event of economic shocks, as we saw during the financial crisis. Moreover, banks made use of hybrid borrowing arrangements that qualified as capital for regulatory purposes but qualified as debt for tax purposes.

Of course, tax policy is not the only factor that encourages private-sector overindebtedness. Financial firms that

feel either implicitly or explicitly protected from losses by government guarantees have greater incentives to increase leverage and rely on risky funding. And prior to the housing market crash, government home mortgage guarantees contributed to lowered lending standards that helped fuel home mortgage borrowing. Additionally, some economists have argued that there are inherent characteristics of debt that encourage its overuse (see “The Public Perils of Private Debt,” p. 11), although I am a bit skeptical of these claims.

At a minimum, subsidizing debt through the tax code is likely to exacerbate these problems. In my view, we would be better off scaling back the tax preferences that favor the use of debt over equity. For housing, there are ways to encourage homeownership (assuming that is a goal policymakers want to pursue) without encouraging the buildup of private debt. Establishing tax-preferred savings vehicles that homebuyers can use as down payments would encourage them to build equity instead of debt, which would better insulate the economy from the negative effects of price changes in the housing market. The government already does this to some degree by allowing first-time homebuyers to withdraw some funds without penalty from their IRA to help make a down payment.

For firms, either eliminating or capping the corporate interest deduction would help to remove the artificial bias toward debt financing. Alternatively, the government could give equity financing equal treatment by providing an equivalent deduction for dividends. A recent study of six large countries in the European Union by economists at the European Commission's Joint Research Center suggests that fully eliminating the corporate debt bias could cut the financial losses associated with banking crises by as much as half. Moreover, reducing excessive household indebtedness would reduce the likelihood of costly and burdensome workouts when borrowers get in trouble. Regardless of the exact size of the effect, it seems clear that reducing the tax favoritism for debt would help reduce the negative effects of credit booms and busts.

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A handwritten signature in black ink, appearing to read "Jeff M Lacker". The signature is fluid and cursive.

JEFFREY M. LACKER
PRESIDENT
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