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Mr. Chairman, the Congress is faced this year with a decision on whether to continue to let tax-exempt state and local bonds be used to finance single-family homes, or to allow this authority to expire on December 31, 1983, as it is now scheduled to do. The revenue consequences of this decision are significant. Single-family mortgage revenue bonds are projected to cost $7.9 billion in lost revenue over the 1984-1988 period under present law, and $10.7 billion if the expiration or "sunset" provision does not take effect.

My testimony this morning will cover three areas:

- Conditions that led up to the Mortgage Subsidy Bond Tax Act of 1980;
- Experience since the 1980 act; and
- Policy alternatives that the Congress might wish to consider.

CBO has prepared for the record a more detailed paper on recent trends in mortgage revenue bond financing. This statement will briefly summarize the main points of that report.

BACKGROUND

In the early 1970s, state housing agencies began issuing tax-exempt bonds for owner-occupied housing in significant and increasing quantities. Local governments and housing agencies first issued tax-exempt bonds for single-family housing in 1978. Because the interest paid on these bonds is tax-exempt, the federal government gives

up revenue to subsidize home purchases. State and local governments issue bonds at relatively low tax-exempt rates and relend the proceeds at slightly higher rates for mortgages, making below-market mortgage rates available to many homebuyers.

In response to a surge in bond issues for owner-occupied housing and associated revenue losses, the Congress passed the Mortgage Subsidy Bond Tax Act of 1980. This legislation sharply restricted the use of these bonds in order to reduce revenue losses and to target assistance more effectively. The act contained a sunset provision that ends the use of bonds for single-family homes after 1983. In the meantime, the act set state bond volume limits and home purchase price limits, introduced targeted area requirements, and restricted the subsidy principally to first-time homebuyers. The Tax Equity and Fiscal Responsibility Act of 1982 eased some of the restrictions in the 1980 act relating to the first-time homebuyer rule, purchase price limits, and arbitrage limitations.

EXPERIENCE SINCE THE 1980 ACT

The volume of single-family housing bonds dropped sharply in 1981 after limits were imposed in 1980, but then grew again in 1982, reaching a level about equal to the 1980 volume. These fluctuations were a response to interest rates and housing market conditions as well as to the provisions of the 1980 and 1982 acts.

The Volume of Mortgage Revenue Bonds

After a sharp rise in the issuance of housing bonds from $1.4 billion in 1975 to $14.0 billion in 1980, total housing bond volume dropped precipitously to $4.8 billion in 1981. The drop in volume was largely the result of the federal restrictions enacted in December 1980 and the high market interest rates prevailing during the year. After the market conditions improved during the summer of 1982, many jurisdictions were able to issue bonds more easily. In 1982, tax-exempt bonds for housing finance totaled $14.4 billion--$8.8 billion for single-family housing, $5.1 billion for multi-family rental housing, and $0.5 billion for veterans' housing (see Table 1). In that year, housing bonds accounted for 17 percent of all new long-term tax-exempt issues; bonds for owner-occupied housing alone accounted for 10 percent.

Mortgage bond interest rates declined steadily through most of 1982, along with rates for tax-exempt bonds generally. At the same time, the relative advantage of tax-exempt financing diminished. This can be explained partly by the recent tax rate cuts that have reduced individual demand for tax-exempt bonds and by the marked increase in the volume of all tax-exempt issues, including industrial development bonds. In 1982, tax-exempt interest rates were approximately 20 percent lower than comparable taxable rates, down from a 30 percent differential during the previous ten years. Although the spread between taxable and tax-exempt rates has narrowed, lower interest rates in general have brought many potential homebuyers back into the market. Thus, if the sunset date for mortgage revenue bonds is repealed, the volume of issues is likely to rise steadily over the next several years.

TABLE 1. VOLUME OF TAX-EXEMPT HOUSING BONDS, 1975-1982

Year	Total Volume Tax-Exempt Bonds	Total Housing Bonds	Total State Revenue Bonds		Total Local Revenue Bonds		Total Veterans' General Obligation Bonds
			Single-Family	Multi-family	Single-Family	Multi-family[a]	
			In Millions of Dollars				
1975	30,090	1,436	---	869	---	2	565
1976	34,962	2,741	680	1,420	---	21	620
1977	46,766	4,398	959	2,633	---	241	584
1978	48,979	6,946	2,792	1,748	619	735	1,155
1979	47,991	12,072	3,333	1,929	4,491	729	1,590
1980	54,086	14,048	4,974	1,379	5,524	839	1,332
1981	56,548	4,834	1,662	711	1,186	405	870
1982	86,351	14,432	5,212	2,784	3,571	2,360	480
			Percent of Total Volume of Tax-Exempt Bonds				
1975	100	5	---	3	---	---	2
1976	100	8	2	4	---	---	2
1977	100	9	2	6	---	1	1
1978	100	14	6	4	1	2	2
1979	100	25	7	4	9	2	3
1980	100	26	9	3	10	2	2
1981	100	9	3	1	2	1	2
1982	100	17	6	3	4	3	1
			Percent of Total Volume of Housing Bonds				
1975	N/A	100	---	61	---	---	39
1976	N/A	100	25	52	---	1	23
1977	N/A	100	22	60	---	5	13
1978	N/A	100	40	25	9	11	17
1979	N/A	100	28	16	37	6	13
1980	N/A	100	35	10	39	6	9
1981	N/A	100	34	15	25	8	18
1982	N/A	100	36	19	25	16	3

NOTE: 1982 figures are preliminary.

SOURCES: Total tax-exempt bond volume figures calculated by The Bond Buyer and the Congressional Budget Office. Housing bond volume figures calculated by the Office of Financial Management, Department of Housing and Urban Development, and the Congressional Budget Office.

a. Includes bonds issued for permanent financing under Section 11(b), bonds for urban redevelopment housing projects, and other local issues for multifamily, rental housing issued under Sections 103A and 103b(4)(A).

Targeting Under the 1980 Act

The Mortgage Subsidy Bond Tax Act of 1980 targeted mortgage assistance by:

- Focusing aid on low-income areas and areas of chronic economic distress;
- Imposing home purchase-price limits; and
- Making assistance available only to first-time homebuyers, except in targeted areas.

Experience under these provisions has varied widely. Some housing agencies and local governments have targeted their programs as much as possible on economically distressed areas and low-income homebuyers (and might have done so without federal requirements), while others have sought to minimize the impact of the act's targeting provisions in order to improve the financial backing behind the bonds and to reassure bondholders. Since the 1980 act was passed, new legislation and regulatory changes have eased the targeting provisions of the act.

Targeted Areas. The 1980 act required that a specified portion of bond proceeds be lent to people buying homes in targeted areas. (The amount may be either 20 percent of an issue's lendable proceeds or 40 percent of average annual home mortgages within targeted areas in the issuer's jurisdiction, whichever is less.) The act defined targeted areas as those census tracts where 70 percent of families have incomes of not more than 80 percent of statewide median income, or areas of chronic economic distress if so approved by the Secretaries of the Treasury and the Department of Housing and Urban Development.

When the 1980 act was passed, most states contained census tracts that qualified automatically as targeted areas. Since July 1981, however, 38 states have also had specific economically distressed areas approved as targeted areas. Applications propose areas as small as city neighborhoods and as large as two-thirds of a state. A Treasury Department regulation limiting targeted areas to 20 percent of a state's population was in place until May 1982. Since then, the total population living in targeted areas has risen well above 20 percent in several states, reaching as high as 50 percent in a few states.

States and localities issuing bonds often seek to minimize the burden of the targeted-area requirements by allocating as few bond funds to targeted areas as is allowable. The majority of issuers make their allotments to targeted areas on the basis of the market-share rule, thereby enabling them to set aside less than 20 percent of their mortgage funds for targeted areas. Issuers are able to set aside much less than 20 percent of their mortgage funds when the targeted areas in their jurisdiction are very small, when there have been very few recent home sales in targeted areas, or when the sales prices of homes located in targeted areas have been quite low.

Purchase Price Limits. The 1980 act limited the use of bonds to the financing of houses costing no more than 90 percent of the average area purchase price for a home not located in a targeted area and to 110 percent of the average area purchase price for a home located within a targeted area. TEFRA eased these limits by raising them to 110 and 120 percent, respectively.

Average home prices vary greatly from state to state and even from city to city, and thus purchase price limits vary as well. The Internal Revenue Service (IRS) published a listing of average area purchase prices that implied purchase price limits in 1982 ranging from about $49,000 to about $167,000 for new homes not located in targeted areas and from about $37,000 to about $158,000 for existing homes, assuming the homes were financed by bonds issued after TEFRA's enactment. The price limits in targeted areas were almost 10 percent higher.

Although most issuers in 1982 used the estimates of average area purchase prices provided by the IRS to calculate their purchase price limits, a few state and local issuers chose to set higher purchase price limits, based on their own estimates of average area purchase prices. For example, Alaska's Housing Finance Corporation set a purchase price limit of $128,000 for new houses when the limit calculated according to IRS data would have been $111,000. On the other side, several other issuers set some or all of their purchase price limits below those allowable under the 1980 act.

As can be seen, limits based on average area purchase price allocate federal assistance very unevenly, with more affluent areas receiving a larger share of the federal subsidy. This effect is often exaggerated when issuers use their own estimates of their area's average purchase price. The effectiveness of purchase price limits in targeting assistance toward lower income areas also varies greatly among states and localities because of differences in program design. In any event, most purchase price limits indirectly target aid by income because they discourage many middle- and upper-income homebuyers from seeking bond-subsidized mortgages.

Income Limits. In addition, most states and localities impose explicit income limits on homebuyers, although such limits are not federally required. A sample of 40 state issues in 1982 shows income limits ranging from between $16,000 and $36,000 in Indiana to between $26,000 and $60,000 in Arizona. In a sample of 28 local issues, income limits spanned a narrower range, from $26,000 in San Francisco to $60,000 in Tucson, Arizona. Three states and several localities imposed no income limits at all. The use of income limits obviously varies widely, making only upper-and upper-middle income homebuyers ineligible in many cases.

OPTIONS

As the sunset date for single-family mortgage revenue bonds approaches, the Congress must choose whether to let this authority terminate, extend it in its current form, or extend it in some altered form. If current law remains in effect, the authority for single-family mortgage bonds will expire at the end of the year. At that time, $39.4 billion in bonds will still be outstanding. The revenue losses associated with these bonds will total $1.5 billion in 1983 and will rise to $1.7 billion in fiscal year 1984. Subsequently, the revenue loss will level off and begin to decline gradually. Total estimated revenue losses for fiscal years 1984 to 1988 amount to $7.9 billion.

If, on the other hand, the sunset date is repealed, revenue losses over the 1984 to 1988 period are estimated at $10.7 billion. The difference of approximately $2.8 billion understates the revenue effects of the continued use of the bonds, however. Every time a state or local government issues a mortgage revenue bond (or, for that

matter, any tax-exempt bond), the federal government sustains revenue losses for as long as the debt is outstanding. Most mortgage bonds have staggered or serial maturities for up to 30 years. Ten years after a bond is issued, more than 80 percent of the issue will still be outstanding. Accordingly, a more appropriate way to look at the cost of mortgage revenue bonds is to calculate the amount of subsidy commitment over the life of the bonds.

To illustrate this point, although the additional revenue loss of not repealing mortgage revenue bonds would amount to an estimated $2.8 billion over the next five fiscal years, during the same period the federal government would commit itself to $24.1 billion in net new subsidies for single-family homes (see Table 2). The present value of the commitment would be $11.8 billion. (The present value of the commitment is the multiyear stream of revenue losses, discounted for the fact that losses in the later years have a lower current cost than those in the early years.) Although mortgage revenue bonds involve a multiyear commitment, the long-term costs of new issues do not appear in budget documents. The full costs of most direct housing assistance programs, however, now appear in the budget, with an amount of budget authority expected to pay the full 15- to 30-year expense set aside at the time that new commitments are made.

Regardless of how costs are budgeted, tax-exempt bonds are generally less efficient than direct subsidies--that is, a smaller proportion of federal expenditure is realized in subsidy by the homebuyers. A CBO analysis undertaken a few years ago indicated that, in the case of tax-exempt mortgage bonds, approximately 54 percent

TABLE 2. NET NEW SINGLE-FAMILY MORTGAGE BOND REVENUE LOSSES FROM REPEAL OF THE SUNSET PROVISION, 1984 to 1988 (In billions of dollars, by calendar year except as noted)

	1984	1985	1986	1987	1988	Total[a]
Estimated Bond Issues	10.4	13.0	16.9	20.4	23.6	84.3
Federal Subsidy Over the Term of the Bonds	3.5	4.2	5.0	5.4	5.9	24.1
Present Value of the Subsidy Commitment	1.7	2.1	2.6	2.6	2.9	11.8
Fiscal Year Revenue Losses	0.1	0.2	0.5	0.8	1.2	2.8

a. Totals may not add because of rounding.

of the subsidy went to the homebuyers. Most of the remainder went to bondholders and intermediaries, including issuers, underwriters, and bond counsel. A small portion of the subsidy represented an offset for the lower mortgage interest deductions of program recipients. In contrast, the Section 235 direct mortgage assistance program was 90 percent cost-efficient. Apart from direct subsidy programs, more efficient means of assisting homebuyers may be available within the tax system, such as direct tax credits for homebuyers.

If the use of the bonds is continued, the Congress could target the subsidy more narrowly on low- and moderate-income households by placing federal income limits on homebuyers or by limiting the subsidy to homebuyers who forgo the deduction of mortgage interest from taxable income. Although income limits would concentrate the subsidy on those homebuyers most in need of financial aid,

they would probably not reduce the volume of mortgage revenue bonds significantly unless they were very low. Requiring a choice between interest deductions and the bond subsidy could have a greater effect on volume as would more stringent state-by-state caps on volume. Income ceilings would involve administrative problems of monitoring compliance and making adjustments for regional cost-of-living variations. Limiting the subsidy to homebuyers who forgo the deduction of mortgage interest would be an administratively simpler way to target assistance to lower-income households. Taxpayers in higher marginal brackets would be better off taking the interest deduction and would automatically exclude themselves from the program. Lower-income homeowners benefit little or not at all from mortgage interest deductions and so would prefer the bond subsidy.

Finally, if the Congress decides not to repeal the sunset provision in the Mortgage Subsidy Bond Tax Act of 1980, it may wish to consider new restrictions on the uses of tax-exempt bonds for private and quasi-public purposes in order to keep deficits from climbing higher. At present, mortgage bonds are subject to state-by-state volume limits. The Congress may wish to consider similar limits for tax-exempt bonds that finance industrial development, pollution control, private hospitals, port and airport facilities, trade show and convention centers, and other privately owned facilities. It may also want to reconsider the restrictions that the Administration and the Senate Finance Committee proposed last year, which would have required that private investment financed with tax-exempt bonds be depreciated over longer recovery periods than those permitted under current law.