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Losing interest deduction on debt

This tax deduction loss effectively eliminated the consumer from competing with the government for credit dollars

OPINION

by Joseph J. Tallal, Jr.

Now that we are beginning life under the new tax law, touted as simpler and fairer, we may all begin to experience some disillusionment. We'll all learn, for example, that the only simplicity in the 2,000 pages of tax law is the reduction of tax brackets from 15 to three. What's more, we'll all find out that the new law is not necessarily fairer than its predecessors—especially when it comes to the elimination of the deduction for interest on consumer debt.

One prominent congressman gave us a clue on this: he stated that he didn't like the new law and it wasn't what he wanted; but he'd vote for it because it took away most of the tax deductions and shelters, and raising the rates later would be easy.

However, the loss of the interest deduction on consumer debt is not just another deduction that was cut. It was a move to eliminate competition for credit dollars.

One of the causes of inflation is an increase in the supply of money without a corresponding increase in goods and services on which to spend that money. In short, if the government simply turns on the printing presses and produces billions of new pieces of paper, without any expansion in the products or services for which we spend those dollars, the overall value of all dollars will be reduced to accommodate this new flood. As a dollar becomes worth less, it takes more of them to buy the same thing. This increase in cost is inflation.

Another cause of inflation is the overall rapid increase in the cost of any product that is irrevocably woven into the fabric of our economy. Such was the case with the rapid rise of oil prices in the early 1970s when supplies were inadequate to meet consumers' demands.

The old adage, 'don't borrow, pay cash' should enjoy an immediate comeback. As an increasing percentage of consumers are driven out of the credit marketplace the government will re-enter, borrowing to meet its deficits without creating the high interest rates it caused the last time it did so.

The federal government's budget will always affect inflation, but in a delayed manner. An example is the government budgeting and then spending $200 billion more than expected revenues. This can only be accomplished in one of two ways and both create inflation. First, as mentioned above, they can turn on the printing presses. This function is controlled by the Federal Reserve Board.

Sometimes, however, the Fed refuses to play ball. Congress overspends, but the Fed says, "No more dollar bills." This "tight money" policy leaves Congress no alternative but borrowing. We saw this scenario develop in the early 1980's when the federal government entered the credit market to borrow dollars and competed directly with businesses and individuals.

Unfortunately, the volume of money the government required quickly absorbed the supply of credit available and heated up the competition for the remaining money. Interest rates escalated rapidly during this time, and the government found itself in a Catch 22 situation. As the cost of interest on the national debt skyrocketed, the government's budget deficit increased, requiring it to borrow still more money. During this period, the prime interest rate rose to 22 percent. Interest, like oil, is woven into our overall economy and this 22 percent interest, with the high deficits and the maximum printing of new money, caused the highest inflation in this country's history. It is apparent that someone in Congress fully understands this problem and is attempting to eliminate duplication of this past mistake. Consequently, in the new tax law, deduction of interest for all consumer loans except for two homes is totally disallowed.

The general rule for the consumer during the last several decades has been, "Borrowing is justified as long as the annual cost of borrowing, less any tax savings, is less than the annual inflation rate." For example, let's assume an interest rate of 12 percent, inflation of 9 percent, and a 50 percent tax bracket. In this scenario, 12 percent less 6 percent tax savings equates to a true cost of 6 percent. If inflation reduced the value of the original dollar you borrowed at the beginning of that year by 9 percent, you pay your loan with a dollar discounted at 9 percent, thus making 9 percent at a cost of 6 percent leaves a net profit of 3 percent after expenses.

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Using this formula, we can confirm that it has been wise to borrow money for consumer purchases in almost every year for the last 25 years except the last two. In other words, the inflation rate has almost always paralleled the interest rate but usually runs about 10-30 percent lower.

Now, however, interest is no longer deductible and the tax rate has been reduced to 28 percent. Using the same illustration, let's look at the costs of borrowing. If interest is at 12 percent, but non-deductible, then the true cost of interest is 12 percent. With inflation at 9 percent, the net would be a loss of 3 percent. This is dramatic because the only way inflation can now pay the cost of borrowing is if it more than doubles the interest rate. This has been an extreme rarity in the last 25 years.

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Where is all this leading?

Through the new tax law change, Congress has just altered one of the most basic economic principles we have all learned to live by. Because the cost of consumer debt is no longer deductible, the incurrence of such is no longer economically profitable. Obviously, this doesn't mean that everyone will stop borrowing just because interest is no longer deductible. It is also obvious that the old depression philosophy "Don't borrow; always pay cash," which died in the late 1960s with the emergence of high inflation and high tax brackets, should enjoy an immediate comeback. In short, this provision will start consistently driving an increasing percentage of consumers out of the credit marketplace. The government will then be able to re-enter the market in their places, borrowing to meet its deficits without creating the high interest rates it caused the last time it did so.

In spite of this and other problems I am not alone in perceiving the new tax law is basically good. It relieves some of the frustration of the average taxpayer and greatly inhibits his ability to act out those frustrations by manipulating certain segments of the economy—after all, this was the effect of many of the now-disallowed tax shelters.

I believe a true "balance the budget" amendment to the Constitution is our best next step. With a reasonable tax system and a fiscally restrained Congress, the main economic decay that has occurred in our system over the last 25 years would come under control. ∎

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