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Pay or save?

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Many individuals are faced with the choice of increasing their mortgage payment beyond the required amount (prepaying the mortgage) or increasing their investments in tax-advantaged retirement accounts. The authors of a 2006 paper entitled, "Responsible Fools? The Tradeoff between Mortgage Prepayments and Tax-Deferred Retirement Savings," examined whether individuals were making choices that were financially optimal.

In general, the benefit of increasing the contribution to a tax-advantaged account is that the investment grows either on a tax-free basis (Roth accounts) or on a tax-deferred basis (IRAs, 401(k)s, profit-sharing plans, etc.). This allows for a tax arbitrage. The mortgage interest is tax deductible if one itemizes, while the earnings of the retirement savings account are either tax-deferred or tax-free.

In the paper, the authors documented that, for some individuals, the tax benefit more than offsets the slightly higher rate on the mortgage (which in turn is higher than what can be earned by investing in a mortgage-backed security of similar maturity -- used by the authors because it matches the risk characteristics of a mortgage). They found that the advantage improved if, by increasing the investment in a 401(k) plan, individuals also received a matching contribution from their employer.

The paper, published in April by the Social Science Research Network, concluded that 45 percent of individuals would benefit from the strategy of increasing contributions to a retirement savings account instead of prepaying their mortgage. Note that individuals most likely to benefit were those in higher tax brackets.

According to the paper, the decision to increase retirement savings yielded incremental savings of between 11 cents per dollar (if the investment was made in Treasury instruments) and 17 cents per dollar (if the investment was made in a mortgage-backed security).

Finally, the authors -- Gene Amromin of the Federal Reserve Bank of Chicago, Jennifer C. Huang of the University of Texas at Austin and Clemens Sialm of the University of Michigan -- estimated the cumulative cost of inefficient decisions. They concluded, "In the aggregate, correcting this inefficient behavior could save U.S. households" as much as \$1.7 billion per year."

Because the above benefits are basically riskless (they are just a tax arbitrage), why did individuals forego the benefit? The authors hypothesized that, in general, a high aversion to debt (the desire to be debt-free) drove an individual's "investment" choice toward paying down the mortgage instead of increasing retirement savings.

The paper also pointed out that there are two circumstances that work in favor of prepaying the mortgage. First, those with mortgages with a loan-to-value ratio of more than 80 percent might consider paying down the mortgage to that level to eliminate the cost of private mortgage insurance. For those who do not

itemize deductions in a lower tax bracket, the prudent choice would be to pay off the debt (particularly if it is likely one would be in a higher tax bracket when taking future withdrawals).

The second point concerns penalties that individuals would face if they were to withdraw funds early from a tax-advantaged account.

Individuals who withdraw funds from such accounts before age 59½ would face a 10 percent penalty. Thus, individuals should consider whether there could be a liquidity risk -- meaning a reason that might require them to withdraw funds from a tax-advantaged account before the end of the early withdrawal penalty period.

The authors acknowledged that, in a perfect world, individuals would not have to choose between prepaying their mortgage and contributing those funds to savings. When faced with a situation of "one or the other," your individual financial profile determines the final call; but for some individuals it might be more prudent to contribute funds now earmarked for mortgage prepayment to a tax-deferred savings vehicle.

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