Revised: 3-31-77

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Before The

SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

APRIL 1, 1977

Mr. Chairman and Members or the Committee:

I am pleased to be here to discuss with you the problem of homeownership affordability and two bills (S. 664 and S. 1078) that are directed at this problem. As you are aware, homeownership costs have risen rapidly in recent years. Concern over the decreasing ability of many families to afford homeownership is reflected in many recent proposals.

My remarks today will focus on four areas:

1. The budget trade-offs involved in directing more assistance toward homeowners and the current emphasis on homeownership assistance in federal spending on housing;

2. The recent changes in homeownership affordability for particular categories of homeowners. This subject is discussed in a recent Congressional Budget Office report: Homeownership: The Changing Relationship of Costs and Incomes, and Possible Federal Roles; 1/

3. The potential impact on homeownership affordability problems of the proposal included in both bills to expand Federal Housing Administration insurance of graduated payment mortgages and of the proposal included in S. 664 for tax-free individual housing accounts; and

4. A brief description of some alternative mechanisms to address homeownership affordability problems.

1/ Other papers prepared by the CBO that focus on federal housing policies include: The Section 8 Housing Programs: Budget Issues, July 1976; Housing Finance: Federal Programs and Issues, September 1976; A Budgetary Framework for Federal Housing and Related Community Development Policy, February 1977, and Housing Assistance for Low- and Moderate-Income Families, February 1977.

BUDGET TRADE-OFFS

Homeownership affordability is only one of the problems toward which federal housing assistance can be directed. Within a limited budget, funds spent on programs assisting homeowners compete with funds spent on programs which address other housing problems, such as the excessive housing costs and low housing quality of many low- and moderate-income households who are predominantly renters. Decisions to implement homeownership assistance programs that require subsidies necessarily involve either larger federal deficits or budget trade-offs with programs that address other national problems and needs.

Homeowner assistance currently receives substantial emphasis in federal housing activity. The fiscal year 1977 housing budget includes \$1.4 billion outlays in the unified budget, \$3.7 billion outlays for off-budget entities, and \$12.2 billion foregone revenues through housing-related tax expenditures (see Table 1). Of this total net support of \$17.3 billion, at least \$11 billion directly assists homeowners through tax expenditures. Much of the on- and off-budget outlays also assist homeowners through mortgage credit programs but the amount of direct benefits to homeowners from these activities cannot be readily identified. Moderate-income homeowners are also assisted by the Section 235 interest subsidies included in the housing assistance component of the housing budget.

TABLE 1. THE HOUSING BUDGET, FISCAL YEAR 1977 a/, IN MILLIONS OF DOLLARS

	Budget Authority	Outlays
ON-BUDGET		
Mortgage Credit & Thrift Insurance (401)	$3,189	$-2,205
Community Development-Housing Related (part of 451)	700	523
Housing Assistance (part of 604)	28,110	3,089
Totals: On-Budget	$31,999	$1,407
OFF-BUDGET ENTITIES-HOUSING RELATED	$8,107	$3,700
TAX EXPENDITURES-HOUSING RELATED		
Homeowner Benefits		$10,965 b/
Other		1,200 b/
Total Foregone Revenues		$12,165 b/

a/ On-budget estimates from third concurent resolution, off-budget and tax expenditure estimates from the President's fiscal year 1978 budget.

b/ Foregone revenues.

HOMEOWNERSHIP AFFORDABILITY PROBLEMS

The bills under discussion today propose additional homeownership assistance in order to ease the affordability problems resulting from increases in house prices and operating costs. To assess the impact of these increases on homeownership affordability, it is important to note that these increases would affect different groups of homeowners differently and that the incomes of homeowners are also rising.

The recent Congressional Budget Office study of this issue examined changes in homeonership affordability over the 1970 to 1975 period and found that the situation facing different groups of current or potential homeowners differed significantly. Mr. Chairman, with your permission I would like to insert this report in the record. In summary the findings are shown in Table 2 and indicate that:

- First-time buyers of homes on average suffered substantial declines in affordability between 1970 and 1975. Annual carrying costs for first-time buyers of median new homes rose almost twice as fast as their incomes, and their costs for median existing homes rose one-and one-half times as fast as income. Downpayments rising faster than incomes also contributed to the problem of declining affordability for first-time buyers.

- Other homeowners on average had incomes rising faster than their housing costs for the same period. Typical families already owning a home who moved to another during the period benefited from increased value in the homes they sold. These repurchasers could apply that increased value against the increased price of the houses they purchased. Homeowners who didn't move faced only increases in operating costs. The incomes of these nonmovers increased about twice as fast as their housing costs.

TABLE 2: PERCENT CHANGES IN HOUSING COSTS, INCOME, AND GENERAL CONSUMER PRICES, 1970-1975

	Percent Change
Monthly Housing Costs For:	
First-Time Buyer of Existing Housing	63.0%
First-Time Buyer of New House:	
Median-priced (not controlled for quality)	82.4
Controlled for quality	59.8
Rebuyers (assuming buying similar house)	27.3
Nonmovers	22.8
Downpayment Costs for First-Time Buyer of:	
Existing housing	53.6
Median-priced new house	67.9
New house controlled for quality	48.4
Median Family Income	39.0
Consumer Price Index	38.6

These changes in affordability were essentially the same for all income groups, because families at all income levels experienced approximately the same rate of income growth between 1970 and 1975. For lower-income families the real problem is not changes in affordability but the fact that they could not generally afford homeownership even in 1970. Because these families were disproportionately renters in 1970, they would in general have been first-time buyers if they became owners beteen 1970 and 1975. Homeownership affordability became even

more limited for lower-income renters between 1970-1975. Thus, changes in homeownership affordability affected first-time homebuyers most severely. The continuing problem is most severe for lower-income families.

First-time homebuyers numbered about two million households in 1974 constituting roughly one-half of all homebuyers. They were predominantly younger families headed by persons less than 35 years old and with median income of about $14,000, or somewhat higher than the $12,900 median income of all families (see Table 3).

TABLE 3: CHARACTERISTICS OF FIRST-TIME HOMEBUYERS, 1974 a/
(Percentage Distribution of 1.91 Million Households)

Age of Head of Household	18-24	25-34	35-44	45-64	65+
	15.3%	47.1%	19.3%	15.5%	2.9%

Family Income (median income = $13,998)	Less than $5,000	$5,000-$9,999	$10,000-$14,999	$15,000-$19,999	$20,000-$24,999	$25,000 and over
	6.2%	20.7%	29.1%	21.1%	11.7%	11.3%

a/ First-time buyers characteristics are dervied from the data in the 1974 Annual Housing Survey about recent movers who were renters before and homeowners after moving. Two qualifications to this data are: (1) it includes an unknown number of households who owned homes in the past, became renters and then homeowners again, and thus aren't really first-time buyers; and (2) it excludes 630,000 homebuyers who had a different household head before moving, therefore missing such groups as newly married couples buying homes after living singly with their parents.

POTENTIAL IMPACT OF S. 664 AND S. 1078 ON AFFORDABILITY PROBLEMS

The bills under consideration today propose programs that could assist homebuyers with affordability problems due to both carrying costs and downpayment costs. Initial annual carrying costs would be reduced by the graduated payment mortgages insured by the Federal Housing Administration (FHA). Funds for down payments would be easier to accumulate with the tax-free individual housing accounts proposed in S. 664. I would like to discuss each of these proposals in terms of their federal costs, who they would benefit, and by how much.

Insurance of Graduated Payment Mortgages

Graduated payment mortgages can improve affordability by reducing monthly mortgage payments in early years below the payments required by the level payment mortgage now generally used. Higher payments are required in later years. These increases in payments are expected to be paralleled by increases in the homeowner's income. Both S. 664 and S. 1078 would expand authority for FHA insurance of these mortgages. This could increase homeownership affordability with no direct federal costs if lenders will make graduated payment mortgages and if insurance premiums cover the actual losses on defaulted mortgages. 2/

2/ There is uncertainty about potential losses from insurance of these loans both from the risk of default if a particular homeowner's income doesn't increase as expected and from the limited degree of risk sharing possible with only a small number of insured loans.

The federal cost of insuring graduated payment mortgages and whether borrowers would actually benefit depend in part on whether incomes do increase as fast as the mortgage payments. Under both of these bills, FHA plans to insure five different types of graduated payment mortgages with payments increasing at rates up to 7 1/2 percent per year. Median-family incomes have increased at rates of about 7 percent per year over the 1965-1975 decade, and at 6.8 percent per year from 1970 to 1975. For younger families (who are the major group of first-time homebuyers), income may be expected to grow faster than the average as they reach ages of peak earning power. This was the case between 1965 and 1975 when the median income of households with heads aged 25-34 in 1965 grew by 8.5 percent per year. Thus the proposed rates of increase in mortgage payments don't seem unreasonably high compared to past income growth. The rate of income growth in the future is, of course, uncertain and primarily a function of the growth in the economy as a whole.

The amount of benefit derived from reducing early year homeownership costs would be significant under the five types of mortgages to be insured by FHA. A first-time buyer of a median priced new house in 1975 would have had monthly mortgage payments of $239 with a level payment FHA insured loan at 8 1/2 percent (see Table 4). The five graduated payment mortgage plans would have reduced those payments by anywhere from $21 to $56 per month (under the plan that has payments increasing by 7 1/2 percent per year). However, these reductions would not have been

sufficient to fully offset declines in affordability since 1970 for first-time buyers of new homes. For total carrying costs to be the same proportion of median income in 1975 as they were in 1970, mortgage payments for the first-time buyer of the median priced new house would have to be reduced by $95, to $144 per month. The effect of the graduated payment mortgage alternatives on restoring the affordability conditions of first-time buyers of existing housing would also be substantial.

TABLE 4: COMPARISON OF MONTHLY MORTGAGE COSTS FOR 1975 MEDIAN PRICED NEW HOUSE (25 percent downpayment, 8.5 percent interest rate, 30-year term)

Type of Loan	Monthly Mortgage Payment in First Year
Normal FHA-Insured Loan	$239
Graduated Payment Loan	
2% annual increase for 10 years	212
3% annual increase for 10 years	200
2 1/2% annual increase for 5 years	218
5% annual increase for 5 years	200
7 1/2% annual increase for 5 years	183
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Tax Free Individual Housing Accounts

Section 3 of S. 664 proposes that up to $2,500 per year deposited in special savings accounts--called Individual Housing Accounts--could be deducted from gross income for federal tax purposes.3/ The resulting reduction in income taxes would make it easier to save toward purchase of a house and hence improve the affordability of downpayments. Unlike insurance of graduated payment mortgages, this proposal would involve federal costs through tax expenditures or foregone revenues. I believe the Treasury Department is estimating the magnitude of these potential tax expenditures and their results will be important for considering the budget tradeoffs.

I would like to focus on who will benefit from these tax provisions, how much benefit they will receive, and the targeting of those benefits toward people with the severe homeownership affordability problems. Like all tax deductions this proposal will be of more benefit to higher income tax payers. For each dollar deposited they save more in taxes than lower income taxpayers who have lower tax rates. Higher income people are also likely to be financially able to make larger deposits into individual housing accounts.

3/ We have been advised that the present bill inadvertently omits a restriction against present homeowners using Individual Housing Accounts and assume that appropriate amendment would be made.

Table 5 shows the impact of the proposed individual housing accounts for a married couple with one child at different income levels. By depositing $1,000, a couple with $9,000 income 4/ would save $165; a couple with $14,000 income, or about middle income, would save $212; and a couple with $27,500 income would save $320. By depositing $2,500 the tax savings are increased at each income level but are still about twice as large at the $27,500 income level as compared to $9,000 income. Because higher income people are more likely to make larger Individual Housing Account deposits than lower income people, actual tax savings are likely to be more than twice as large for families at the higher income level.

TABLE 5. IMPACT OF INDIVIDUAL HOUSING ACCOUNT AT DIFFERENT INCOME LEVELS a/

	Adjusted Gross Income Before Deduction of Individual Housing Account Deposit					
	$9,000	$11,000	$14,000	$17,500	$22,500	$27,500
Tax Savings from $1,000 Deposit	$165	$190	$212	$226	$280	$320
Tax Saving from $2,500 Deposit	$397	$460	$497	$556	$662	$773

a/ Assumes married couple filing jointly with one dependent, having the average amount of nonhomeowner itemized deductions of all taxpayers at their income level, and standard deduction of $3,000 as proposed by the President.

4/ This and following references to income refer to adjusted gross income before deducting the Individual Housing Account deposit.

The assistance for downpayments provided by individual housing accounts is targeted for first-time homebuyers, who as a group recently suffered declines in homeownership affordability. However, those with the most severe problem are lower income first-time buyers. With the substantially larger benefits at higher income levels, it appears that tax-free individual housing accounts would largely have the impact of letting higher income renters accumulate a downpayment faster than they would otherwise. This proposal may not provide much improvement in the affordability of downpayments for low- and moderate-income renters.

ALTERNATIVE MECHANISMS TO ADDRESS THE HOMEOWNERSHIP AFFORDABILITY PROBLEM

Other possible options to reduce mortgage payment and operating costs include:

1. Reduce interest rates with annual subsidies as in the Section 235 program;
2. Reduce interest rates with one lump sum subsidy as in the GNMA Tandem program in which the federal government buys below market interest rate mortgages and then resells them at a loss; and
3. Other types of alternative mortgage instruments such as deferred payment mortgages that involve partial payment of of mortgage costs by the federal government in early years with later repayment with interest.

Other options to reduce downpayment costs include:

1. Tax credits, as opposed to deductions, for renters' saving toward downpayments which could improve the targetting of tax benefits toward lower income families; and

2. Reductions in FHA downpayment requirements which would make downpayments more affordable but have the major problem that potential homebuyers with relatively low income would be hard pressed to meet the enlarged monthly payments that smaller downpayments necessarily produce.

3. Insurance of second mortgages that are paid back only in later years of the main mortgage loan. Such insurance could involve little federal cost if premiums covered the cost of defaults.

SUMMARY

To reduce the requirement for additional budget resources, new programs to improve homeownership affordability could be designed that involve little or no budget cost. One such approach is insurance of graduated payment mortgages that reduce carrying costs in early years of homeownership. The cost reductions under graduated payment mortgages are not large enough though to return first time buyers to 1970 level of affordability or to make homeownership affordable to lower income people.

Another way to reduce the federal cost of homeownership assistance programs is to target assistance toward those most in need or to target assistance toward lower cost housing. First-time homebuyers and low- and moderate-income households have the greatest homeownership affordability problem. The proposed tax-free individual housing accounts

target assistance toward first-time buyers, but in a way that will most likely be used by higher income renters. Restricting assistance to buyers of existing, as opposed to new, homes would reduce federal costs because the prices are generally lower and are rising more slowly.

That concludes my prepared testimony, Mr. Chairman. I will be happy to answer any questions you and other committee members may have.