INTERGOVERNMENTAL FISCAL IMPACTS OF TAX-EXEMPT SINGLE-FAMILY HOUSING BONDS

Statement of

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The volume of tax-exempt bonds issued to assist single-family housing has grown dramatically in the last year, with many cities throughout the country issuing bonds for this purpose for the first time. This rapid proliferation of single-family housing bonds led Chairman Ullman and Representative Conable of the House Committee on Ways and Means to introduce legislation on April 25 that would effectively prohibit future issues of these bonds. The introduction of this legislation has brought these programs to at least a temporary halt, and the Ways and Means Committee has been working on a more permanent legislative solution for the last two and a half months.

In my testimony this morning I will briefly describe the purposes of housing bonds, point out some of their advantages and potential disadvantages, and review some options the Congress may wish to consider. All of this is discussed in greater detail in a CBO report entitled Tax-Exempt Bonds for Single-Family Housing, which was released in April.

PURPOSES OF HOUSING BOND PROGRAMS

Housing bonds can be used basically for two purposes: to make homeownership easier to afford and to revitalize deteriorated neighborhoods.

Many Americans are concerned that the cost of owning a home is rising beyond the reach of the average family. However, despite sharp increases in homeownership costs, the rate of homeownership has continued to grow in recent years. As of 1976, nearly 65 percent of all households owned their own homes. Recent increases in the rate of homeownership have been especially great among young families. Between 1970 and 1976 alone, the rate of homeownership among husband-wife households in which the head of the household was under 30 grew from 39 percent to 48 percent.

Mortgage subsidy bonds help reduce housing expenses by lowering mortgage interest rates by about 1-1/2 to 2 percentage points. For example, a family with a gross income of $16,000 buying a house with a $40,000 mortgage would save about $550 a year after taxes if it received a mortgage financed with tax-exempt bonds. While that saving may not be large enough to affect the decision of most families about whether or not to buy a house, it would enable them to devote less of their income to housing or to purchase a higher-priced home.

Housing bonds can also help revitalize deteriorated neighborhoods by offering lower-cost mortgages to people who buy homes in those neighborhoods. So far, however, only two or three local bond programs have targeted funds in rehabilitation areas.

States and localities generally do not have to establish large administrative staffs to supervise mortgage bond programs, and they do not have to spend any of their own funds on the programs.

EFFECTS OF HOUSING BOND PROGRAMS

Even though housing bonds can make housing more affordable and can help to revitalize deteriorated neighborhoods, the bonds could create problems if their volume grows substantially. They could cause large federal revenue losses in the future, upset conventional mortgage lending practices, and push up tax-exempt interest rates relative to taxable rates.

Potential Volume

The growth in the volume of single-family housing bonds issued by localities has been dramatic. Cities and counties issued only about $600 million in single-family mortgage bonds in all of 1978. By March of 1979, however, that volume was being issued by localities each month. In the first four months of 1979, single-family housing bonds constituted 25 percent of all new tax-exempt bond issues.

The attractiveness of single-family housing bonds is governed by the spread between the interest rate at which localities can borrow and the conventional mortgage interest rate. That spread must be large enough to cover the programs' administrative costs as well as to provide savings to the homebuyers.

The Treasury Department and the staff of the Joint Committee on Taxation estimate that, in the absence of federal limits, about half of all mortgages will be financed with tax-exempt bond revenues in 1984. This means that about $240 billion of single-family housing bonds will be issued in 1984, compared to only about $3 billion in 1978. We believe this volume of bonds is a reasonable possibility. Since only about $46 billion of tax-exempt bonds of all kinds were issued in 1978, however, the projected volume of single-family housing bonds could impose large strains on the tax-exempt bond market in future years.

Federal Revenue Loss

Each billion dollars of new tax-exempt, single-family housing bonds costs about $22.5 million dollars in foregone federal tax revenues every year for the life of the bonds. The revenue loss occurs because the increased volume of tax-exempt bonds takes many investors out of taxable investments and into those that are tax-exempt. If half of all mortgages are financed by tax-exempt bonds in 1984, the federal revenue loss will be about $11 billion in that year.

Effect on the Municipal Bond Market

To a certain extent, housing bonds will crowd out state and local borrowing for other purposes. In the current bond market, each billion dollars of new tax-exempt housing bond issues drives up interest rates on

other tax-exempt bonds by between .04 and .07 percentage points. While this relationship probably will hold for an increase of up to about $10 billion in new housing bond issues, it is difficult to predict beyond that range. As tax-exempt interest rates rise, some municipal projects that would otherwise have been undertaken will not go forward.

However, since tax-exempt borrowing for most purposes other than housing has been declining recently, housing bonds are now filling in the gap left by the absence of these other issues and are not causing visible increases in tax-exempt interest rates.

Effect on Housing Prices and Construction

Because housing bond programs stimulate the demand for single-family homes, they push up the prices of existing homes and thereby encourage new housing construction and condominium conversion. The increased investment in housing that results does not necessarily represent a net increase in total national investment, however, since at least some of it will come at the expense of investment in areas other than housing.

The bond programs may not even add substantially to total investment in housing. The funds raised through the sale of tax-exempt housing bonds will, to some extent, simply replace money that would otherwise have flowed into the mortgage market from other sources. The Urban Institute estimates that each $1 billion in tax-exempt mortgage bonds adds only about $200 million in new money to the mortgage market.

Distributional Implications

Single-family housing bonds subsidize primarily middle- and upper-income people. Upper-income people benefit because the increased supply of tax-exempt bonds provides additional opportunities for them to shield their income from taxation. This aspect of housing bond financing serves also to make the federal income tax less progressive. In addition, households receiving subsidized mortgages will be primarily middle-income ones. A study of results from the first local housing bond programs shows that the income distribution of households served so far is similar to that of households receiving conventional mortgages in the same areas.

While housing bond programs are financed by federal taxpayers as a whole, their benefits are not distributed on any consistent basis throughout the country. One family may be able to get a low-interest rate mortgage simply because it happens to live in a locality that has decided to issue single-family housing bonds, while a family in another locality may not. As stated in a memo of the Advisory Commission on Intergovernmental Relations, "eligibility for the program is in part determined by accidents of geography, rather than by measures of objective need."

CONGRESSIONAL OPTIONS

Congress has a number of options for dealing with single-family housing bonds, including taking no immediate action, imposing limits of various kinds, or banning them entirely in favor of some other form of assistance. These options are described in more detail in the April CBO report I referred to earlier. I will just go over them briefly this morning, focusing especially on the options currently being considered by the House Committee on Ways and Means.

Taking No Action

The federal government could leave control of housing bond programs to state legislatures and local governments. Most states have not as yet enacted enabling legislation for local housing bond programs, and the needed legislation may well contain limits on the type of housing that can be provided. The states that provide explicitly for local housing bond programs may decide to restrict the programs to more narrowly defined public purposes. In Minnesota, for example, recent legislation imposes income limits on mortgagors and price limits on the houses they may buy.

One drawback in relying on state action to limit single-family housing bond programs is that, while a state and its citizens may receive substantial benefits from such a program, it does not bear all of the costs. A state may thus have less of an incentive to limit housing bond programs than does the federal government, whose taxpayers bear the full cost of the federal subsidy.

Imposing Limits on Housing Bonds

The Congress could restrict housing bond programs by imposing limits on:

- o the income of purchasers,
- o the purchase price of the homes,
- o the geographic areas in which homes can be purchased,
- o the type of purchaser (first-time homebuyers, for example), and
- o the overall volume of bonds.

The House Committee on Ways and Means has tentatively agreed to legislation that would incorporate all of these limits.

The income and purchase price limits in the Ways and Means bill serve to direct the subsidy to low- and moderate-income households, and also cut back substantially on the projected future volume of single-family bonds. These limits by themselves would reduce the projected 1984 volume from about $240 billion to about $85 billion.

The Ways and Means bill gives targeted areas a modest competitive advantage over other areas, by relaxing some of the restrictions in those areas. Since these provisions represent a liberalization of the generally applicable limits, however, they increase the projected volume beyond what it would be under those limits.

The first-time homebuyer limit also has a significant effect on projected future housing bond volume, reducing it in 1984 from the $85 billion it would reach with only income and purchase price limits, to a level of about $35 billion. While this first-time homebuyer limit serves to reduce future volume, it may not be the most effective way of helping young homebuyers. The greatest problem for first-time homebuyers usually is getting the money needed for a down payment; an interest subsidy extending over the life of the mortgage does not help much with that. In addition, such a restriction may be difficult to administer and enforce. It also creates incentives for families to stay in their first house and penalizes those who are transferred from one city to another or who wish to relocate for other reasons.

Statewide caps on housing bond volume are by far the most effective way of limiting future volume. The Ways and Means bill limits the volume of single-family bond issues in any given state to 5 percent of the average volume of mortgages originated in that state during the preceding three years. Adding that cap to the other limitations in the bill reduces the projected 1984 housing bond volume from about $35 billion to about $15 billion. However, caps of this type require some system to allocate either bonding authority or the available mortgages, since the number of eligible applicants will normally exceed the mortgages available. The Ways and Means Committee has not yet addressed this problem in detail.

Permit Only General Obligation Single-Family Bonds

Congress could require single-family bonds to be explicitly backed by the full faith and credit of the issuing government. This would make them general obligation rather than revenue bonds. It would mean that issuing governments would have to consider more carefully the public purposes being served by the bonds and to consider their possible effects on other uses of their borrowing power.

Many states, however, have statutory and even constitutional limits on the type and amount of general obligation debt that may be issued. Until changes were made in these provisions, a temporary halt might be necessary in some state and local housing bond programs. The review of single-family bond programs that this would require could be valuable, however, since it would give state legislatures and voters the opportunity to consider carefully the public purposes they should serve.

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

Another possible alternative is to allow only state-established state and local housing agencies to issue tax-exempt housing subsidy bonds. State housing agencies in 34 states have issued single-family housing bonds, starting in the early 1970s. State-established housing agencies have full-time staffs and ongoing administrative capabilities. They have generally offered better terms to homeowners than have cities

and counties. The effective interest rate reduction has been about one-half of a percentage point greater for state-agency mortgages than for local mortgages.

In general, state-established housing agencies have imposed lower income limits on mortgagors than have cities and counties. There are far fewer examples of such agencies financing very expensive homes than there are of cities and counties doing so. State-established agencies are usually limited in their bonding authority by their legislatures. Since they must appeal to the legislatures for increases in this bonding authority, their activities are subject to some review.

Restricting the tax-exemption to bonds issued by state-established housing agencies might thus keep their overall volume down and help to target them on low- and moderate-income families. It could also lessen the possibility of cities and surrounding suburban jurisdictions setting up competing programs.

Prohibiting All Single-Family Housing Bonds

Congress could prohibit future issues of tax-exempt single-family bonds, as was proposed in the legislation introduced on April 25 by Chairman Ullman and Representative Conable of the House Ways and Means Committee. The main argument for this option is that tax-exempt bonds are not a very cost-effective form of subsidy. Only about 40 to 50 percent of the federal subsidy actually reaches the homebuyer in the form of mortgage interest savings. The rest goes to high-income bondholders

as a payment for the use of their money; to lawyers, underwriters, and others involved in marketing the bonds; and to various reserve funds that provide additional security for bondholders.

If additional subsidies for homeownership are desired, other mechanisms exist that are more cost-effective. For example, a recent analysis prepared by CBO for the Senate Committee on Banking, Housing, and Urban Affairs indicates that under interest subsidy programs similar to the HUD Section 235 program and the GNMA Tandem Plan approximately 90 percent of the total federal subsidy reaches the homebuyer.

The Ways and Means Committee is considering a proposal by Representative Jacobs that would provide all first-time homebuyers with a tax credit equal to 10 percent of the mortgage interest they pay, with a maximum credit of $400 a year. Under this approach, the full amount of the federal subsidy would go directly to the homebuyer, with none of it diverted to intermediaries. Because a tax credit program would be more efficient than housing bonds, it could serve about three and a half times as many families with the same federal expenditure.

CONCLUSION

The dilemma this presents for your committee and the Congress is a difficult one. There is a proper reluctance to interfere in the affairs of state and local governments. At the same time, the incentives for restraint on the part of state and local governments are clearly diminished when many of the costs of their actions are borne by federal taxpayers.

The dilemma is made even more difficult when state and local use of the federal subsidy threatens to expand as rapidly as it does in this case. It is always easier to limit programs in their early stages than to cut them back later on. On the other hand, one may not want to cut them before they have had a chance to prove their worth. Some approach that would limit the total overall volume of housing bond issues while allowing states and localities to experiment with different types of programs might be one way of resolving this dilemma.

APPENDIX

Effects of a Serious Recession on Bond Defaults

Cities and counties that issue mortgage subsidy bonds are fairly well protected in the event of a serious recession. The cities and counties do not pledge their credit to the bonds; the bonds are backed only by the mortgages themselves and by private and federal insurance, so that even if there were massive defaults on the mortgages the cities and counties would bear no direct liablity. It is possible, however, that the credit rating of the issuing government would be adversely affected.

The bond programs are all structured so that low-downpayment mortgages must be covered by private mortgage insurance or by FHA insurance or VA guarantee. In addition, the issuer usually takes out insurance on the entire pool of mortgages, covering all losses on the mortgage loans up to a limit of 10 percent of the initial aggregate amount of principal.

In rating the bonds, rating agencies also consider the likelihood of timely payments of principal and interest under a variety of general economic conditions, including a serious recession. If they feel that the issuing locality is particularly vulnerable to a recession, the rating agencies will predicate good ratings on the condition that certain extra precautions have been taken, such as more insurance or larger reserve accounts.