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TAX-EXEMPT BONDS FOR SINGLE-FAMILY HOUSING

A STUDY

PREPARED BY THE

CONGRESSIONAL BUDGET OFFICE

FOR THE

SUBCOMMITTEE ON THE CITY

OF THE

COMMITTEE ON
BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

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LETTER OF TRANSMITTAL

To the Committee on Banking, Finance, and Urban Affairs:

Transmitted herewith for use by the full Banking, Finance, and Urban Affairs Committee is a Congressional Budget Office study on "Tax-Exempt Bonds for Single-Family Housing," which was prepared for the Subcommittee on The City at my request. I wish to thank Ms. Cynthia Gensheimer of the Congressional Budget Office staff for her excellent work in carrying out this important study.

Sincerely,

HENRY S. REUSS,
Chairman, Subcommittee on the City.

PREFACE

In 1978 localities began issuing tax-exempt bonds to finance single-family home mortgages. Prepared at the request of Henry S. Reuss, Chairman of the House Committee on Banking, Finance and Urban Affairs, this paper analyzes the potential extent and effects of this new financing tool and provides a background for analyzing various proposals to limit the use of tax-exempt single-family housing bonds. In accordance with CBO's mandate to provide objective analysis, the report offers no recommendations.

Cynthia F. Gensheimer of the Tax Analysis Division prepared the report under the direction of James M. Verdier and with the assistance of Huda Fadel and others in the Tax Analysis Division. Charles Davenport, Martin Levine, and others in the Congressional Budget Office provided valuable suggestions and comments. Patricia H. Johnston edited the paper. Linda Brockman and Shirley Hornbuckle typed the draft and prepared the manuscript for publication.

Many people outside of the Congressional Budget Office gave generously of their time and assistance. Much of the information contained in the report is drawn from work by George Peterson of the Urban Institute that was supported by the Office of Policy Development and Research of the U.S. Department of Housing and Urban Development. Harvey Galper and other Treasury Department officials carefully reviewed a draft and provided valuable comments. Other individuals who contributed significantly to the report include Elizabeth Stabler; Bruce F. Davie; Dana Cahoon; numerous people at the Department of Housing and Urban Development, the Joint Committee on Taxation, GNMA, and FmHA; local officials across the

country; investment bankers who kindly sent the Congressional Budget Office much information; state housing agency and savings and loan association officials; and bond counsels.

Alice M. Rivlin
Director

April 3, 1979

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SUMMARY

The latest innovation in the municipal bond world is the tax-exempt single-family housing bond issued by localities. About 20 localities issued these bonds for the first time in 1978, and by April 1, 1979, localities had sold over $1.6 billion in single-family housing bonds. Unlike localities, states have issued such bonds since 1970 through their state housing agencies, which issued $2.7 billion of these bonds in 1978.[1] Without federally-imposed limitations, CBO estimates that annual new issues of state and local single-family housing bonds could reach $20 to $35 billion in 1984.

In submitting its budget for fiscal year 1980, the Administration said that it planned to propose legislation to limit the use of tax-exempt bonds for housing. According to the Administration, this legislation would limit single-family housing bonds to those that finance housing for low- and moderate-income families or that further "other narrowly targeted public policy objectives."

HOW THE PROGRAMS WORK

The basic structure of Chicago's first bond program is typical of most of the other local programs. In July 1978, the City of Chicago issued $100 million in tax-exempt bonds to finance home mortgage loans for low- to middle-income homebuyers,

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1. Urban Institute compilation.

defined as those with incomes of $40,000 or less.[2] Because of the tax exemption, Chicago was able to market the bonds with a low interest rate of about 7 percent, thus enabling it to charge an interest rate on the mortgage loans of about 8 percent--about 2 percentage points below the market rate on conventional mortgages.

After city officials decided on the basic structure of the program (such as income ceilings and the selection of participating financial institutions) and marketed the bonds, they played a passive role in the administration of the program. The bond proceeds were turned over to a savings and loan association, which processed loan applications, automatically accepting those that met the city's income eligibility criteria and its own credit worthiness standards. The selected homeowners send their monthly mortgage payments to the savings and loan association, which then forwards the money to another financial institution, which pays the bondholders. Because the bonds are not backed by the city's full faith and credit, the bondholders and mortgage insurers assume any risks of a bad mortgage portfolio.

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2. One of the important issues in the debate over tax-exempt single-family housing bonds is how to define "middle-income" and "moderate-income." In this paper, unless otherwise indicated, middle-income means roughly incomes between $20,000 and $30,000, and moderate-income income means incomes between $10,000 and $20,000. Low- or lower-income means incomes below $10,000, and higher- or upper-income means incomes above $30,000. These dividing lines are obviously somewhat arbitrary, and will vary depending on family size, area of the country, and other factors.

STATE HOUSING AGENCY PROGRAMS

State housing finance agencies in 34 states have sold single-family housing bonds, using a program structure very similar to that of the local programs. Although state agencies have, in the past, financed multifamily housing for people with low and moderate incomes, in recent years they have shifted their efforts sharply toward single-family housing, much of it in suburban areas and much of it aimed at middle-income families. In 1978, 62 percent of new state agency tax-exempt bond issues were for single-family housing, up from 26 percent in 1975.[3]

State housing finance agencies are established by specific state laws and are usually limited both in the total amount of bonds they can issue and the kinds of housing they can finance. State agency programs thus tend to be subject to regular legislative review and oversight. They may also reflect broader statewide priorities, such as the development or revitalization of particular areas within the state. In most other respects, however, the state and local housing bond programs are quite similar, and unless federal limitations are imposed, it is likely that state agencies will continue to increase their emphasis on single-family housing for middle-income homebuyers.

EFFECTS OF TAX-EXEMPT HOUSING BOND PROGRAMS

Program Growth

In 1978, the total amount issued in single-family housing bonds (not including those for veterans' housing) was $3.2 billion, $2.7 billion by state housing agencies and $550 million by localities. In 1979, state agency issues are likely to

3. Urban Institute compilation.

grow to $4 billion, bringing the single-family total for the year to about $8 billion.

In 1984, CBO estimates that state housing agencies and localities will issue between $20 billion and $35 billion in single-family housing bonds, representing around 10 percent of estimated new mortgage originations for that year and 30 to 50 percent of all long-term tax-exempt bonds estimated to be issued during the year.

Only about fifteen states now allow local jurisdictions to issue single-family mortgage revenue bonds, but several state legislatures are currently considering enabling legislation, and within a few years there will probably be only a few states in which localities do not have this authority.

Federal Revenue Loss

Each billion dollars of new tax-exempt, single-family housing bonds issued costs about $22.5 million in foregone federal tax revenues each year for the life of the bonds. Based on CBO's projections of total state and local single-family housing bond issues, the revenue loss from those bonds will be $340 million in fiscal year 1980 and between $1.6 and $2.1 billion in 1984.

Effect on Tax-Exempt Interest Rates

The projected sharp increase in tax-exempt housing bonds will push up interest rates on other tax-exempt bonds, especially those for multifamily low-income housing. George Peterson of the Urban Institute estimates that $1 billion of new issues of single-family housing bonds increases interest rates on all tax-exempt bonds by between 0.04 and 0.07 percentage points and on housing bonds by between 0.11 and 0.14 percentage points.[4] The single-family

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4. George E. Peterson, Tax-Exempt Financing of Housing Investment (Washington, D.C.: The Urban Institute, forthcoming, 1979). This research

housing programs could thus increase significantly the cost of borrowing for other municipal projects, especially for multifamily rental projects for low- and moderate-income people.

Effect on Home Mortgage Financing

The effects of mortgage revenue bond programs on traditional mortgage finance depend on their popularity generally and on the share of mortgage financing they comprise in specific localities. If the bonds finance a large share of the mortgage activity in a locality, they could raise home prices in that area, draw business away from nonparticipating lenders, and lower interest rates on unsubsidized mortgages. In addition, the way in which localities ration mortgage money among applicants and lending institutions may be discriminatory.

OTHER FEDERAL HOMEOWNERSHIP SUBSIDIES

The tax subsidy provided through the state and local housing bonds is only one of several federal homeownership subsidies. Others include the tax deductibility of mortgage interest and property tax payments, special capital gains treatment of housing, the Department of Housing and Urban Development's (HUD's) homeownership assistance program (Section 235), HUD's rehabilitation program (Section 312), and the Farmer's Home Administration (FmHA) homeownership program (Section 502).

Largest in scale are the subsidies offered through the income tax system for itemized homeownership deductions. Those provisions, which mostly benefit middle- and upper-income taxpayers, will cost $14.6 billion in lost revenues in 1980. The

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direct spending programs run by HUD and FmHA serve primarily to reduce the cost of homeownership for low- and moderate-income people living in urban and rural areas, respectively.

Compared to the other federal homeownership subsidies, the mortgage bond programs have both strengths and weaknesses. In general, tax subsidies are less controllable than direct spending programs, since they are available to all eligible taxpayers and their size depends on taxpayer behavior and cannot be precisely predicted. Since the costs of the direct spending programs appear in the federal budget, the programs can be evaluated in relation to each other and scaled back or expanded as desired by the Congress and the President. Some of the program financing is fairly complex, however, so real costs of direct spending programs may be obscured. Because tax subsidies tend to have fewer eligibility limits and tend to be more self-administering, they may generate less paperwork and red tape than direct spending programs.

Compared to federally run programs, the local programs have the advantage that localities can tailor them to their own specifications. At the same time, however, the local programs may not further widely accepted public purposes.

OPTIONS FOR CONGRESSIONAL CONSIDERATION

There is a wide range of alternatives for the Congress to consider, from taking no action to eliminating the tax exemption on all single-family housing bonds.

Take No Action

Two principle reasons have been suggested for the Congress to take no action on the mortgage bond issue. First, many people claim that the bond programs are serving a public purpose by subsidizing homeownership for middle-income people, who do not generally benefit from other federal homeownership subsidies. Secondly, since state legislatures may act to confine the bond programs to those that serve well-defined purposes, no federal action may be necessary.

Ban All Tax-Exempt Single-Family Housing Bonds

Removing the tax exemption for all single-family bonds, both state and local, would eliminate the need to make difficult and sometimes arbitrary distinctions between the types of single-family bonds that serve a public purpose and those that do not. If a total ban is thought to be too harsh, an exception could be made for bonds that are backed by the full faith and credit of the issuing governments. Requiring issuing governments to assume a greater responsibility for the bonds would ensure that they consider more carefully the public purpose being served by the bonds.

Limit the Programs

Single-family housing bonds could be limited by restricting their tax exemption to one of three kinds of programs: those financing low- and moderate-income housing, those financing housing in economically depressed neighborhoods, or those supervised by legislatively established governmental agencies.

Limit the Subsidy to Low- and Moderate-Income Families. The subsidy could be directed to low- and moderate-income families in the following ways:

- Income ceilings. Eligibility could be limited to families with incomes below some specified level, such as 80, 100, or 120 percent of area median income. The major drawback to an income ceiling is that it is applied only when the mortgage is first made, while the subsidy lasts for the life of the mortgage. Families with low or moderate incomes in one year might well have middle or upper incomes ten or twenty years later.

- o Mortgage or purchase price ceilings. Mortgage or purchase price ceilings could overcome the difficulty with income ceilings, because people are likely to incorporate their expectations about their future incomes into their decisions about the kind of house and mortgage they can afford. Either ceiling could reflect variations in the cost of housing if it were dependent on area median income. Mortgage and purchase price ceilings would not guarantee, however, that no high-income people would receive subsidies. Unless the mortgage or purchase price ceiling were coupled with an income limit, some high-income people could qualify for subsidized mortgages by buying inexpensive homes, making large downpayments, or taking out second mortgages.

- o Requiring a choice between the tax-exempt bond subsidy and mortgage interest tax deductions. Requiring homeowners to choose between participating in a state or local mortgage bond program and taking the current mortgage interest deduction would be another way of effectively limiting the subsidy to low- and moderate-income people. High income people would find the deduction more advantageous and would elect not to participate in the state or local programs.

Target the Subsidy on Depressed Areas. The Congress could allow the bond programs to finance homes in designated depressed areas for people of all income groups. It could still direct the subsidy to low- and moderate-income people for homes outside the designated areas.

If it chose this option, the Congress would have to decide how to delineate eligible neighborhoods. Geographic targeting might push up housing prices in the aided areas and cause the displacement of low-income renters. In addition, the assisted homeowners might be higher-income persons, who already receive sizable homeownership subsidies through the income tax system.

Limit the Subsidy to State or Local Agencies Established by State Legislation. The Congress might wish to confine the tax exemption for housing bonds to those issued by state or local agencies established under specific state authorizing statutes. This could be coupled with income and/or geographic targeting. If all bonds had to be issued by governmental agencies, there might be broader public consideration of the purposes served by the bond programs and some balancing of state-wide priorities. In addition, programs run by established agencies might be administered better than those set up on *ad hoc* basis by localities. The better structuring might occur at the cost of more bureaucracy, however.

State agency programs would probably be better able to target assistance on selected depressed neighborhoods than would local programs, because localities might be forced to use these programs to compete for residents. Locally run programs could be effectively targeted, however, if state enabling legislation or federal law spelled out the areas in which they could operate.

Combine Limits with Expansion of Other Subsidy Programs

Finally, if the Congress decided to limit or eliminate the tax exemption on housing bonds, and if it determined that further subsidization of homeownership was in the public interest, it might wish to expand the use of another homeownership subsidy program, such as the Government National Mortgage Association (GNMA) Tandem program or HUD's Section

235 homeownership program. Either of those options could provide a larger subsidy than that offered by the local programs and could be directed easily to the groups the Congress would like to serve. Since the costs of either of those programs would fall within HUD's budget, they could be evaluated and balanced against other housing subsidies.

Alternatively, a tax credit for mortgage interest and property taxes could be substituted for the current deductions. This would make these homeownership subsidies more equal for all homeowners and would extend the subsidy to the large number of homeowners who currently use the standard deduction and hence do not benefit directly from the homeowner deductions.

Finally, states and localities could be given the option of issuing taxable bonds with a federal interest subsidy, or bondholders themselves could be given the option of paying tax on their bond interest and receiving a tax credit for a portion of the interest. The taxable bond option would reduce somewhat the windfall subsidy high-income bondholders now receive, and would make it profitable for many more tax-exempt or low-tax investors to enter the bond market, thus broadening the market for state and local bonds and pushing down the interest rates states and localities must pay.

Allowing this taxable bond option just for single-family housing bonds would give these bonds a comparative advantage over other tax-exempt bonds, however. If the Congress wanted to limit single-family bonds, it would have to require that interest on the bonds be taxable, and then set the federal interest subsidy at a rate below the level needed to compensate fully for the higher interest rate on the taxable bonds.

CHAPTER I. INTRODUCTION

In July 1978, the City of Chicago issued $100 million in tax-exempt bonds to finance low-interest home mortgages for families with incomes up to $40,000. Because the interest on the bonds was exempt from federal taxes, Chicago could sell the bonds at an interest rate as low as 7 percent, thereby providing mortgages at an interest rate about two percentage points below the prevailing market rates.

By the end of 1978, 19 localities in seven states had issued about $550 million in tax-exempt bonds to finance home mortgages. In the first three months of 1979, 32 localities in 12 states had sold an additional $1 billion in single-family housing bonds. In March of this year, Chicago marketed a second bond issue, this one for $150 million, with some tighter limitations on the number of high-income homebuyers who could receive the loans.

This flurry of activity prompted the Administration to consider whether some limitations should be imposed on this use of the federal tax exemption subsidy. The Administration has indicated that it will propose legislation to limit single-family housing bonds to those that finance housing for low- and moderate-income families or that further "other narrowly targeted public policy objectives."[1]

HOW THE PROGRAMS WORK

Since its first appearance less than a year ago, the use of local single-family housing bonds has become more sophisticated, but its basic mode of

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1. The Budget of the United States Government, Fiscal Year 1980, p. 71.

operation has not changed. A local government borrows money at a low, tax-exempt interest rate and relends the proceeds, through a private lending institution, to individuals for home mortgages. After the bonds have been marketed, the locality plays a passive role in the administration of its program. In general, the local government does not set up an agency to administer the program. Instead, local lending institutions process the loan applications, and, as long as funds last, they automatically accept those that meet both the eligibility criteria set up by the locality and the creditworthiness criteria they use in making their own loans. Homeowners send their monthly mortgage payments directly to the lending institution, which forwards the receipts, less certain fees, to another financial institution, which pays off the bonds.

WHY ARE HOUSING BONDS TAX-EXEMPT?

The tax exemption for state and city housing bonds is contained in legislation enacted by the Congress in 1968. In the Revenue Adjustment Act of 1968 (Public Law 90-364), the Congress placed strict limits on the use of tax-exempt bonds by states and localities for essentially private purposes. The legislation came in response to the widespread and growing use of tax-exempt bonds to finance the construction of plants for private industry. The 1968 legislation, as amended, generally prohibits the use of these so-called "industrial development bonds," except for certain "small issues" (usually $1 million or less, but in some cases up to $10 million). In addition, industrial development bonds are permitted for certain specified "quasi-public" purposes, even though much of the direct benefit from the bond accrues to private companies and individuals (Internal Revenue Code, Sec. 103[b]). The purposes listed include the purchase of pollution control equipment for private firms, the development of land for industrial parks, the financing of airports, docks, wharves, sports facilities, convention or trade show facilities, and "residential real property for family units." It is this last exception that provides unambiguous authority for tax-exempt housing bond issues.[2]

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2. Bond counsel generally have taken the view that most single-family mortgage bonds are technically not industrial development bonds and are thus tax-exempt by the same legal authority as are regular municipal bonds (Internal Revenue Code, Sec. 103[a]). This question has not been definitively settled by either Internal Revenue Service rulings or court decisions.

   The provision limiting industrial development bonds, which was added to the bill by an amendment proposed on the Senate floor by Senator Abraham Ribicoff (D-Conn.), did not originally contain the exception for "residential real property for family units." This exception, along with some others, was added to the bill in the House-Senate conference. (Howard M. Zaritsky, Congressional Research Service, "The Legislative History of the Income Tax Treatment of Industrial Development Bond Interest" [August 12, 1977], and "Industrial Development Bonds: Legislative History of the Residential Real Property Exclusion," [December 22, 1978]). The brief explanation of the exception that appears in the Conference Report (H.R. Report No. 1533, 90th Cong., 2d Sess. [1968]) discusses only multifamily rental housing, although single-family homes are not specifically excluded. Since state housing finance agencies did not begin to finance single-family housing with tax-exempt bonds until 1970, it may not have occurred to the conferees that tax-exempt bonds could be used for this purpose.

INNOVATION IN THE TAX-EXEMPT BOND MARKET

If localities have had authority to issue tax-exempt, single-family housing bonds for at least ten years, why was none issued before 1978? State housing agencies have been issuing tax-exempt bonds since about 1970, so the concept was not really new. The application of the concept to localities was new, however, and the firm of E.F. Hutton has been given credit for that innovation.[3]

Investment bankers soon discovered that this latest innovation in the municipal bond area was popular with many local officials. There are perhaps three major reasons for the popularity of single-family housing bonds.[4]

First, the demand for single-family housing is very strong today. There is a large and growing number of people in the home-buying age range of 25-34 years. Changing lifestyles are resulting in new household formation, and people find housing a good investment in times of inflation.

Second, the spread between home mortgage interest rates and interest rates on municipal bonds has

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3. "Jim Lopp's Innovative Bonds," Business Week, November 13, 1978, p. 108. The city of Minneapolis issued $17.5 million in tax-exempt single-family bonds in May 1978, two months before the Chicago issue that was put together by E.F. Hutton. The Minneapolis program had an income ceiling of only $22,000, however, and received much less publicity than the Chicago issue.

4. These reasons were cited in a speech by Leon T. Kendall, President and Chief Executive Officer of the Mortgage Guaranty Insurance Corporation, at a conference in Washington on "Tax-Exempt Mortgage Bonds for Single-Family Housing," sponsored by the Bureau of National Affairs and the Institute for Professional and Executive Development, March 23, 1979.

only recently become large enough to make these programs feasible. As explained in Chapter II, unless that spread is at least 1.5 percentage points, there is not enough difference between what the locality takes in and what it pays out to cover administrative costs.

Lastly, these programs appeal strongly to local officials who believe that the programs provide them with an opportunity to give positive benefits to their constituents with no expenditure of local or state tax revenues. Local officials also find the programs appealing because they benefit middle-income residents, whom they wish to attract to their jurisdictions. As discussed in Chapter V, however, the Congress might want to consider whether such programs serve public purposes.

This paper is intended to help the Congress evaluate the Administration proposal and other proposals to limit the use of tax-exempt housing bonds. It begins, in Chapter II, with a description of the Chicago single-family mortgage bond program and those of other localities. Chapter II also gives a general description of state housing finance agency single-family bond programs.

In Chapter III, the following questions are examined:

- What is the potential for growth of city and state single-family mortgage revenue bond programs?

- To what extent will these housing bond programs drive up the interest rates paid by states and localities on tax-exempt bonds for roads, schools, public buildings, sewer systems, and other traditional public activities?

- What effect will these programs have on mortgage interest rates, housing prices, and the activities of private mortgage lending institutions?

- o How are the benefits of the tax-exempt bond subsidy likely to be shared among home-buyers, lending institutions, bond underwriters, and other intermediaries, local jurisdictions, and the purchasers of tax-exempt bonds?

- o How large is the revenue loss to the Treasury from these programs likely to be?

Chapter IV looks at other federal subsidies for single-family housing and compares them with the subsidy provided through tax-exempt bonds.

Chapter V analyzes a number of options open to the Congress, including:

- o Taking no action.

- o Eliminating the tax-exemption for all single-family mortgage bonds, with a possible exception for bonds that are backed by the full faith and credit of the issuing government.

- o Limiting tax-exempt bond financing to housing for families with low and moderate incomes.[5]

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5. One of the important issues in the debate over tax-exempt single-family housing bonds is how "middle-income" and "moderate-income" should be defined. In this paper, unless otherwise indicated, middle-income means roughly incomes between $20,000 and $30,000, and moderate-income means incomes between $10,000 and $20,000. Low- or lower-income means incomes below $10,000, and higher- or upper-income means incomes above $30,000. These dividing lines are obviously

- Allowing tax-exempt bond financing for higher-income families only when it serves some specifically defined public purpose, such as revitalizing designated geographic areas.

- Allowing only legislatively established state or local housing authorities to issue tax-exempt housing bonds.

- Combining limits on tax-exempt financing for single-family homes with expansion of one or more of the other federal homeownership subsidies.

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somewhat arbitrary, and will vary depending on family size, area of the country, and other factors.

CHAPTER II. TAX-EXEMPT MORTGAGE BOND PROGRAMS

This chapter describes the general characteristics of existing and probable future local and state mortgage bond programs. From a mechanical perspective, the state and local programs are very similar, but they do differ in several ways. The biggest difference is that the state programs are conducted by ongoing agencies established by state legislatures, whereas the local programs usually function independently of governmental supervisory agencies. In addition, the state agencies have traditionally limited their homeownership subsidies to low- and moderate-income families, although in some states that is no longer true. The localities, on the other hand, tend to use higher income limits. A few of the state agencies have experimented, with some success, with programs aimed at revitalizing economically depressed neighborhoods. Although several cities have made similar attempts, they may be unsuccessful if adjacent communities can sponsor competing programs not restricted by neighborhood.

LOCAL PROGRAMS

The local mortgage assistance programs enacted to date have primarily been aimed at reducing the costs of homeownership. In some instances (California localities, for example), the stated intent of the programs has been to encourage people of all income levels to move into blighted redevelopment areas.[1]

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1. The mayor of Wilmington, Delaware, cited three key objectives of his city's program:

Aside from the California redevelopment programs (which carry no income limits), all of the others purport to be aimed at low- and moderate-income families, but the localities have, in all cases, set their income levels so that they include a majority, and usually a vast majority, of the population. Income ceilings have ranged from $18,000 in Pueblo, Colorado, to $50,000 in Evanston, Illinois, and $60,000 in Anchorage, Alaska. Most localities have established income limits of $30,000. According to the most recent Census data, 89 percent of U.S. households had incomes below $30,000 in 1977, and 98 percent had incomes below $50,000.[2]

Table 1 lists the local mortgage revenue bonds that were marketed before April 1, 1979, and gives some summary statistics for each, including income and mortgage ceilings if they were imposed.

> (1) to help cut the cost of homeownership in Wilmington for qualified low- and moderate-income families, (2) to stimulate the revitalization of City neighborhoods by encouraging new construction and the rehabilitation of vacant properties, and (3) to expand the City's tax base. (Media Release, December 13, 1978.)

In Chicago, Illinois, the primary purpose of the first program was to attract suburban people to the city and to deter outmigration of city residents to the suburbs. The program's secondary purpose was to attract industry and add to the city's tax base. (Telephone conversation with Clark Burrus, City Comptroller, November 17, 1978.)

2. U.S. Bureau of the Census, Current Population Reports: Consumer Income, "Money Income in 1977 of Households in the United States" (December 1978), p. 22.

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TABLE 1. TAX-EXEMPT SINGLE-FAMILY HOUSING BONDS ISSUED BY LOCAL GOVERNMENTS AS OF APRIL 1, 1979

Issuing County or City	Bond Size (in Millions of Dollars)	Date	in Dollars			Bond Rating c/	
			Income Ceiling a/	Area Median Income b/	Mortgage Ceiling	Standard and Poor's	Moody's
Alaska							
Anchorage	50.00	3/1/79	60,000	22,000	none	AA	A
Arkansas							
Jacksonville	15.00	2/1/79	29,000	15,100	58,000	AA	NR
Jefferson County (1)	24.16	12/1/78	29,500	11,900	59,000	AA	NR
Jefferson County (2)	16.52	12/1/78	29,500	11,900	59,000	AA	NR
Jonesboro	20.00	2/1/79	39,500 d/	11,800	none	AA	NR
Little Rock	75.00	3/1/79	32,000	15,100	none e/	AA	Aa
Lonoke County	25.00	3/1/79	30,000	10,800	60,000	AA	A
Mississippi County	15.00	2/1/79	29,000	10,100	58,000	AA	NR
Sebastian County (1)	9.56	3/1/79	27,500	11,500	55,000	NR	Aa
Sebastian County (2)	17.80	3/1/79	27,500	11,500	55,000	NR	Aa
Sebastian County (3)	3.40	3/1/79	27,500	11,500	55,000	NR	NR
Sebastian County (4)	1.73	3/1/79	27,500	11,500	55,000	NR	NR
West Memphis	16.50	3/1/79	29,000	12,530	none e/	AA	NR
California f/							
Duarte	39.67	11/1/78	none	18,000	none	A	NR
Fresno	12.68 g/	8/1/78	none	14,200	none	A	NR
Hawaiian Gardens	14.45	3/1/79	none	18,000	none	A	NR
La Habra	32.00	3/27/79	none	18,000	none	AA	Aa

(continued)

TABLE 1. (Continued)

Issuing County or City	Bond Size (in Millions of Dollars)	Date	in Dollars: Income Ceiling a/	in Dollars: Area Median Income b/	in Dollars: Mortgage Ceiling	Bond Rating c/: Standard and Poor's	Bond Rating c/: Moody's
California (contd.)							
Marin County	15.73	8/1/78	none	19,900	none	A	NR
Richmond	7.20	7/1/78	none	19,900	none	A	NR
San Bernardino	34.77	1/1/79	none	14,800	none	A	NR
San Pablo	6.85	8/1/78	none	19,900	none	A	con(A)
Colorado							
Delta County	6.20	4/1/79	20,000	10,000	50,000 e/	AA-	NR
Denver	50.00	8/1/78	20,000	18,500	none	AA	NR
Mesa County	15.00	11/1/78	24,000	13,700	none	AA	NR
Pueblo City	20.00	8/1/78	18,000	15,300	none	AA	NR
Pueblo County	25.45	12/1/78	18,000	15,300	none	AA	NR
Delaware							
Sussex County	20.98	3/1/79	30,000	14,700	60,000	NR	A 1
Wilmington	17.92	1/1/79	30,000	19,500	none	AA	NR
Illinois							
Village of Addison	25.00	4/1/79	40,000	20,700	80,000	NR	NR
Belleville	25.00	11/1/78	40,000	17,900	80,000	AA	NR
Chicago (1)	100.00	7/1/78	40,000	20,700	none	AA+	con(A 1)
Chicago (2)	150.00	3/1/79	40,000 d/	20,700	none	AA	Aa
Danville	15.42	12/1/78	30,000	15,700	none	AA	NR
Decatur	15.00	1/1/79	40,000	17,800	80,000	AA	NR
Evanston	25.00	1/1/79	50,000 d/	20,700	100,000	AA	Aa
Highland Park	8.00	2/1/79	40,000 d/	20,700	85,000 e/	AA	NR
Pekin	15.00	12/1/78	40,000	19,200	50,000	AA	NR
Quincy	16.76	11/1/78	40,000	15,200	none	AA	NR

(continued)

TABLE 1. (Continued)

Issuing County or City	Bond Size (in Millions of Dollars)	Date	in Dollars: Income Ceiling a/	in Dollars: Area Median Income b/	in Dollars: Mortgage Ceiling	Bond Rating c/: Standard and Poor's	Bond Rating c/: Moody's
Illinois (contd.)							
Rock Island	20.00	11/1/78	40,000	18,700	none	AA	NR
Wheeling	15.00	1/1/79	40,000	20,700	80,000	AA	A
Kentucky							
Johnson County	12.40	2/1/79	40,000	8,200	80,000	AA-	NR
Louisiana							
East Baton Rouge	100.00	3/1/79	29,500	15,800	none e/	AA	Aa
New Orleans	85.00	4/1/79	40,000 d/	15,100	75,000	AA	Aa
Terrebonne-Houma Parish	25.00	4/1/79	25,000	14,600	65,000	AA	NR
Maryland							
Baltimore h/	11.89	5/1/78	none	19,000	none	A	NR
Montgomery County	56.84	4/1/79	19,500	23,200	none e/	A+	Aa
Minnesota f/							
Minneapolis(1)	17.50	5/1/78	22,000	20,200	44,500 e/	AA	A 1
Minneapolis(2)	55.24	12/1/78	22,000	20,200	44,500 e/	AA	Aa
St. Paul	50.00	4/1/79	22,000 i/	20,200	50,000 j/	NR	Aa
South St. Paul	10.00	1/1/79	26,000	20,200	60,000 e/	AA	NR
New Mexico							
Albuquerque	78.56	3/1/79	24,000	14,200	52,000	A	Aa
Clovis	8.00	2/1/79	28,000	11,900	65,000	AA	NR

(Continued)

TABLE 1. (Continued)

Issuing County or City	Bond Size (in Millions of Dollars)	Date	in Dollars: Income Ceiling a/	in Dollars: Area Median Income b/	in Dollars: Mortgage Ceiling	Bond Rating c/: Standard and Poor's	Bond Rating c/: Moody's
West Virginia							
Cabell-Putnam-Wayne Counties	50.00	4/1/79	30,000	14,200	none	NR	NR
Kanawha County	27.50	12/1/78	30,000	15,300	none	AA	Aa
Monongalia County	20.13	3/1/79	30,000	14,000	none	AA	Aa
Wood County	21.31	3/1/79	30,000	14,700	none	AA	Aa

a/ Household or family income, adjusted according to varying local definitions.

b/ Median income for a family of four obtained from Department of Housing and Urban Development, Area Median Income for Standard Metropolitan Statistical Areas and Non-Urban Counties (December 1978).

c/ The purpose of rating investment bonds is to indicate the probability of timely payment of interest on the bonds and repayment of principal. Standard and Poor's Corporation rates bonds using the following scale (from highest to lowest): AAA, AA, A, BBB, BB, B, CCC. The scale employed by Moody's Investment Corporation is (from highest to lowest): Aaa, Aa, A 1, A, Baa 1, Baa, Ba, B, Caa, Ca, C. The designation "con(A)" means that the bonds have been conditionally rated "A"; the rating may be conditional for a variety of reasons, such as the construction of the housing not being complete at the time of the rating. Conditional ratings are reassessed when the underlying uncertainty no longer exists. NR means the bonds were not rated.

d/ A portion of the bond proceeds are either reserved for households with lower incomes than the table entry, or funds are made available first only for households below a lower income limit than that appearing in the table.

(Continued)

Footnotes (Continued)

e/ There is a home purchase price ceiling.

f/ These bonds were issued by local redevelopment agencies, as discussed in the text in Chapter II. They differ from the other bonds in several significant respects.

g/ A portion of the Fresno bond proceeds will be used to finance an apartment complex.

h/ The Baltimore bond proceeds finance new condominiums in the Coldspring development area only. The program is similar to the California Senate Bill 99 programs and somewhat different from the others.

i/ $22,000 for purchasers of existing homes and $27,500 for purchasers of new homes. There are no income limitations on purchasers of homes in redevelopment areas.

j/ The mortgage ceiling for homes outside redevelopment areas is $50,000 for an existing single-family home and $60,000 for newly constructed or substantially rehabilitated homes. If the home is inside a redevelopment area, the mortgage ceiling is $85,000.

Because interest earned on municipal bonds is exempt from federal income taxation, bond buyers are willing to accept lower interest rates on tax-exempt than on taxable bonds. Thus, localities can issue tax-exempt revenue bonds at relatively low interest rates and relend the proceeds for mortgages at interest rates that cover administrative and legal costs but are still lower than conventional mortgage interest rates by one or two percentage points. The lower mortgage interest rates benefit homebuyers participating in these local mortgage programs.

Costs and Procedures for Local Mortgage Assistance Programs

Localities can sponsor mortgage revenue bond programs at little or no cost to themselves. Experienced investment bankers have prepackaged plans that they can modify to fit the localities' specifications. Local lenders handle the administrative chores of processing the loan applications, selecting those that are credit worthy, and collecting the monthly mortgage payments. Private insurance companies (and the federal government for FHA-insured or VA-guaranteed loans) provide layers of security for the bondholders. Best of all from the locality's perspective is that it incurs no liability in the event of mortgage default. The locality does not back the bonds in any way; security for bondholders is provided by the mortgages, mortgage insurance, and reserve funds from contingency accounts set up initially with a portion of the bond proceeds.

Once a locality has decided to sponsor a mortgage revenue bond program and ascertained that it is authorized to do so under state law, it must determine the kind of mortgage assistance program it wants. Will the bond proceeds finance only new homes, only existing homes, or both? Will the mortgages be conventional, FHA-insured or VA-guaranteed, or a mixture? What size bond will it sell? What income limits will it establish? Will it impose ceilings on mortgage amounts or purchase prices?

To ensure favorable ratings and to facilitate marketing, there is a natural tendency for the localities to establish criteria that create a portfolio of relatively safe mortgage loans. Standard and Poor's describes the highest quality portfolio as "that which is restricted to a large pool of geographically diversified, seasoned, high-equity mortgages on single-family detached, owner-occupied dwellings."[3]

Simultaneously, the localities usually decide how many and which lenders they would like to work with. The first cities to initiate the programs worked with only one lending institution each, but the trend has been toward groups, or consortia, of lenders. In the latter case, the localities face the difficult task of apportioning the loan funds among the participating lenders. More and more frequently, the lending institutions have been required to pay a percent of their allocations as fees that are refundable only if they fulfill their commitments. That arrangement discourages the participants from requesting more than they can reasonably handle.

After the above decisions have been made and the bonds have been marketed, the proceeds are placed in various accounts held by a trustee (usually a commercial bank). The lending institutions accept applications for the low-interest mortgage loans, nearly always on a first-come, first-served basis. They review the applications and accept those that meet both the eligibilty criteria established by the locality and the credit-worthiness criteria the lenders use in making their own loans. The selected homeowners pay the lenders a fee for processing their loan applications and often pay an additional program participation fee that is unique to the local programs. The homeowners send their monthly principal and interest payments to the lending institutions, which retain a

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3. Standard & Poor's Corporation, Standard & Poor's Municipal and International Bond Ratings: An Overview (New York: Standard and Poor, 1978), p. 46.

portion as a servicing fee and periodically forward the remainder to the trustee, for distribution to the bondholders.

Depending on state law, the locality sponsoring the program may or may not be required to establish a local agency to oversee it. In California, for instance, the authorizing legislation stipulates that the municipality outline blighted neighborhoods and then establish local redevelopment agencies to supervise new development (Senate Bill 99 program) or rehabilitation (Marks-Foran program) within those neighborhoods.[4] The existing Minnesota enabling legislation allows only six cities to sell tax-exempt bonds to fund mortgage-assistance programs and requires that the programs be administered by ongoing local agencies.

More often, the localities do not have to establish supervisory agencies and, in fact, have only to select the eligibility criteria for the homeowners and choose the program's structure, as described above. The localities usually hire financial advisers to help them select investment firms. The investment banking firm or firms and their attorneys assume the administrative role of formulating the program design according to the locality's specifications. For their services, the investment bankers have generally received over 2 percent of the bond proceeds. For example, E.F. Hutton's fee was $2.3 million for the $100 million Chicago bond sale. Although the fees paid to the investment bankers in some of the first

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4. By law, the legislative body of a California city can name itself to be a redevelopment agency, as the city councils in San Bernardino and Richmond have done.

issues were unusually high, competitive forces may push them down.[5]

The profits to be earned by investment bankers have encouraged aggressive marketing on the part of the firms that became involved at an early stage.[6] In some states, investment bankers have made proposals to large numbers of communities,[7] urging upon local officials the appeal of programs that encourage middle-income homeownership.

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5. There is some question of how well competitive forces work in this case, since the locality, which selects the underwriter, has little incentive to keep costs down. As long as the spread between the conventional mortgage interest rate and the tax-exempt borrowing rate is large enough to pay the minimal administrative fees, local government officials may not be greatly concerned if one of the participants (underwriter, lending institution, trustee) receives an overly generous fee. In fact, they might even view this as one way of making the program politically acceptable.

6. Arizona Governor Babbit said that New York underwriters "are flocking into town like vultures trying to stir up business." (Daily Bond Buyer, December 7, 1978.) A vice president of one of the investment banking firms said that its strategy is to "saturate" a state and then move on to concentrate in another state. (The Oakland Press, November 26, 1978.)

7. Before the Michigan Attorney General declared programs there to be illegal under state law, about twenty counties had plans ready to be implemented. (Daily Bond Buyer, January 2, 1979.)

Early Results of The First Programs

Statistics on the first beneficiaries of the Chicago, Denver, and Minneapolis programs are now becoming available. Tables 2 and 3 display income profiles for beneficiaries of the Chicago and Denver programs. The average household income of the mortgage recipients in Chicago was $20,750.[8] In Denver, the average household income of the beneficiaries was $17,162 as of January 29, 1979.[9] The average income of buyers under Minneapolis' housing ownership program was $15,693.[10]

The income statistics on beneficiaries are, unfortunately, out-of-date and understate current total income. In an effort to make enforcement of the eligibility cutoffs as uniform and straightforward as possible, most localities have defined income as that reported on the applicant's federal or state tax return of the previous year. The lenders, naturally, look at more current levels of income in assessing credit worthiness. In evaluating the loan applications, the lending institutions consider child support payments and social security receipts as income, neither of which is generally included in the tax return definition of adjusted gross income.

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8. First Federal Savings and Loan Association of Chicago, The Chicago Plan, Report as of December 9, 1978 (1978).

9. Midland Federal Savings and Loan Association, Single-Family Mortgage Revenue Bonds, Denver, Colorado, Status Report (January 29, 1979).

10. Minneapolis Housing & Redevelopment Authority, MHRA Housing Ownership Programs: Results (1978), p. 12.

TABLE 2. INCOME DISTRIBUTION OF CHICAGO HOUSEHOLDS RECEIVING TAX-EXEMPT BOND-FINANCED MORTGAGES--LOANS APPROVED AS OF DECEMBER 9, 1978

Income Group (in Dollars)	Households Number	Households Percent
0- 4,999	61	2.84
5,000- 9,999	145	6.75
10,000-14,999	382	17.78
15,000-19,999	559	26.03
20,000-24,999	435	20.25
25,000-29,999	320	14.90
30,000-34,999	171	7.96
35,000-40,000	75	3.49
Total	2,148	100.00

SOURCE: First Federal Savings and Loan Association of Chicago, The Chicago Plan, Report as of December 9, 1978 (1978).

TABLE 3. INCOME DISTRIBUTION OF DENVER HOUSEHOLDS RECEIVING TAX-EXEMPT BOND-FINANCED MORTGAGES--LOANS CLOSED AS OF FEBRUARY 28, 1979

Income Group (in Dollars)	Households Number	Households Percent
0- 8,999	4	1.2
9,000-11,999	30	8.9
12,000-14,999	64	18.9
15,000-17,999	87	25.7
18,000-20,999	124	36.6
21,000-23,999	28	8.2
24,000 and Over	2	0.5
Total	339	100.0

SOURCE: Midland Federal Savings and Loan Association, Single-Family Mortgage Revenue Bonds, Denver, Colorado, Status Report (February 28, 1979).

Although inflation systematically pushed 1978 incomes above 1977 incomes, the most significant cause of deviation between 1978 and 1977 levels stemmed from families in which one or more members entered the work force in 1978. An official at First Federal Savings and Loan Association of Chicago said that many of the assisted homeowners in Chicago were young professionals who had recently completed their educations. Some of them could conceivably have had little or no income in 1977 but incomes above $40,000 in 1978. In one such case, a family with 1977 adjusted gross income of $6,872 qualified for and received a loan of $100,000.[11] By the same token, some people in Chicago with 1977 incomes exceeding $40,000 but with 1978 incomes below the ceiling were not allowed to participate.

The cities are also now attempting to evaluate how successful their programs have been in attracting residents. It is almost impossible for them to make a reliable assessment of this, however. To do so they would need to know how many people would have moved to the city had the low-interest rate mortgages not been available and then calculate the net addition attributable to the program. Short of doing that, the cities can attempt to determine for each of the houses financed with the bond proceeds, where the previous resident lives now and where the new resident lived before.

In Denver and Minneapolis, the cities did not collect data on the new locations of the home sellers, so the statistics they did collect cannot begin to answer the question of whether there has been a net increase in city population as a result of the program. If all of the sellers moved to the suburbs, there could even be a net reduction. With that limitation in mind, the preliminary statistics for Denver indicate that 21 percent of the 339 loans that were

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11. First Federal of Chicago, Chicago Plan-Loans as of October 31, 1978 (1978).

closed as of February 28, 1979 had been made to people who had formerly lived in the suburbs.[12] In Minneapolis, 38 percent of the buyers in the first three housing ownership programs had previously lived outside the city.[13]

Chicago did gather statistics on the home sellers, but its data are incomplete because some of the sellers were the estates of deceased owners and some of the previous occupants had been renters, and the city did not follow up on the new locations of the renters.[14] For the sellers for whom data was collected, 36.4 percent moved from the city to the suburbs, and 31.6 percent of the buyers moved to the city from the suburbs.[15]

Although it is not possible to draw firm conclusions from the available statistics, the limited experience with the local mortgage bond programs to date does suggest that they have been somewhat successful in inducing people to move into the cities. If that tendency becomes more pronounced, the suburbs may

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12. Midland Federal Savings and Loan Association, Status Report.

13. Minneapolis Housing and Redevelopment Authority, MHRA Housing Ownership Programs: Results (1978).

14. Since 26 percent of the Chicago loans financed condominiums, over half of which had just been converted from apartments, this was a significant omission. (First Federal of Chicago, The Chicago Plan, Report as of December 9, 1978).

15. Ibid.

begin to establish competing programs, with the net effect then being an overall subsidization of homeownership with few net locational incentives.[16]

SINGLE-FAMILY PROGRAMS SPONSORED BY STATE HOUSING FINANCE AGENCIES

Many of the state housing finance agencies sell tax-exempt revenue bonds to finance single-family home mortgages at below-market interest rates. Of the 37 states with state housing agencies that have issued bonds, 34 have sold single-family housing bonds.[17] Many of the state agency single-family programs are structured like the local programs--that is, the state sells tax-exempt bonds and apportions the proceeds to private lenders, who in turn use their standard evaluation criteria to review loan applications of eligible people.

In addition to financing single-family homes, the state agencies use their tax-exempt borrowing powers to finance multifamily rental housing projects. In recent years, the state agencies have dramatically

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16. Four Chicago suburbs (Evanston, Highland Park, Addison, and Wheeling) have already sold their own single-family housing bonds, and at least one other (Chicago Heights) plans to do so. The response may have been greater but for the fact that in Illinois only cities with populations over 25,000 have authority to sell the bonds.

17. A few existing state agencies (Indiana, Nebraska, Ohio, Oklahoma, District of Columbia) are inactive because they do not have the clear legal authority to sell bonds. A few other states (New York, New Jersey, and Massachusetts) have more than one state housing agency, so the total number of agencies issuing bonds is greater than 37. (Congressional Budget Office calculation.)

shifted their orientation from multifamily to single-family programs. In the brief period from 1975 to 1978, the share of their bond proceeds that was used to finance single-family housing grew from 26 percent to 62 percent.[18] State housing agencies issued about $4.5 billion in tax-exempt bonds in 1978, including those for both single-family and multifamily programs.[19] Table 4 lists the single-family housing bonds that state housing agencies marketed between June 1, 1978 and April 1, 1979.

The shift in emphasis from multifamily to single-family programs has coincided with a shift in orientation from assisting primarily low-income to assisting primarily moderate-income people. In addition, the scene of most state housing agency activity has been moving from the Northeast to the West and Southwest.[20]

The state housing agencies are instrumentalities of the states, and in nearly all cases they can issue tax-exempt bonds without having to obtain approval by referenda, as long as the agency's total debt outstanding is less than the debt authorization limit

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18. Urban Institute compilation based on Moody's Municipal and Government News Reports; bond prospectuses from issuing governments; and Weekly Bond Buyer.

19. Ibid.

20. George E. Peterson, Tax-Exempt Financing of Housing Investment (Washington, D.C.: The Urban Institute, forthcoming, 1979). This research was supported by the Office of Policy Development and Research of the U.S. Department of Housing and Urban Development.

TABLE 4. TAX-EXEMPT SINGLE-FAMILY HOUSING BONDS ISSUED BY STATE HOUSING AGENCIES--JUNE 1, 1978 TO APRIL 1, 1979

Issuing State Agency	Bond Size (in Mil-) lions of Dollars)	Date	in Thousands of Dollars			Bond Rating	
			Income Ceiling a/	Mortgage Ceiling	Purchase Price Ceiling b/	Standard and Poor's	Moody's
Alaska							
Housing Finance Corporation (1)	44.00	12/1/78	23.7-65.2	75.0	none	A	A
Housing Finance Corporation (2)	60.00	3/1/79	23.7-65.2	75.0	none	A	A
California							
Housing Authority (1)	50.00	7/1/78	varies c/	none	60.0-69.0 d/	A+	A 1
Housing Authority (2)	50.00	11/1/78	varies c/	none	60.0-69.0 d/	A+	A 1
Housing Authority (3)	75.00	2/1/79	varies c/	none	60.0-69.0 d/	A+	A 1
Colorado							
Housing Finance Authority	90.00	8/1/78	16.50	none	55.0	AA	Aa
Connecticut							
Housing Finance Authority	82.68	11/15/78	13.6-27.5 e/	none	50.0-60.0	AA	Aa
Iowa Housing Finance Authority	150.00	3/1/79	17.3	none	55.0	AA	A 1
Kentucky							
Housing Corporation	125.00	8/1/78	15.0-20.5 f/	none	40.0	AA	Aa
Housing Corporation	59.34	4/1/79	15.0-20.5 f/	none	40.0	AA-	A 1

(Continued)

TABLE 4. (Continued)

Issuing State Agency	Bond Size (in Mil-) lions of Dollars)	Date	in Thousands of Dollars Income Ceiling a/	Mortgage Ceiling	Purchase Price Ceiling b/	Bond Rating Standard and Poor's	Moody's
Maryland Community Development Administration	20.00	4/1/79	22.7-24.1 g/	none	varies h/	AA	Aa
Michigan State Housing Development Authority	30.00	11/1/78	19.1	40.0 i/	none	A+	A 1
Nevada Housing Division	113.58	6/1/78	18.4-26.0	none	55.0-60.0	AA	Aa
New Hampshire Housing Finance Agency	81.09	8/1/78	22.0	45.0	55.0	AA	A 1
New Jersey Mortgage Finance Agency	74.92	8/10/78	none	45.0	none	A+	A 1
New Mexico							
Mortgage Finance Agency (1)	61.2	7/1/78	17.0-27.0	none	47.0	A	A 1
Mortgage Finance Agency (2)	97.3	1/1/79	17.7-18.7	none	51.7	A	B 1
State of New York Mortgage Agency	113.35	10/26/78	none	50.0	none	A+	A 1
North Carolina Housing Finance Agency	37.30	4/1/79	13.9-15.2	40.0	none	A+	Aa
Oregon Housing Division	48.00	11/1/78	16.5	none	42.0	A+	A 1

(Continued)

TABLE 4. (Continued)

Issuing State Agency	Bond Size (in Millions of Dollars)	Date	in Thousands of Dollars: Income Ceiling a/	Mortgage Ceiling	Purchase Price Ceiling b/	Bond Rating: Standard and Poor's	Moody's
Rhode Island							
Housing and Mortgage Finance Corporation	56.00	8/1/78	18.5-19.5	40.0	none	A 1	A 1
Housing and Mortgage Finance Corporation	80.60	1/12/79	18.5-19.5	40.0	none	A 1	A 1
Housing and Mortgage Finance Corporation	163.27	3/15/79	18.5-30.0 i/	50.0	none	AA-	Aa
South Carolina State Housing Authority	84.87	1/1/79	14.4-16.8 f/	none	42.0	AA	Aa
South Dakota Housing Development Authority	147.00	3/1/79	14.4-32.2 k/	none	none	AA	A 1
Tennessee Housing Development Agency	50.00	10/1/78	12.0-16.9	none	28.5-32.5	A+	A 1
Utah Housing Finance Agency	56.98	1/1/79	14.3-15.8 f/	none	38.0-41.0	AA	Aa
Virginia							
Housing Development Authority (1)	75.00	8/1/78	16.0	none	35.9-55.0 i/	AA	A 1
Housing Development Authority (2)	100.00	2/1/79	16.0	none	35.9-55.0 i/	AA	A 1
West Virginia Housing Development Fund	100.00	4/1/79	20.0-25.0	none	48.7	AA	Aa

(Continued)

TABLE 4. (Continued)

Issuing State Agency	Bond Size (in Millions of Dollars)	Date	in Thousands of Dollars: Income Ceiling a/	Mortgage Ceiling	Purchase Price Ceiling b/	Bond Rating: Standard and Poor's	Moody's
Wyoming							
Community Development Administration (1)	53.60	8/1/78	23.0-26.5	60.0	none	AA	Aa
Community Development Administration (2)	68.30	3/1/79	30.0	60.0	none	AA	Aa

a/ Income limits in some states vary with location or family size. Where a range is indicated, the numbers represent the range of limits.

b/ Some purchase price ceilings may vary by location and/or type of house. Where a range is indicated, the numbers represent the range of limits.

c/ Prior to January 1, 1979, there was no income limitation for purchasers of homes in revitalization areas, but there was an income limit of 120 percent of HUD area median income for all other purchasers. As of January 1, 1979, the income limit for all home purchasers is 100 percent of HUD area median income, with some adjustments for family size.

d/ Purchase price ceiling is $90,000 in the San Francisco area.

e/ Income limits are waived in urban areas.

f/ Upper income limit is shown for a family of four, but the limit may be adjusted upward for each additional family member.

(Continued)

TABLE 4. (Continued)

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g/ Computed for a family of four.

h/ The Maryland Community Development Administration housing bonds will finance a number of housing projects, each of which will have a purchase price ceiling.

i/ Limit is higher if the home has energy-saving devices.

j/ For this particular program, called the "moderate income program," the buyer must have an income of $18,501, but no more than $30,000.

k/ Proceeds of this bond fund two programs. $71,935,000 is used for loans for low-income people (maximum income of $14,410, and $58,141,250 is used to purchase loans from bank portfolios to assist moderate-income people (maximum income of $32,200).

imposed by its state legislature.[21] Except for the few state agencies that have unlimited debt authorization, agencies must limit the scope of their operations and choose those programs that they feel are most worthwhile. Of course, each state can decide for itself the amount of bonding authority it will grant its housing finance agency. Since the state agencies must appeal to their legislatures for increases in their debt authorization limits, the legislatures have some indirect control over the agencies' activities.

Purposes of State Agency Single-Family Housing Programs

The single-family housing programs of state agencies can be categorized in three groups by their primary purposes: stimulating mortgage lending at selected times, revitalizing depressed cities or neighborhoods, and generally reducing the costs of homeownership.

Stimulating Lending. A few states have countercyclical programs that they activate only when they believe that mortgage money is becoming tight in their states. At those times, the state agencies buy mortgages out of the portfolios of lending institutions in order to provide the institutions with more funds for lending. There is little concern for the type of single-family mortgage or the income of the homeowner, since the goal is simply to inject new funds into the mortgage market.

Revitalizing Depressed Areas. Several states conduct mortgage assistance programs directed at depressed areas to encourage urban revitalization. Both New Jersey and Connecticut run such programs, without any limit on the incomes of the assisted homebuyers. The California Housing Finance Agency runs a

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21. None of the localities that has sold residential mortgage revenue bonds has had to seek prior voter approval, and in only isolated instances have the localities been subject to debt limits for this kind of bond.

similar program but now imposes moderate-income limits. The New Jersey plan is more oriented to middle-income buyers than the Connecticut program, since it imposes a mortgage ceiling of $45,000 for a single-family house. In Connecticut, the program establishes a purchase price cap which varies somewhat by location. It was recently lowered from a maximum of $80,000 to a maximum of $50,000 to $60,000 for a single-family home, depending on location.[22] In New Jersey, subsidized mortgages are mostly confined to homes in designated depressed neighborhoods, while in Connecticut homes with subsidized mortgages may be located anywhere within the nine eligible cities.

Both the Connecticut and New Jersey urban aid programs are relatively new, but some statistics are available on the mortgages that have been granted so far. The income distribution for the beneficiaries of the Connecticut Urban Area Program appears in Table 5, and some statistics on the beneficiaries of the New Jersey Neighborhood Loan Program are shown in Table 6. The statistics on in-migration should be evaluated in light of the caveats mentioned earlier in this chapter.

Reducing Costs of Homeownership. The third category of state programs is directed toward lowering the costs of homeownership for low- and moderate-income families. The majority of state programs fall in this category. They all set moderate income limits and/or mortgage ceilings. Most of the programs are structured in the same fashion as the city mortgage assistance programs, although they do have permanent staffs. Some state agency bonds are backed by the general obligation of the state housing finance agency.

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22. Until January 1978, there was no limit on either purchase price or income, and the mortgage ceiling was $80,000 for the Connecticut Urban Area Mortgage Program. (Connecticut Housing Finance Authority, 1977 Annual Report, p. 7.)

TABLE 5. INCOME AND CITY DISTRIBUTION OF CONNECTICUT HOUSING FINANCE AUTHORITY URBAN AREA COMMITMENTS--MAY 18, 1977-OCTOBER 31, 1978

Income of Assisted Homeowners (in Dollars)	Number	Percent
Under 30,000	3,785	86.2
30,000-39,999	451	10.3
40,000-49,999	109	2.4
50,000-59,999	25	.6
60,000 and over	23	.5
Total	4,393	100.0

Selected Characteristics of Connecticut Commitments

City	Average Mortgage (in Dollars)	Average Sales Price (in Dollars)	Average Income (in Dollars)	Percent Moved to City	Number of Commitments
Bridgeport	36,886	43,900	21,750	20	787
Hartford	31,752	35,805	21,250	26	710
New Britain	31,726	38,151	20,760	21	482
New Haven	32,268	36,138	20,853	24	494
New London	35,288	38,556	19,324	48	83
Norwalk	51,989	68,239	28,665	36	560
Stamford	53,602	71,240	30,169	22	306
Waterbury	28,782	34,061	19,391	19	576
West Haven	36,741	43,277	21,665	31	395
					4,393
Average for All Urban Areas	36,954	44,648	22,565	25	--

SOURCE: Connecticut Housing Finance Authority, October 31, 1978, Item Number 2(d).

TABLE 6. SELECTED CHARACTERISTICS OF NEW JERSEY MORTGAGE FINANCE AGENCY NEIGHBORHOOD LOAN PROGRAM TRANSACTIONS--MORTGAGE LOANS CLOSED MARCH 1977-JULY 31, 1978 a/

Characteristic	One-Four Family Homes	One-Family Homes Only
	In Dollars	
Average Household Income	20,964	19,860
Average Sales Price	29,866	26,362
Average Mortgage Loan Amount	26,340	24,239
Average Age of Buyer	36 years	35 years
Previous Location of Buyer b/		
	In Percents	
Within Same City	69.7	NA
Within Same County but from Other City	18.8	NA
Within Same State but from Other County	8.2	NA
From Out of State	3.3	NA

SOURCE: New Jersey Mortgage Finance Agency (NJ MFA).

a/ During this period, about 1,300 mortgage loans were closed. The NJ MFA has computerized information on only 1,032 of them, and because of reporting omissions, information on all characteristics is not available for all borrowers.

b/ Statistics on the previous location of buyers are based on a smaller sample than are the other statistics. The NJ MFA has data on the previous location of only 728 of the buyers.

VETERANS' HOUSING

California, Wisconsin, and Oregon sell large volumes of tax-exempt bonds to finance homes for veterans. From May 1975 to June 1978, Wisconsin sold a total of $730 million in tax-exempt bonds to finance primary home mortgage loans for veterans.[23] In fiscal year 1977 alone, Oregon made $630 million in home and farm loans to veterans.[24] As of February 1979, the Oregon Department of Veterans' Affairs had over $3 billion of debt outstanding, all of which had been issued to finance homes or farms for veterans.[25] In 1979, California will issue about $375 million in bonds for home mortgages for veterans.[26]

The veterans' programs differ from the state agency single-family housing programs in several significant respects. All three states finance their veterans' programs with general obligation bonds, which are backed by the state's full faith and credit. The state agency bonds, on the other hand, are revenue bonds which are not guaranteed by the states.

The agencies administering the California and Oregon veterans' programs evaluate loan applications and service loan payments, unlike the state housing agencies which generally delegate these functions to private lending institutions. The Wisconsin program does rely on private lenders for most of its loan processing.

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23. "State Veterans Programs," The Wisconsin Taxpayer, vol. 46 (July 1978), p. 4.

24. Department of Veterans' Affairs, State of Oregon, Annual Report 1977, p. 9.

25. Ibid, p. 25.

26. Telephone conversation with Willard Smith, Manager of the CAL-VET program, March 5, 1979.

In general, state housing authorities place limits on the incomes of loan recipients. To be eligible for a veterans' loan in Wisconsin, a veteran and his spouse cannot have a combined income greater than $22,000, and the value of the property must be less than $55,000.[27] There are no income limits for veterans in California and Oregon, but there are single-family home mortgage limits of $43,000 and $42,500, respectively.[28]

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27. The Wisconsin Taxpayer, p. 3.

28. State of California, Department of Veterans' Affairs, CAL-VET Farm and Home Loans for California Military Veterans (March 1979); and State of Oregon, Department of Veterans' Affairs, Oregon Veterans Farm and Home Loans (January 1979).

CHAPTER III. POTENTIAL EXTENT AND EFFECTS OF LOCAL MORTGAGE BOND PROGRAMS

POTENTIAL EXTENT

The local single-family housing bond was a relatively novel concept in 1978, and localities in only seven states issued them.[1] Even so, a total of about $550 million of locally sponsored single-family mortgage bonds was marketed in 1978. In the first three months of 1979, another $1 billion in local bonds was issued, and more issues are being marketed every week (see Table 1).

CBO estimates that localities will issue a total of about $4 billion in single-family housing bonds in 1979. By 1984, the total annual volume of new single-family bond issues (both state and local) could reach a level of between $20 and $35 billion if no federal restrictions are imposed. There are a great many uncertainties involved in making these projections of future activity, however. The 1984 estimate in particular should be viewed as mainly an educated guess. Some of the factors that were taken into account in making these estimates are set out in more detail below.

Projections for 1979

In the first three months of 1979, 32 localities issued a total of about $ 1 billion in single-family housing bonds. Assuming that the same level of activity per month will continue for the rest of the year, about $4 billion of local single-family

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1. Arkansas, California, Colorado, Illinois, Maryland, Minnesota, and West Virginia.

housing bonds will be marketed in 1979.[2] Scores of additional localities around thecountry are now making final plans to issue similar bonds. Individual local issues are rarely less than $15 million, and the largest cities typically market issues of $75 to $100 million.

In the short term, the volume of new issues will be limited by the fact that many states do not permit localities to issue bonds of this kind. Localities in only about a dozen states have clear authority to issue residential mortgage revenue bonds (see Table 7).[3] In some states, it may be possible to interpret the existing statutes in a way that would grant localities this authority, even though the original intent of the legislature might not have been to authorize such activity. Judicial review will likely be needed to resolve these ambiguities. In many other states, localities are clearly prohibited from issuing single-family housing bonds. New enabling legislation will be on the agendas of many state legislatures in 1979, however, so the outlook is continually changing.

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2. This estimate may be conservative if projections made by the California Savings and Loan League prove to be correct. The League predicts that over $1 billion of single-family housing bonds will be issued in 1979 by California localities alone. (California Savings and Loan League, "Tax-Exempt Mortgage-Secured Bonds" (1979, processed), p. 10.

3. Bond counsel are now researching the law in many states to determine what can and cannot be done under applicable state laws and constitutions. While the results of this research are generally proprietary and not publicly available, Table 7 summarizes the results of the analysis done by one law firm.

TABLE 7. STATES WITH ACTIVE LOCAL SINGLE-FAMILY BOND FINANCINGS: BOND ISSUERS, LEGAL AUTHORITIES, AND LIMITS

State	Issuer	Authority	Limits
Arkansas	Facilities Board	Facilities Board Act	Public purpose
California	Redevelopment Agency	Senate Bill 99	New construction only
Colorado	City or county	Economic Development Revenue Bond Law	Only owner-occupied homes, low- and moderate-income
Illinois	Home rule entity	Home rule powers	Public purpose
Kansas	Home rule city	Home rule powers	Public purpose
Kentucky	County	Kentucky Revised Statute Sec. 67. 803	New construction or rehabilitation
Louisiana	Public trusts	Public trust act	Public purpose
Maryland	Few cities and counties	Special or local laws	Public purpose
Minnesota	Few cities	Special laws	Low- and moderate-income
New Mexico	City	Home rule powers	Public purpose
West Virginia	City or county	Industrial Development Act	Public purpose

SOURCE: John J. Wagner, "Structuring Successful Local Mortgage Revenue Bond Issues," in reference materials for the Housing and Development Reporter of the Bureau of National Affairs Conference, Tax-Exempt Mortgage Bonds for Single-Family Housing (March 22-23, 1979) p. II-4.

Even in states in which clear authority exists, it is still not certain how extensive activity will be in 1979. Activity in these states may be light because local officials are just learning about a new concept, or it may be heavy because localities may move quickly to implement programs before they are restricted by the Congress or by their state legislatures.

Projections for 1984

CBO estimates that from $20 to $35 billion in new single-family mortgage bonds could be issued in 1984.[4] This fairly wide range reflects the considerable uncertainties involved in predicting mortgage bond volume that far into the future.

In general, the future volume of single-family housing bonds will depend on a number of different factors:

- The size of the spread between the interest rate at which the locality can borrow and the conventional mortgage interest rate;

- The demand for housing and the supply of loan funds offered by private lenders;

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4. This estimate includes single-family mortgage bond issues by both state agencies and localities. The reason for including both state and local programs in this longer-term estimate is that the programs are likely to be competing for much of the same market in many states and are likely to respond in the same way to the various economic, market, and demographic forces that will determine future volume. It is, therefore, difficult to separate the two types of programs in any meaningful way when making longer-term volume estimates.

- o The number of states in which state usury laws effectively prohibit mortgage lending at what would be market rates for conventional mortgages;

- o The extent to which rising interest rates cause individuals to take their money out of savings accounts, drying up a major source of conventional mortgage financing;

- o The effectiveness of state housing finance agencies in meeting single-family housing demands; and

- o The level of federal housing subsidies.

Detailed Explanation of Volume Estimates

While the CBO estimate of 1984 volume does not attempt to take each of the above factors into account in a precise and systematic way, the estimate does embody assumptions about the most important ones.

Potential Share of Mortgage Market. By 1984, most states will probably have passed legislation authorizing their localities to issue single-family housing bonds, just as in the early 1970s they passed statutes permitting localities to issue pollution control bonds.[5]

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5. Although the Congress granted explicit authority for pollution control bonds in 1968, none was issued in 1969 or 1970. In 1971, they were issued by localities in just eight states, but by 1974 they had been issued in 43 states. The passage of enabling legislation in the various states may not have followed this pattern exactly, but it can be reasonably assumed that the first issuance of pollution control bonds followed closely after statutory authority was granted in each state.

Most of the local single-family housing bond issues have been large enough to finance between 20 and 30 percent of the single-family mortgages made annually in the localities, although there have been wide variations in those percentages, from around 10 percent in Chicago and around 50 percent in Wilmington, Delaware, to almost 80 percent in Jefferson County (Pine Bluff), Arkansas.[6] Because rating agencies generally frown on issues estimated to fund 40 percent or more of local residential mortgage originations, there is some incentive to limit the size of issues.

Gross new mortgages made on single-family homes in the United States totalled around $176 billion in 1978.[7] Assuming 10 percent annual growth in total gross mortgage lending, $20 to $35 billion of tax-exempt, single-family housing bonds would finance about 10 percent of all mortgages made in 1984. Given the experience in the communities that have already sponsored mortgage revenue bond programs and assuming that nearly all states will have passed enabling legislation by then, the $20 to $35 billion estimate for 1984 is probably conservative.[8]

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6. The $40.7 million in bonds issued by Jefferson County in 1978 represents almost the entire amount of previous annual new single-family lending in the county. Lending in 1977, without the bonds, was $41.3 million. (Reported in the Official Statement of Jefferson County, December 1, 1978.)

7. U.S. Department of Housing and Urban Development, Assistant Secretary for Housing-Federal Housing Commissioner, Office of Financial Management.

8. In Oregon, where the state has been selling bonds to finance homes for veterans since 1945, about 25 percent of all single-family homes are

Displacement of Other Sources of Mortgage Money. To a large extent, the funds raised through the sale of tax-exempt mortgage bonds will simply replace money that would otherwise have flowed into the mortgage market from other sources. A study by the Urban Institute, for example, estimates that each $1 billion in tax-exempt mortgage bonds would add only about $200 million in new money to the mortgage market.[9] The other $800 million would simply replace mortgage money that would otherwise have been provided through the sale of mortgage-backed securities or from the deposits of savers in lending institutions. This replacement effect occurs because tax-exempt mortgage bonds are likely to compete with both mortgage-backed securities and savings accounts for investor and depositor funds, especially when tax-exempt interest rates approach the rates paid on these taxable investments.

As structured to date, state and local mortgage bond programs have relied heavily on the willingness of private lending institutions to participate as processors of loan applications and servicers of monthly mortgage payments. Since private lenders do not hold the mortgages in their own portfolios, they receive no return from the mortgages themselves and earn only servicing fees. As private lenders begin to realize that the tax-exempt mortgage bond programs are, to some extent, displacing mortgage loans that they could make and receive a direct

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financed by the sale of tax-exempt bonds. (Telephone conversation with Ernest Smith, Administrator of Farm and Home Loans, Oregon Department of Veterans' Affairs, March 5, 1979.)

9. George E. Peterson, John A. Tuccillo, and John C. Weicher, Analysis of Mortgage Revenue Bonds Issued by Local Governments (Washington, D.C.: The Urban Institute, forthcoming, 1979). This research was supported by the Office of Policy Development and Research of the U.S. Department of Housing and Urban Development.

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return on, their enthusiasm for participating in the mortgage bond programs may begin to wane. This could reduce the potential extent of these programs, although, if private lenders want to continue making mortgage loans, they may ultimately have little choice but to participate in the local programs.

Some investment bankers have argued that the current popularity of local mortgage bond programs is attributable to the fact that money is now so tight and interest rates so high that private lenders are either unwilling or unable to meet the current demand for mortgage money. The local mortgage bond programs, it is said, are filling a cyclical gap and will decline in volume and popularity if future interest rates decline and mortgage money from regular sources becomes more available.

In the short term, this view is consistent with the displacement analysis in the Urban Institute study just cited. That study found that, at least during the first few months after new tax-exempt mortgage bonds are issued and the proceeds lent out, most of the bond funds do in fact represent a net addition to new mortgage lending. It is only after about 18 months that the full displacement effect begins to show up.

Even if local mortgage bond programs are currently filling a cyclical gap, however, they might not be very efficient over the long term in providing countercyclical injections of funds into the mortgage market. Because taxable and tax-exempt interest rates tend to be closest during times of high interest rates and tight money,[10] the tax-exempt bond subsidy mechanism is least efficient when, under the countercyclical theory, it is needed most.

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10. For more details on this, see George E. Peterson, Tax- Exempt Financing of Housing Investment (Washington, D.C.: The Urban Institute, forthcoming [1979]), Chapter 4.

Capacity of the Tax-Exempt Bond Market. There is some question whether the tax-exempt bond market can absorb new issues of $20 to $35 billion of single-family mortgage bonds in 1984 without driving interest rates on housing bonds to such high levels that their advantage over conventional mortgage interest rates would be largely eroded. To operate the programs, localities must be able to charge an interest rate on the mortgages large enough to pay the interest rate on the bonds and to cover the program's administrative costs. As discussed later in the chapter, the increased supply of housing bonds would drive up interest rates on all tax-exempt revenue bonds and could drive up the rates on housing bonds even more. The programs would have to be discontinued if bond interest rates reached levels close to mortgage interest rates. It is impossible, however, to make a precise estimate of what volume of single-family housing bonds would cause this to happen. Econometric estimates of interest rate effects are not accurate enough to be used for such large-scale changes.

Since only $39 billion in new non-housing tax-exempt bonds was issued in 1978, however, compared to $175 billion in new mortgage originations, it is clear that a large share of new mortgages could not be financed in the tax-exempt bond market without swamping that market. Table 8 shows the relationship between the sizes of these two markets over the last 10 years. As indicated there, new mortgage originations have always been much larger than the entire tax-exempt bond market. Even if the non-housing portion of the tax-exempt bond market reached a level of $40 to $50 billion in new issues by 1984, it is unlikely that it could absorb $35 billion or more in housing bonds without serious dislocations.

TABLE 8. HOME MORTGAGE LOANS AND TAX-EXEMPT BOND SALES, ANNUAL VOLUMES, CALENDAR YEARS 1970-1978: IN BILLIONS OF DOLLARS

Calendar Year	Total Originations of Mortgage Loans on One - Four Family Homes a/	Total Sales of Long-Term State and Local Tax-Exempt Bonds b/
1970	35.6	17.8
1971	57.8	24.4
1972	76.1	22.9
1973	79.5	23.0
1974	68.5	22.8
1975	78.6	29.3
1976	110.1	33.8
1977	156.6	45.1
1978	176.1	46.2

a/ U.S. Department of Housing and Urban Development, Assistant Secretary for Housing-Federal Housing Commissioner, Office of Financial Management.

b/ The Daily Bond Buyer (March 8, 1979), p. 14.

Relationship of Volume Projections to Estimates of Effects

The answers to each of the questions that are addressed later in this chapter hinge on the annual volume of local mortgage revenue bonds. If the annual volume is very small, the local programs would not have much of an effect. If the volume is very large, on the other hand, the repercussions would be felt strongly both in lost revenues and in the tax-exempt bond and mortgage markets.

Since the CBO projections of future volume are tentative, the discussion of the impact of the local mortgage assistance programs that follows will be in terms of effect per billion dollars of new issues.

POTENTIAL COST IN FEDERAL REVENUE LOSSES

The Treasury Department estimates that state and local single-family housing bonds will cost about $250 million in lost federal revenues in fiscal year 1979.

In the future, CBO estimates that each $1 billion of new state or local single-family housing bonds would cost about $22.5 million per year in lost revenues over the life of the bonds. Thus, if annual single-family housing bond issues of state housing agencies and localities increase from their 1978 level of about $3 billion to the level of $20 to $35 billion projected for 1984, the revenue loss for 1984 would be somewhere between $1.6 and $2.1 billion.

Assumptions Used for Revenue Loss Estimates

The assumptions on which the estimates of the potential revenue loss is based are discussed below.

Some of the money invested in single-family mortgage bonds is diverted from investments that would otherwise be taxable, resulting in lost federal tax revenue.[11] Calculating the amount of tax payments lost in this manner necessitates making several simplifying assumptions.

The revenue loss depends on the marginal tax rates of the people who invest in the bonds. CBO has assumed that the average marginal tax rate of the investors is 30 percent and that the alternative taxable investments yield 10 percent a year.[12] The initial loss in revenue from each $1 billion of new issues of tax-exempt housing bonds would thus be $30 million annually for the life of the bonds ($1 billion x .10 x .30 = $30 million).

Only about 85 percent of the bond proceeds are invested in home mortgages, however. (The remainder goes into various reserve accounts.) In addition, since the assisted homeowners pay about 2 percentage points less interest on their mortgages than they otherwise would, they have smaller interest payments to deduct from taxable income. Assuming that the average income tax bracket of the homeowners is 30 percent, these effects would offset the tax loss by

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11. Since interest earned on municipal bonds is usually exempt not only from federal taxation but also from taxation in the state of issuance, the single-family housing bonds create losses in state tax revenues as well, in amounts varying with the income tax rates in the various states.

12. In reality, investors rarely move directly from fully taxed to tax-exempt investments. Instead, when a new tax-exempt issue is marketed, a chain reaction is set in motion in which each investor moves down one rung on a ladder of securities, the highest rung being fully taxed and the lowest rung being tax-exempt. The net effect of each investor moving down a rung, however, is equivalent to the effect of one investor moving directly from the top to the bottom.

about $5 million per billion dollars of new issues ($1 billion x .85 x .02 x .30 = $5 million).

Another offset to the tax loss occurs to the extent that investment bankers, providers of mortgage pool insurance, and participating lenders experience increases in taxable income as a result of the programs. Payments for these services are assumed to equal one percent of the mortgage pool, and the marginal tax rate of these institutions is assumed to be 30 percent, so that this offset would be $2.5 million for each billion dollars of new issues ($1 billion x .85 x .01 x .30 = $2.5 million).

The net tax loss per $1 billion of tax-exempt single-family housing bonds would thus be around $22.5 million per year for the life of the bonds.[13] Table 9 shows, for various levels of annual issuance of local mortgage revenue bonds, the yearly addition to the federal tax loss. If annual new issues approached the $20 to $35 billion range, however, the revenue loss estimates shown in the table could be too high, since this heavy volume of new issues could reduce the interest rate spread between earnings on taxable and tax-exempt investments.

These estimates do not attempt to address the secondary effects that mortgage revenue bond programs are likely to have on federal tax receipts. For example, the programs might induce some people to buy more expensive homes than they otherwise could afford, stimulating housing demand and pushing up the price of housing. This, in turn, would be likely to stimulate housing construction. To the extent that the construction increases demand for labor and materials, income tax receipts would rise. The rise would be offset in part, however,

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13. The present value of the tax loss of $1 billion of tax-exempt single-family bonds is $153 million, incorporating the above assumptions and an average bond life of 12 years.

TABLE 9. TREASURY TAX LOSS AS A FUNCTION OF THE ANNUAL VOLUME OF NEW ISSUES OF SINGLE-FAMILY HOUSING BONDS

Annual New Issues of Single-Family Housing Bonds (in Billions of Dollars)	Addition to Annual Treasury Tax Loss (in Millions of Dollars)
5	113
10	225
15	338
20	450
25	563
30	675

SOURCE: Congressional Budget Office.

by increased individual deductions for mortgage interest payments and property taxes. In addition, the increased investment in housing would probably occur largely at the expense of decreased investment in other markets. If the net effect is a substitution from one kind of investment to another, there would be no net secondary effect on tax receipts.

IMPACT ON STATE AND LOCAL BORROWING COSTS

One frequently expressed concern about the expected proliferation of mortgage revenue bonds is that it could seriously impair the ability of localities to finance their more traditional capital expenditures on schools, roads, water and sewage facilities, libraries, hospitals, and police and fire stations. A large increase in the volume of tax-exempt housing bond issues would drive up tax-exempt interest rates both in absolute terms and relative to those on taxable investments.[14] The effect would probably be felt especially strongly

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14. Some investment bankers have argued that there is substantial room in the tax-exempt bond market for additional new issues to be marketed without driving up tax-exempt interest rates. The reason given is that so-called "advance refundings" of tax-exempt bonds, which totaled about $9 billion in 1978, have been cut off because of regulations promulgated by the Treasury Department in September 1978. Advance refundings are expected to total only between $1 billion and $2 billion in 1979 (Telephone conversation with Arthur Kalita, Assistant Director, Public Securities Association, March 12, 1979). Even if local mortgage bond issues simply fill this gap, an increased supply of tax-exempt bonds would still cause rates to be higher than they otherwise would have been. In other words, were total issues of tax-exempt bonds to decline in 1979, tax-exempt interest rates would also decline. Thus, even if new

in the cost of borrowing for multifamily rental projects, which compete most directly with single-family mortgage bonds.

George Peterson of the Urban Institute has estimated that each additional billion dollars of tax-exempt housing revenue bonds adds between 0.04 and 0.07 percentage points to the tax-exempt interest rate.[15] This interest rate effect would probably hold for volumes of new issues up to about $10 billion, but it would not be correct to continue to use it for volumes of up to $20 to $35 billion. The interest rate range was derived by the Urban Institute in original work. It is supported by work based on two other econometric models, which find that issues of $1 billion of new housing bonds would

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issues of $8 billion of single-family mortgage bonds did not cause interest rates to rise visibly, they would still cause them to be higher than they would otherwise have been.

15. George E. Peterson, Tax-Exempt Financing of Housing Investment (Washington, D.C.: The Urban Institute, forthcoming, 1979). An increase in the volume of tax-exempt bond issues should cause tax-exempt interest rates to rise, as bond sellers try to induce investors to absorb the added supply. Peterson claims that this expected effect has not been observed recently because, simultaneous with the increase in supply, there has been a temporary increase in the demand for tax-exempt bonds on the part of casualty and property insurance companies. Because of regulated rate increases, these companies recently found themselves with an unusually large fresh source of investable funds.

increase tax-exempt interest rates generally by between 0.05 and 0.085 percentage points.[16]

The total volume of all long-term tax-exempt bonds issued in 1978 for purposes other than housing was about $39 billion.[17] Peterson's estimates imply that, because of the $7.6 billion of housing bonds that were issued in 1978, state and local government interest payments on new non-housing issues alone will be between $119 million and $207 million higher per year than they otherwise would have been.

Impact on Multifamily Housing Bond Interest Rates

There is some evidence that investors consider housing revenue bonds to be somewhat different from other tax-exempt bonds.[18] Interest rates on housing

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16. Peter Fortune, "The Impact of Taxable Municipal Bonds: Policy Simulations with a Large Econometric Model," National Tax Journal (March 1973); and Patric H. Hendershott and Timothy W. Koch, An Empirical Analysis of the Market for Tax-Exempt Securities: Estimates and Forecasts (New York: New York University Graduate School of Business Administration, 1977).

17. The total volume of long-term tax-exempt bonds issued in 1978 was $46 billion (Daily Bond Buyer, January 2, 1979), of which $7.6 billion was either general obligation or revenue bonds for housing. (Urban Institute compilation based on their survey of housing finance agencies; Moody's Muncipal and Government News Reports; bond prospectuses; and the Weekly Bond Buyer.)

18. Peterson, Tax-Exempt Financing of Housing Investment. This view is supported by a comment made by a market analyst at John Nuveen and Company: "Today, the prices of most high-grade and revenue obligations are trading in concert

bonds have consistently been higher than interest rates on other tax-exempt bonds, reflecting the perception that housing bonds are riskier than bonds backed by the full faith and credit of the issuer. Peterson predicts that at today's interest rates and levels of bond issuance, an additional $1 billion of housing bonds would increase the spread between the interest rates on housing and other tax-exempt bonds by .07 percentage points. An additional $1 billion of local mortgage revenue bonds would thus add a total of about 0.12 percentage points to the cost of borrowing for other housing projects.[19] Thus; the expected growth of local housing bonds may significantly raise the costs of borrowing, both for traditional municipal functions and for low- and

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with one another, but the large market for mortgage-backed issues is in a world of its own." (John Nuveen and Company, Inc., Municipal Market Comments, March 9, 1979.)

19. The total effect on housing bond interest rates for each $1 billion in new mortgage bond issues (between 0.11 and 0.14 percentage points) is the sum of the effect on tax-exempt bond rates in general (0.04 to 0.07 percentage points for $1 billion of new issues) and the differential effect on housing bonds (0.07 percentage points for $1 billion of new issues). Again, however, predictive techniques are not, at present, refined enough to make interest rate projections for new housing bond issues in annual volumes as large as $20 to $35 billion.

moderate-income multifamily rental housing projects.[20]

EFFECT ON CONVENTIONAL MORTGAGE FINANCING[21]

Depending on how popular a mortgage financing technique the local bond programs become, they could have varying repercussions for traditional mortgage financing. The larger their share of mortgage origination, the more pronounced the following effects:

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20. The financial community is already noting upward pressure on interest rates for single-family housing issues, as indicated by the following excerpt from John Nuveen and Company's Municipal Market Comments of March 9, 1979: "The recent flood of local mortgage agency borrowing is beginning to create serious indigestion in the market place. Underwriters of these securities are experiencing investor resistance, because of the seemingly endless supply of available bonds. With one offering coming on the heels of the next, yields are becoming more and more generous."

    A municipal research analyst for Dean Witter Reynolds, Inc. noted: "Yet never in recent times has the municipal market been faced with such potential volume. . . . It is extremely difficult to calculate the market's ability to accommodate such 'growing pains.'" (Dean Witter Reynolds, Inc., Tax-Exempt Single-Family Mortgage Bonds Issued by Local Governments, (1979) p.6.)

21. For a good discussion of the market responses evoked by mortgage bond programs, see Kenneth Thygerson, Carroll Melton, and Thomas Parliment, "Considerations Relative to the Issuance of Industrial Development Revenue Bonds for

- Increased housing prices;

- Decreased conventional mortgage interest rates;

- New housing construction in areas with room to expand;

- Increased condominium conversion; and

- Change in the structure of the savings and loan industry.

Housing Market Demand and Supply Responses

Many of the people who obtain low interest rate mortgages through the local mortgage bond programs would have bought homes and financed them conventionally had the programs not existed. In this respect, the programs tend to displace private mortgage financing. However, some people are induced by the favorable mortgage terms either to buy more expensive homes than they had otherwise intended or to buy homes instead of renting.

Since the mortgage assistance programs stimulate the demand for single-family housing, they push up the price of housing in the sponsoring cities or counties. Developers respond to the higher house prices by building more homes and by converting apartment buildings to condominiums. Other things being equal, the increased supply of houses and condominiums should, in turn, exert some downward pressure on property values, although prices would probably never fall back to the level they were before the programs were initiated.

Mortgage Lendings," U.S. League of Savings Associations, Economic Working Paper #21 (1978), pp. 48-54.

Effects on Private Lenders

In addition to causing housing prices to rise in the cities or counties conducting the programs, the mortgage bond programs diminish household demand for private mortgage funds and may induce local lenders to attract customers by offering conventional mortgages at lower interest rates. Savings and loan institutions may have less money to lend, though, as higher rates on tax-exempt bonds cause investors to take their money out of savings and certificate accounts and use it to purchase tax-exempt bonds.

When investing in mortgages becomes less profitable because of lower interest rates, lenders will channel their funds to investments that are relatively more profitable, to the extent that they can. The lenders who suffer most will be those least able to shift their investments to mortgages in localities in which higher interest rates prevail or to different types of lending, such as commercial or auto loans. While all lenders in areas in which tax-exempt housing bond financing is used will experience these effects to some extent, the net impact will be greatest on those institutions that do not take part in the tax-exempt programs and thus do not receive any compensating benefits.

Which lenders are likely to be invited to participate in the local programs? The rating policy for bonds encourages localities to choose to work with the largest, most experienced local lending institutions. The ratings on the bonds depend on the "weakest link in the chain."[22] In other words, a bond rating reflects the reputations of all of the participating lenders, and the rating may suffer if there is even one institution that is inexperienced or crippled by a high default record. Moreover, the

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22. Standard & Poor's Corporation, Standard & Poor's Municipal and International Bond Ratings: An Overview, (1978) p. 47.

complexity of the local officials' supervisory and adminstrative role grows with the number of participating lenders.[23]

If the criteria of the rating agencies and the administrative complications of multilender arrangements were the only factors that local officials considered, the localities would almost certainly work exclusively with the one or two largest lenders in the area. To engender widespread community support for the mortgage assistance programs and in an attempt to be fair, however, most of the localities have included several lenders in their programs. In multiple lender, or consortium, arrangements, potential discrimination among lenders shifts from the lender selection stage to the allocation of bond funds among lenders.

If local mortgage assistance programs grow to comprise a large portion of mortgage financing, they could alter the structure of the industry centered around mortgage finance. The role performed by savings and loan institutions in these local mortgage assistance programs is essentially the work traditionally performed by mortgage bankers: the origination of mortgages for sale to another party. Instead of originating mortgages to be held in their own portfolios, savings and loan associations in these programs originate loans for others. With substantial bond program growth, savings and loan institutions could become less independent, with the city or other representatives of the bondholders in effect telling them when to make loans, to whom, in what neighborhoods, and so forth. To a certain extent, the local governments would replace the

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23. In multilender situations, localities usually hire an administrator (usually a commercial bank) to oversee the arrangements. The administrator receives a fee, so mortgage interest rates have to be a little higher to cover the administrative cost of the multilender arrangement.

traditional lenders as portfolio managers and as the group specifying the eligibility requirements for homeownership. Private lenders generally base their considerations on purely economic grounds and lend to the most credit-worthy applicants. Local governments, however, may have broader social or economic development goals that could lead them to require that other criteria be applied in evaluating mortgage applications. While the bond market will ultimately judge the financial soundness of those criteria, local governments are not likely to use as fiscally sound methods in making mortgages as the private market would. On the other hand, governments can use this opportunity to help groups that they consider deserving.

EFFECT ON DISTRIBUTION OF FEDERAL TAX BURDENS

Any increase in tax-exempt borrowing, such as that resulting from local single-family mortgage revenue bonds, tends to make the federal tax structure less progressive. The purchasers of tax-exempt bonds, for reasons explained below, are in relatively high marginal tax brackets. Through investing in an added supply of tax-exempt bonds, these high--bracket purchasers pay smaller percentages of their incomes in taxes than they otherwise would. Since the taxes of lower-income people are not affected by the volume of tax-exempt bonds, the net effect of the new issues is a less progressive federal income tax.

Since the interest rates on tax-exempt bonds are generally only about two-thirds as high as those on taxable bonds, the tax saving has to be fairly substantial before tax-exempt bonds become a reasonable investment. For that reason, tax-exempt bonds are attractive only for people in relatively high marginal tax brackets--in recent years, for those in the 30 percent bracket and over. (For a family of four filing a joint return, the 32 percent marginal tax bracket is reached with a total annual income of about $36,000.) The importance of a high marginal tax rate can be seen in the following example.

Suppose two options are open to investors: buying taxable bonds yielding 10 percent annually or buying tax-exempt bonds yielding 7 percent annually. Investors compare the bond yields and choose the bond that gives them the greater after-tax return. The tax-exempt bond would give all investors 7 percent interest after taxes. The taxable bond, however, would earn different amounts for investors in different marginal tax brackets. With a taxable bond paying 10 percent interest, for example, the after-tax return would be 8 percent for someone in a 20 percent marginal tax bracket and only 4 percent for someone in a 60 percent bracket. (See Table 10.) In this particular example, investors in marginal tax brackets above 30 percent find the tax-exempt bond the better investment, while those in marginal tax brackets below 30 percent would buy the taxable bonds.

As more tax-exempt bonds are brought to market, their issuers will have to offer higher interest rates to induce additional individuals to invest in them. The marginal tax brackets of the most recent investors will decline as the supply of tax-exempt bonds at higher interest rates increases. High-bracket investors, who had found tax-exempt bonds a profitable investment at an interest rate of 7 percent, can thus obtain additional tax savings when the tax-exempt interest rate rises above 7 percent as a result of the increased volume of tax-exempt bonds.[24]

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24. Those investors who already hold tax-exempt bonds will experience a reduction in the value of their bonds when interest rates go up, since increases in interest rates on new issues always push down the potential selling price and thus the value of outstanding bonds. This will have no effect on an investor's decision to purchase new tax-exempt bonds, however,

TABLE 10. EFFECT OF INVESTOR'S MARGINAL TAX RATE ON EFFECTIVE BOND YIELDS: IN PERCENTS

	After-Tax Return	
Investor's Marginal Tax Rate	10% Taxable Bond	7% Tax-Exempt Bond
10	9	7
20	8	7
30	7	7
40	6	7
50	5	7
60	4	7
70	3	7

SOURCE: Congressional Budget Office.

DISTRIBUTION OF THE MORTGAGE SUBSIDY

Mortgage revenue bonds pose several distributional questions apart from their effects on federal tax burdens:

- How will the localities decide to apportion the available mortgage money among the applicants?

- How will the local officials apportion the bond proceeds among the participating lenders?

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since the extra savings from the higher tax-exempt interest rates will occur irrespective of any changes in the value of the investor's existing portfolio of tax-exempt bonds.

- o Who shares the mortgage subsidy in addition to the assisted home buyers?

Allocation of Subsidy Among Mortgage Applicants

At the favorable interest rates accompanying the subsidized mortgages, lending institutions are likely to receive more mortgage loan applications than they can fund.[25] In the programs enacted to date, the lending institutions have reviewed applications on a first-come, first-served basis.[26] Although that solution may be the fairest way to deal with the rationing problem, it poses a difficult question of its own. The first-come, first-served approach rewards the most well-informed of the city's residents.[27] The first Chicago program was criticized because several developers of large condominium-conversion projects (who found it in their interest to keep well informed of the city's plans) spread the word about the program to their customers. Because they were among the first applicants, many people buying the condominiums received subsidized loans.

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25. With income ceilings set at rates of about $30,000 in most localities (see Table 1), about 90 percent of families across the country should be eligible for the low-interest-rate mortgages (see page 10).

26. In isolated cases, applications from low-income people are approved first, and applications from higher-income people are approved only if funds permit.

27. Kenneth Thygerson, Carroll Melton, and Thomas Parliment, Considerations Relative to the Issuance of Industrial Development Revenue Bonds for Mortgage Lending, U.S. League of Savings Associations (1978), p. 72.

Allocation of Funds Among Lenders

It is unlikely that the funds raised by bond sales will be adequate to accommodate all the local lending institutions desiring to administer the programs. The localities will have to work out rationing schemes to deal with this situation. They have already begun to use more than one lender to select home buyers and administer the mortgages, and it is probable that this trend will continue. When more than one lender is involved, some local authority has to accept commitments from the lenders for the amount of mortgage money they can administer and then trim requests so that the sum of the commitments equals the pool of mortgage money expected from the bond sale. It may be very difficult to divide the total in a manner considered equitable by all involved. In addition, as discussed earlier, there is some evidence that the majority of participating lenders may be larger lending institutions, so the programs may discriminate against smaller lenders.

Division of the Subsidy

The subsidy provided by the local mortgage assistance programs benefits several groups. The recipients of the subsidized mortgages are the most visible beneficiaries. The home sellers and, in fact, all property owners in the localities sponsoring the programs would benefit to the extent that the programs increase the demand for housing and thereby push up housing prices in the area. By the same token, people purchasing houses without the advantage of the interest subsidy might suffer by having to pay higher prices for their homes than they otherwise would.[28] The subsidized buyers would pay higher prices, too, but for them the higher

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28. This effect would be offset in whole or in part if unsubsidized mortgage interest rates fell as a result of the programs.

prices would usually be more than offset by the lower interest rates.

As described earlier, the mortgage bond programs would encourage new investment in housing, at least in part at the expense of non-housing investment. This reallocation of resources would benefit suppliers of building materials, developers, and builders and would correspondingly hurt other members of the private sector.

In some instances, localities have sold mortgage revenue bonds to finance mortgages exclusively in one or two new housing developments. Although the intentions of the sponsoring localities might be beyond question, the developer might, without very careful supervision, use the opportunity simply to charge higher prices on the homes than he otherwise would have been able to, and thus capture most of the subsidy himself.

Some of the cities sponsoring the mortgage assistance programs state that their purpose in doing so is to attract new residents and/or to increase their tax bases. The first municipality in a metropolitan area to implement a mortgage assistance program might find that the program serves to attract new residents, subsequently increasing the tax base and perhaps revitalizing its older neighborhoods and attracting new industry. However, the natural reaction of surrounding communities to sponsor their own housing programs would clearly counter those effects in the same way that local competition has eroded many of the locational incentives created by industrial development bond financing of industrial plants.[29]

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29. The first states that authorized the issuance of industrial development bonds did find that they attracted new industry, but when other states began to feel the effects, they quickly passed their own authorizing legislation. At

To the extent that the mortgage bond programs push up housing prices, local property tax bases would also be pushed up. This could mean that local property tax receipts would rise, that tax rates would be lowered, or both. Taxpayer resistance, however, might well prohibit local governments from obtaining any substantial increase in property tax receipts.

As stated earlier, the mortgage programs may accelerate or encourage the conversion of apartment buildings to condominiums.[30] That effect poses a potential distributional issue, since those who are displaced may find their lives disrupted as they attempt to relocate.

Anyone whose business involves any aspect of the marketing of tax-exempt bonds stands to gain from their increase. This group includes investment bankers, bond counsel, financial consultants, and bond rating agencies. Suppliers of mortgage pool insurance, the banks chosen as custodians and trustees, and the participating lending institutions will all share a portion of the subsidy.

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that point, many localities were issuing the bonds simply to retain local industry.

30. The most recent Minneapolis program explicitly encourages condominium conversions: "One of the purposes of the MHRA [Minneapolis Housing and Redevelopment Authority] Housing Ownership Program IV is to encourage the conversion of rental units to owner-occupied units." (Minneapolis Housing and Redevelopment Authority Housing Ownership Program IV, Procedureal Guides, December 1, 1978, p. 6).

CHAPTER IV. FEDERAL SUBSIDIES FOR SINGLE-FAMILY HOUSING

The federal government conducts several programs that subsidize single-family homeownership.[1] This chapter briefly describes the major programs, including their costs and beneficiaries. This information should be useful in evaluating the mortgage revenue bond subsidy programs and in determining whether there are areas of duplication and overlap. In addition, if the Congress should decide to restrict or eliminate the mortgage bond programs, it may wish to consider expanding one or more of the existing subsidy programs at the same time.

The homeownership subsidy programs that will be described in this chapter include:

- GNMA Tandem Plan,
- HUD Section 312 Rehabilitation Loan Program,
- HUD Section 235 Homeownership Program,
- FmHA Section 502 Rural Homeownership Program,
- Deductibility of home mortgage interest and property taxes from federal income tax, and
- Special capital gains treatment of housing.

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1. For a detailed discussion of federal homeownership programs, see Congressional Budget Office, Federal Housing Policy: Current Programs and Recurring Issues, Background Paper (June 1978); and Homeownership: The Changing Relationship of Costs and Incomes, and Possible Federal Roles, Budget Issue Paper (January 1977).

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GNMA TANDEM PLAN

The Government National Mortgage Association (GNMA) is a corporation within the Department of Housing and Urban Development (HUD) that purchases Federal Housing Administration (FHA), Veterans Administration (VA), and conventional mortgages under a variety of programs. Under its so-called "tandem plan," GNMA provides an interest subsidy that permits lenders to offer mortgages at a below-market interest rate of 7.5 percent. GNMA purchases these low-interest mortgages from lenders at the market interest rate, absorbing as a subsidy the difference between 7.5 percent and the market rate.

Although GNMA has authority to purchase both single-family and multifamily mortgages, new commitments recently have been concentrated almost entirely on multifamily mortgages. Under the Emergency Home Purchase Act of 1974 and the Emergency Housing Act of 1975, GNMA was authorized to purchase conventional as well as FHA and VA single-family mortgages if the Secretary of HUD determined that:

> inflationary conditions and related governmental actions or other economic conditions are having a severely disproportionate effect on the housing industry and the resulting reduction in the volume of home construction or acquisition threatens seriously to affect the economy and to delay the orderly achievement of the national housing goal. . . .[2]

Over $12 billion in budget authority was provided for single-family mortgages under this program between 1974 and 1977. While no new commitments are currently being made, standby authority to resume the program

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2. Section 313 of the National Housing Act, as amended by the Emergency Home Purchase Act of 1974 (P.L. 93-449) and the Emergency Housing Act of 1975 (P.L. 94-50).

will be in effect until October 1, 1979, and the Administration is seeking legislation to extend this standby authority for another year.[3]

There are no income limits for borrowers under this emergency single-family program, although the maximum mortgage amount (with some exceptions) is $42,000 per unit. The primary purpose of the program is to stabilize housing production and to smooth out cyclical fluctuations in the secondary mortgage markets, rather than to make housing available to families who could not otherwise afford it.

HUD SECTION 312 REHABILITATION LOAN PROGRAM

HUD finances rehabilitation loans under its Section 312 program for improvements to residential and commercial structures located in designated economically depressed areas. The loans for improvements on residential property may not exceed $27,000 per unit, and those for improvements to nonresidential property may not exceed $50,000. There is no limit on the income of the property-owner, but legislation enacted in 1978 authorized HUD to establish a sliding interest rate scale, so that middle- and upper-income individuals will be charged interest rates greater than the 3 percent charged to lower-income individuals.

Relative to other federal homeownership programs, Section 312 has a small appropriation. Its outlays are expected to be $91 million in fiscal year 1979 and $125 million in fiscal year 1980. In 1980, it is estimated that the program will finance rehabilitation loans for 12,800 single-family homes.[4]

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3. U.S. Department of Housing and Urban Development, Summary of the HUD Budget, Fiscal Year 1980 (January 1979), pp. GNMA 3-4.

4. The Budget of the United States Government, Fiscal Year 1980, Appendix, p. 525.

HUD SECTION 235 HOMEOWNERSHIP PROGRAM

Through the Section 235 Homeownership Program, HUD assists low- to moderate-income people in purchasing newly constructed or substantially rehabilitated single-family homes. HUD pays that portion of the family's housing expenses (mortgage payments, property taxes and insurance premiums) that exceeds 20 percent of adjusted gross income. The subsidy could bring the effective mortgage interest rate paid by the homeowner to as low as 4 percent. As it is now structured, the program limits eligibility to families whose incomes fall below 95 percent of area median income (as determined by HUD annually for each Standard Metropolitan Statistical Area [SMSA] and nonurban county).

The maximum allowable mortgage ranges from $32,000 in low-cost areas to $38,000 in high-cost areas, with some additional allowance for family size. The home purchaser must make a cash outlay of at least 3 percent of the purchase price at the time of sale. The subsidy is discontinued when the mortgagor is able to meet his housing costs by spending 20 percent or less of his adjusted gross income.

The program was restructured in 1975, and, because the revised eligibility criteria were relatively strict, only about 18,000 units were completed and eligible for subsidy payments in fiscal years 1977 and 1978.[5] As of December 1977, the average household income of the 3,049 families assisted under the revised Section 235 Program was $11,532. Twenty-three percent of those families were headed by minorities, and 2.1 percent were headed by elderly persons. A

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5. U.S. Department of Housing and Urban Development, Summary of the HUD Budget, Fiscal Year 1980 (January 1979), p. H-17.

little under 9 percent of the assisted families were living outside SMSAs.[6]

FARMERS HOME ADMINISTRATION SECTION 502

The Farmers Home Administration (FmHA) makes direct low interest rate mortgages to low- and moderate-income families buying homes in rural areas. Under its Section 502 program, FmHA lends money directly at an 8.75 percent interest rate to families with adjusted annual incomes below $15,600 ($18,500 in Hawaii and $23,000 in Alaska). If the families have low incomes (generally $10,000; $12,200 in Hawaii and $15,600 in Alaska), they are eligible to receive an additional subsidy that could reduce their mortgage interest rate to as little as 1 percent.

The loans can be made for rehabilitation, construction, or the purchase of existing homes. FmHA restricts the size of the home but not its mortgage amount or purchase price.

In fiscal year 1977, the recipients of Section 502 loans had an average annual income of $9,890.[7] The program has been marred by a high rate of delinquency in mortgage payments. The program receives appropriations to cover defaults and interest subsidies.

FmHA's budget does not register a cost for those loans that it makes at the same interest rate at which it borrows, even though that rate is below market interest rates. For those mortgages that it makes at

6. "Housing and Community Development Program Activity Report," prepared by the Staff of the Human Resources and Community Development Division, Congressional Budget Office (March 23, 1978), Table 6E.

7. Smith, Milgram, Eprile, Agelasto, and Schussheim, "Descriptions and Evaluations of Selected Housing Subsidy Programs," Congressional Research Service 78-77S (March 28, 1978), p. 33.

interest rates below its borrowing rate, it records an interest-subsidy outlay.

For fiscal year 1980, FmHA expects that new obligations (the amount of new loans granted) under its Section 502 program will be just over $2 billion, enough to support 64,500 units.[8]

Beginning in 1979, if approved by the Appropriations Committees, FmHA plans to conduct a rural homeownership assistance program similar to HUD's Section 235 homeownership program. FmHA's plans are to subsidize certain Section 502 low-income homeowners so that they do not pay more than 25 percent of their adjusted incomes for housing expenses, including mortgage payments, property taxes, insurance, utilities, and maintenance expenses. The housing expenses in excess of 25 percent of adjusted income would be paid by the government. FmHA estimates that the new homeownership assistance program would assist 15,000 families in fiscal year 1980 and would require new obligations of $985 million to cover estimated current and future-year costs for those families.

TAX DEDUCTIBILITY OF MORTGAGE INTEREST AND PROPERTY TAXES

In fiscal year 1980, the federal government will forego revenues of $14.6 billion as a result of federal income tax provisions enabling homeowners to take itemized deductions for mortgage interest and property taxes paid on their owner-occupied homes.[9] This is by far the single largest federal subsidy for homeownership.

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8. The Budget of the United States Government, Fiscal Year 1980, Appendix, p. 165.

9. Special Analyses, Budget of the United States Government, Fiscal Year 1980, p. 198.

The tax savings from these two homeownership subsidies are heavily concentrated among higher-income taxpayers. Table 11 shows the distribution of these tax subsidies by income group.

SPECIAL CAPITAL GAINS TREATMENT OF HOUSING

The Revenue Act of 1978 allows taxpayers 55 years of age and over to exclude from their income, on a one-time basis, up to $100,000 of the capital gain they receive on the sale of their principal residence. The act repealed a former provision that allowed people over the age of 65 to exclude a smaller amount of the gain on home sales. In addition to the one-time exclusion for those over 55, all taxpayers are allowed to defer payment of taxes on capital gains from their home sales if they purchase new homes of equal or greater value within 18 months of the sale of their former residences. The special over-55 exclusion is estimated to cost $535 million in lost revenue in fiscal year 1980 and $785 million in 1984, while the general deferral provision is estimated to cost $1.0 billion in 1980 and $1.5 billion in 1984.

COMPARISONS OF FEDERAL SUBSIDIES WITH LOCAL HOUSING BONDS

The subsidy provided through the tax-exemption of interest on the local housing bonds will be channeled primarily to middle-income people, although the uniqueness of each of the local programs makes it difficult to generalize. In contrast, the primary beneficiaries of the direct spending programs for housing are mostly lower-income people, and those of the tax subsidies are mostly middle- to upper-income people. The distribution of the benefits of the various direct spending programs and tax subsidies discussed above is shown in Table 12.

In terms of their cost to the federal government, the subsidies provided through the tax system are largest in the aggregate. The costs of the direct

TABLE 11. 1979 HOMEOWNER TAX INCENTIVES a/ (1979 LAW AND 1978 INCOME LEVELS)

Expanded Income (in Thousands of Dollars)	Number of Total Returns (Thousands)	Number of Homeowners b/ (Thousands)	Returns with Itemized Homeowner Deductions a/		Average Homeowner Deductions a/ (in Dollars)	Average Tax Saving from Homeowner Deductions a/ (in Dollars)	Total Tax Saving or Revenue Loss (in Millions of Dollars)
			Number (Thousands)	Percent of Homeowners			
0 to 5	23,197	3,696	166	4.5	536	90	15
5 - 10	19,223	8,567	1,403	16.4	899	142	199
10 - 15	14,195	7,579	2,902	38.3	1,104	203	589
15 - 20	11,577	7,494	3,946	52.6	1,236	265	1,047
20 - 30	12,930		6,927		1,596	414	2,871
30 - 50	5,709		4,349		2,395	851	3,700
50 - 100	1,339	20,568	1,137	61.8	3,551	1,734	1,972
100 - 200	265		232		4,638	2,525	587
200 and Over	65		57		6,877	3,968	227
Total	88,499	47,904	21,120	44.1	1,724	531	11,207

SOURCE: Staff of the Joint Committee on Taxation and the Congressional Budget Office.

NOTE: Details may not add to totals because of rounding.

a/ Deductions for home mortgage interest payments and property taxes.

b/ Bureau of the Census, Annual Housing Survey; 1976, series II-150-76C, pt. C, p. 1 (February 1978), adjusted to 1978 income levels. Homeowner income as measured by the Bureau of the Census is not strictly comparable to the "expanded income" used in the rest of this table, since the Census Bureau uses a somewhat broader definition of income. Since there is probably substantial underreporting of income in the Census Bureau survey, however, these differences may not be too significant. In addition, the Census Bureau data represent a count of "owner-occupied units," which is not exactly comparable to the number of tax returns with homeowner deductions, since some units may have more than one tax return filer. Again, however, the differences are not likely to be too significant.

spending programs, however, are more visible in the budget than those of the tax subsidies. The aggregate cost of the direct spending programs is easier to control in the sense that spending budgets must be approved annually by Congress. Even so, the costs of some of the direct spending programs are obscured because they are financed in complex ways. And even when their costs are readily ascertainable, most federal programs tend to develop staunch supporters at an early stage, so that cutbacks become difficult. The less visible tax subsidies have their strong defenders as well, and their total costs vary in response to taxpayers' actions rather than Congressional decisions. The tax subsidies are effectively entitlement programs: anyone who meets the prescribed eligibility standards is automatically entitled to the subsidy. Congress thus cannot definitively establish budget ceilings for tax subsidies; it can only estimate probable costs.

The federal direct outlay programs have large overhead costs and, in general, entail more red tape and paperwork than the local mortgage bond programs. This results, in part, because federal programs must cover a wide diversity of local circumstances while at the same time maintaining the standardized and formal procedures needed to provide uniformity of treatment. Federal subsidy programs, therefore, are not as flexible and informal as smaller local programs can be.

Federal direct spending programs can have explicit goals and can focus exclusively on one group of beneficiaries (for example, low-income people). The local programs tend to have more varied goals. On the one hand, the local programs have the flexibility to respond to the diverse desires of the various communities. On the other hand, without federal regulation, the local programs provide no assurance that the federal subsidy will be devoted to a broadly-accepted public purpose.

TABLE 12. PERCENTAGE DISTRIBUTION OF FEDERAL HOMEOWNERSHIP SUBSIDY BENEFITS, BY INCOME GROUP

Income Group b/ (in Dollars)	Program a/			
			Rural Housing e/	
	Section 235 c/	FHA Credit d/	Interest Subsidy	Non-Interest Subsidy
0 to 9,999	17	5	92	61
10,000 to 19,999	82	62	8	39
20,000 to 49,999	0.7	33	0	0
50,000 to 99,999	0	0	0	0
100,000 to 199,999	0	0	0	0
200,000 and Over	0	0	0	0
Total i/	100	100	100	100

SOURCE: Department of Housing and Urban Development; Farmers Home Administration, Department of Agriculture; and Department of Treasury.

a/ Distributions are unavailable for Veterans Administration credit programs.

b/ Income distributions for the first five columns are based on slightly differing definitions of income for each spending program, since each administering agency uses its own particular definition of income. Nevertheless, because the definitions vary only slightly, information in these columns does illustrate the relative general distributions of these spending program benefits by income class. In the last three columns, significant differences in the distribution of tax expenditures resulting from the use of expanded income rather than the narrower income definitions used in the first five columns exist for the most part only for individuals with incomes in excess of $50,000. Taxpayers with incomes below $50,000 generally do not have significant amounts of tax preference income.

(Continued)

TABLE 12. (Continued)

GNMA Tandem f/	Section 312 g/	Mortgage Interest Deduction h/	Property Tax Deduction h/	Deferral and Exclusion of Capital Gains i/
Program a/				
1	35	2	2	1
46	47	16	15	16
51	17	63	55	64
2	1	15	19	12
0	0	4	6	5
0	0	1	3	2
100	100	100	100	100

c/ Calendar year 1978.

d/ Section 203, the major FHA home insurance program, calendar year 1977.

e/ Section 502, the major FmHA homeownership program, fiscal year 1978.

f/ Conventional single-family mortgages purchased by GNMA, first half of calendar year 1976. Distribution of FHA and VA mortgages purchased by GNMA would show a greater concentration of benefits in the lower income classes.

g/ Calendar year 1977.

h/ Calendar year 1978 income levels, 1979 law.

i/ Deferral of tax and exclusion of capital gains on sale of personal residences, 1979 law and 1978 income levels.

j/ Components may not add to 100 percent because of rounding.

CHAPTER V. OPTIONS FOR CONGRESSIONAL CONSIDERATION

The Congress has several options for handling the issue of tax-exempt mortgage bonds. One choice is, of course, to take no action. At the other extreme, it could ban all single-family housing bonds. Alternatively, it could limit the bonds in a variety of ways, allowing the interest on the bonds to be tax-exempt only if the bonds finance specified eligible activities. If the Congress does decide to limit the use of housing bonds, it may wish also to expand the scope of other federal subsidies for homeownership.

In considering these options, the Congress faces the important issue of the extent to which local housing bond programs are serving public purposes. Since the programs are being subsidized by the exemption of the bond interest from federal taxation, the programs should serve goals that are in the national interest.

One commonly held view is that the federal government should subsidize only those activities that cannot be handled adequately by the private sector. According to this view, federal housing subsidies may be appropriate for families with moderate incomes but not for higher-income families, who are being adequately served by the private sector.[1] Similarly,

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1. There is some question over the extent to which the private sector can provide housing for moderate-income families. Two studies published last year by the United States League of Savings Associations, for example, indicate that many moderate-income families are, in fact, able to buy homes. In a 1977 survey of 8,500 mortgage borrowers at 200 savings associations throughout the country, the League found that 15 percent of these homebuyers had household incomes under $15,000, 38

federal housing subsidies may be appropriate in geographic areas that the private sector is not serving adequately.

The goals of federal housing policy are quite broad and diverse, however, so that this "public purpose" test may not give clear answers in all cases.[2] In addition, if the Congress decides that local housing bond programs, with or without restrictions, do serve worthwhile purposes, it should, of course, still consider whether they do so efficiently and at the lowest possible cost.

TAKING NO ACTION

As stated above, the Congress could simply take no action to limit single-family housing bonds and allow state and local programs to continue to develop subject only to the provisions of state law.

Such state and local programs, it is argued, are serving a genuine need by providing housing to middle-income families who generally do not benefit from existing federal housing subsidy programs. As shown

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percent had incomes under $20,000, and 60 percent had incomes under $25,000. A follow-up analysis indicated that these families were able to afford homes mainly by buying older, less expensive houses and by devoting more than 25 percent of their incomes to housing. United States League of Savings Associations, Economics Department, Homeownership: Realizing the American Dream (1978), and Homeownership: Affording the Single-Family Home (1978).

2. For a discussion of the various goals of federal housing policy, see Congressional Budget Office, Federal Housing Policy: Current Programs and Recurring Issues, Background Paper (June 1978), Chapter II.

in Table 12 in the preceding chapter, most of the direct federal subsidy programs for homeownership tend primarily to benefit lower-income families. These programs are also quite limited in the number of homebuyers they can assist, because funding levels are set each year by the Congress and are generally not adequate to provide assistance to all families that are nominally eligible. While tax deductions for home mortgage interest and property taxes are available to a wide range of homeowners, recent sharp increases in the standard deduction have diminished the value of this subsidy for many moderate-income homeowners. This point is discussed more fully later in this chapter.

Single-family mortgage bond programs may also be used to attract homebuyers to particular redevelopment areas, thus helping to fulfill state or local redevelopment goals and strengthening local tax bases. As discussed earlier, a number of programs have specifically expressed this goal. Without some explicit statewide guidelines, however, competing programs in nonredevelopment areas could make this goal difficult to achieve.

Although there may be instances of abuse in single-family bond programs--unusually high income or mortgage limits, for example--it has been argued that state legislatures or local governments should be left to correct these abuses and to impose reasonable limits on the programs. Most states have not as yet enacted specific enabling legislation for local single-family mortgage bond programs, and whatever legislation is enacted in the future may contain limits on the type of housing that can be provided. In those states that explicitly do allow local housing bond programs, legislation may be enacted to restrict the programs to more narrowly defined public purposes. In Kansas and Colorado, for example, legislation has been recently introduced that would cut back on the scope of the local housing bond programs now authorized in those states.[3]

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3. Daily Bond Buyer, March 7 and 8, 1979.

One drawback in relying on state action to limit single-family mortgage bond programs is that, while individual states and their citizens may receive substantial benefits from the programs, they do not bear all the costs. The costs, in the form of lost revenues from the federal tax exemption, are borne by all U.S. taxpayers, who ultimately pay higher taxes to cover the cost of the subsidy. The benefits, by contrast, go only to people living in areas where single-family mortgage bond programs are in effect. Individual states thus have less of an incentive to limit these programs than does the federal government, whose taxpayers bear the full cost of the federal subsidy.

PROHIBITING ALL SINGLE-FAMILY HOUSING BONDS

The Congress could simply ban all financing of single-family homes by tax-exempt bonds, including the financing by state housing finance agencies. While it might be argued that some single-family housing bonds are serving a valid public purpose by aiding a segment of the market that the private sector is not adequately serving, it is very difficult to draft a federal statute that would confine single-family bond financing to the desired activities. Any lines that might be drawn legislatively--allowing state agency bonds but not local bonds, allowing bonds for low- and moderate-income families but not higher-income families, allowing bonds only in narrowly defined geographic areas, and so forth--would inevitably be somewhat arbitrary and burdensome to administer. A ban on all single-family bonds would be clear and easy to administer.

Multifamily rental housing bonds could still be permitted, since these bonds are now almost always used to finance projects that receive direct federal subsidies under the Section 8 or other HUD multifamily subsidy programs. It has already been determined that these projects are serving a federally established public purpose. It is possible, of course, that tax-exempt bonds could be used to finance multifamily rental housing for high-income people if this rule were adopted, but this could be prevented if multifamily bonds were permitted only for federally subsidized, multifamily housing.

A Possible Exception for General Obligation Bonds

If a ban on all tax-exempt bonds for single-family housing is thought to be too harsh, an exception could be allowed for bonds that are explicitly backed by the full faith and credit of the issuing government. The bonds would then, in effect, be general obligation bonds rather than revenue bonds. The underlying mortgages would still represent the major security for the bondholders, and the bonds would still be paid off with the proceeds of the mortgages, but the issuing government would have to place its full faith and credit behind the bonds and cover the losses in case of mortgage defaults.

If states and localities had to use general obligation bonds to finance single-family housing, they would have to consider more carefully the public purpose to be served by the bonds. They might also have to make some trade-offs between this use of their borrowing power and its use for other purposes.

Single-family bonds could also be issued at lower interest rates if they were backed by the full faith and credit of the issuing government, as well as by the underlying mortgages. This would make it possible to reduce further the interest rates on the mortgages and to serve a somewhat lower-income group of potential homebuyers.

There are some potential problems with requiring that single-family bonds be issued as general obligation bonds, however. States and localities that have strong credit ratings would have a comparative advantage in the tax-exempt bond market over those with weaker ratings, and could, therefore, pay significantly lower rates on their bonds. These financially strong governments may not always be the juris-

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dictions that have the greatest need for single-family bond programs.

If states and localities are required to place their own full faith and credit behind the bonds, they might also become more cautious in the kinds of single-family bond programs they establish. Because the states and localities would be responsible in case of mortgage default, they would have a greater interest in ensuring that mortgages in their portfolios were relatively safe. To do that, they might enforce more conservative eligibility standards for those obtaining mortgages and seek to give preference to higher-income homebuyers who are likely to be better credit risks. Public purposes, such as aiding moderate-income homebuyers and encouraging single-family housing in redevelopment areas, might thus not be as well served under these programs.

Finally, many states have statutory and even constitutional limits on the amount of general obligation debt that states and localities may issue. Thus, it could be very difficult for states and localities to issue single-family bonds, since these bonds would be in direct competition with other, more traditional uses of state and local borrowing power.

As noted briefly in Chapter II, California, Oregon, and Wisconsin all sell general obligation bonds rather than revenue bonds to finance veterans' housing. Further study of the experience in those states might give some indication of how this option might work out in practice.

IMPOSING LIMITS ON MORTGAGE REVENUE BONDS

The Congress can direct the use of housing bonds to narrower purposes by limiting their tax exemption in one or more ways. Most of the approaches require modifying Section 103 of the Internal Revenue Code, which establishes the tax-exempt status of interest on local mortgage revenue bonds. As discussed earlier, Section 103 was modified in 1968 to make interest on most industrial development bonds taxable. An exception was allowed for bonds financing "residential real property for family units." This exception could be tightened by restricting tax-exempt housing bonds to those that serve some more narrowly defined purpose.[4]

The Congress could modify Section 103 to provide that the interest on single-family housing bonds would be tax-exempt only if the programs:

- Assist low- to moderate-income home purchasers or first-time homebuyers;

- Aid in the revitalization of economically depressed areas, and/or;

- Are conducted by ongoing state or local government agencies.

Directing the Subsidy to Low- and Moderate-Income Families

If the Congress decides to limit the local mortgage assistance programs to those that assist people

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4. There is some dispute over whether single-family mortgage revenue bonds are industrial development bonds, and hence are exempt under the residential family housing exemption of Section 103(b)(4)(a), or whether they are tax exempt because they are technically not industrial development bonds. Many bond counsel, relying on a private Internal Revenue Service ruling, do not treat bonds issued for mortgage purchase programs as industrial development bonds. The distinction has not made much difference until now, since the bonds were tax-exempt, however categorized. But if legislation were enacted restricting the ability of localities to issue tax-exempt mortgage revenue bonds, the Congress would have to resolve the ambiguity or add a new paragraph to Section 103 to deal explicitly with housing bonds.

who otherwise might not be able to afford homes, it could impose an income limit, a mortgage limit, or a home purchase-price limit. Each of the alternatives has some strengths and weaknesses, which will be discussed below. If any of the restrictions is chosen, the Congress would have to define the group it intends to assist and then choose the appropriate dollar ceiling or ceilings on income, home price, or mortgage amount.

Income Limits. Judiciously selected income limits could direct the housing subsidy to low- to moderate-income households. They could also confine the scope of the programs and thereby minimize adverse market effects.

The difficulties inherent in an income ceiling are primarily administrative problems of defining household income, monitoring compliance, and regionally adjusting the limit for variations in the cost of living. Although most of the administrative problems of income limits could be resolved, one is especially difficult to deal with. As currently structured, the low interest rate on mortgages is a subsidy that continues throughout the life of the mortgage, while income eligibility is determined only at the time of application.[5] This situation is unlike that of a rental housing subsidy for which tenant income eligibility can be periodically monitored and enforced.

The severity of this income-ceiling problem depends on whether the Congress wants to direct the

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5. The federal government could require income eligibility to be reassessed annually, so that homeowners whose incomes rose to exceed the cut-off level would be forced to prepay their mortgage loans and to refinance their homes. However, this option would create large administrative costs. In addition, it would cause a good deal of uncertainty for the bondholders, whose bonds would probably be called early if there were prepayments.

subsidy to people of truly moderate means and whether households receiving the subsidized mortgages will experience sizable income increases during the life of the mortgages. How can city officials select applicants whose incomes are likely to remain fairly stable over the next 30 years? Can they routinely disqualify the applications of upwardly mobile families and young professionals or families in which the wife is temporarily not drawing a salary? In 1977, the national average age of home buyers was 32.5 years.[6] Average family incomes now tend to be about $4,000 higher for households headed by people aged 35 to 44 than for those aged 25 to 34.[7] That means that 10 or 15 years into their mortgages, many of the subsidized households will no longer be in low-income categories, although they will still receive subsidies as long as they have outstanding mortgage balances.

Income ceilings also create a few other administrative problems. As always, there is a trade-off between thoroughness and ease of administration. First, Congress must decide what to include in its definition of income.[8] Ideally, income should include wages and salaries, overtime, fringe benefits, bonuses, social security and welfare benefits, tax-exempt interest, pension annuities, and alimony payments. But monitoring the many forms of income listed here is difficult; many of these forms of income are never reported at all.

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6. Homeownership: Affording the Single-Family Home, U.S. League of Savings Associations, 1978, p. 43.

7. Bureau of the Census, Current Population Reports: Consumer Income, "Money Income in 1977 of Households in the United States," December 1978, pp. 22-23.

8. Ideally, the Congress would probably want to use a wealth limit measured by net worth or net asset value, but this would pose very substantial administrative burdens.

If the Congress decides to use an income definition based on federal income tax data, it has to recognize certain limitations: some income, because it is exempt from taxation, will not appear on the forms filed (for example, transfer payments or tax-exempt interest); and income information from income tax forms will always be outdated if it is based on the previous year's income.

Finally, because the cost of living varies from one city to another, the Congress might want to define its income ceiling in terms of HUD data on area median income, rather than as one absolute figure nationwide.[9]

Mortgage Ceilings. Imposing a limit on the amount of the mortgage could also direct the subsidies to low- or moderate-income households and lessen the programs' adverse effects on housing prices and tax-exempt interest rates. The Federal Housing Administration (FHA) uses mortgage limits to define eligibility for its loan programs. Mortgage ceilings are much simpler to administer than income ceilings, but they may be difficult to direct to low- and moderate-income people, particularly if second mortgages are allowed. Even with a mortgage ceiling, affluent people could receive subsidies on expensive homes if they made large down payments or took out second mortgages on their homes.

It is also difficult to define mortgage ceilings so that they reflect regional differences in incomes and housing prices. One approach would be to define the mortgage limit in terms of area median income, as discussed in the next section on purchase price ceilings.

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9. HUD annually publishes median income data for each of the nation's SMSAs and nonurban counties. Those figures are used as part of the eligibility criteria for HUD's Section 8 Rental Program and its Section 235 Homeownership Assistance Program.

If the Congress did choose to impose a mortgage maximum, one possibility would be to use the FHA mortgage ceiling, which is now $60,000. One problem with this approach, though, is that the FHA limit may be set too high to serve as an effective damper. Purchasers of single-family homes now take out mortgages equal, on the average, to about 75 percent of the purchase price of the home.[10] A mortgage ceiling of $60,000 would therefore work out to a purchase price ceiling of about $80,000. In December 1978, only about 17 percent of existing single-family homes sold for more than $80,000[11], while only about 25 percent of new single-family homes sold for more than that amount.[12] If a mortgage limit were set low enough, however, and if it were coupled with a prohibition on second mortgages, it could serve fairly well to direct the subsidy to households of limited means.

Purchase-Price Ceilings. Home purchase-price ceilings provide yet a third means of directing the subsidy to a low- or moderate- income group. Compared to income ceilings, purchase-price ceilings are much simpler to administer. Compared to mortgage ceilings, purchase-price ceilings are more accurate in targeting on low- and moderate-income people.

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10. Federal Home Loan Bank Board, "Terms on Conventional Home Mortgages," News Release, December 6, 1978, Table 1.

11. National Association of Realtors, Existing Home Sales (January 1979), p. 11.

12. U.S. Department of Commerce, Bureau of the Census, and U.S. Department of Housing and Urban Development, New One-Family Houses Sold and For Sale, November 1978 (January 1979), Table 4, p. 6.

For most households, home purchase price is probably a good predictor of expected future income. Families are likely to incorporate their estimates of their future income streams into their consideration of the home price that they can afford.

Using one purchase price nationwide would be a simple approach administratively but would not reflect variations in the price of housing across the nation. Home purchase prices vary widely in several different respects, such as by region, city size, whether the house is inside or outside an SMSA, and whether the house is newly built or was previously occupied. In 1977, for example, the median purchase prices of homes in small, medium and large cities were $37,000, $42,308, and $49,500, respectively.[13] The average price for newly built homes purchased in SMSAs in December 1978 ranged from $43,800 in Pittsburgh to $104,600 in Los Angeles, as shown in Table 13. Regional differences in home values are reported in Table 14. Differences resulting from locations inside and outside SMSAs are noted in Table 15.

Regional differences in home prices could be approximated in a federal purchase-price ceiling by making the purchase-price limit dependent on area median income. Since HUD publishes statistics on area median income annually for each SMSA and nonurban county, most of the variations in purchase prices noted above could be handled through a ceiling established by this method.

One problem with a purchase price ceiling is that wealthy people might be able to devise ways of sidestepping the limit. Unknown to the lending institution, the buyer could make part of his down payment directly to the seller, and they could agree to record a purchase price that fell below the prescribed limit. To avoid this problem, purchase

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13. U.S. League of Savings Associations, Homeownership: Affording the Single-Family Home (1978), pp. 110, 113-114.

TABLE 13. AVERAGE PURCHASE PRICES FOR SINGLE-FAMILY HOMES PURCHASED WITH CONVENTIONAL MORTGAGES: DECEMBER 1978, BY SMSAs*

Metropolitan Area	Average Purchase Price (in Dollars): Newly Built Homes	Average Purchase Price (in Dollars): Previously Occupied Homes
Atlanta, Ga.	70,800	56,100
Baltimore, Md.	69,700	59,000
Boston-Lawrence-Lowell, Mass.	87,700	57,800
Cleveland-Akron-Lorain, Oh.	75,700	53,600
Chicago, Il.-Gary, Ind.	77,800	66,700
Columbus, Oh.	86,200	46,100
Dallas-Ft. Worth, Tex.	75,100	52,100
Denver-Boulder, Colo.	64,200	72,100
Detroit-Ann Arbor, Mich.	62,200	50,500
Greensboro-Winston Salem-High Point, N.C.	60,300	51,000
Honolulu, Hi.	64,800	74,400
Houston-Galveston, Tex.	63,400	60,600
Indianapolis, Ind.	66,300	53,100
Kansas City, Mo.	69,200	51,200
Los Angeles-Long Beach-Anaheim, Cal.	104,600	83,500
Louisville, Ky.	77,700	49,000

(continued)

TABLE 13. (continued)

Metropolitan Area	Average Purchase Price (in Dollars) Newly Built Homes	Previously Occupied Homes
Miami-Ft. Lauderdale, Fla.	54,500	58,400
Milwaukee-Racine, Wisc.	80,700	59,300
Minneapolis-St. Paul, Minn.	74,100	62,600
New York, N.Y.; Newark-Jersey City, N.J.	90,400	67,700
Philadelphia, Pa.; Wilmington, Del.; Trenton, N.J.	59,000	50,100
Phoenix, Ariz.	62,000	65,100
Pittsburgh, Pa.	43,800	50,200
Portland, Ore.-Wash.	71,100	64,400
Rochester, N.Y.	62,300	56,800
Salt Lake City-Ogden, Ut.	61,400	62,300
San Diego, Cal.	98,400	81,000
Seattle-Tacoma, Wash.	51,900	65,300
San Francisco-Oakland-San Jose, Cal.	101,200	87,800
St. Louis, Missouri-Ill.	62,400	47,800
Tampa-St. Petersburg, Fla.	53,900	44,000
Washington, D.C.-Md.-Va.	87,600	87,900

SOURCE: Federal Home Loan Bank Board, Mortgage Interest Rate Survey.

* Standard Metropolitan Statistical Areas.

TABLE 14. MEDIAN VALUE OF OWNER-OCCUPIED HOMES IN 1976, BY REGION*

Region	Median Dollar Value
Northeast	36,200
North Central	30,500
South	27,500
West	39,000

SOURCE: U.S. Bureau of the Census, 1976 Annual Housing Survey, vol. C, Series H-150-76, pp. 167, 178, 189, 200.

* The four regions into which the Census Bureau divides the United States are:

Northeast -- Maine, Vermont, New Hampshire, Massachusetts, Rhode Island, Connecticut, New York, New Jersey, Pennsylvania;

South -- Maryland, Delaware, District of Columbia, West Virginia, Virginia, North Carolina, South Carolina, Georgia, Florida, Kentucky, Tennessee, Alabama, Mississippi, Texas, Oklahoma, Arkansas, Louisiana;

North Central -- North Dakota, South Dakota, Nebraska, Kansas, Minnesota, Iowa, Missouri, Wisconsin, Michigan, Illinois, Indiana, Ohio; and

West -- Washington, Oregon, California, Montana, Idaho, Wyoming, Utah, Colorado, Arizona, New Mexico, Hawaii, Alaska, Nevada.

TABLE 15. MEDIAN VALUE OF OWNER-OCCUPIED HOMES IN 1976, BY TYPE OF LOCATION

Type of Location	Median Value (in Dollars)
Inside SMSA* and Inside Central City	29,400
Inside SMSA but Outside Central City	38,300
Median in SMSAs	35,100
Outside SMSA	26,100
National Median	32,300

SOURCE: U.S. Bureau of the Census, _1976 Annual Housing Survey_, vol. C, Series H-150-76, pp. 7, 12, 17, 22.

a/ Standard Metropolitan Statistical Area.

price ceilings might have to be combined with income ceilings.

Limiting Subsidy to Those Who Forego Deduction of Mortgage Interest. Another way of directing the subsidy to low- and moderate-income people would be to require the home purchaser to choose between receiving a homeownership subsidy in the form of a mortgage financed by a tax-exempt bond or in the form of the tax deduction for mortgage interest allowed under current law. This option does not imply that there is anything improper about a home purchaser receiving both types of subsidy.[14] Requiring the choice would simply be an administrative device to induce higher-income people to exclude themselves voluntarily from the mortgage bond programs.

For taxpayers in higher marginal tax brackets, the existing mortgage interest tax deduction would almost always save them more in taxes than they would gain from the lower interest rates in the mortgage bond programs. Thus, if high-bracket taxpayers had to choose between keeping their mortgage interest deduction and taking part in a mortgage bond program, they would decide not to take part in the bond program. Moderate-income people in lower marginal tax brackets, on the other hand, who benefit very little or not at all from the mortgage interest tax deduction, would find the low-interest rate mortgages offered by localities more attractive (see Table 16).[15]

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14. There is, for example, no "double deduction" involved when a homebuyer receives both subsidies, since the mortgage interest deduction of a homebuyer taking part in a local mortgage bond program would automatically be somewhat lower to reflect the lower interest rate paid on mortgages financed with tax-exempt bonds.

15. A simple example can illustrate the point. Suppose that all home purchasers had the options of a mortgage financed by tax-exempt bonds at an

TABLE 16. TAX-EXEMPT BOND SUBSIDY COMPARED WITH MORTGAGE INTEREST DEDUCTION SUBSIDY: EFFECTIVE MORTGAGE INTEREST RATES IN PERCENTS

Buyer's Adjusted Gross Income (in dollars) a/	Marginal Tax Rate	Rate on Bond-Financed Mortgage	Rate on Privately Financed Mortgage b/
13,000	14	8	8.6
15,000	16	8	8.4
19,000	18	8	8.2
23,000	21	8	7.9
28,000	24	8	7.6
32,000	28	8	7.2

SOURCE: Congressional Budget Office.

a/ Married couples with two children filing jointly.
b/ After tax deduction.

Under this option, the taxpayer himself would evaluate the two alternatives. If he was in a very low marginal tax bracket but expected his income to rise soon, he would probably choose to forego partici-

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interest rate of 8 percent with no tax deduction for mortgage interest, or a privately financed mortgage at an interest rate of 10 percent, on which the interest payments can be deducted from taxable income. Putting aside other considerations, such as additional deductible expenses, any taxpayer in a marginal tax bracket above 20 percent would pay an effective after-tax interest rate on his private mortgage of less than 8 percent and so would choose the mortgage interest tax deduction. Any taxpayer in a marginal tax bracket below 20 percent would choose the mortgage financed by the tax-exempt bond.

pating in the local program. On the other hand, if he initially chose to participate in the local program and then experienced an increase in income that made the tax deduction option more attractive, he could refinance his home and opt out of the local program.

The goal of restricting participation in the state and locally sponsored programs to low- and moderate-income people could be satisfied under this option without too much governmental policing or complex bureaucratic rulemaking. The IRS would, however, have to establish a system for states and localities to report the names of homeowners with subsidized mortgages. This would probably have to be done only once for each homebuyer, since the IRS would presumably be able to keep track of subsidized homebuyers once their names were in the system. If homebuyers later decided to opt out of their subsidized mortgages and resume taking their mortgage interest deduction, they could simply inform the IRS of this at the time they submitted their next tax return.

This option would thus provide a relatively nonbureaucratic way to impose an income limit that is effectively self-monitoring and that automatically provides adjustments for family size and other expenses that are taken into account in the tax code.

Directing The Subsidy To First-Time Homebuyers

The tax-exempt bond subsidy could be directed primarily or exclusively to first-time homebuyers. First-time homebuyers generally have greater difficulty in accumulating the money needed for a down payment than do people who can use the proceeds from the sale of another home. Because they are generally younger, first-time homebuyers also tend to have lower incomes and are thus less able to afford the monthly payments on a home than are older families with higher incomes.[16]

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16. For a detailed analysis of the homeownership affordability problems faced by first-time home-

If people seeking to buy their first home only temporarily have low incomes, however, and if their earnings are likely to rise substantially in future years, there might be some question whether a public purpose is being served by enabling them to buy a home a year or two sooner than they might otherwise be able to. Excluding upwardly mobile young professionals from first-time homebuyer programs would be administratively difficult, however, and many people might consider it inequitable.

The goal of helping first-time homebuyers might be served more effectively and at lower cost by some method other than tax-exempt mortgage bond programs. Since the largest and most unique problem faced by most first-time homebuyers is the lack of enough money for a down payment, a down payment subsidy would meet their needs more effectively than an interest rate subsidy. It might be possible for states and localities to use the proceeds of tax-exempt bonds to provide down payment subsidies rather than interest rate subsidies, but this would require a substantial restructuring of the current programs.

Another approach that would deal directly with the problems of first-time homebuyers, and that would require no government subsidy at all, is the graduated payment mortgage. With this type of mortgage, homebuyers are able to make lower monthly payments in the early years of the mortgage, in exchange for making somewhat higher monthly payments in later years when their incomes are likely to be higher.

Graduated payment mortgages were authorized on an experimental basis for FHA-insured mortgages by Sec-

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buyers, see Congressional Budget Office, Homeownership: The Changing Relationship of Costs and Incomes, and Possible Federal Roles (January 1977).

tion 245 of the National Housing Act.[17] The program was liberalized and made permanent in 1977. Just under 10 percent of FHA mortgages were made under the program in fiscal year 1978, and it is estimated that about 30 percent of the FHA mortgages made in fiscal years 1979 and 1980 will be graduated payment mortgages.[18] Legislation has been introduced in both the Senate and the House that would further liberalize the Section 245 program by lowering the down payment requirements and allowing lower monthly payments in the earlier years of the mortgage.[19]

The Federal Home Loan Bank Board has issued regulations, effective January 1, 1979, that would permit all federally chartered savings and loan associations to issue graduated payment conventional mortgages, following generally the same guidelines set out in the FHA Section 245 program.[20] In addition, a number of states permit state-chartered savings institutions to make graduated payment mortgages.

Graduated payment mortgages, along with other ways of aiding first-time homebuyers, are discussed in

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17. Added by the Housing and Community Development Act of 1974 (Public Law 93-383), Section 308 (August 22, 1974).

18. Telephone conversation with Brian Chappelle, Federal Housing Administration, Office of Housing, Single-Family Insured Housing Division, March 27, 1979.

19. S. 740, introduced in the Senate on March 22, 1979, by Chairman Harrison A. Williams, Jr. and other members of the Senate Committee on Banking, Housing and Urban Afairs, and H.R. 3175, introduced in the House on March 22 by Representatives Les AuCoin and John J. LaFalce, members of the House Committee on Banking, Finance and Urban Affairs.

20. Federal Register, December 20, 1978, pp. 59336-59340.

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more detail in the January 1977 CBO report on homeownership cited earlier.[21]

Geographic Targeting

The Congress might wish to allow local mortgage assistance programs to be used to encourage the renovation and revitalization of economically depressed urban neighborhoods. They could be used for this purpose instead of, or in addition to, being used to help low- and moderate-income families or first-time homebuyers afford homeownership.

Geographic targeting poses three primary difficulties, however. First, the Congress would have to decide how to define eligible neighborhoods. Second, this option could cause the displacement of low-income neighborhood residents by higher-income newcomers--sometimes called "urban gentrification." Lastly, directing a large amount of subsidized mortgage funds into a relatively small geographic area might well cause an increase in housing prices in that neighborhood.

It is extremely difficult to delineate economically depressed neighborhoods in any satisfactory way. Census figures are available at the Census tract level, but they are collected only at ten-year intervals and rapidly become outdated.

If the Congress did decide to allow tax-exempt bond financing of home mortgages for all income groups in designated neighborhoods, it would have to delegate to some organization the task of certifying eligible districts. Natural choices for certifying agencies include the Treasury Department, HUD, and state housing authorities.

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21. Congressional Budget Office, Homeownership, Chapter VI, pp. 33-45.

HUD has established guidelines for geographic targeting for other programs, including the GNMA targeted tandem program. HUD instructs cities that meet the eligibility criteria for Urban Development Action Grants (UDAG) to outline blighted neighborhoods within their jurisdictions, called "neighborhood strategy areas."[22] These neighborhood areas are eligible for special assistance and could be used for geographic targeting restrictions for housing bonds as well. The guidelines established by HUD for cities to use in selecting neighborhood strategy areas are rather vague, although the areas must be approved by HUD.[23]

Granting the authority for neighborhood approval to state housing finance agencies in states with such agencies would leave the door open for innovative programs designed to attract middle- and upper-income people to depressed neighborhoods. Since some state

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22. Eligibility criteria for the UDAG program are based on statistical data on the age of the city's housing stock; the rates of growth in the city's population, employment level and per capita income; the city's unemployment rate; and the percent of the population below the poverty level. For eligibility criteria for large cities and urban counties, see Federal Register, vol. 43, No. 251 (January 10, 1978), p. 1605. For criteria for small cities, see Federal Register, vol. 43, No. 61 (March 29, 1978), p. 13342.

23. The neighborhood strategy area "is an area which is selected by the applicant . . . for a program of concentrated community development activities . . . . Such an area may consist of a locally defined neighborhood or planning district, one or more census tracts, enumeration districts, or parts thereof." (Federal Register vol. 43, no. 41 [March 1, 1978], pp. 8460-8461).

agencies might be tempted to interpret the law loosely, however, the Congress could grant the Secretary of HUD the authority to review state agency decisions.[24]

Some evidence suggests that there is a new but growing trend for young professionals to move back into some older cities and renovate deteriorated neighborhoods.[25] This movement is occurring independently of government programs and reflects the attractions city life has to offer the new residents. If the federal government targeted the homeownership subsidy on blighted neighborhoods, many of the beneficiaries would be affluent, young, and upwardly mobile. Thus, geographically-targeted subsidies could exacerbate the trends and problems of "gentrification."

The Congress would have to weigh advantages and disadvantages to decide whether it wanted to direct this subsidy to designated neighborhoods. Certainly the elimination of urban blight is desirable. On the other hand, this route would entail subsidizing a group that already receives a large homeownership subsidy through the tax deductibility of mortgage interest and property tax payments. Further, it could have the self-defeating effect of raising house prices

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24. There is a precedent for this kind of review in the designation of historic preservation areas in the 1976 Tax Act. Historic areas can be designated by the federal or state government, but if the area is state-designated, the Secretary of the Interior must approve both the authorizing statute and the district itself. (Tax Reform Act of 1976 (Public Law 94-455), Sec. 2124.)

25. See, for example, Franklin J. James, "Private Reinvestment in Older Housing and Older Neighborhoods: Recent Trends and Forces," statement before the Senate Committee on Banking, Housing, and Urban Affairs, July 10, 1977; "Displacement: City Neighborhoods in Transition," The National Urban Coalition, 1978; and U.S. Department of Housing and Urban Development, Displacement Report (February 1979).

in the designated neighborhoods, thereby worsening the displacement problem and generating demands for an offsetting federal subsidy program to help those who are displaced.

Restricting the Tax-Exemption to Bonds Sold by State and Local Housing Agencies

Several of the options available for Congressional action involve the roles of state or local governmental agencies. They include allowing only legislatively established state and local housing authorities to issue tax-exempt housing bonds, and either putting no further restrictions on the bonds or coupling the restriction with geographic or income targeting.

Several arguments support limiting the tax-exemption to interest on bonds issued by state, and perhaps local, housing agencies.[26] Most of the arguments rest mainly on the presumption that state agencies have competent full-time staffs that are better able to administer the programs and look after the interests of the home purchasers than are the local government employees or city council members who now supervise the local programs.

One criterion for comparing the effectiveness of state agency and local programs is the size of the reduction in mortgage interest rates. The mortgage payments must always cover administrative costs. When the cities conduct programs independently of government agencies, they essentially hire underwriters and local lenders to do the work the agencies would have done. The less costly route can be determined by

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26. The official position of the U.S. League of Savings Associations is that the Congress should eliminate the tax-exemption on all single-family housing bonds issued by local governments, the implication being that no limits should be placed on state housing agencies. (U.S. League of Savings Associations, Press Release, March 2, 1978.)

examining the spreads between mortgage interest rates and bond interest rates for agency-run and nonagency-run programs. The less costly structure (agency or no agency) will have the smaller average spread.

By restricting bond issuance to state agencies, the Congress could eliminate much of the competition among communities engendered by the mortgage revenue programs. One community would no longer be pushed into offering a mortgage assistance program solely in response to a neighboring community's program.

Critics of the local programs have also pointed out possible conflicts of interest that could prompt biased selection of program participants.[27] This issue is related to the distributional questions discussed in Chapter III. Both the state and local programs provide opportunities for various kinds of discrimination, however, so it is difficult to compare them on this basis.

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27. In analyzing the single-family housing bonds issued in Jefferson County, Arkansas, for example, the firm of Dean Witter Reynolds Inc. noted:

> There are several instances of conflict of interest regarding individuals that are serving as members of both the Health Care and Residential Facilities Board and as board of directors of the lending institutions. One joint manager of the issue serves as an originator and servicer of the mortgage loans; the custodian, and two persons from its Board of Directors also serve as members of the Facilities Board that administers the program.

(Dean Witter Reynolds Inc., Tax-Exempt Single-Family Mortgage Revenue Bonds Issued by Local Governments [New York: Dean Witter Reynolds Inc., 1979], p. 25.)

Channeling the subsidy through state-sponsored agencies does provide a good check on housing bond activity, since most state housing agencies must appeal to their state legislatures for increases in bond authority limits. This provides an opportunity for statewide legislative review that is lacking in most of the local programs. In addition, the bond limits mandated by most state legislatures for their housing authorities serve somewhat to limit the overall scope of the programs nationwide.

There are some arguments against allowing only state housing agencies to issue mortgage revenue bonds, however. Local programs may be more responsive to locally perceived problems. Moreover, local programs conducted independently of established state or local government authorities may involve less bureaucracy and red tape.

Some cities run their mortgage bond programs through local housing authorities.[28] If the Congress decided to allow only ongoing government authorities to issue single-family housing bonds, it might consider allowing local as well as state housing authorities to issue the bonds, provided the local authorities are established under state laws spelling out their responsibilities.

If the Congress decided to allow only legislatively established housing authorities to issue mortgage revenue bonds, it might want to impose some additional restrictions. Although some state housing agencies would confine their activities to subsidizing housing for low- or moderate-income people or for urban development even without federal restrictions, there is little reason to believe that would always be the case. Many of the same pressures causing cities

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28. The Minneapolis Housing and Redevelopment Authority, for example, runs a home mortgage assistance program in addition to several other local housing programs.

to sponsor broad-based, middle-income housing subsidies are also at work on state housing finance agencies.

MODIFYING OTHER FEDERAL HOMEOWNERSHIP SUBSIDIES

Proponents of local mortgage bond programs argue that they attract residents to central cities and subsidize middle-income homeownership. Both goals could be furthered by revamping other federal subsidies.

- The GNMA tandem program, now used only for multifamily mortgages, could be used for mortgages on single-family existing homes and targeted on economically depressed cities or neighborhoods.

- The scope of HUD's Section 235 homeownership program could also be enlarged.

- To subsidize lower- and middle-income homeowners, the federal income tax deduction for mortgage interest and property tax payments could be changed to a tax credit, since this tax device benefits lower-income taxpayers more than the tax deduction.

GNMA Tandem Program

The GNMA tandem program could be used to provide an interest subsidy for single-family housing, with or without income and geographic targeting limits. This option would allow a larger subsidy than that provided by the local mortgage bond programs. GNMA could make the subsidy as large as desired by raising or lowering the interest rate that it instructs lenders to use in making loans (see Chapter IV), with GNMA absorbing the difference. The local bond programs can provide a maximum subsidy equal only to the difference between the tax-exempt and taxable bond interest rates. After subtracting administrative costs, this difference is usually no more than one or two percentage points. The Congress would also be able to control the size and cost of the GNMA program, and, since its cost would appear in HUD's budget, the Congress and HUD would be better able to evaluate it in comparison with other housing subsidy programs.

Income limits, purchase-price limits, or geographic targeting could all be accomplished at the federal level. Localities might not consider an expanded GNMA tandem program an attractive alternative to tax-exempt housing bonds, because the local housing bonds would probably have fewer strings attached than the federal GNMA program.

HUD Section 235

An alternative to expanding the GNMA tandem program would be to expand HUD's Section 235 homeownership program.[29] This option has some of the same features as an expansion of the GNMA program: its costs fall under HUD's budget; it can provide a larger subsidy than can the tax-exempt housing bonds; and the federal government can easily prescribe and change assisted homeowner eligibility requirements.

The Section 235 program might provide an undesirable incentive for assisted homeowners to buy relatively expensive homes. Once an assisted homeowner is paying 20 percent of his income for housing, the additional cost he would incur from larger housing expenses (up to the maximum allowable) is zero. There is, therefore, no incentive for him to buy a home less expensive than the most expensive home allowed.

Homeownership Tax Credit

If the Congress wanted to extend homeownership to low- and moderate-income families, the current federal

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29. To expand the section 235 program, the Congress would probably have to relax one or more of the eligibility criteria. For example, it might have to increase the eligibility limit for qualifying mortgages.

income tax deductions for mortgage interest and property taxes could be converted to credits. With credits, taxpayers would subtract a percentage of their mortgage interest and property tax payments directly from their final tax bill, rather than deducting the total amount from the income on which the tax is calculated. A 25 percent tax credit, for example, would allow a homeowner with $1,000 in mortgage interest and property tax payments to reduce his taxes by $250. Anyone whose marginal tax bracket was less than 25 percent would pay lower taxes with a 25 percent credit than with a deduction, while those with marginal tax brackets of more than 25 percent would pay more. A credit could also be taken whether or not the taxpayer itemized his deductions.

Converting the homeowner tax deductions to credits would extend current homeownership subsidies to many homeowners with low and moderate incomes who now receive little extra benefit from the homeownership tax deductions. With the sharp increases in the standard deduction in recent years, relatively few homeowners with moderate incomes now find it profitable to itemize their deductions, and those who do generally receive only a modest extra tax saving from itemizing.[30] As shown in Table 11 in Chapter IV, only about 38 percent of homeowners with incomes between $10,000 and $15,000 now itemize their deductions, compared to about 62 percent of those with incomes above $20,000.

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30. Homeowners who take the standard deduction do, of course, benefit indirectly from the homeownership tax deductions since the standard deduction, to serve its simplification purpose, must be set high enough to exceed the itemized deductions including homeownership deductions) of most taxpayers. Homeowners who take the standard deduction, however, receive no extra tax saving compared to nonhomeowners with the same incomes, since they both take the same standard deduction.

Converting the homeowner deductions to a credit could result in a larger federal revenue loss than the current system, depending on the size of the credit, but the additional cost could be less than the cost that the Treasury expects to incur as a result of the single-family housing bond programs. As shown in Table 17, a 20 percent credit would cost about $600 million less in lost revenues than the current homeownership deductions, while a 30 percent credit would cost about $4.5 billion more.

With a 20 percent homeownership credit instead of the current deductions, half of all homeowners would end up paying higher taxes, and half lower (see Table 17). The breakeven point would be at about the $25,000 income level, with most homeowners below that level paying lower taxes and most with incomes above $25,000 paying higher taxes. If the credit were set at 25 percent, only about one-third of homeowners would pay higher taxes, and the breakeven income level would be about $35,000. With a 30 percent credit, about 22 percent of homeowners would pay higher taxes, and the breakeven income level would be about $40,000.

TAXABLE BOND WITH A FEDERAL INTEREST SUBSIDY

There have been several proposals in recent years to combine taxable state and local bonds with a federal interest subsidy. Under the most common proposal--the taxable bond option or "TBO"--states and localities are simply given the option of issuing taxable bonds if they wish, with the federal government paying an interest subsidy to the issuing government to make up for the higher interest that has to be paid on taxable bonds. A variant of this--approved last year by the Senate Finance Committee but not enacted by the Congress--would allow the bondholder to decide whether or not he wanted to pay tax on the bond interest.[31] If the bondholder chose to treat the in-

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31. Revenue Act of 1978, S. Rept. No. 95-1263, 95th Cong., 2d Sess. (October 1, 1978), pp. 143-150.

TABLE 17. CONVERTING HOMEOWNER DEDUCTIONS a/ TO CREDITS
1979 LAW AND 1978 INCOME LEVELS

			20 Percent Credit		
Expanded Income b/ (in Thousands of Dollars)	Number of Returns with Homeowner Deductions a/	Percent of Total Returns	Average Tax Increase (+) or Decrease (-) Per Return with Homeowner Deductions a/	Percent of Home-owner Deduction a/ Returns with Tax Increase	Total Revenue Gain (+) or Loss (-) (in Millions of Dollars)
Below 5	166	.7	-90	.6	-15
5-10	1,403	7.3	-185	1.8	-260
10-15	2,902	20.4	-234	17.1	-678
15-20	3,946	34.1	-213	37.0	-840
20-30	6,927	53.6	-77	50.0	-535
30-50	4,349	76.2	+292	85.4	+1,269
50-100	1,137	84.9	+1,004	97.5	+1,141
100-200	232	87.6	+1,621	99.6	+376
200 and above	57	87.7	+2,702	100.0	+154
Total	21,120	23.9	+29	50.0	+612

(continued)

SOURCE: Staff of the Joint Committee on Taxation and the Congressional Budget Office.

a/ Deductions for home mortgage interest and property tax payments.

b/ Expanded income is a broader concept than the "adjusted gross income" concept. Expanded income includes the untaxed portion of capital gains, percentage depletion in excess of cost, depreciation in excess of straight-line, and other "tax preference" items included in the minimum tax; however, it excludes investment interest up to the amount of investment income. It therefore comes closer to "real" economic income than does the usual adjusted gross income figure.

TABLE 17. (Continued)

25 Percent Credit			30 Percent Credit		
Average Tax Increase (+) or Decrease (-) Per Return with Homeowner Deductions a/	Percent of Home-owner Deduction a/ Returns with Tax Increase	Total Revenue Gain (+) or Loss (-) (in Millions of Dollars)	Average Tax Increase (+) or Decrease (-) Per Return with Homeowner Deductions a/	Percent of Home-owner Deduction a/ Returns with Tax Increase	Total Revenue Gain (+) or Loss (-) (in Millions of Dollars)
-108	0.6	-18	-133	0.6	-22
-244	0.1	-343	-297	0.1	-417
-330	0.9	-959	-421	0.1	-1,223
-329	8.2	-1,300	-444	0.9	-1,753
-199	24.3	-1,380	-321	7.4	-2,221
+152	77.5	+662	+13	63.0	+57
+821	96.6	+934	+640	95.3	+728
+1,397	99.6	+324	+1,168	98.7	+271
+2,386	100.0	+136	+2,070	100.0	+118
-92	32.2	-1,944	-211	22.1	-4,460

terest as taxable, the federal interest subsidy would be paid directly to him. State and local governments would not be involved at all and would continue to issue bonds in the same manner they do now.

These taxable-bond-plus-interest-subsidy proposals are all intended to reduce somewhat the inefficiency of the current tax-exempt bond subsidy. As it now operates, a significant portion of the tax-exempt bond subsidy is diverted to bond purchasers with high marginal tax brackets (see Chapter III). As a consequence, the full amount of the federal tax subsidy does not reach state and local governments.

The taxable bond option proposals would serve to channel a larger portion of the subsidy to state and local governments by broadening the market for tax-exempt bonds and cutting back the portion of the subsidy that is diverted to high-bracket bondholders. The proposals would broaden the market by making the bonds a profitable investment for individuals in low marginal tax brackets and institutions, such as pension funds and life insurance companies, that pay little or no tax. Both the interest subsidy and the broader market would serve to reduce the interest rates states and localities must pay on their bonds. This, in turn, would reduce the amount of windfall subsidy going to high-bracket bondholders.

Some alternatives involving taxable bonds with an interest subsidy include:

- o Instituting a taxable bond option (TBO) for all municipal bonds, including single-family housing bonds;
- o Instituting a taxable bond option for single-family housing bonds only;

This provision, called a "bondholder taxable bond option and credit," was proposed by Senator John C. Danforth (R-Mo.).

- Requiring that interest on all single-family housing bonds be taxable but granting states and localities a direct federal subsidy to cover some portion (maybe 20 or 30 percent) of the interest costs of their single-family housing bonds.

Instituting a taxable bond option with an interest subsidy just for housing bonds (or just for single-family housing bonds) would give these types of bonds a comparative advantage over other types of tax-exempt bonds, since states and localities would issue taxable bonds only when the federal interest subsidy on the taxable bond was large enough to more than make up for the higher interest rate on the taxable bond. This alternative would therefore only be attractive if the Congress wished to give some extra advantage to housing bonds rather than limiting their use. It would also cost the federal government more, since the increased outlays for the interest subsidy would exceed the extra revenue gained from taxing the interest on the bonds.

If the Congress wished to reduce the subsidy for housing bonds, it could require that these bonds be taxable, and combine this with a relatively low federal interest subsidy of 20 or 30 percent. An interest subsidy set at this level would not fully compensate for the higher interest rates that would have to be paid on the taxable bonds, but some subsidy would still be provided. This alternative would reduce the cost to the federal government, since the increased revenues from taxing the bonds would exceed the outlays required for the interest subsidy.

Taxable bonds with an interest subsidy might have some advantages in terms of federal budget visibility and control. The interest subsidy could be provided through annual appropriations and could be placed in the HUD budget rather than appearing as a revenue loss or "tax expenditure."[32] This would make it easier for the Congress to control the subsidy and monitor its use. Having the subsidy in the HUD budget would also facilitate comparison with other housing subsidy programs.

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32. Section 802 of the Housing and Community Development Act of 1974 (Public Law 93-383) authorized HUD to pay from its budget an interest subsidy of 33 percent to state housing finance agencies that agreed to issue taxable bonds for housing. That authority was never used, however, primarily because the 33 percent subsidy was not large enough to make up for the higher interest rates the agencies would have had to pay on taxable bonds. As a result, this year the Administration asked that the $600 million in budget authority provided for the Section 802 program in 1976 be rescinded, effectively ending the program. The Congress agreed to the rescission request on March 27, 1979. (Congressional Record, March 27, 1979, pp. S3456-7).

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