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Responsible Fools? The Tradeoff between Mortgage Prepayments and Tax-Deferred Retirement Savings by Jennifer Huang, Gene Amromin, Clemens Sialm

Have a few extra dollars? Debating whether to pay down your mortgage or invest a bit more in your retirement account? A working paper by Huang, Amromin, and Sialm suggests the latter may be a wiser choice.

SSRN-Responsible Fools? The Tradeoff between Mortgage Prepayments and Tax-Deferred Retirement Savings by Jennifer Huang, Gene Amromin, Clemens Sialm:

"a significant number of households can perform a tax arbitrage by cutting back on their additional mortgage payments and increasing their contributions to tax-deferred accounts (TDA). Using data from the three latest Surveys of Consumer Finances, we show that more than 45% of U.S. households that are accelerating their mortgage payments instead of saving in tax-deferred accounts are making the wrong choice."

Why would people pass up the tax savings? It may be that people have been so ingrained that debt is bad that they merely want to pay it down as soon as possible. In the authors' words: "self-reported debt aversion and risk aversion variables explain to some extent the household preference for paying off their debt obligations early at the expense of forgoing the tax arbitrage. We term these households responsible fools" since they are motivated to reduce their debt obligations in spite of incurring considerable monetary losses in the process."

Additionally, the authors point out that "[t]his propensity of debt-averse households to forgo this tax arbitrage is related to the findings in Graham (2000), who shows that many corporations forgo substantial tax benefits by holding too little debt."

The paper goes on to show that this is also consistent with the findings that people segment their accounts and do not consider retirement and housing accounts as substitutes.

Interesting paper.

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