RURAL HOUSING PROGRAMS: LONG-TERM COSTS AND THEIR TREATMENT IN THE FEDERAL BUDGET

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NOTE: Unless otherwise noted, all years in this text refer to fiscal years.

PREFACE

The Congress is considering this year proposals to restructure rural housing assistance. This paper, requested by the Senate Budget Committee, describes current programs and explains how the budgetary treatment obscures their costs. It provides estimates of the long-term cost of the current programs and discusses options both for reducing costs and for modifying the budgetary treatment to make costs more apparent.

Roberta Drews of CBO's Human Resources and Community Development Division prepared this paper and Ben Steffen provided the computer modeling of long-term program costs. They worked under the supervision of Nancy M. Gordon and Martin D. Levine. Robin Seiler and Ann Hadley reviewed earlier drafts of the report and provided helpful comments. Many members of the CBO staff, including Brent Shipp, Lloyd Atkinson, Patricia Ruggles, Joel Slackman, and Peter Taylor, also contributed necessary information and useful comments. Numerous persons at the Farmers Home Administration of the Department of Agriculture provided program and budget data used in the study. Francis Pierce edited the paper. Mary Braxton typed the several drafts and prepared the manuscript for publication.

In accordance with CBO's mandate to provide objective and impartial analysis, this paper contains no recommendations.

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Director

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SUMMARY

Although the federal government is a major mortgage lender in rural areas, current budget practices obscure the costs of this activity and make it difficult for the Congress to assess the consequences of annual funding decisions. The Farmers Home Administration (FmHA), an agency of the U.S. Department of Agriculture, subsidizes the housing costs of some low- and moderate-income households in rural areas by providing reduced-interest homeownership and rental housing loans. The cost to the federal government of outstanding mortgages totaled $1 billion in 1981 and is expected to reach $1.7 billion by 1983. Despite the growing cost of rural housing assistance, the Congress does not now have available estimates of the additional costs that result from each year's new lending activity.

MAJOR FmHA LENDING PROGRAMS

The two major FmHA lending programs are the Section 502 homeownership program, which finances the purchase of newly built or existing single-family homes, and the Section 515 rental housing program, which finances the construction or rehabilitation of multifamily rental projects.[1]

The Section 502 program provides 33-year mortgages at effective interest rates as low as 1 percent. For low-income borrowers[2]--the vast majority of Section 502 participants--the FmHA sets interest rates at levels that enable them to spend 20 percent of their incomes on mortgage payments, property taxes, and insurance. The FmHA then pays the difference between the interest rates charged on funds to finance the program and the rates paid

1. The program names refer to section numbers of the Housing Act of 1949 (Public Law 81-171), as amended.

2. Low-income borrowers are those with incomes below a range of $11,500 to $18,000 in the continental United States, depending on area housing costs, with adjustments allowed for certain household expenses. Moderate-income levels are set $5,500 higher than low-income limits.

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by its borrowers; this difference is referred to as an interest credit. Over time, as borrowers' incomes change, the effective interest rates are recalculated to maintain the housing-cost-to-income ratio of 20 percent. Households receiving interest-credit loans must repay the government at least part of the interest subsidy received, if their homes have appreciated in value at the time they are sold. Moderate-income borrowers do not receive interest-credit agreements and pay interest rates that are tied to federal borrowing costs but that are generally below private mortgage rates.

The Section 515 rental housing program provides 50-year mortgages to developers with interest credits reducing effective interest rates to 1 percent, thereby permitting tenants to pay reduced rents. Tenants of Section 515 projects are required to contribute toward their housing expenses the greater of 25 percent of their incomes or the minimum project rent, which includes the costs of amortizing the 1 percent mortgage and project expenses. The developer keeps the minimum rent, and the FmHA collects any payments above the minimum. Payments above the minimum rent are referred to as "overage" payments and are treated as additional interest payments, thereby reducing total program costs.

THE LONG-TERM COST OF RURAL HOUSING PROGRAMS

If the Congress authorized $3.2 billion in Section 502 and Section 515 interest-credit assistance in 1983--the level funded in 1982--the resulting long-run cost would range from $1.0 billion to $1.6 billion in 1983 dollars. Although the Congress has modified the programs in recent years in order to lower program costs, other options exist to lower costs still further.

Long-Term Program Costs

The net long-term cost of providing $100 million in additional Section 502 interest-credit loans in 1983 would range from $23 million to $29 million in 1983 dollars (see Summary Table). The interest subsidies associated with these loans would range from $33 million to $41 million. The subsidy recapture provision would reduce the interest subsidy costs by about one-third, or from $10 million to $13 million.

SUMMARY TABLE. LONG-TERM COSTS OF INTEREST-CREDIT RURAL HOUSING PROGRAMS PER $100 MILLION IN ASSISTANCE IN 1983 (In millions of 1983 dollars)

Program	Range of Estimates[a]
Section 502 Net Costs	23 to 29
Interest Subsidy Costs	(33 to 41)
Offsetting Collections from Recapture Provisions[b]	(-10 to -13)
Section 515 Net Costs	54 to 100
Interest Subsidy Costs	(89 to 130)
Offsetting Collections from Overage Provisions[b]	(-19 to -58)

SOURCE: Congressional Budget Office.

a. These estimates are based on four sets of assumptions about long-term real interest rates, economic activity, and program operation. See the Appendix for details.

b. Net income to the FmHA.

Providing $100 million in additional interest-credit Section 515 loans in 1983 would cost from $54 million to $100 million in 1983 dollars over the term of the commitments. Interest subsidies for Section 515 lending would range from $89 million to $130 million, which is higher than for Section 502 loans because borrower interest rates remain fixed at 1 percent and because the term extends for 50, instead of 33, years. These costs would be partially offset by the overage collections, which could range from $19 million to $58 million. The FmHA has little information, however, on overage collections to date, making estimates of future overage collections especially uncertain.

Options That Would Reduce Costs

The long-term costs of Section 502 and Section 515 interest-credit loans in 1983 could be lowered either by reducing the loan volume in any one year or by requiring tenants to pay a larger share of program costs. The savings realized by providing less assistance would be straightforward; any reduction in funding levels would yield a proportionate reduction in long-term costs. The savings realized from requiring tenants to pay an increased share of their housing costs would depend on how the increase was structured.

Increasing Homeowners' Interest Payments. One way to reduce Section 502 interest-credit program costs would be to require borrowers to pay 25 percent of their income for their mortgage payments, property taxes, and insurance--instead of the currently stipulated 20 percent. This would raise the effective interest rates paid and would reduce the long-run real costs of new assistance provided in 1983 by 30 to 50 percent. Some of the savings could be offset by increases in defaults, however.

Recapturing a Larger Share of Interest Subsidies. Another option would be for the FmHA to recapture a larger share of its subsidy when a property financed with a Section 502 interest-credit mortgage is sold. Currently, the FmHA receives from 9 to 78 percent of the net property appreciation, though not more than the total subsidy provided, depending on the number of months a property was held and the average interest rate paid. The FmHA could, instead, collect a fixed percentage of property appreciation, as is the case in homeownership programs operated by the Department of Housing and Urban Development (HUD). The reduction in long-term costs would depend on the percentage of property appreciation collected. If the FmHA collected 50 percent of net appreciation, long-term real program costs would fall by up to one-third and participants in FmHA and HUD homeowership programs would receive similar treatment. Recapturing a higher share of property appreciation would reduce program costs further but could decrease incentives for homeowners to maintain their properties, thereby lessening the amount of appreciation available for recapture.

Raising the Share of Income Renters Contribute Toward Their Housing Expenses. A third way to increase the share that assisted households pay of their housing costs would be to require that tenants in Section 515 projects pay the higher of 30 percent of their incomes--rather than the current 25 percent--or the minimum rent level. Such a change could reduce long-term costs by anywhere from 30 to 90 percent, depending on the assumptions about tenant incomes. This option would ensure similar treatment of assisted households across federal programs, since renters in

HUD-sponsored programs will be required to pay 30 percent of their incomes by 1986. On the other hand, it would decrease the income that such households would have to spend on other necessities.

THE BUDGETARY TREATMENT OF RURAL HOUSING PROGRAMS

The major FmHA housing loan programs are financed through the Rural Housing Insurance Fund (RHIF), a revolving fund from which program expenditures are made and into which program collections are deposited. Because the RHIF is a revolving fund, budget authority and outlay estimates are not adequate measures of program cost as they are in most federal programs.

The Operation of the RHIF

Each year the Congress authorizes an activity level for rural housing programs, which is financed through four funding sources available to the RHIF. The primary source is the sale of mortgage-backed securities called certificates of beneficial ownership (CBOs) to the Federal Financing Bank (FFB), an off-budget branch of the U.S. Treasury that coordinates federal agency financing. Another funding source is the appropriations made by the Congress to the fund to cover annual interest subsidies and losses on foreclosures for the last year in which they are known--generally two years prior. A third source of financing is borrower payments. Finally, to the extent that its other funding sources are insufficient to meet its needs, the RHIF has permanent, indefinite authority to borrow from the U.S. Treasury, authority that does not expire and that allows unlimited, unsecured borrowing to finance Congressionally authorized lending. Budget authority and outlay levels are the net result of the transactions of the RHIF; as a result they are difficult to estimate and do not represent either the full federal expenditures associated with rural housing aid or the long-run costs associated with any year's funding level.

Options for Changing the Current Budgetary Treatment to Make Costs More Apparent

Modifying the budgetary treatment of the RHIF would not change the actual cost of programs but would make the costs more apparent.

Treating CBO Asset Sales as Borrowing. Transactions between the RHIF and the FFB are treated by law as asset sales,[3] but they may be more appropriately viewed as RHIF borrowing from the FFB. The FmHA continues to maintain possession of and service the mortgages securing the CBO, and it guarantees the timely payment of principal and interest on the securities. Thus, the FFB is not purchasing a pool of mortgages but, rather, is lending to the FmHA based on the agency's guarantee.[4]

Treating the RHIF's transactions with the FFB as sales, rather than as borrowing, moves the financing of rural housing programs out of the unified budget.[5] When the RHIF sells a CBO to the FFB, it offsets its budget authority requirements and reduces its outlay levels by the amount of the sale, while the FFB's budget levels increase by the amount of the sale. Because the FFB spending totals are not included in the unified budget, a large share of the federal expenses of rural housing programs are, therefore, also not included in the budget. Changing the treatment of CBO transactions from asset sales to borrowing would not change actual spending by the federal government, but it would increase unified budget spending totals. Had this change been enacted in 1981 when CBO sales totaled $6 billion, RHIF budget authority requirements and outlays would have risen by that amount, as would the unified budget deficit.

Modifying the Interest Rate Paid on Treasury Borrowing. The Treasury is mandated to charge the RHIF an interest rate on its short-term borrowing based on the average rate on outstanding

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3. Both P.L. 81-171 and P.L. 87-128, as amended, authorize CBO transactions to be treated as asset sales.

4. For a more complete discussion of these transactions see: Congressional Budget Office, _The Federal Financing Bank and the Budgetary Treatment of Federal Credit Activities_ (January 1982).

5. Treating RHIF transactions with the FFB as asset sales rather than as borrowing does not, however, affect program cost estimates. Because the RHIF pays an interest rate based on the government cost of borrowing on the funds, the full cost of the transaction is included in the budget.

long-term securities,[6] which leads at times to underestimated costs for rural housing programs. The Treasury currently charges the RHIF 9.4 percent on its borrowing, but the current rate on its short-term borrowing is over 12 percent. If the rate charged the RHIF were set at the short-term Treasury borrowing rate, the cost attributed to rural housing programs would increase under current interest rate patterns. Had the RHIF been charged in 1981 the average rate on three-month Treasury securities, instead of the rate on outstanding long-term securities, its borrowing costs would have increased from $140 million to $240 million, or by 70 percent.

Fully Funding the Cost of Rural Housing Programs in Advance. The FmHA currently reports the annual costs of the programs only after they are incurred, which is the basis for the appropriation for past-year losses. Thus, the Congress is not able to consider the long-term cost of rural housing loans at the time they are authorized.

The Congress could consider funding the full expected cost of rural housing loans at the time they are made by appropriating an amount equal to the interest subsidies and foreclosure losses expected to result from the new lending. This would allow the Congress to compare the costs of rural housing programs to other programs, particularly the housing programs operated by HUD, which are funded in a similar manner. It would also, however, require large increases in budget authority.

Requiring the FmHA to Provide Estimates of Long-Term Program Costs. As an alternative to providing full funding for rural housing programs, the Congress could require the FmHA to include estimates of the expected long-term costs of additional lending in its budget submissions. This would provide the Congress with cost estimates that it could compare with estimates of the cost of other federal programs. The FmHA might, however, require more resources to prepare such estimates.

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6. See Section 517(h) of Public Law 81-171, as amended.

CHAPTER I. INTRODUCTION

The Farmers Home Administration (FmHA) in the U.S. Department of Agriculture helps provide decent, affordable housing in rural areas, primarily by financing the construction and purchase of single-family and multifamily housing units. At the end of 1981, FmHA had provided over 1.6 million mortgages for single-family dwellings totaling $28 billion, and about 13,000 mortgages for multifamily dwellings--representing about 255,000 units--totaling $5 billion.

Current budget practices obscure the costs of the federal government's mortgage activity in rural areas. The major cost of federal lending is the difference between interest rates paid by borrowers, which range from as low as 1 percent to a current maximum of 13.5 percent, and the rates paid by the FmHA for funds to finance the programs, most recently at 14 percent. The budget for rural housing loan programs does not identify, however, either the total annual cost attributable to outstanding mortgage commitments or the additional expenses that would result from providing new assistance in any one year. Consequently, the Congress does not have available estimates of rural housing program costs that it can compare to other program costs when allocating federal resources.

This paper estimates the long-term cost of FmHA commitments and discusses some of the options available to the Congress both for reducing program costs and for making costs more apparent. Chapter II describes the types of assistance provided through the major FmHA housing loan programs. Chapter III estimates the long-term cost of providing mortgages in 1983 under a variety of assumptions about program operation and the economy's performance, and then discusses options for reducing the cost of rural assistance programs. Chapter IV describes the budget treatment of rural housing loan programs and provides options to make the costs of federal commitments more apparent.

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CHAPTER II. FmHA RURAL HOUSING PROGRAMS

The FmHA has provided housing loans in rural areas for over 30 years, beginning with homeownership loans to farm families and expanding to include a wide range of homeownership, rental housing, farm labor housing, site development, and repair and rehabilitation activities for nonfarm as well as farm households. Initially, FmHA aid was a means of providing credit in rural areas where private credit sources were either nonexistent or inadequate. Although studies suggest that such problems continue to exist in rural areas,[1] the emphasis of FmHA programs has shifted in recent years to focus principally on helping low- and moderate-income rural households who could not otherwise afford adequate housing.

DEVELOPMENT OF RURAL HOUSING PROGRAMS

Current rural housing programs date back to 1949 when, as part of a major effort to improve the nation's housing, the Congress authorized direct loans to farm households unable to obtain private credit.[2] The program assisted an average of 4,000 households a year until the early 1960s, when it was expanded to include nonfarm households and a supplementary program was established to finance multifamily projects for the elderly. By 1968, the FmHA had provided financing for 240,000 single-family units and about 5,000 multifamily units.

The Housing and Community Development Act of 1968 (P.L. 90-448) considerably broadened the scope and increased the volume of FmHA housing efforts. The act authorized the FmHA to make

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1. See: Hughes H. Spurlock and Ronald Bird, Housing Credit: A Rural-Urban Comparison, U.S. Department of Agriculture, Economics, Statistics, and Cooperatives Service, Rural Development Research Report No. 6 (November 1978). Copley International Corporation, Urban and Rural Housing Credit Market Differentials, prepared for the U.S. Department of Housing and Urban Development (January 1979).

2. This was authorized by the Housing Act of 1949, P.L. 81-171.

homeownership loans to low-income households at rates below the federal cost of borrowing and to make reduced-interest-rate loans to developers of multifamily rental projects.[3] Such low-interest loans help ensure the availability of adequate housing for households that could not otherwise afford it. In addition, the FmHA was authorized to finance homesite development and farm labor housing projects. Program levels following the passage of the 1968 act have averaged 92,000 single-family units and 20,000 multifamily units a year.

Currently, these programs are restricted to low- and moderate-income households living in rural areas.[4] By law, low-income households are defined as those with incomes below 80 percent of the median income in their area, or from $11,500 to $18,000 within the continental U.S. Moderate-income limits, which are established by the Secretary of Agriculture, are $5,500 above the low-income limits. In calculating households' incomes, adjustment are made for family size and other factors. Rural areas are currently defined to include undeveloped rural areas and towns with populations below 10,000. Loans may also be made in towns with populations under 20,000 that are outside Census-defined standard metropolitan statistical areas (SMSAs) and that have a certified lack of private credit.

CURRENT RURAL HOUSING PROGRAMS

The major FmHA programs are the Section 502 single-family loan program and the Section 515 multifamily loan program.[5] In addition, the FmHA provides financing for such activities as the repair of housing units occupied by very-low-income tenants, the construction of farm labor housing, site development, supervisory

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3. Residency in multifamily projects was restricted to elderly households from 1962, when such projects were first authorized, to 1966, when residency was widened to include low-income households.

4. Above-moderate-income households are eligible for guaranteed loans, but authorization for such loans has not been granted recently.

5. The section numbers used to identify the programs are the section numbers of the Housing Act of 1949 (Public Law 81-171), as amended, that authorize the programs.

assistance, and compensation for construction defects. These smaller programs represent about 2 percent of total FmHA rural housing aid.

Section 502 Homeownership Loans

The Section 502 homeownership loan program--the largest of the FmHA housing programs--provides qualified households with loans for the purchase, rehabilitation, repair, or relocation of single-family, owner-occupied units.[6] Most Section 502 assistance finances the purchase of new or existing homes; less than 3 percent of 1982 funding will be used for rehabilitation and repair of existing dwellings.

Section 502 mortgages are written with 33-year terms and carry widely-ranging effective interest rates, with the actual rate paid dependent on the borrower's income. Although all loans are written at the FmHA's note rate--approximately the federal cost of long-term borrowing, currently set at 13.5 percent--eligible borrowers may pay reduced rates as low as 1 percent. Under a two-year renewable agreement, the FmHA pays the difference between the government's cost of borrowing and the borrower's interest rate. This difference is referred to as an interest credit. Interest-credit mortgages are often referred to as "subsidized" mortgages, and those without interest-credit agreements as "unsubsidized." Actually, however, all Section 502 mortgages are subsidized from the borrower's point of view. Even the borrower who pays the full FmHA note rate is paying a lower interest rate than would otherwise be available, since the FmHA's note rates are generally below private mortgage rates. Section 502 interest-credit loans are currently limited to low-income households, while Section 502 mortgages without interest credits are made to moderate-income households.

Effective interest rates on interest-credit mortages are set at levels that enable borrowers to spend 20 percent of their adjusted income on mortgage principal and interest payments, real estate taxes, and insurance, with a minimum effective rate of 1 percent. As of January 1982, the average rate paid on outstanding

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6. The FmHA refers to the loans that it finances as insured loans. These are direct loans made by the government, however, and are not the same as the mortgage insurance provided by the Federal Housing Administration.

interest-credit mortgages was 2.7 percent. The FmHA reviews each interest-credit borrower's income every two years, and the interest rate charged on the remainder of the loan is either raised, lowered, or left constant to maintain the housing-cost-to-income ratio of 20 percent. A borrower remains eligible for interest credits as long as his income is below the moderate-income ceiling. Once a borrower's income reaches that level, however, the borrower loses the interest credit and must thereafter pay the full note rate at which the mortgage was written. Interest rates on mortgages written without interest-credit agreements, in contrast, remain fixed at the note rate at which they were written.

When a property that has been financed by an interest-credit mortgage is sold, the federal government may recapture some portion of the interest subsidy it has provided on the mortgage. Under the recapture provisions--which apply only to interest-credit mortgages made on or after October 1, 1979--FmHA may reclaim up to the full value of the interest subsidy, depending on how long the property was held, the average interest rate paid by the borrower, and the property's appreciation. Mortgages without interest-credit agreements have no comparable provisions.

As of the end of 1981, about 960,000 Section 502 mortgages were outstanding, with unpaid principal totaling $19 billion. About 345,000 of these mortgages--or one-third of the total--carried interest credits and had $9 billion in principal remaining; the other two-thirds were bearing interest at the note rates at which the loans were written. For fiscal year 1982, $2.7 billion of Section 502 assistance is planned to assist an estimated 67,500 households. Of that total, about 85 percent of the funding is expected to include interest-credit agreements.

Section 515 Rental Housing Loans

The Section 515 program finances both the construction of new rental housing and the purchase and rehabilitation of existing substandard rental housing projects. Units financed under the Section 515 program are then occupied by low- and moderate-income households, elderly households, or handicapped individuals.

Eligible developers of Section 515 projects include non-profit and limited-profit organizations, and state or local government agencies. Developers must demonstrate their ability to build and operate the proposed project and must be unable to obtain private financing at rates that would allow rent levels that low- and moderate-income households could afford.

All Section 515 loans made in 1982 will include interest credits and will carry 50-year terms. Mortgages are written at the FmHA's note rate--that is, the current market rate for outstanding long-term Treasury securities, currently 13.5 percent--and borrowers then receive interest-credit agreements reducing their effective interest rates to a uniform 1 percent.[7]

In addition to making principal and interest payments based on a 1 percent mortgage, developers may be required to make additional payments depending on their tenants' income levels. Tenants are required to pay the higher of 25 percent of their adjusted annual income or the minimum project rent, with the developer collecting the minimum rent and the FmHA receiving any rental income above that level.[8] Minimum rent levels are established annually for every project, based on the principal and interest payment required to amortize a 1 percent mortgage, operating and maintenance expenses, reserve requirements, and return on investment. The rental income above minimum rent levels that is collected by the FmHA is referred to as "overage" and is treated as additional interest income, not reducing the principal due on a mortgage.

Because even with 1 percent financing the resulting project rent levels may be too high to be easily affordable to low-income households, two additional forms of subsidy may be linked to Section 515 interest-credit mortgages: rural rental assistance payments administered by the FmHA, and Section 8 assistance administered by the Department of Housing and Urban Development (HUD).

Under the rural rental assistance program, the FmHA contracts with Section 515 landlords to pay the difference between 25 percent of tenant income and minimum project rent levels, thus ensuring that low-income tenants pay no more than 25 percent of their income for housing expenses. Under current rent levels for

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7. Participants in the Section 515/Section 8 program, described later in this section, pay interest rates above 1 percent.

8. No tenant may be required, however, to pay more than the market rent for his unit, which is defined to include the cost of amortizing the note rate mortgage.

newly constructed projects, a household must have an adjusted annual income below about $13,000 to qualify for rental assistance payments.[9]

The Section 515/Section 8 program uses a subsidy very similar to rental assistance payments to assist a poorer population than may be served by Section 515 alone.[10] Under an agreement between the Secretaries of HUD and Agriculture, the FmHA finances the construction of rental housing at interest rates one to two percentage points below the current note rate. HUD then provides long-term commitments through its Section 8 new construction/substantial rehabilitation rental assistance program to pay the difference between a percentage of tenants' incomes--scheduled to be 30 percent for all tenants by 1986--and the project rent.

As of the end of 1981, 7,900 Section 515 loans were outstanding with $3.7 billion in unpaid principal. Since the start of the program over 250,000 units have been provided. About $940 million is planned for Section 515 assistance in 1982, which will provide 29,400 additional units. In addition, $398 million has been set aside for new rental assistance commitments in 1982, which will assist 14,280 households. Supplemental Section 8 assistance is also planned for 4,000 of the Section 515 units.

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9. This estimate is based on an assumed unit cost in 1982 of $32,800 and on a 1982 rent level of $275 per month for newly constructed projects.

10. For further information on housing programs administered by the U.S. Department of Housing and Urban Development in general and on Section 8 assistance in particular, see: Congressional Budget Office, Federal Housing Assistance: Alternative Approaches (May 1982).

CHAPTER III. THE LONG-TERM COSTS OF RURAL HOUSING PROGRAMS AND OPTIONS FOR REDUCING COSTS

For 1982, the Congress authorized $3.2 billion dollars in Section 502 and Section 515 interest-credit loans; if the Congress provided the same amount of new lending in 1983, the resulting long-run costs could be expected to range from $1.0 billion to $1.6 billion. This chapter estimates the total long-term costs of providing interest-credit Section 502 and Section 515 loans in 1983 and discusses strategies for lowering these costs.

PROGRAM COSTS

The costs of both the Section 502 and Section 515 interest-credit programs depend primarily on the interest rates the FmHA must pay to finance loans and on the rates that borrowers are able to pay over the term of the commitments. To develop the cost estimates described in this chapter, four sets of assumptions have been made about long-run economic conditions, which are described in detail in the Appendix. No one long-term scenario represents a forecast of future economic conditions. Instead, the four scenarios--taken together--encompass a range of possible future conditions and illustrate the resulting program costs.

Long-Term Costs of Section 502 Interest-Credit Loans

The major cost of interest-credit Section 502 mortgages is the difference in the FmHA's interest income and interest expense. The minimum required rate for a Section 502 interest-credit mortgage is 1 percent; the FmHA most recently obtained program financing at 14 percent.[1] If this interest rate differential were maintained for the 33-year term of a Section 502 mortgage, then a $42,000 home--the estimated rural average for 1983--would require a federal interest subsidy of $95,000 over the term of the mortgage.

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1. At the current time, even borrowers who pay the full rate on an FmHA loan are receiving a federal subsidy since the note rate charged is 13.5 percent.

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A much smaller cost of the Section 502 interest-credit program is the loss due to foreclosed mortgages. Although the agency has little information about such costs, estimates are that about 7 percent of all mortgages are acquired by the FmHA and that the FmHA is able to collect about 91 percent of the balance due on these mortgages.[2]

The Section 502 interest-credit program contains two provisions designed to reduce federal costs. First, borrowers must have their income recertified once every two years in order to continue paying reduced interest rates.[3] At that time, the interest rate is adjusted to keep principal, interest, tax, and insurance payments at 20 percent of the borrower's income. Thus, during a period of rising incomes, the interest rates paid by Section 502 borrowers would increase every two years, thereby increasing the amount of interest income collected by the FmHA.

Second, Section 502 interest-credit mortgages include a subsidy recapture provision, so that when a property is sold the borrower must repay the FmHA at least a portion of the interest subsidy received if the home has appreciated in value. The borrower may be required to pay from 9 to 78 percent of net property appreciation. The exact amount repaid depends on the amount of interest subsidy received and on the amount of property appreciation (see the Appendix for details). Borrowers are not required to repay any of the subsidy if the property value has not appreciated, nor are they ever required to repay more than the total amount of the interest subsidy received.

Under a range of assumptions about long-term interest rates, growth in borrower income, and property appreciation rates, the net cost of providing $100 million in Section 502 interest-credit loans during 1983 would range from $23 million to $29 million in

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2. These estimates are based on actual FmHA data on the proportion of borrowers that leave the Section 502 program--due both to foreclosures and prepayments--and on data provided by the Department of Housing and Urban Development on the distribution of withdrawals between foreclosures and prepayments in the Federal Housing Administration Section 203 mortgage insurance program. See the Appendix for details.

3. Borrowers are supposed to notify the FmHA of any changes in income between certification periods.

1983 dollars, or from $9,700 to $12,200 per unit assisted (see Table 1). The interest subsidy cost would range from $33 million to $41 million, and the losses due to borrower default would raise costs by less than 1 percent. Offsetting these costs would be the income from the subsidy recapture provisions, which would range from $10 million to $13 million and would reduce total costs by about one-third.

Long-Term Cost of Section 515 Interest-Credit Loans

The major cost of the Section 515 interest-credit program is also the difference between interest income and interest expense, but in this program the borrower's effective interest rates generally remain fixed at 1 percent for the term of the agreement.[4] If the FmHA's cost of financing remained at the most recent rate of 14 percent, then a $35,700 unit--the estimated average for 1983--financed at one percent would require a federal interest subsidy of $126,000 over the 50-year term of the mortgage. Losses due to foreclosures are much smaller in the Section 515 program than in the Section 502 program because developers are required to make a minimum investment in their projects and so will generally sell a project, and thus protect their equity, rather than allow the FmHA to foreclose.

Offsetting the interest subsidy costs of the Section 515 program is the "overage" provision, whereby tenants must pay the higher of 25 percent of their incomes and the minimum project rent. In cases where 25 percent of income is higher than the minimum rent, the developer receives the minimum rent and the FmHA collects the balance, which is treated as additional interest income and offsets the agency's interest expenses. Based on projected unit costs and rent levels, the FmHA could expect to receive overage payments in 1983 from tenants who have incomes over $14,000. The FmHA does not have information, however, on the amount of overage collected in the past or on the income of new Section 515 tenants, making estimates of future overage collections particularly uncertain.

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4. Section 515 mortgages written in conjunction with HUD's Section 8 program, discussed in Chapter II, carry interest rates one to two percentage points below the FmHA note rate. Thus, they require a much smaller interest subsidy than Section 515 mortgages in general but a much larger supplementary rental assistance subsidy through Section 8.

TABLE 1. LONG-TERM COSTS OF AUTHORIZING $100 MILLION IN SECTION 502 INTEREST-CREDIT ASSISTANCE IN 1983 UNDER A RANGE OF ASSUMPTIONS (In millions of 1983 dollars)

	Low Real Interest Rates, Low Inflation	Low Real Interest Rates, High Inflation	High Real Interest Rates, Low Inflation	High Real Interest Rates, High Inflation
Net Costs	27	23	29	24
Interest Subsidies	39	33	41	34
Foreclosure Losses	a	a	a	a
Collections from Subsidy Recapture[b]	-13	-10	-13	-10

SOURCE: Congressional Budget Office. See Appendix for further details on the assumptions underlying each alternative.

NOTE: Columns may not add because of rounding.

a. Less than 0.5.

b. Net income to the FmHA.

Under a range of assumptions about future interest rates, tenant incomes, and rent levels, the net cost per $100 million of Section 515 mortgages provided in 1983 would range from $54 million to $100 million in 1983 dollars (see Table 2), or from $19,300 to $35,700 per unit assisted. The interest subsidy is estimated at $89 million to $130 million, which is greater than Section 502 interest costs since Section 515 borrower interest rates are assumed to be fixed at 1 percent and since Section 515 mortgages are written for longer terms. Overage collections could offset these costs by $19 million to $58 million, or 20 to 50 percent, depending on the tenant incomes and the rent levels over time.

OPTIONS FOR REDUCING THE LONG-TERM COST OF INTEREST-CREDIT ASSISTANCE

If the Congress chose to continue providing interest-credit rural housing loans, program costs could be reduced either by providing a smaller volume of additional assistance than in the past or by requiring assisted households to pay a larger share of program costs.

Providing less assistance would produce long-term savings in proportion to the reduction in loan volume. In 1982 the Congress has authorized $2.3 billion in Section 502 interest-credit loans and $940 million in Section 515 aid (see Table 3). Providing the same volume of interest-credit assistance in 1983 would result in Section 502 costs ranging from $530 million to $670 million and Section 515 costs ranging from $510 million to $940 million. Any percentage reduction in these levels would yield the same percentage savings in long-term costs. For example, the Administration has proposed reducing Section 502 interest-credit aid by 60 percent, which would lower costs to a range of $210 million to $260 million, and reducing Section 515 aid by nearly 80 percent, lowering long-term costs to $110 million to $200 million.

The savings realized from requiring households to bear a larger share of program costs would depend on how such increases were structured. Specific options include:

- o Increasing the share of income that Section 502 borrowers pay for housing;
- o Requiring a larger repayment of subsidy when a Section 502-financed home is sold; and
- o Raising the rent levels in section 515 projects.

TABLE 2. LONG-TERM COSTS OF AUTHORIZING $100 MILLION IN SECTION 515 INTEREST-CREDIT ASSISTANCE IN 1983 UNDER A RANGE OF ASSUMPTIONS (In millions of 1983 dollars)

	Low Real Interest Rates, Low Inflation[a]	Low Real Interest Rates, High Inflation[a]	High Real Interest Rates, Low Inflation[a]	High Real Interest Rates, High Inflation[a]
Net Costs	54	70	100	76
Interest Subsidies	112	89	130	95
Overage Collections[b]	-58	-19	-29	-19

SOURCE: Congressional Budget Office. See Appendix for further details on the assumptions underlying each alternative.

NOTE: Columns may not add because of rounding.

a. Initial tenant income levels also vary in each alternative.

b. Net income to the FmHA.

TABLE 3. LONG-TERM COST OF ALTERNATIVE 1983 FUNDING LEVELS FOR RURAL HOUSING INTEREST-CREDIT LOANS (In millions of 1983 dollars)

Program	Repetition of 1982 Loan Volume		Administration's Proposed 1983 Loan Volume	
	Total Lending	Long-Term Cost	Total Lending	Long-Term Cost
Section 502	2,300	530 - 670	900	210 - 260
Section 515	940	510 - 940	200	110 - 200
Total	3,240	1,040 - 1,610	1,100	320 - 460

SOURCE: Congressional Budget Office.

Increasing the Share of Income That Households Pay For Section 502 Interest-Credit Mortgages

One way to lower Section 502 interest-credit program costs would be to increase the share of their adjusted income that households pay, thereby decreasing federal interest subsidies. Currently, participating low-income households are required to spend 20 percent of their income on mortgage principal and interest payments, property taxes, and insurance. By contrast, low-income households with privately written mortgages spend an average of 45 percent of their income on housing expenses, including utilities.[5] If assisted households were required to pay 25

5. This estimate is for households living outside standard metropolitan statistical areas with 1980 incomes below $10,000. At that time the income limit for Section 502 interest-credit borrowers was $11,200. See: U.S. Department of Commerce, Bureau of the Census, Current Housing Reports, Series H-150-80, Financial Characteristics of the Housing Inventory for the United States and Regions: 1980, Annual Housing Survey: 1980, Part C, Table A-1, p. 32.

percent of their income, the long-term real cost of providing $100 million worth of Section 502 interest-credit mortgages in 1983 would fall by 30 to 50 percent--from a 1983 dollar range of $23 million to $29 million to a range of $13 million to $17 million (see Table 4). If such households paid 30 percent of their income, then constant-dollar costs would decline by up to 80 percent below otherwise expected levels, ranging from $4 million to $11 million per $100 million of 1983 assistance provided.

Although raising borrower payments would reduce program costs, it could have at least two drawbacks--the full savings might not be realized, and an increase could introduce disparities among programs in their treatment of similar households. First, if borrowers found that paying an increased amount for each month for mortgage, taxes, and insurance costs--in addition to the other costs of homeownership such as utilities, maintenance, and repairs--was too great a financial burden to bear, then defaults might increase. The possibility that some of the increase in revenue might be offset by an increase in foreclosures is not reflected in these estimates. Second, borrowers under the HUD-administered Section 235 program currently pay 20 percent of their income for principal and interest payments, taxes, and insurance.[6] If the amount paid by Section 235 recipients was not also changed, then disparities would be introduced in the treatment of similar program participants.

Increasing the Amount of Subsidy Recaptured When Section 502 Interest-Credit Mortgages Are Terminated

The long-run costs for Section 502 interest-credit assistance could also be lowered by increasing the share of its subsidy that the federal government recaptures when a Section 502 interest-credit mortgage is terminated. Under current provisions, a homeowner must pay the lesser of the amount of the subsidy received and a percentage of the property's net appreciation ranging from 9 to 78 percent. Under Congressional Budget Office assumptions about average borrower income levels and interest rates paid,

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6. The Section 235 program makes interest payments to private mortgage lenders on behalf of low-income households. Generally, participants in the Section 235 program have higher incomes and must pay higher interest rates than Section 502 interest-credit borrowers.