Trusts for Investments in Mortgages (TIMs)--an idea that grew out of the recent President's Commission on Housing--would amend the tax code and provide additional regulations to increase the flexibility for issuing MBSs. 18/ Under the TIMs provisions, the MBS would be a security interest in a form of business trust to be organized by any mortgage market participant with the minimum required assets. All types of mortgages would be eligible for pooling to back securities under the TIMs proposal, including first and second mortgages on single-family units, condominiums, cooperatives, and rental projects. Conventional, FHA-insured, VA-guaranteed, FmHA-guaranteed, plus a variety of alternative mortgage instruments would be eligible for MBS pools under the TIMs regulations. Because the assets and income from MBSs issued under the TIMs provisions would come from residential mortgage loans, the instrument might be an attractive investment for savings and loan associations, state housing finance agencies, and pension plans.

The TIMs provisions would authorize the issuance of MBSs with characteristics that could give them a competitive advantage over present MBSs. Proposed TIMs provisions would eliminate the need for individual rulings by the Internal Revenue Service to exempt MBSs from the requirements of the grantor trust mechanism and would have distributions from the MBSs taxed at the investor level only. Protection of the investor from the removal (or call) of a prepaid mortgage from the pool backing the MBS could be provided by allowing issuers to hold back and reinvest any portion of a monthly payment to be distributed to investors at a later date. Payments also could be made less frequently than monthly to appeal to a broader group of investors than MBSs currently do. The marketing of securities prior to the delivery of their underlying mortgages could be allowed under the TIMs provisions as well.

Although the proposed TIMs provisions would eliminate the restrictions associated with the grantor trust management mechanism, the same advantages as offering MBSs without this form of management could be achieved directly if the Treasury would expand the reinvestment latitude and other characteristics of this trust mechanism. If the Treasury were to redefine the terms of the grantor trust management mechanism, a more flexible MBS could be offered with perhaps greater simplicity than would be involved in establishing the TIMs provisions by statute.

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18. S. 1822, introduced in the Senate during the first session of the 98th Congress, would amend the tax code to encourage investment in MBSs through trusts for investments in mortgages (TIMs) but would preclude the FNMA and the FHLMC from being trustees, directors, or shareholders for these securities.

Liberal issuing requirements for MBSs under the TIMs proposal--whether achieved by statute or regulation--might, however, attract small issuers into an investment activity for which they are not adequately prepared. If small mortgage brokers marketed MBSs that generated sizable losses for their investors, the TIMs provisions--by bad example--could impede expansion of a secondary market in privately issued conventional MBSs. This risk could be reduced by requiring issuers of MBSs to maintain a reserve equal to some percentage of the outstanding principal balance of the mortgages in the pool.

Further Modifying ERISA Regulations. Another means of encouraging the issuance and trading of private conventional MBSs would be to modify further ERISA regulations to promote the purchase of these securities by pension plans. Pension plan investment in mortgages and MBSs could match a source of long-term investment cash with a demand for long-term credit, contributing to the overall efficiency of credit markets. Pension plans had assets of $600 billion--roughly equivalent to that of the savings and loan industry--in the early 1980s, and plan assets are projected to grow to over $1 trillion by the middle of the decade. 19/ While some state and local employee pension plans include MBSs in their portfolios, private pension plans generally do not. 20/

Although ERISA regulations have been amended twice since the beginning of 1982 to encourage pension plan investment in mortgages and MBSs, plan investment in privately issued conventional MBSs is still on less

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19. Barbara L. Miles, "The Government National Mortgage Association Mortgage-Backed Securities Program: Proposed Limitations on the Use of 'Ginnie Maes'," Congressional Research Service, Library of Congress (June 29, 1982), p. 9.

20. The limited amount of private pension plan investment in mortgages has been attributed to many factors, including greater familiarity of plan investment managers with bonds than MBSs; investment prohibitions in the Employee Retirement Income Security Act (ERISA) regulations; and the unusual and uncertain cash flow patterns of securities due to the prepayment of mortgages in the pools. Some of the reasons for public pension plan investment in conventional MBSs include receptivity of their in-house managers to mortgage investments, the size of these plans, and their willingness to make timely decisions. Exemption of public plans from ERISA regulations, and a political motivation toward local or in-state investment, are also cited as reasons for this investment.

advantageous terms than investment in MBSs issued or guaranteed by the federal secondary market credit entities. In short, while the security--rather than its underlying mortgages--is evaluated to be a plan asset for FNMA and FHLMC MBSs and for GNMA-guaranteed MBSs, in the case of privately issued conventional MBSs, the underlying mortgages are evaluated to be plan assets. Because each conventional mortgage in a pool must be acceptable as a pension plan asset, there is a greater likelihood that a plan will reject for investment a security backed by conventional mortgages.

The federal government could encourage pension plan investments in privately issued conventional MBSs by amending ERISA regulations to treat those securities and the federally issued or guaranteed MBSs alike. Such a change--which would not require a change in law--might go a long way toward promoting a test of the viability of the secondary market in privately issued conventional MBSs. Increased trading of these securities could, in turn, encourage the development of a futures market in them. A futures market in privately issued conventional MBSs would reduce the interest rate risk and uncertainty associated with the security by guaranteeing its future rate. It could thus enhance the competitiveness of the instruments with GNMA-guaranteed MBSs--which have futures markets on both the Chicago Board of Trade and the Amex Commodity Exchange.

On the other hand, amending ERISA regulations to allow pension plan investment in privately issued conventional MBSs and federally issued and guaranteed MBSs on the same terms might diminish control over the quality of these investments. If investments in conventional mortgages and in privately issued MBSs backed by them turned out to be riskier than investments in federally insured or guaranteed mortgages and federally issued or guaranteed MBSs, pension plans might experience greater losses and thus lower net returns on their funds.

Reducing Direct Federal Housing Credit Activity

A third set of options would reduce the direct federal role in the housing finance system with the hope of stimulating greater private activity. Specific alternatives include:

- Limiting or refocusing federal mortgage insurance;

- Reducing GNMA activity or removing the favored status of GNMA securities; and

- Reorganizing the Federal Home Loan Mortgage Corporation by reducing its direct tie to the federal government.

The first two options would curtail the direct federal role in the housing finance system. The third option--reorganizing the FHLMC--would move into the private sector an institution that now operates within the public domain.

All of these options are based on the belief that federally supported mortgage credit activity impedes the development of private-sector alternatives which, if they existed, would generate efficiencies that would lower interest rates more than the publicly sponsored ones they would supplant. Whether such private alternatives would develop rapidly to fill a void left by federal withdrawal is uncertain, however; nor is it certain that the private-sector alternatives would be more efficient. Furthermore, if private alternatives did not develop quickly, appreciably reducing the federal role could cause dislocations for the housing finance system. The risks of such dislocations could be lessened, but not eliminated, if federal credit activity was reduced only gradually or in selective areas where it overlaps most with private activity.

Limiting or Refocusing Federal Mortgage Insurance. The government could reduce federal mortgage insurance activity by lowering the volume of loan insurance commitments the FHA is authorized to make annually, by refocusing the program on groups of borrowers less likely to be served by private insurers, or by establishing reinsurance contracts with private mortgage insurance companies.

The Congress could limit the mortgage insurance programs of the FHA directly by reducing the annual authorization for new insurance. The Administration recommended sharply reduced commitment levels for both fiscal years 1983 and 1984, but in neither case has the Congress adopted the reduced levels. For fiscal year 1983, the Administration originally recommended a limitation on new insurance commitments of $35 billion, but the Congress initially set the limit at $45.9 billion and later increased it to $50.9 billion in an act providing supplemental appropriations for fiscal year 1983. For fiscal year 1984, the Administration recommended a limitation of $39.8 billion in its January 1983 budget submission, but the Congress has again set the limit on new FHA insurance commitments at $50.9 billion. If in the future the Congress reduced markedly the volume of new FHA insurance, the impacts on potential homebuyers would depend on how the remaining insurance was rationed--specifically, on whether it was made available to those borrowers least likely to be served by private insurers.

The Congress also could lessen the volume of new FHA insurance by increasing premiums. Annual premiums are currently 0.5 percent of the unpaid principal value, and premium collection as a lump-sum-payment--equivalent to 3.8 percent of the total value of a 30-year level payment mortgage--at the time of settlement was authorized in the Omnibus Budget Reconciliation Act of 1982. If the premium rate was increased uniformly, low-income borrowers might be excluded from the mortgage insurance program because of its cost. In addition, with higher premiums, FHA insurance could become noncompetitive with insurance provided by private issuers. 21/ On the other hand, even at higher premiums, FHA insurance could retain an advantage over private mortgage insurance because FHA-insured loans are eligible for packaging in securities guaranteed by the GNMA.

Alternatively, FHA mortgage insurance programs could be limited by explicitly targeting them on certain groups of borrowers. For example, federal mortgage insurance could be focused on the higher-risk borrowers less likely to be served by the private sector. 22/ Limiting FHA insurance in this manner would continue service to those most in need, but could also raise federal costs, since default rates would probably increase. Furthermore, because FHA insurance is already targeted on underserved populations, any further targeting could eliminate households who would not be acceptable to private insurers. 23/

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21. The FHA charges all borrowers a flat fee of 0.5 percent of the loan value. Private mortgage insurers in their annual premium plans, on the other hand, vary the percentage of the outstanding loan value charged as the premium by the year of the mortgage term, by the percentage of the loan insured, and by the loan-to-value ratio. For example, the first-year premium on a mortgage with a loan-to-value ratio of 86 to 90 percent--of which 20 percent is insured--would be 0.5 percent. The premium on this loan in all subsequent years would be 0.25 percent. On the other hand, the premium on a mortgage loan insured for 10 percent of its value and with a loan-to-value ratio of 80 percent or less, would be 0.125 percent of the outstanding loan value throughout its term.

22. The loan-to-value ratio is one conventionally accepted measure of loan riskiness. In 1981, a greater percentage of the mortgages insured by private mortgage insurers than by the FHA had loan-to-value ratios below 90 percent.

23. See James Barth, Joseph Cordes, and Anthony Yezer, "Federal Government Attempts to Influence the Allocation of Mortgage Credit: FHA Mortgage Insurance and Government Regulations," in Congressional Budget Office, Conference on the Economics of Federal Credit Activity, Part II-Papers (September 1981), pp. 159-232.

Finally, the government could lessen federal mortgage insurance activity by authorizing reinsurance contracts with private mortgage insurance companies. During the first session of the 98th Congress, Senator Proxmire introduced S. 835, a bill that would authorize the FHA to establish reinsurance contracts requiring that private mortgage insurance companies assume a percentage of the loss on any of the mortgages insured under the largest FHA insurance programs and delegating to private insurers certain functions--such as credit approval, appraisal, inspection, commitment, claims processing, and property disposition. Any reinsurance contract would provide for the sharing of premiums and of necessary insurance reserves between the FHA and the private mortgage insurance companies.

Although requiring reinsurance contracts would share the risk between the government and private insurers, its eventual impact on federal expenses would depend on precisely how premiums and risks were shared. Also, requiring such contracts could either increase the cost of insurance or limit its availability for higher-risk homebuyers, if private mortgage insurers were unwilling to participate under current FHA terms.

Reducing GNMA Activity or Removing the Favored Status of GNMA Securities. Proposals to reduce GNMA activity or to remove the favored status of its securities are motivated by a concern that the GNMA MBS program may impede the development of private guarantee programs for MBSs. If, in fact, GNMA MBSs merely supplant private, nonguaranteed securities that would have been issued in any event, limiting GNMA activity could help stimulate the existing small market in MBSs neither issued nor guaranteed by federal secondary market credit entities. 24/ As long as the current GNMA MBS program is in operation, however, it is impossible to know whether GNMA securities principally supplant other MBS issues or supplement the total volume of MBSs. Eliminating the GNMA MBS guarantee program entirely or reducing it sharply would allow one to examine its impact but could seriously disrupt secondary market activity if the GNMA guarantee proved essential to the issuance and trading of MBSs backed by FHA/VA/FmHA mortgages. Although less precipitous changes might enable information to be gathered about the responsiveness of the private market with fewer dangers, even gradual changes would not be

24. See David F. Seiders, "The GNMA-Guaranteed Passthrough Security: Market Development and Implications for the Growth and Stability of Home Mortgage Lending," Staff Study No. 108, Board of Governors of the Federal Reserve System (December 1979), p. 4; and Patric H. Hendershott and Kevin E. Villani, "Residential Mortgage Markets and the Cost of Mortgage Funds," American Real Estate and Urban Economics Association Journal, vol. 8, no. 1 (Spring 1980), p. 59.

without some risks. Furthermore, as private alternatives developed, they might prove less efficient than the publicly supported ones they would supplant.

Specific options for curtailing government activity include:

- Reducing GNMA guarantee activity across the board;

- Authorizing the guarantee only of securities backed by pools of innovative mortgages; and

- Eliminating the full-faith-and-credit GNMA guarantee.

--Reducing GNMA guarantee activity across the board. GNMA's guarantee activity could be reduced directly by cutting back the annually legislated ceiling on new MBS guarantees or indirectly, either by limiting the number of FHA/VA loans or by increasing fees on new GNMA guarantee commitments. 25/ Limiting GNMA's guarantee activity in any of these ways would lessen the contingent liability of the federal government for payment of principal and interest to investors in the guaranteed MBSs. It would not, however, reduce the government's contingent liability for the underlying mortgage debt unless it was accompanied by a reduction in the number of federally insured or guaranteed loans. 26/ The impact on near-term federal revenues would depend on how the amount of commitment and guarantee fees was affected.

However it was accomplished, there is a serious question whether a retrenchment in GNMA-guaranteed MBSs would be sufficient to encourage development of a secondary market in privately issued nonguaranteed or

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25. Effective October 1, 1982, the GNMA initiated an issuer application fee and increased the commitment application fee for its MBS program. An issuer application fee of $250 is now required when any mortgage lending institution first seeks GNMA approval to become an issuer of MBSs. The former commitment application fee of $500 has been replaced by a sliding scale fee. For the first $1.5 million of commitment amounts the fee is $500, while an additional fee of $200 is charged for each $1 million (or part thereof) above $1.5 million.

26. In its January 1983 budget submission, the Administration recommended a $58.65 billion limit on GNMA commitments for guarantees of mortgage-backed securities for fiscal year 1984. The 1984 Department of HUD-Independent Agencies Appropriation Act established a ceiling of $68.25 billion.

privately guaranteed MBSs. Because regular payment of principal and interest on GNMA securities would still carry the full-faith-and-credit guarantee of the federal government, it might be difficult for nonguaranteed or privately guaranteed MBSs to compete with even a reduced volume of GNMA-guaranteed securities.

--Authorizing the guarantee only of securities backed by innovative mortgages. Another means of reducing the volume of GNMA-guaranteed MBSs would be to authorize the agency to guarantee only those securities backed by pools of innovative federally underwritten mortgages--that is, loans using other than fixed-rate long-term repayment schedules. If one reason for seeking FHA insurance, VA guarantees, or FmHA guarantees for mortgages is to make them eligible for guarantee by the GNMA, then limiting the GNMA guarantee to this smaller pool of mortgages could, for example, lessen the demand for FHA mortgage insurance and increase the share of mortgages insured by private companies. A GNMA guarantee program scaled back in this way could continue to encourage the development of innovative mortgages while providing information on both the investor acceptance of such loans and the pricing of new types of mortgage-backed securities for use by the private market. 27/ On the other hand, doing away with GNMA guarantees for noninnovative mortgages could reduce substantially the flow of funds to housing through the secondary market unless private activity expanded rapidly to fill the gap.

--Eliminating the full-faith-and-credit guarantee. A third way to reduce federal involvement in the secondary mortgage market would be to eliminate the full-faith-and-credit government guarantee currently enjoyed by GNMA MBSs and transfer the guarantee function to the FNMA or the FHLMC. 28/ In either event, because the guarantee no longer would be backed by the full faith and credit of the government, lenders would likely perceive it to be of less value. Thus, if lenders continue to make FHA-insured, VA-guaranteed, and FmHA-guaranteed loans with the intention of marketing them in guaranteed MBSs, they would probably seek to raise the

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27. See The Report of the President's Commission on Housing (1982), p. 167.

28. The FHLMC interprets its charter as allowing it to guarantee MBSs issued by other institutions. S.1821, as reported by the Senate Banking, Housing, and Urban Affairs Committee, would prohibit the FHLMC from guaranteeing mortgage-related securities issued by others. In its legislative proposals presented at hearings before the Senate Subcommittee on Housing and Urban Affairs on May 5, 1983, the FNMA sought authority to guarantee MBSs issued by others.

interest rate on underlying loans, or, if that was not permissible, to increase the points charged in order to compensate for the reduced value of the guarantee on the MBSs.

If either the FNMA or the FHLMC assumed the guarantee function, the expected increase in interest rates or points on FHA-insured, VA-guaranteed, or FmHA-guaranteed mortgages would be limited to the value of the GNMA cash-flow guarantee relative to that of one of the federally sponsored credit agencies. 29/ Under any circumstances, eliminating the full-faith-and-credit GNMA guarantee would lessen only the federal government's contingent liability for the proceeds of the securities; it would not eliminate the government's contingent liability for the underlying mortgage debt. Eliminating the GNMA guarantee would also reduce federal receipts by ending commitment and guarantee fees.

Reorganizing the Federal Home Loan Mortgage Corporation. Another way of diminishing the direct federal role in the housing credit market would be to reorganize the FHLMC as a private institution to more nearly resemble the FNMA. Although diminishing the FHLMC's ties to the federal government could encourage the development of other private secondary market institutions, its net impact on housing credit markets would depend on the precise nature of the reorganization and how the restructured agency chose to operate--something which is difficult to forecast in advance. 30/

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29. Both the MBS issues and the debentures of the FNMA and the FHLMC are already attractive to investors because: they are exempt from Securities and Exchange Commission requirements; they do not jeopardize the tax status of pension plans, insurance companies, or thrift institutions; they may be used as collateral by financial institutions for repurchase agreements or Federal Home Loan Bank or other borrowing; and they are exempt by regulation from the prohibited transactions rules governing pension funds under the Employee Retirement Income Security Act. See Barbara L. Miles, "The Government National Mortgage Association Mortgage-Backed Securities Program: Proposed Limitations on the Use of 'Ginnie Maes'," Congressional Research Service, Library of Congress (June 29, 1982), pp. 12-13.

30. See To Expand and Reorganize the Federal Home Loan Mortgage Corporation, Hearings before the Subcommittee on Housing and Community Development, Committee on Banking, Finance and Urban Affairs, House of Representatives, 97 Cong., 2 sess. (April 21 and June 3, 1982), p. 537.

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During the 97th Congress, three bills--S. 1805, H.R. 4787, and H.R. 6442--were introduced which would have reorganized the FHLMC as a private taxpaying entity. Under these proposals, the private FHLMC would be precluded from borrowing from the Federal Home Loan Bank System, but the Federal Home Loan Banks would provide a $200 million emergency fund for the FHLMC. The FHLMC's securities would continue to be treated as they currently are under state investment laws, which ensure a broad market for them, and would continue to be considered eligible investments for federally supervised institutions. Because the Federal Home Loan Bank member institutions provided the initial $100 million to capitalize the FHLMC, the current stock of the FHLMC would be redistributed to the savings and loan associations, and the FHLMC would be authorized to recapitalize itself by selling stock to either the users of its program or the general public.

A private, taxpaying FHLMC could either lessen or increase the federal government's liability for mortgage debt, depending on the specifics of the reorganization and the operation of the newly private agency. Because the FHLMC would become a private institution, the federal government would have explicit responsibility for the mortgage debt the FHLMC acquired only up to the limit in the emergency fund. Thus, under the proposals made during the last Congress, the federal contingent liability would be lessened unless actual liabilities of the FHLMC ever were to exceed $200 million. On the other hand, if a private FHLMC acquired a sizable proportion of all conventional mortgages, the Congress might find it difficult to allow the institution to become insolvent. If that occurred, the federal government's effective liability could eventually increase.

A related question is whether, if the FHLMC was reorganized as a private institution with virtually the same operating authority as the FNMA, the two institutions should then be merged. Senator Tower, in introducing on August 4, 1983, legislation to alter some present federal secondary credit market programs, raised the broader issue of the future institutional forms of both the FHLMC and the FNMA. 31/ Among the specific options cited were merging a reorganized FHLMC with the FNMA, as well as leaving the FNMA intact while transfering ownership of the FHLMC to the private sector. If a merger of the two federal credit entities was undertaken, the impact on the housing credit market--and particularly on fully private competitors--would depend on what specific authorities were granted to the new agency and what ties it retained to the government. In any event, a FNMA-FHLMC merger might not be feasible unless attempted after the FNMA had experienced several quarters without reporting a loss. (For the

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31. The Congressional Record, August 4, 1983, pp. S11779, S11782.

first quarter of 1983 the FNMA reported its first profit since the fourth quarter of 1980, and it continued to report a profit for the second and the third quarters of 1983.)

ALTERING FEDERAL SUBSIDIES

A second broad issue is whether to change the federal subsidies now provided for housing. This question arises out of two different--but not necessarily contradictory--concerns. On the one hand, homeownership has become increasingly difficult for low- and moderate-income households to finance, even with the existing subsidies provided through the tax system. At the same time, some believe that federal tax policies give greater incentives to investment in residential housing overall than is warranted in the present state of the economy, particularly in light of lagging productivity growth in other sectors of the economy.

The sections that follow describe two sets of options for altering housing subsidies. Both sets deal with federal tax provisions, the major source of present subsidies for housing. The first set of options would increase subsidies for persons who might otherwise find homeownership difficult to afford; the second set of options would curtail untargeted federal subsidies as a means of reducing the relative attractiveness of housing as an investment compared with other uses of capital. Options from either set could be pursued separately, or specific alternatives from both sets might be adopted simultaneously, with some or all of the increased federal revenues generated by the latter options used to help offset the revenue losses resulting from the former.

Increasing Targeted Subsidies

Targeted subsidies for particular groups of homebuyers could be increased by:

- Extending the use of tax-exempt revenue bonds for single-family mortgages beyond the currently scheduled December 31, 1983, expiration;
- Establishing a tax credit for mortgage interest payments by homebuyers; or
- Authorizing tax-subsidized savings accounts for home purchases.

The first two options would reduce after-tax interest costs for homebuyers. The third would assist them to accumulate the necessary down payment.

Extending the Use of Tax-Exempt Mortgage Revenue Bonds. One means of subsidizing mortgage credit would be to extend the availability of tax-exempt mortgage revenue bonds for single-family housing beyond the scheduled expiration on December 31, 1983. Specific alternatives include extending the current program or targeting the use of bonds more narrowly.

Regardless of the form of a mortgage revenue bond program, however, tax-exempt bonds are generally less efficient than direct subsidies--that is, a smaller proportion of the revenue loss is realized by the homebuyer than is the case for outlays under direct expenditure programs. A CBO analysis undertaken several years ago indicated that between 43 percent and 54 percent of the subsidy provided through tax-exempt mortgage revenue bonds went to the homebuyers. Most of the remainder went to bondholders and intermediaries, including issuers, underwriters, and bond counsel. In contrast, a now largely inactive direct mortgage assistance program for low- and moderate-income homebuyers (the Section 235 program) was 90 percent cost-efficient.

--Extending the current program. Extending the current program for tax-exempt mortgage revenue bonds would increase the future supply of below-market-interest rate mortgages for homebuyers. It would, however, result in increased revenue losses to the Treasury and could also increase borrowing costs to state and local governments for all purposes by driving up the interest paid on other tax-exempt bonds. Continuing the present program would provide an estimated $84 billion in additional reduced-interest mortgages over the 1984-1988 period and would result in an increased revenue loss of $2.8 billion during the corresponding five fiscal years. 32/

--Targeting the program more narrowly. Alternatively, the Congress could repeal the present "sunset" provision for tax-exempt mortgage revenue bonds for single-family homes, but target the use of bonds more narrowly. The current program targets aid on first-time homebuyers and, to a lesser degree, on areas designated as distressed on the basis of such factors as the condition of the housing stock in the area and the potential

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32. This revenue loss is in addition to the $7.9 billion expected between 1984 and 1988 as a result of the $39.4 billion in bonds that will be outstanding on December 31, 1983. The difference of $2.8 billion understates the eventual revenue effect of continued use of the bonds, however, because it does not reflect the fact that the federal government will continue to sustain revenue losses for as long as the newly issued bonds are outstanding--up to 30 years in many cases.

for the use of owner financing to improve housing conditions. In addition, price limits on homes purchased with bond-assisted mortgages limit maximum benefits per household. There is evidence to suggest, however, that many of the households currently assisted might have been able to purchase homes without the assistance. In a recent study, the General Accounting Office found that borrowers with incomes above $20,000 received three-quarters of the mortgage loans, and borrowers with incomes above $35,000 received 15 percent of the mortgage loans provided from revenue bond proceeds. 33/

The present subsidy could be more narrowly targeted on low- and moderate-income households by placing income limits on households, by establishing mortgage-value ceilings, or by limiting the subsidy to households that forgo the deduction of mortgage interest from taxable income. 34/ Any such change would target assistance on those households most in need of financial aid to purchase homes but would not reduce the federal revenue loss unless it led to a reduction in the total volume of bonds issued--something that is now controlled principally by state-by-state limits.

Establishing a Tax Credit for Mortgage Interest Payments by Homeowners. Another means of increasing subsidies to housing credit for low- and moderate-income homebuyers would be to establish a partial tax credit against mortgage interest payments. Such a credit could extend the present mortgage interest tax subsidy to the many lower-income homeowners who do not benefit from the current interest deduction, because they take the standard deduction rather than itemize.

A tax credit for mortgage interest payments could be targeted on low- and moderate-income families either by restricting its use to families with incomes below specified limits or by requiring that families choose between

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33. General Accounting Office, The Costs and Benefits of Single-Family Mortgage Revenue Bonds: Preliminary Report (April 1983), pp. 11, 14, 16-17.

34. Requiring that home purchasers choose between receiving a mortgage financed by a tax-exempt bond or deducting mortgage interest payments from taxable income would likely cause high-income households to exclude themselves from the bond program. The existing mortgage interest deduction would almost always save those households more in taxes than they would gain from the lower interest rates in the bond program. See Congressional Budget Office, Tax-Exempt Bonds for Single-Family Housing (April 1979), p. 95.

the credit and the present mortgage interest deduction. In either case, if a tax credit was established without altering present mortgage interest deductibility provisions, the credit would add to total federal revenue losses. Alternatively (as discussed below), the additional revenue loss resulting from a tax credit could be partially or fully offset by limiting mortgage interest deductibility. 35/ In any event, a tax credit is a more efficient subsidy mechanism than mortgage revenue bonds--that is, a greater share of the revenue loss would be realized by homebuyers as reductions in their net housing costs. Therefore, a larger number of households could be aided at the same total cost to the government.

Authorizing Tax-Subsidized Savings Accounts for Home Purchases. Taking a different approach, the Congress could assist first-time homebuyers to accumulate funds for down payments by authorizing tax-subsidized savings accounts, known as individual housing accounts (IHAs). 36/ These accounts, similar to individual retirement accounts, would permit prospective homeowners to deposit up to a maximum amount each year and in total into a savings account whose balance could be used as a down payment on a home. Annual contributions to the accounts either would be tax-deductible or would qualify for tax credits, while interest earnings would be tax-free. If funds were withdrawn from these accounts and used for other than their intended purpose, a penalty would be assessed against the account holder.

Tax-subsidized housing savings accounts would enable prospective buyers to accumulate down payments more quickly than otherwise would be possible, to purchase homes of increased value, or to increase the size of their down payments--thereby reducing monthly payments throughout the mortgage term. Such accounts would probably benefit higher-income households--with greater saving potential--more than less affluent ones.

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35. H.R. 3594 and S. 1598, introduced during the first session of the 98th Congress, would provide limited tax credits for mortgage interest payments in states or localities that elect not to use mortgage revenue bonds.

36. Several forms of individual housing accounts have been proposed in bills introduced during the first session of the 98th Congress. Two bills--H.R. 2916 and S. 1435--would establish accounts similar to individual retirement accounts to facilitate the accumulation of down payment funds for the purchase of a principal residence. Other bills--H.R. 2567 and S. 1051, for example--would also permit homeowners to prepay more rapidly mortgages on houses acquired before the accounts were established.

Providing a tax credit rather than deductibility for contributions to these accounts would target aid more narrowly on households most in need of assistance.

Reducing Overall Subsidies

In addition to--or independent of--increasing targeted homeownership subsidies, the Congress could alter federal policy to reduce the less targeted subsidies that are now provided for housing. Such changes could be viewed either as a means of financing greater targeted subsidies or as unrelated actions intended to encourage the flow of capital to--and the greater growth of--sectors of the economy other than housing. Since the present system of subsidies for housing was put in place to encourage both residential investment generally and homeownership specifically, reductions in those subsidies would represent a break with past policies. On the other hand, the sharp rise in these subsidies in recent years may make a reexamination of them at this time appropriate. 37/

If the Congress chooses to reduce subsidies for investment in housing, numerous options are available. The examples described below would limit the deductibility of mortgage interest payments from income for tax purposes (the largest present homeownership tax subsidy) or alter the excess bad debt reserve tax deduction now available to thrift institutions, which encourages them to invest in residential mortgages. 38/

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37. As discussed earlier, tax laws enacted during the past few years have further enhanced the relative incentives for investment in rental housing versus other assets. The Economic Recovery Tax Act of 1981 increased the investment incentives for rental housing as well as for other real and personal property; the Tax Equity and Fiscal Responsibility Act of 1982 then removed some of the incentives for investment in plant and equipment established by the 1981 act. See Patric H. Hendershott and James D. Shilling, "Capital Allocation and the Economic Recovery Tax Act of 1981," Public Finance Quarterly, vol. 10, no. 2, April 1982, pp. 242-73.

38. Other options, not considered here, could reduce indirect encouragements for investment in housing by, for example, eliminating deposit insurance for federally chartered lending institutions. While such a change would eliminate one of the principal advantages that the major mortgage lenders have in attracting deposits, it would also lessen the safety of the dominant investment opportunity available to small savers.

Limiting Mortgage Interest Tax Deductibility. The Congress could lessen the total amount of subsidy to the housing sector--and increase federal revenues as well--by establishing a ceiling on the amount of mortgage interest payments homeowners can deduct from their taxable incomes. Limiting the deductibility of home mortgage interest payments would increase the after-tax cost of ownership, thus decreasing the relative attractiveness of homeownership as an investment and potentially directing some consumer saving toward other types of investments. Capping interest deductibility could also alter home prices by reducing the demand for expensive houses on which mortgage interest payments would be above the ceiling and increasing the relative demand for less expensive houses. These demand shifts, and any associated price changes, could result in capital losses for owners of more expensive houses and capital gains for owners of less expensive houses. Eventually these might be reduced as the supply of housing adjusted, but the adjustment process could take a very long time. Some may regard such gains and losses as inequitable, on the ground that homebuyers assume tax laws will remain constant when they make their purchases.

A ceiling on home mortgage interest payments would impose significant tax increases on taxpayers now benefiting most from deductibility--primarily those with high incomes and with large amounts of mortgage debt. For example, had a $5,000 ceiling on mortgage interest deductibility been in effect in 1981, over 55 percent of the resulting tax increase would have fallen on taxpayers earning $50,000 or more. A $10,000 ceiling would have affected very few taxpayers with incomes under $50,000, with almost 45 percent of the tax increase falling on taxpayers with incomes of $100,000 or more. Because of large increases in interest rates in the past few years, recent homebuyers would be most adversely affected by a ceiling on home mortgage interest payments.

The Congress could consider several variants of the ceiling on mortgage interest deductibility to limit the financial hardship imposed on certain groups of taxpayers. One alternative would be to place a ceiling on the mortgage amount instead of on the amount of mortgage interest that is deductible. Under this option, only interest payments corresponding to a mortgage balance below a certain amount, say $75,000, would be deductible. Establishing a ceiling on the mortgage amount would lessen differences in the treatment of households that bought homes with similar sized mortgages but at different times and therefore with different interest rates. A ceiling on the mortgage amount would not, however, eliminate the differential tax treatment of households that bought similarly priced homes with mortgages above the ceiling at different times. A variation of this approach would be to establish a sliding scale of deductibility with, for example, homeowners able to deduct all interest payments corresponding to the first $75,000 worth of mortgage balance, but progressively smaller shares of the interest payments on mortgage amounts above that level. This option would shield more recent buyers from sizable tax increases but would result in a smaller revenue gain for the government.

A different approach would be to disallow the deduction of, say, 5 percent of annual mortgage interest payments for all households. This would spread the additional tax burden equally across all homeowners who itemize, but would have a small impact on the allocation of credit between housing and other sources since the disincentives to buy expensive homes would be reduced only slightly.

The deductibility of mortgage interest payments also could be limited indirectly by establishing a cap for all nonbusiness, noninvestment interest deductions. The Congress could, for example, establish a $10,000 cap for all interest payments on home mortgages, auto loans and other installment purchases, credit card carryovers, and consumption borrowing taken together. Such a cap would reduce the incentive for all forms of borrowing above the cap. For example, at a 14 percent interest rate, interest on borrowings up to $71,000 would be fully deductible, while at a 10 percent rate, interest on borrowings up to $100,000 would be deductible.

Finally, the deductibility of mortgage interest payments could be allowed only for principal residences. Although this alternative would generate additional revenue, it could result in households with more than one residence purchasing more expensive principal residences and less costly second or more residences than otherwise. In addition, because the change would affect only a small proportion of all homeowners, it would probably have little effect on the overall allocation of capital between housing and other investments.

Increases in federal revenue resulting from any limit on mortgage interest tax deductibility would depend on the level of the ceiling and the form the cap took. For example, according to CBO estimates made in 1982, a $5,000 ceiling on mortgage interest deductions would have increased federal revenues by about $31 billion over a five-year period, while a $10,000 ceiling would have increased federal revenues by about $6 billion over five years. According to an estimate prepared one year later, a $10,000 cap on all nonbusiness, noninvestment interest deductions would increase federal revenues by $9 billion over a five-year period.

Modifying the Excess Bad Debt Reserve Tax Deduction. Overall federal subsidies to the housing sector could also be altered by modifying Section 593 of the Internal Revenue Code which establishes an excess bad debt reserve tax deduction for thrift institutions. Under current law, savings and loan associations and mutual savings banks may deduct as much as 34 percent of their total taxable incomes as additions to their bad debt reserves if specified percentages of their assets are held in mortgages or other qualifying forms. Savings and loan associations must hold 82 percent of their assets in qualifying forms to take the full deduction, and the deduction is gradually decreased until it reaches zero when qualifying assets amount to 60 percent of an institution's total. Mutual savings banks may take the full deduction if they hold 72 percent of their assets in qualifying forms, and lose the deduction entirely if 50 percent or less of their assets are qualifying.

Although the federal revenue loss resulting from these provisions is relatively small--an estimated $335 million in fiscal year 1983--the potential effect of the excess bad debt reserve tax deduction on the investment behavior of thrift institutions is probably considerable. The importance of this deduction may help account for the numerous applications during the first quarter of 1983 for charter conversions by savings and loan associations seeking to become mutual savings banks, allowing them to take the maximum tax deduction while holding a smaller percentage of qualifying assets. 39/

The excess bad debt reserve tax deduction could be modified in a variety of ways to lessen either the incentive for thrift institutions to invest in housing or the resulting revenue loss from the deduction. Some options to accomplish the former would work against achieving the latter, however. Specific options for altering the deduction include: lowering the maximum qualifying levels of assets, lowering the percent of taxable income deductible as an addition to the institution's bad debt reserve, or reducing both.

Lowering the maximum qualifying levels of assets while retaining the percentage of taxable income that is deductible would probably lessen the amount of investment in housing by thrift institutions but would not reduce the federal revenue loss. Lowering the maximum percentage of taxable income deductible as an addition to an institution's bad debt reserve, while retaining the existing maximum qualifying levels of assets, would lessen the federal revenue loss and reduce the incentive for thrift institutions to hold the maximum percentage of qualifying assets--thereby potentially decreasing housing investment. Lowering both the maximum qualifying levels of assets and the percent of taxable income deductible would probably lessen the amount of investment in housing still further, while reducing the federal

39. As described in Chapter IV, such charter conversions were authorized by the Garn-St. Germain Depository Institutions Act of 1982.