Temporary Reinstatement of Tax Deduction for Credit Card Interests for the Financially Vulnerable

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Abstract

Authors propose a temporary reinstatement tax deduction for credit card interest to delay or prevent more foreclosure, add financial flexibility among the unemployed or underemployed in the aftermath of the recent recession, and to include those who have been excluded from benefits of recent stimulus programs. Suggestions on how to fund the proposed tax revision are also provided.

Key words: Credit cards, Consumer credit reform, tax deduction, foreclosure, unemployment

Introduction

As the historic Great Recession officially ended in June of 2009 by having 2 consecutive months of growing Gross Domestic Products (GDPs, National Bureau of Economic Research, 2010), the impacts of the Recession are still lingering. For example, owners of almost 2.9 million housing units or properties received a foreclosure notice or similar in 2010 (Schmit, 2011). It means that 1 out of 45 housing units received a foreclosure filing in the country IN 2010. In spite of the Obama administration's $75 billion effort to reduce forecloses through mortgage term renegotiation, the current foreclosure rate still remains very high. Unfortunately, the number is unlikely to go down significantly in the near future, as the country's unemployment rate still very high. The current economic recovery progresses very slowly without fast improvement in the job market. During this recovery process, some financial elites of the bailed financial institutions were awarded exorbitant bonuses from tax payers' money and ignited public outcries.

Unlike the financial elites who can be accredited as primary suspects of this economic crisis, the working poor and financially disadvantaged still suffer greatly from the harsh realities of losing their jobs and homes, as the expansion of GDP has not entailed an immediate and drastic relief on the unemployment rate and foreclosure rate. Thus, until a more stable labor market returns, more measures are needed to protect those who may lose their jobs, who currently receive unemployment insurance benefits, or who have reduced income due to shortened working hours. One measure that can provide relief for the financially vulnerable is to reinstate tax deduction on interest accrued from credit card debts, which are often being used a means of survival for the population.

Credit card debts: Means for survival

In the US, Bank of America first launched a general purpose credit card in 1959 with an expectation that the bank would be able to make profits from revolving customers (Stein, 2004, November 23). Since then, credit cards have become an essential item to the American consumer. In 2000, the amount of credit *offered* to American households was roughly $3 trillion (Draut & Silva, 2003). This number can then be translated into approximately $21,000 of *available* credit from six credit cards in each household. From this available credit, the total credit card debt accrued reached $692 billion in 2001, which means the average credit card debt among American families was $4,126 in that same year. By the end of 2008, the total amount of credit card debt in the US jumped to $972.73 billion and the average balance of outstanding credit card debt among households with at least one credit card was $10,679 (Woolsey & Schulz, 2009).

According to the Joint Congress Economic Committee (May, 2009), about 13.9% of disposable income from October through December in 2008 went to pay monthly payments or service fees from using mostly credit cards and other revolving consumer debt. Various factors explain the drastic increase in the credit card debts among American consumers. Certainly, reckless consuming behaviors among credit card holders are one of the reasons (Joireman, Kees, & Sprott, 2010; O'Guinn & Faber, 1989). Yet, it should be noted that "living beyond their means" does not sufficiently explain the increase. Other major contributors of the snowballing debt include rising housing and health care costs, as well as, declining real wages (Manning, 2000, pp. 61-62). Just as low-income farmers in the antebellum American society needed to borrow for their survival during the winter or after a poor harvest, modern day low-income families used credit cards as a lifebuoy for survival between the increase in living expenses and decrease in the real wage (Gelpi & Julien-Labruyère, 2000).

Hence, credit cards are used as financial Band-Aids for low-income families (Merrick, n.d.), often serving as "bridge loans" between paychecks (Telvick, 2004, November 23). The plastic moneys are even use to finance higher education. For example, one study reports that more than a quarter of college students used credit cards to help pay for tuition (Baum & Saunders, 1998, February). The National Association of College and University of Business Officers (NACUSO) also found that on average 18% of college tuition and fees were paid by credit cards in 2003 (2004, August).

Major landmarks in public policies

Even though credit cards serve as lifebuoys for the financially vulnerable, the interest on the credit cards is no longer tax deductible. In 1986, the federal tax code was revised to phase out the tax deductions for interest payments on consumer credit by 1991 to discourage consumers' spending through plastic money, while the tax deduction for home mortgage was left intact. Unfortunately, the policy was unable to achieve its goal of reducing credit card debts. According to the Federal Reserve (2008, February 7), revolving credit, mostly plastic money, began to decline after the new policy. However, credit card usage soon began to increase sharply. Not only did the policy fail to achieve its intended goal, it favors homeowners and discriminates the most financially vulnerable who cannot afford to have a home. For example, the interest on the primary home up to $1 million mortgage can be tax deductible (if married and jointly filed) and on the second house up to $100,000 (if married and jointly filed, Internal Revenue Service [IRS], n.d.). Even interest on home equity loans to purchase other items can be tax deductible and their interest rates are much lower than that of credit cards, as they are categorized as secured loans. Non-homeowners who are more likely to be members of the low income strata are excluded from these governmental subsidies and less expensive loans. This is a very regressive tax policy favoring the haves.

Ironically, while the government sought to discourage credit card usage through the discontinued tax deduction policy, it also adopted several public policies which facilitated financial institutions' exploitation of credit card holders. Since the Federal Reserve System was established in 1914 to exert governmental power on financial markets (Homer, 1977), one of the most important governmental policies on regulating credit cards was the 1978 Supreme Court decision *in re* Marquette National Bank vs. First of Omaha Service Corp. This ruling allows national banks to charge any interest rates to consumer credit borrowers as long as their rates are within the legal caps set by the states where the national banks' headquarters are located, not by the states where actual customers are located (Map, 2004, November 23). As a result, 8 out of 10 major credit card companies began to relocate to a few states where there was no state cap on credit card interest. The remaining two banks, Direct Merchants and Bank of America which later moved to North Carolina after its merger with another bank, decided to operate their headquarters in Arizona which specifies 36% as the maximum interest cap on credit cards.

Another important milestone that created more favorable conditions for lenders, while jeopardizing credit card users, is Title II of the Depository Institutions Deregulation and Monetary Control (DIDMC) Act of 1980. Following the Vietnam War, the US began to experience double-digit inflation rates. In 1980, the rate crested to 14% (Manning, 2000, pp. 78-79). While the inflation rate was high, usury laws of many individual states specified the maximum interest rates on credit cards. Therefore, in some states, the inflation rate began to exceed what lenders were allowed to charge to their credit card customers (Stein, 2004, November 23). As a result, credit card lenders were losing money from credit card business. Because of this extremely high inflation rate, Title II of the DIDMC Act mandated gradual elimination of individual state's ceilings on credit card interest rates (Federal Reserve Bank of Boston, n.d.). The combination of the 1978 Supreme Court ruling and the deregulation in 1980 created competition among states to bring financial institutions to create jobs and tax revenues for the states.

For example, South Dakota eliminated its cap on credit card interest rate to facilitate Citibank's relocation to the state from New York where there was a strong anti-usury law (Stein, 2004, November 23). Following South Dakota, Delaware changed its laws to elicit banks from the Empire State and other states by offering "the ability to charge interest rates not subject to any legal ceiling, to raise interest rates retroactively, to charge variable interest rates, to levy unlimited fees for credit card usage and to foreclose on a home in the event of default for credit card debts" (Greth, 1981, March 17).As a result, credit card companies sharply increased interest rates and penalties for late payments. In November of 2010, the most recent average annual percentage rate (APR) of credit cards was 13.44% (Federal Reserve, 2011, January 07). However, this average APR is quite deceptive, since many credit cards offer promotional 0% introductory rate. When credit card holders make a late payment, the actual credit card APR can be as high as 30% to 40% (Hobson, 2005, July 20). Credit card lenders also eliminated the grace period for late payments and began to charge an average of $29 per late payment (Draut & Silva, 2003).

The late fee soon became the fastest growing income source for credit card lenders. In 1996, credit card lenders enjoyed \$1.7 billion net income from late payment penalties (Draut & Silva, 2003). This figure increased to \$18.1 billion in 2007 (Chu & Acohido, 2008). After witnessing this abuse for almost three decades, Congress and the Board of Governors of the Federal Reserve finally took action by promulgating a new rule that requires financial institutions to obtain permission from credit or debit cardholders to charge overdraft fees (Federal Reserve, 2009, November 12). The new rule also puts a cap on the late fee up to only \$25 beginning July 2010. It is certainly a right, but insufficient, step to protect American consumers. During this financial crisis, American consumers, especially the less fortunate, have been forced to be in a condition to pay even higher fees to use further consumer credits. For example, while financial institutions were bailed out from tax money, those institutions, in return, abruptly reduced credit card holders' credit limits in an effort to prevent further loss from prospective credit defaults. This reaction based on fear is understandable, yet this practice should have been blocked by the government as a condition of the bailout.

Without any governmental sanctions, this reduction in available consumer credit creates a downward spiral movement among the financially vulnerable under the current credit score formula. As less available credit increases the current-debt-to- available-credit ratio, thereby decreasing the credit score for consumer credit users, the cost of loans become more expensive under the current risk-based interest system. Our government failed to curtail this irresponsible corporate behavior. Meanwhile, the decisions by financial institutions branded even those who faithfully paid their monthly bills into more risky groups, forcing them to pay higher fees for future loans, and certainly created a system for more revenue for those financial institutions. The reduction in available credit should only occur when our labor market becomes stable to an acceptable level. Because the unemployed or under employed suffer from loss or reduction of income, they have lost financial flexibility and have come to critically depend on their available credit to survive.

Precipitously wiping out available consumer credit is a way of fossilizing their weakened financial flexibility and accelerating the financially vulnerable into foreclosure or bankruptcy which in return hurts the financial institution. As interrelated parts of a system, one irresponsible move on behalf of financial institutions, such as prematurely reducing available credit, can result in more cascading failure. A creative solution is needed to assist those who lost the financial flexibility in weathering this economic downturn. The new solution must help a much wider spectrum of struggling Americans, such as those who may have to relinquish their homes, who have been exploited by financial institutions, who rely on credit cards for survival, or who see various new tax incentive programs as just unreachable mirages because they cannot afford to buy a new home or a more fuel-efficient car. Thus, suggested here is temporary reinstatement of tax deduction for credit card interest.

Temporary reinstatement of tax deduction for credit card interest

According to the most recent Federal Reserve's consumer credit data (2011, January 07), revolving consumer credit (mostly credit card debt) has reduced to \$796.5 billion in November 2010 from \$957.5 billion in 2008 in the aftermath of the financial meltdown. If we use the Federal Reserve's average interest rate on credit cards (13.44%), approximately \$107 billion is paid to credit card interests each year. Important to note, actual interest rates can be much higher among the financially vulnerable so they may pay a much higher portion of the estimate interest payment than those who are financially stable. Thus, the deduction of credit card interest is likely to benefit the financially vulnerable more than the financially stable. The proposed temporary reinstatement of tax deduction for credit card interest can invite two major concerns: How to secure a revenue for the program? And, how to avoid encouraging already-debt laden consumers to use more credit cards? Regarding the budget, the remaining \$63 billion as of December 31, 2010 (U.S. Government, n.d.) of the \$787 billion American Recovery and Reinvestment Act of 2009 can be funneled to support this program.

As bailed out companies and institutions have returned or announced their plans to return tax payers' money, this revenue also can be used to support the proposed tax deduction. This proposed program can be a precise measure to create an extra disposable income to at least about four million debt-poor Americans who appear to have sufficient income, yet have daily struggles to meet their basic necessities because of their debt (Pressman & Scott, 2009).In addition, decreasing the tax deduction for mortgage interest to a more reasonable amount can fund the proposed tax deduction program for credit card interest. As previously mentioned, tax deduction up to a \$1 million mortgage is very regressive favoring the rich. Therefore, lowering the deductible interest amount for home mortgage is a reasonable suggestion. According to the non-partisan Congressional Budget Office (CBO), a gradual reduction of the tax deduction to \$100,000 a year from 2013 to 2018 will generate about \$41.4 billion without reducing the current tax deduction for home mortgage interest for most American households (CBO, 2009, August).

The money generated can help support the proposed tax deduction for credit card interest without a drastic increase in the federal deficit. The second concern of how to avoid increased credit usage of already debt-laden consumers is legitimate.

Thus, this tax deduction for credit cards should be temporary and phased out as the unemployment comes down to a more acceptable or natural level to avoid encouraging already debt-laden Americans from acquiring additional unhealthy consumer debts. Of course, it is much more desirable for consumers to pay off monthly credit card bills without accruing any interest and those who have credit card debt to keep amounts at a minimum. Yet, this economic meltdown is unprecedented since the Great Depression leaving many with no other option than to rely on credit cards for support during this difficult time. Even though defining a natural or more acceptable unemployment rate is elusive, this program should be phased out once a stable labor market is evident by the unemployment rate. Yes, this proposed program may benefit impulsive credit card users. However, this concern should not prevent us from using a tool that can nudge the financially vulnerable to avoid foreclosure or bankruptcy by giving them extra disposable income.

Conclusion

The reinstatement of tax deduction for interests on credit cards can fill the income gap between the amount needed for solvency and the actual income. It should be noted that this proposed program itself cannot be sufficient to alleviate sufferings of the unemployed, the underemployed, or others who use credit cards as their financial Band-Aides. This program should serve as a just temporary patch, along with the mortgage readjustment program and the extended unemployment benefits, to allow additional time until our job market bounces back to a more normal level. Due to its perceived sinful nature, we have ignored credit card problems or have considered them merely as limited to those who are impulsive and careless. However, it is a real elephant in our house and thus should not be ignored. The Obama administration and the US Congress have taken steps to tighten up loopholes in consumer credit protection. Yet more is needed.

Utilizing revolving consumer credit to help the financially vulnerable withstand this economic change is certainly worthy of consideration. A policy goal of reinstating a temporary tax deduction for credit card interests has been presented in this paper. It is a reserved right of the reader to decide whether or not to support this proposed temporary tax code change. It is the hope, that if the reader finds this proposal as a medicine to relieve the sufferings of many, they will work as pressure points by taking necessary actions, such as writing letters to or calling legislators and mass media outlets. Doing so is a way to promote social justice and social change with and on behalf of those who became more vulnerable during this financial meltdown. As the “cash for clunkers” and new home buyer tax credit programs had strong supports from related business sectors, this proposal may tactically get strong supports from the financial sectors and both Democrats and Republican isles.

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