Bush's Tax Panel Has a Crazy Idea. Let's Go For It

Why This Reform Should Begin at Home

By David Brunori

Pity the poor McMansion owner. If the President's Advisory Panel on Federal Tax Reform gets its way, those folks with the three-car garages, grand entryways, mega-kitchens and spacious bedrooms will lose the tax break they get for any portion of their mortgage over $312,000. In a place like Potomac, where the median sales price for a house is more than twice that amount, that could tear a hole in some fancy pocketbooks, depending on how much their owners have borrowed for their dream houses.

Oh, and that little summer cottage at the beach in Rehoboth or the lakefront place at Deep Creek or Lake Anna? That might cost a bit extra too. The panel wants to eliminate the mortgage deduction for vacation homes.

Planning on a home equity loan to consolidate credit card debt or cover your kid's college tuition? Think it through again. The president's advisory panel is expected to propose taking away the federal tax deduction for payments on that loan, too.

These are still just proposals cooked up by a bipartisan panel, and who can count how many similar proposals have gone nowhere? But it is a panel established by President Bush and charged with making the tax code simpler, fairer and more conducive to economic growth. For it to even consider going after the home mortgage deduction is a gutsy move — even if the president recoils at the very idea.

The home mortgage interest deduction is known as the third rail of tax politics for good reason. It's loved by the people and criticized mostly by academics. It is credited with creating a nation of homeowners, spawning social stability and entire industries designed to cater to everything from financing to construction to furnishing knickknacks and beyond. Tens of millions of Americans have come to rely on the generous tax benefit — and with home prices soaring, they aren't all McMansion owners either. In the District last year, the average house cost $415,178, according to the city's figures.

The mortgage deduction has been part of the tax code ever since the income tax became permanent in 1913 and it survived the 1986 tax reform act that got rid of deductions for most other interest payments. No one has suggested limiting these much-beloved deductions for 20 years. Politicians have been too afraid. Some of the most powerful institutions in the country, gushing with expressions of genuine concern, will rush to the defense of homeowners and fight any proposal that reduces the tax benefits associated with buying real estate.

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In fact, there are many reasons why limiting the home mortgage deduction is a good thing. First and foremost: The federal government needs the money.

Next year, the home mortgage interest deduction will cost Uncle Sam $76 billion in tax revenues. Capping or limiting the deduction would raise billions of dollars, which could trim the massive federal budget deficit or help cover hefty commitments for Hurricane Katrina relief and the continuing war in Iraq.

On top of that, the administration, many members of Congress and millions of Americans would like to see something done about the "alternative minimum tax" (AMT), a minimum rate that is catching and effectively raising the rates of more and more middle-class taxpayers every year because it isn't indexed for inflation. Immediate repeal of the AMT, which was aimed originally at wealthy taxpayers, is impossible because it would cost an estimated $1.2 trillion over 10 years. Even incremental relief would cost billions. Some 20 million Americans are going to be subject to the alternative minimum tax next year.

Because of its lack of transparency, the AMT is a bad way to raise revenue. It is also politically very unpopular. The tax reform panel wants to see it repealed. Short of raising rates, which the president has vowed to oppose, there is no way to raise the money needed to reduce AMT burdens other than by trimming the mortgage deduction.

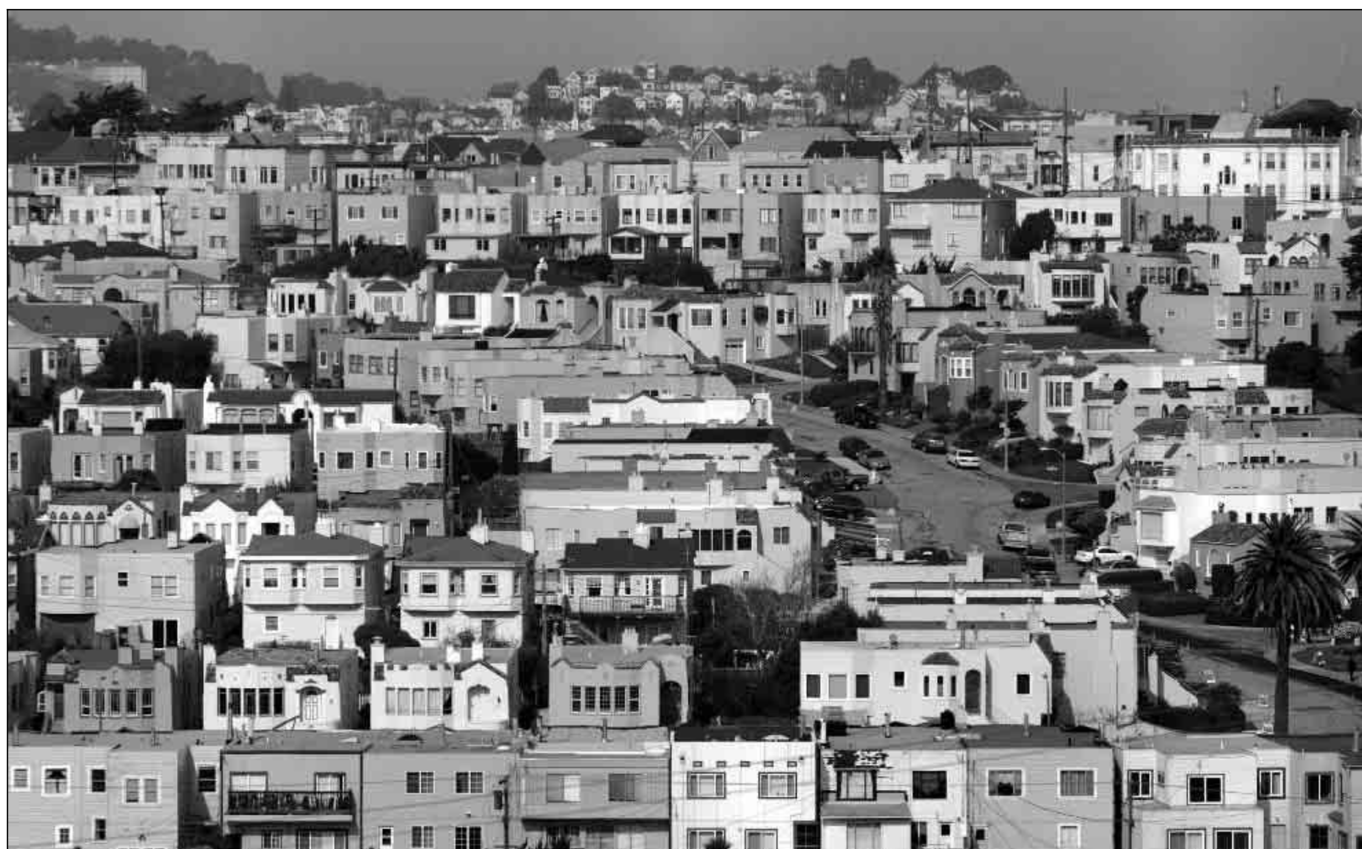
Second, reducing the home mortgage interest deduction would shift the burden of paying for our government needs to those best able to pay. Despite real estate inflation over the past several years, very few Americans carry $1 million worth of home loans. Carrying such debt remains the province of the well-to-do.

Don't feel too sorry for these wealthy fellow citizens trying to keep a stylish roof over their heads. The rich Americans lucky enough to make the payments on those big mortgages would make up for most of the loss of mortgage deductions by facing smaller AMT burdens. Besides, if history is a guide, when the deficit eventually falls, the wealthy would recoup their losses with additional tax cuts.

Just how would the President's Advisory Panel on Federal Tax Reform trim the mortgage deduction?

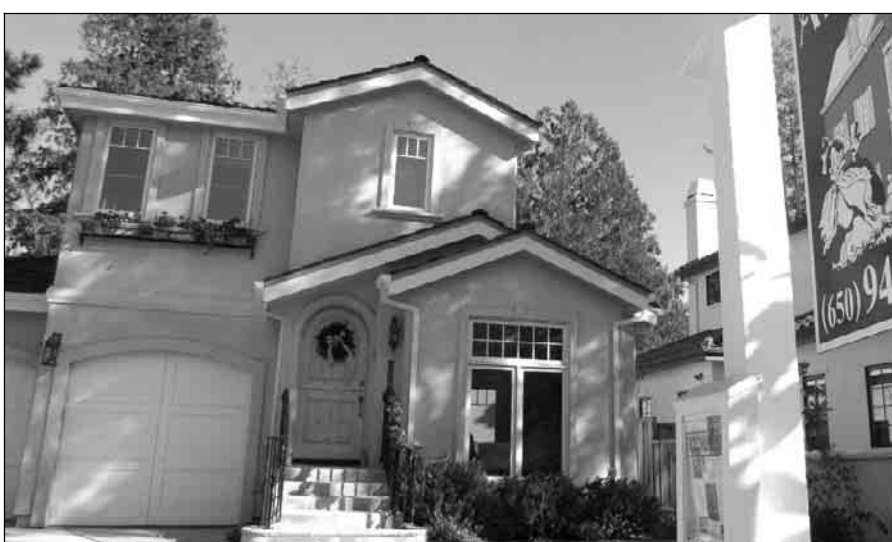
The panel is expected to suggest replacing the home mortgage interest deduction with a new "home credit" of up to 15 percent of mortgage interest paid. That is, 15 percent of all interest paid on your mortgage would be credited against your federal tax liability.

But the panel is expected to recommend that the credit be limited to mortgage indebtedness equal to the Federal Housing Administration's loan limits in the homeowner's area. The limits range from $172,000 to a maximum of $312,000. Oh, and you would not get any tax break for second home mortgages or for home equity loans.



By Marcio Jose Sanchez — Associated Press

A mountain-size break: The tax deduction for mortgage interest will cost the federal government $76 billion next year. If a presidential panel's proposal to cap the deduction is adopted, it will affect wealthier homeowners in expensive urban areas, such as San Francisco, above.



By Paul Sakuma — Associated Press

The house that Uncle Sam built? The presidential panel's recommendation to limit mortgage interest deductions might cool off the hot real estate market in California and elsewhere.

This should light up the switchboards on Capitol Hill. Right now, a couple can deduct from their income the interest paid on mortgages up to $1 million. Especially in the areas of the country with booming real estate markets like San Francisco, New York City, Boston and Washington, limiting that tax break would take political courage that is rarely seen in the tax policy world.

You would think from listening to the folks in the real estate, mortgage banking and home construction industries that the world will end if home mortgage interest deductions are reduced. There's no question that it would be essentially a tax hike for some Americans who got used to having their homes subsidized by other taxpayers. So, yes, the hyper-percolating real estate market might cool somewhat. That might be a good thing, anyway.

But in any case, the roof will not fall in if the home mortgage interest deduction is changed in the manner suggested by the president's panel.

The fact is that only one-third of taxpayers (46 million out of 130 million) itemize their returns. And only a tiny percentage of those deduct interest on mortgages of $300,000 or more. Earlier this year the Congressional Budget Office estimated that limiting the tax break to mortgages up to $500,000 would affect only 1 percent of all homeowners. So this would hardly be a broad-based tax increase. The wonderful thing about the progressive income tax is that it can be manipulated to raise revenue while protecting lower- and middle-income citizens quite easily.

There is simply no tax policy justification for allowing large home mortgage interest deductions. Both conservative and liberal public finance experts have long criticized the home mortgage interest deduction because it shrinks the tax base, thus requiring higher tax rates. That's right, you are paying higher tax rates because of the home mortgage interest deduction.

The mortgage deduction also distorts economic decision-making, effectively subsidizing ever-larger home purchases by making it cheaper to borrow money. (And at the moment, borrowing is already pretty cheap.) That, in turn, has fueled the out-of-control real estate market. People have been buying houses that they might not otherwise have been able to afford. Yet, really smart people since the time of Adam Smith have warned against using the tax laws to distort markets. Perhaps it is time we listened.

The purpose of the mortgage interest deduction was to encourage home ownership. Most Americans would agree that this is a worthwhile goal. But home ownership hovers around 70 percent. The other 30 percent of Americans for the most part don't earn enough money to take out $300,000 to $1 million loans for the starter home of their dreams. Maintaining tax benefits on home loans over $300,000 serves no purpose other than giving the best-off a break. Limiting those benefits would not prevent anyone from basking in the joys of home ownership.

The only policy argument against reducing the amount of the mortgage tax benefit is that people who have already bought homes did so with the expectation that the deduction would continue. I agree that it would be unfair to change the rules after the fact. But transition rules can be designed to protect homeowners with such expectations.

There is even less justification for keeping the tax breaks for second home mortgages. These deductions also cost the federal government billions of dollars a year. The beach house may seem essential during the hot summers here, but we should recognize the tax break for what it is: a vacation subsidy.

The home equity interest deduction is even more absurd. We do not allow people to deduct interest on their credit card debt or unsecured bank loans. Why in the world do we allow them to deduct interest on their home equity loans? Those deductions are government subsidies for whatever the homeowner wants to buy. And the tax code makes no distinction between paying for good things, like college tuition, and frivolous ones, like European vacations.

In the end, the panel did the right thing by making these proposals. Members of Congress will be inundated with calls asserting that capping the benefits will hinder pursuit of the dream of home ownership. It will do no such thing. People do not buy houses because of the tax benefits. They buy houses so that they have a place to call home.

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The Lucrative Side of Bankruptcy

CHAPTER 11, *From B1*

Why the surge in corporate bankruptcies at a time when the economy is expanding? The explanation heard most often is twofold: global competition and out-of-control labor costs. Competition from low-wage assembly plants in Mexico and Asia is tightening the screws on American manufacturers who must pay top-dollar wages to unionized workers as well as promised pension and health benefits, known as "legacy costs," to retirees.

"Legacy costs are killing us," says Robert S. "Steve" Miller, who was named Delphi's chairman and CEO last July. Miller is emblematic of the shifting nature of bankruptcy law. A self-styled "corporate doctor," he has a law degree from Harvard University, a master's degree in finance from Stanford University and a blunt speaking style that makes him quotable in the media.

Before taking Delphi into Chapter 11 on Oct. 8, Miller made it known that unionized employees represented by the United Auto Workers (UAW) would have to accept either a wage reduction of 62 percent, from an average of $26 an hour to as little as $10 an hour, or sharp benefit reductions to retirees. UAW President Ron Gettelfinger denounced the offer as insulting, but Miller defended it at a news conference. The CEO couldn't have been more explicit in describing his view of the modern workplace: "Some people insist that fairness requires that we slash wages across the board if we cut wages for anyone. Well, I am sorry. My job is to preserve the value of this enterprise as we restructure. We have to adjust to market conditions and appropriately pay for our human capital at each level. There are large disparities in this country and around the world in what people can expect for mowing the lawn, versus managing a huge business. It may not be fair, but it is reality."

The Delphi chief often cites reality — and the bottom line — in answering his critics. "They [have to] understand that I haven't got any more money," Miller told the Financial Times.

But the reality, to use Miller's word, isn't so simple. Delphi does have money — specifically, it has $1.6 billion in cash on hand. Even more significantly, it secured $2 billion in loans and revolving credit from Citigroup and J.P. Morgan Chase bank just before it filed for bankruptcy. Which raises a question that the common explanation for Chapter 11 filings doesn't answer: If Delphi is so broke, with unsustainable wage costs and skyrocketing pension obligations, why are two of the nation's major banks offering to lend it money on excellent credit terms?

The answer: For the same reason that Bank of America, General Electric Capital Group, UBS Securities and distressed property, or "vulture," capitalists have invested billions of dollars in supposedly tattered companies entering or exiting Chapter 11 since 2001. Investors can profit richly from the meltdown of established companies — at least in the short run. Chapter 11 protects a company from creditors as management develops a reorganization plan and restructures its liabilities in the hope of becoming profitable again. Older companies may have high legacy costs, but they have long-term customer contracts and plenty of cash flow.

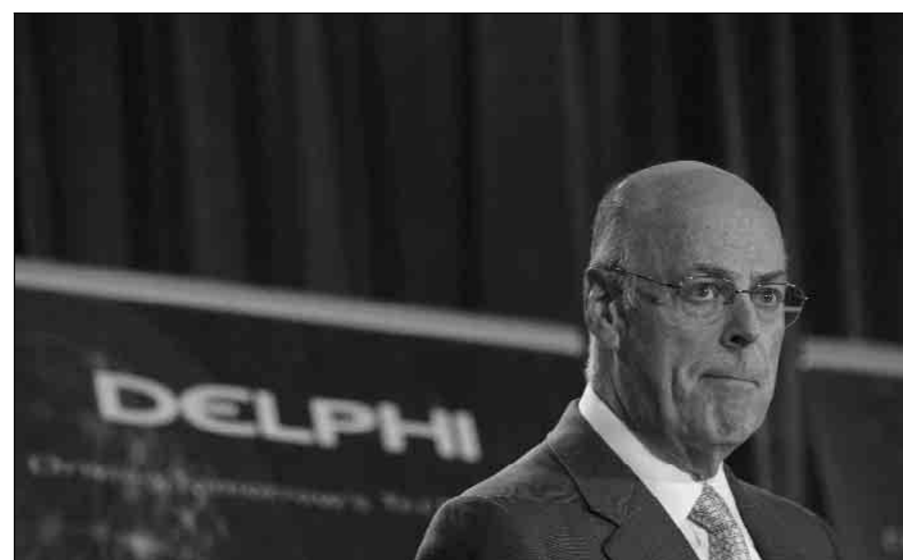
"The way the code is now structured, the temptation is to make the workforce pay for management's mistakes, rather than taking all of the stakeholders into account and rebuilding the company together," says Harley Shaiken, a professor at the University of California at Berkeley who specializes in labor issues. Chapter 11 calls on management to bargain with unions in good faith to reduce costs, but also permits management to petition the court to void labor contracts and substitute whatever terms it chooses. Properly stage-managed and set in motion, the restructuring process can steamroll the union, peel away retiree benefits and dump pension obligations onto the PBGC.

That's exactly what happened during Miller's 19-month tenure as chief executive of Bethlehem Steel. Some 95,000 retirees and dependents lost their health-care plan in 2003 when the bankruptcy judge sold the company's assets to International Steel Group, a company controlled by billionaire financier Wilbur L. Ross.

Meanwhile, the PBGC was left with the responsibility of paying $4.3 billion in underfunded Bethlehem pensions over the next 30 or so years. Because of the less generous terms of PBGC's pension formula, some steelworkers lost 50 percent of their expected pensions as well as their health benefits.

Earlier this year, Ross sold International Steel to London-based Mittal Steel Co., picking up $267 million in profit on the sale. Ross's investment fund has since amassed $4.5 billion, some of which he plans to use to make acquisitions in the auto parts industry, he said recently. One of his possible targets? Delphi. He has made it clear, in recent interviews, that he is carefully watching the company and its Chapter 11 reorganization.

So what others see as an ailing business, Ross sees as an opportunity.



By Bryan Mitchell — Getty Images

The man and the message: After seeking Chapter 11 bankruptcy protection, Delphi's Robert "Steve" Miller warned his workers of drastic cuts, saying "It may not be fair, but it is reality."

Economists often talk about "moral hazard" and "free rider" systems that create incentives for governments or common citizens to behave imprudently and follow short-term strategies that can cause long-range problems. Bankruptcy law can encourage such behavior.

Established by Congress in 1898 as a part of the U.S. district court system, early bankruptcy courts were auction houses where court-appointed referees settled claims among squabbling creditors. Little interest was shown in keeping a company on legal life support until the Great Depression when, faced by an unprecedented number of business failures, the Chandler Act of 1938 created Chapter 11 bankruptcies to allow managers to try restructuring instead of simply liquidating the assets.

The present system dates to the 1978 Bankruptcy Act, which made it easier for a business to file for protection and gave management broad rights to set forth a reorganization plan under the supervision of a bankruptcy judge. The act changed the economic ground rules. Before 1978, few law firms bothered having a bankruptcy department; afterward, nearly every "white-shoe" firm opened up thriving bankruptcy and restructuring practices.

Bankers were not far behind. Rather than fighting with management over existing assets, they began to underwrite management's reorganization plans through "debt-or in possession" loans and revolving credit. This gave them priority claim on company assets if reorganization didn't work (something not offered to employees, who are in the heap of unsecured creditors), and offered lavish rewards to managers who cut costs.

This helps explains an aspect of the Delphi filing that has puzzled observers: CEO Miller's petition to the court to award up to $87 million in bonuses to senior managers, who also would share 10 percent of the equity in the reorganized company.

Logic would suggest that a dynamic corporate doctor would want to amputate, not remunerate, the people who helped get the company in trouble in the first place. Bonuses and equity, however, "incentivize" managers, to use Wall Street lingo, to remain at the company and meet the downsizing targets set by Miller.

It's one of those disembodied tactics of modern business life in which there is no apparent crime — only victims, such as retirees who lose their benefits, and Middle American towns that lose a part of their tax base when the local Delphi plant is padlocked.

Aside from the question of social equity, is Chapter 11 an effective cure for a sick company? There is little evidence that court-supervised reorganization produces a superior company. In fact, quite a few companies that come out of bankruptcy make a return trip, and there is growing evidence that the process diverts capital away from needed investments into the pockets of the restructurers.

"Moral hazard" warns us against letting poorly run companies undercut the practices of strong companies. It would be a pity, says Shaiken, to encourage responsible companies to follow in the Chapter 11 footsteps of weak ones, rending the social and economic fabric of years of comparative labor peace.

You don't have to be UAW's Ron Gettelfinger to be bothered by the contrast between the winners and losers of recent Chapter 11 reorganizations. The enrichment of managers and financiers who parachute into troubled industries is unacceptable if taken from the benefits promised to workers who served their employers loyally in return for a measure of security in their golden years.

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