

The great distortion

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Tax-free debt The great distortion

Subsidies that make borrowing irresistible need to be phased out



THE way that black holes bend light's path through space cannot be smoothed out by human ingenuity. By contrast, a vast distortion in the world economy is wholly man-made. It is the subsidy that governments give to debt. Half the rich world's governments allow their citizens to deduct the interest payments on mortgages from their taxable income; almost all countries allow firms to write off payments on their borrowing against taxable earnings. It sounds prosaic, but the cost—and the harm—is immense.

In 2007, before the financial crisis led to the slashing of interest rates, the annual value of the forgone tax revenues in Europe was around 3% of GDP—or \$510 billion—and in America almost 5% of GDP—or \$725 billion (see [Briefing](#)). That means governments on both sides of the Atlantic were spending more on cheapening the cost of debt than on defence. Even today, with interest rates close to zero, America's debt subsidies cost the federal government over 2% of GDP—as much as it spends on all its policies to help the poor.

This hardly begins to capture the full damage, which is aggravated by the behaviour the tax breaks encourage. People borrow more to buy property than they otherwise would, raising house prices and encouraging over-investment in real estate instead of in assets that create wealth. The tax benefits are largely reaped by the rich, worsening inequality. Corporate financial decisions are motivated by maximising the tax relief on debt instead of the needs of the underlying business.

Debt has many wonderful qualities—allowing firms to invest and individuals to benefit today from tomorrow’s income. But the tax subsidies have tilted the economy in a woeful direction. They have created a financial system that is prone to crises and biased against productive investment; they have reduced economic growth and worsened inequality. They are a man-made distortion and they need to be fixed.

Debt and taxes, life’s certainties

Start with the fragility. Economies biased towards debt are more prone to crises, because debt imposes a rigid obligation to repay on vulnerable borrowers, whereas equity is expressly designed to spread losses onto investors. Firms without significant equity buffers are more likely to go broke, banks more likely to topple (see [Free Exchange](#)). The dotcom crash in 2000-02 caused losses to shareholders worth \$4 trillion and a mild recession. Leveraged global banks notched up losses of \$2 trillion in 2007-10 and the world economy imploded. Financial regulators have already gone some way to redressing the balance from debt by forcing the banks to fund themselves with more equity. But the bias remains—in large part because of the subsidy for debt. Under a more neutral tax system, firms would sell more equity and carry less debt. Investors would have to get used to greater volatility; but as equity buffers got thicker, shareholders would be taking less risk.

A neutral tax system would also lead to more efficient choices by savers and lenders. Today 60% of bank lending in rich countries is for mortgages. Without a tax break, people would borrow less to buy houses and banks would lend less against property. Investment in new ideas and businesses that enhance productivity would become relatively more attractive, in turn boosting economic growth.

Removing the advantages that debt enjoys would also lead to a fairer system. Relief on mortgage payments is a subsidy that flows to people who need it least: studies show that the richest 20% of American households by income gain the most. Mortgages would become costlier. But new instruments would emerge to allow individuals to bridge the gap between current savings and future income that debt alone now closes—for example, shared-equity mortgages that divide the gains and losses from house-price movements between banks and homeowners.

Lenders and borrowers

If the arguments for getting rid of the debt distortion are overwhelming, the path to its elimination could hardly be more rocky. Politicians do not much like changes that will lower house prices. There is a big co-ordination problem: tax is a matter for national governments, and few countries will be prepared unilaterally to withdraw subsidies that might make them less appealing to footloose companies. In addition, vested interests will bleat loudly. Businesses that depend heavily on debt—banks, private-equity firms and the like—will be ready to spend some of the billions they gain from the tax subsidy on lobbying to defend it.

Up like a rocket

Change in national indebtedness* 2000-14



Sources: IMF; McKinsey

*Public and private †2000-13

†Purchasing-power parity

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This argues for a staged approach. The place to start is the subsidies on residential mortgages. Not only do these subsidies increase financial fragility, they fail to achieve their purported goal of promoting home-ownership. The shares of people owning their own homes in America and Switzerland, two countries with vast subsidies, are 65% and 44% respectively—no more than in other advanced economies like Britain and Canada that offer no tax break. The wisest step would be to phase out tax relief gradually, as Britain did in the 1990s.

Getting rid of the tax breaks for corporate debt will be harder. The few countries that have tried to level the playing field have done so by giving an equivalent handout to equity. Belgium and Italy, for instance, give dividend payments and profits flowing to equity holders some of the same perks enjoyed by interest payments. But such systems are fiddly and lower a country's tax base at a time when governments need money.

The best approach is gradually to phase out tax breaks for debt at the same time as lowering the corporate-tax rate. That would make the policy revenue-neutral, and would also defuse the risk to governments who want to push ahead but fear losing a war waged on tax competition.

Acting in concert or alone, countries should act soon. When interest rates are low, as now, the sweeteners for debt are smaller and thus easier to remove. When rates rise—as, inevitably, they will—the subsidy will become more valuable. This is the moment to tackle the great debt distortion. There may never be a better chance.

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