THE REPORT OF THE PRESIDENT'S COMMISSION ON HOUSING

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THE PRESIDENT'S COMMISSION ON HOUSING
730 Jackson Place, NW Washington, DC 20503
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April 29, 1982

The President of the United States
The White House
Washington, D.C.

Dear Mr. President:

The President's Commission on Housing has completed its work. Tomorrow it will disband.

When you created the Commission last June, and repeatedly since, you expressed deep concern for the housing needs of Americans and for the health of the structure that serves those needs. The Commissioners you appointed have subordinated their routines to the task you gave them. We share your concerns for the housing needs of this nation and are committed to your economic and financial principles. It is now my privilege and pleasure to present our Report to you and to Secretary Pierce.

The Report sets forth housing recommendations and options, with discussion and analysis. The Commissioners have—without suppressing or eliminating diverse views among us—sought to provide far-reaching yet workable policy options for your Administration.

We hope and believe that this Report will prove itself a solid foundation on which you and your Administration will formulate a housing policy consistent within itself and with your basic principles. At the same time, we feel a sense of urgency, given the current conditions in housing, and hope that efforts to implement the fundamental reforms proposed by the Commission will begin immediately.

Justice demands that we commend the staff of the Commission for its dedication. Staff members left their other pursuits, put in the extraordinary hours required for the task, and performed in high spirits with great skill.

The Commission thanks you for the privilege of a rich experience.

Sincerely,

W. F. McKenna

William F. McKenna
Chair

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PREFACE

The President's Commission on Housing was established by Executive Order on June 16, 1981. The creation of the Commission was an expression of President Reagan's commitment to housing and of his desire to find remedies to the housing problems that affect millions of Americans.

The Commission's mandate was timely and important. The President called upon the Commission to recommend to him and to the Secretary of Housing and Urban Development options for the development of a national housing policy. Further, the President sought the Commission's advice on the role and objectives of the Federal government in the future of housing.

Specifically, the Executive Order directed the Commission to:

> "Analyze the relationship of homeownership to political, social, and economic stability within the nation;
>
> "review all existing federal housing policies and programs;
>
> "assess those factors which contribute to the cost of housing as well as the current housing finance structure and practices in the country;
>
> "seek to develop housing and mortgage finance options which strengthen the ability of the private sector to maximize opportunities for homeownership and provide adequate shelter for all Americans;
>
> "detail program options for basic reform of federally-subsidized housing."

The President appointed 30 Commissioners—all of them expert in some area of housing. To conduct its business and to address a wide range of topics in a short time, the Commission organized itself into committees, subcommittees, and task forces. A description of the structure of the Commission and the process by which it operated appears in the Methodology Appendix.

This document fulfills the directive of the Executive Order to submit a comprehensive final report to the President and the Secretary no later than April 30, 1982. The intent of the report is two-fold: to describe the principles and vision of the future that underlie the Commission's recommendations, and to offer recommendations and options for reform.

Major Issues

Housing is a national priority; and President Reagan has often reaffirmed his commitment to maintaining its prominence on the nation's agenda. Recently, he said:

> "I believe that our citizens should have a real opportunity to live in decent, affordable housing. I pledge to foster good housing for all Americans through sound economic policies."

But new approaches are required to meet the problems of today and to restore the vitality of the housing sector, especially within the context of a rapidly changing financial environment and an economy suffering the consequences of prolonged abuse. If the nation is to chart its way through this difficult period in housing, a clear and consistent policy framework is essential. This report provides an important step in developing such a policy framework.

Five issues were particularly important to the Commission. They serve as a basis for organizing this report and for framing the Commission's recommendations:

- What is the relationship between housing and the rest of the economy?
- How can the nation best provide housing for the poor?
- How can the private market expand housing opportunities?
- How will America's housing be financed in the future?
- How can government regulations be simplified, thus lowering the cost of housing?

Consideration of the first of these issues—the relationship between housing and the economy—led the Commission to articulate the principles that have guided its work. The four remaining issues are basic to the Commission's view of the future of housing in America, and each will be addressed in one of the report's four major sections.

Structure of the Report

The report begins with an overview essay that outlines the Commission's perspective and highlights its primary recommendations. The Commission seeks to create a housing sector that functions in an open environment—with minimal government participation. Government's role should emphasize individual freedom of choice. Thus, housing aid to the disadvantaged ought to take the form of a consumer-oriented housing payments program to provide to the household the wherewithal to make its own housing decisions. In areas such as housing regulation and housing finance, the Commission seeks to reduce or remove legal and regulatory barriers that have made housing less available or less affordable.

Four sections follow the overview essay, and each begins with a chapter that introduces the subject area and presents basic relevant data.

Section I deals with housing for lower-income Americans and presents a new system of government aid. The Commission believes that the current approach, which has focused on housing production, has been inefficient, costly, and less able to address today's primary lower-income housing problem—affordability. The centerpiece of the new system would be a Housing Payments Program, complemented by adding a Housing Component to the Community Development Block Grant (CDBG), making new construction an eligible activity under CDBG, and restructuring the system of public housing.

Section II considers the role of private institutions in the housing delivery system. Of particular concern is the difficulty facing those households—especially first-time buyers—desiring to purchase their own homes in a climate of inflation and high interest rates. The Commission presents options for increasing the availability of homeownership and proposals designed to address the issues of rental housing and of how better to use the country's current resources of land and the existing housing stock.

Section III analyzes the housing finance system. The Commission proposes recommendations designed to restore and increase the viability of institutions that have traditionally specialized in mortgage finance, attract other lenders into the mortgage market, and redirect the role of government credit agencies to complement rather than compete with the private market. These recommendations are aimed at insuring a stable flow of funds for housing to meet fully the financing needs of the 1980s and beyond.

Section IV addresses government regulation of housing. The fact that these regulations increase the cost and decrease the availability of housing is not a new finding—it has been noted by several previous commissions. Nonetheless, regulations with these undesirable effects have proliferated at the Federal, State, and local levels. Commission recommendations would reverse this trend and increase the affordability and availability of housing by reducing unnecessary government regulations. This section presents a plan for identifying and implementing these regulatory reforms.

Conclusion

The Commission has sought to provide the President, the Secretary, and the public with a comprehensive report. The Commission's recommendations are diverse and cover a broad range of subjects, but they form a cohesive whole. They focus primarily on establishing the foundation for a revitalized system of housing delivery that will work over the long term; they do not deal with specific issues of budget or program administration. Taken together, the recommendations set forth the Commission's proposed blueprint of a housing system that should serve the nation well for many years.

TO HOUSE A NATION: AN OVERVIEW

Americans today are the best-housed people in history. But they are concerned that for their children the best may be past: homes may be less spacious and pleasant, their children's needs less well served, and at a much more burdensome cost. These worries have been heightened by the agony of the housing industry since the nation fell into the painful grip of accelerating inflation during the 1970s.

Concerned that continuation of past policies would deny future generations their "opportunity to live in decent, affordable housing," President Ronald Reagan in June 1981 established a Commission on Housing to help chart a new path for the rest of this century. It was the first such group to be appointed since the Kaiser Committee of 1967.

That "Committee on Urban Housing" did its work at a time of high optimism about what government could accomplish in the economy. The numerical targets for housing production and the expansive rhetoric of the Kaiser report reflected a common belief that all problems would be solved if only the government would set the right goals and enforce the right policies. The 1968 legislation that enacted the major recommendations of the Kaiser Committee provided huge direct and indirect government subsidies to homebuilding, generating an unstable housing boom that eventually collapsed.

These programs put people in homes, but it soon became apparent that such programs were contributing to deterioration rather than renewal, to misery rather than comfort. The more obviously inefficient ones were eventually shut down, but a belief in the potency of government programs and policies remained.

President Reagan's Commission on Housing approached its task with optimism based on an entirely different belief: that the genius of the market economy, freed of the distortions forced by government housing policies and regulations that swung erratically from loving to hostile, can provide for housing far better than Federal programs. The 1970s taught not only the limits of the good that can be done by government action, but also the depths of the harm that can be wrought by ill-thought or ill-coordinated government policy.

But this Commission also met in the third year of a deep housing recession. Repeatedly in its ten months of work, the Commission had to confront evidence of the current plight of housing: young couples who cannot find a first home they can afford to buy; empty nesters who cannot find purchasers for their houses; newcomers to the city confronting a short supply of rental units; low-income families compelled to spend an unconscionable portion of their income for an adequate place to live; thrift institutions hobbled as a source of funds for homebuilders or homebuyers; builders facing bankruptcy as interest charges swallow the potential profit on unsold inventory; construction workers unemployed in substantial numbers; and suppliers of building materials cut to the bone and into the bone by the sharp decline in demand for their products.

Nevertheless, the Commission was charged with the task of looking across the valley. In the end, the Commission decided there could be no sound and stable housing industry without a sound and stable economy. Dependency on emergency government programs will not yield prosperity for the economy as a whole or any significant sector of it. To take reflationary actions apparently in support of housing would be to sow the seeds for another crop of disasters. The Commission judged suggestions for cures to the current crisis by measures of whether they would ease or block the passage to a more efficient system of housing supply and a more effective system of housing demand in the years to come.

The Commission believes that an immediate start on the long-term treatment would be the best remedy for today's afflicted households and builders and mortgage lenders. A Housing Payments Program to help lower-income consumers will put families into better apartments much faster than a scheme for subsidizing construction will put foundations in the ground. A thrift industry empowered to solve its own problems without legal handcuffs and regulatory restrictions will generate more money for housing than could be hoped for from institutions seeking to recapture a past that has gone forever. Freedom from the law's delays and unnecessary land-use restrictions will be more help in the long run to make housing more affordable than mortgage subsidies to builders.

Much of what needs to be done, both now and into the future, cannot be the doing of the Federal government. People live in places, and land is intrinsically local, its uses controlled by local regulation. The legal order and legislative atmosphere needed for housing to thrive in this society must be created by States and localities. Interest rates will come down, but the burden of unwise, short-sighted, restrictive, and antiquated regulation will continue to cripple housing unless the States and localities act, and act soon.

In the following pages, the President's Commission on Housing seeks to present a vision of a system for housing with a greater choice of housing opportunities for all Americans, at sustainable costs for both households and taxpayers. Its recommendations adhere to principles adopted by the Commission in October 1981. These principles held that national policy must:

- Achieve fiscal responsibility and monetary stability in the economy;
- Encourage free and deregulated housing markets;
- Rely on the private sector;
- Promote an enlightened federalism with minimal government intervention;
- Recognize a continuing role of government to address the housing needs of the poor;
- Direct programs toward people rather than toward structures; and
- Assure maximum freedom of housing choice.

If these principles are followed, the Commission is convinced that the American economy will provide housing that is adequate to the needs of the people, available to those who seek it, and affordable in the context of a growing national prosperity. In this vision there is a role for all levels of government: to maintain a legal and economic order that promotes the production of homes, and to extend housing opportunities to all Americans, particularly lower-income and minority families.

The Commission believes that these goals are most likely to be achieved if government shrewdly encourages rather than suspiciously controls the exercise of private initiative through the spectrum of activities that produce the homes in which we live.

HOUSING TRIUMPH, HOUSING TRAGEDY

From the high ground of his second inaugural, Franklin Roosevelt saw "one-third of a nation ill-clothed, ill-housed, ill-fed." At the time of his death eight years later, the housing of the nation was still in bad shape: 40 months of war, requiring the diversion of resources away from housing and consumer durables, had prevented construction and hindered maintenance. Some 40 percent of the nation's homes in 1946 were dilapidated or lacked indoor plumbing, and 10 percent of the nation's households lived in overcrowded accommodations.

But conditions were ripe and ready for the society to take its housing needs in hand. Interest rates were held low by the Federal government's financial policies; demand for housing by returning veterans and their new families was high; builders were full of ideas for the mass production of housing; the road-building projects of the Great Depression had opened up the suburbs to intense settlement. The Federal Housing Administration (FHA)-insured, level-payment, self-amortizing, long-term

mortgage was quickly supplemented by a Veterans Administration (VA)-guaranteed mortgage permitting returned servicemen to buy homes with no downpayment at all.

Housing creation on the scale that the veterans and their families demanded—and deserved—was something new in American history. Additional government programs were used as a catalyst for private production of inexpensive rental units, and with bipartisan support— Robert Taft standing beside Robert Wagner among the sponsors—the Housing Act of 1949 set the nation on a course to achieve "a decent home and a suitable living environment" for all Americans. Results were immediate. The proportion of the nation's capital formation represented by housing was greater in the 1950s than it had ever been before.

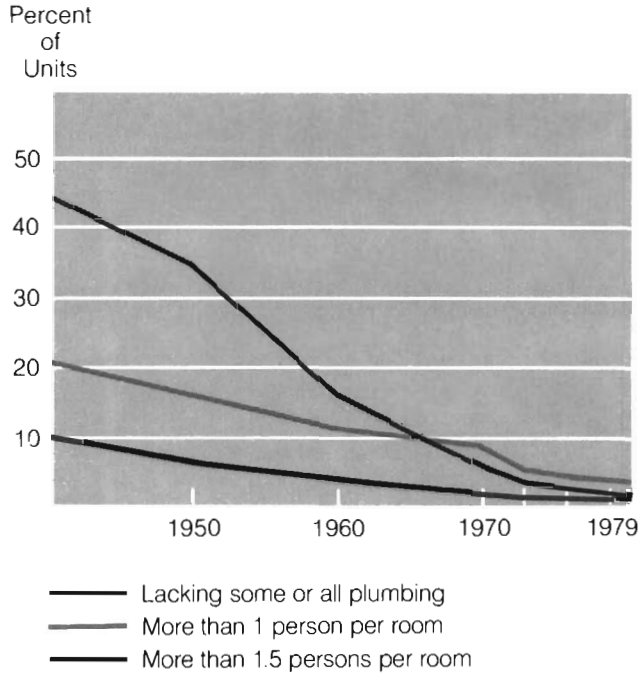
All parts of the financial sector participated in the flow of funds to housing. Commercial banks converted major portions of their Treasury securities portfolios to mortgage loans; savings and loan associations dedicated to housing grew at historically unprecedented rates; insurance companies acquired large amounts of mortgages and invested directly in building apartment projects.

Land was cheap and available without narrow zoning restrictions. Localities, eager to grow, bonded themselves cheerfully to provide the infrastructure of roads, water, sewerage, fire departments, police protection, and schools. Easy mortgage money and a tax code that made homeownership cheaper than renting drew more and more families to the realization of a universal dream—it is not just an American dream—of a home of one's own.

Through the 1950s, most American families significantly improved the quality of their housing—most families, but not all. Blacks especially continued at a disadvantage in the housing markets, partly because the government's own FHA, as a matter of policy, had refused to insure homes in integrated neighborhoods. Public housing programs designed to help the big-city poor had suffered visible failures: huge structures rose above the cityscapes like faceless warehouses, and with the passage of time the communities clustered within them were demoralized, blighted by crime, and frustrated by the failure of their expectations.

In the 1960s, government turned to the private sector to produce low-income housing. But with this change in focus, there arose the practice of doing good by stealth, of burying government subsidies in the tax code and committing assistance

Improvements in the Quality of America's Housing



Sources: U.S. Department of Commerce, Bureau of the Census, and U.S. Department of Housing and Urban Development.

In the years since 1949, the overall quality of America's housing has improved enormously. The average new house built in 1979 had twice as many square feet of living space as the average new house built in 1950, while the fraction of American households living in overcrowded and seriously inadequate shelter declined dramatically. The figure portrays the decline in inadequate housing.

The figure is based on generally accepted criteria for housing adequacy. Using even wider standards—including measurements of how often heating equipment, water supply or sewage services failed; the presence of broken plaster, loose handrails in hallways; etc.—the Congressional Budget Office (CBO) in 1977 found that 7.5 percent of all households were living in units "judged to be in need of rehabilitation."

Despite this progress, problems remain. Using the CBO measures, the incidence of rehabilitation need was found to be highest among black households (19.1 percent), very low-income renters (18.6 percent), and rural Southern households (12.8 percent).

funds in such a way that their burden would fall mostly on succeeding generations rather than on the budgets approved by the authors of the programs.

The 1968 legislation that followed the Kaiser Report created conditions of government subsidy and tax incentive that made it virtually impossible for anyone not to make money by promoting or building homes. The number of housing units produced jumped by 65 percent from 1970 to 1973—but the dollar value of that construction more than doubled. Inflation had taken root.

Shortages of land, materials, and labor drove the price of housing higher and faster than the rise in the Consumer Price Index. The frantic boom that followed the devaluation of the dollar and the jump in oil prices created unsustainable pressures on the financial system, especially the system that supplied funds for housing. Moreover, while previous housing cycles had tended to mitigate excessive expansion or decline in the rest of the economy — housing had in most postwar business cycles turned down before the other sectors, and had then led the way out of the recession—the 1974–75 slump coincided with economic collapse and made the recession more painful.

But as painful as was the slump for housing, the recovery and the ensuing boom eventually proved to be worse. By the fourth quarter of 1976, the inflation rate had fallen below 5 percent, and economic recovery was proceeding nicely; by 1980, inflation was back in double digits, as the Federal government tried more of the same old policies and prices jumped. The impact on housing was profound. Stimulated by the accelerating increase in home prices, consumers enormously increased their demand for single-family houses, which were regarded as the best hedge against inflation, the safest investment of a family's funds.

Housing production rose above the 2,000,000-unit-a-year level in 1977 and 1978; single-family production, in fact, rose above the levels of the record year of 1972. However, because of prior overbuilding, and the skimming off of the best rental prospects to homeownership, multifamily housing was left out of the boom.

At the same time, housing prices shot up. In 1972, when production peaked, the average new house was sold for $35,700; by 1981, this price had reached $88,400. In nine years.

The inflation of the 1970s greatly advantaged the two-thirds of the nation that owned homes by comparison with the one-third that did not, despite the continuation and then renewed expansion of government programs designed to improve the housing of the bottom third of the population. For most American homeowners, the gigantic increase in home prices translated into an increase in their wealth.

But the inflation that drove up the dollar value of homes also drove up interest rates, multiplying the burden facing the potential home purchaser, and the combination of the two forced the collapse of homebuilding that began in 1980 and was still far from remedy in 1982. Individuals could not afford to buy new homes unless they already owned a home and then, as the storm darkened, buyers could not afford the prices homeowners wanted for their old homes. And potential tenants could not afford the rents potential landlords had to pencil in when they calculated the rate of return on new apartment house construction.

The extreme cyclicality of housing construction in the 1970s had reduced the relative efficiency of the production system. Skilled workers had to get more for their time on the job because they had to expect so many weeks of unemployment. Builders resisted investment in more productive equipment because they had to expect that such investment would lie idle much of the time. Perhaps worst of all, the periods of frenetic activity encouraged localities and States—and even the Federal government—to impose ever more costly regulatory restraints and preconditions before permits to build housing would be issued.

Further, fundamental change took place in the financial system in the late 1970s. After 15 years of excessive government spending and monetary growth, inflation expectations finally matched current reality. Savers would no longer be the involuntary subsidizers of borrowers. They would demand and receive market rates on their money. Ceilings on deposit accounts were quickly adjusted to the new reality. Meanwhile, mortgage rates ratcheted up with market rates and remain at near-record levels awaiting convincing evidence that government spending will be controlled and that the Federal Reserve will slow the creation of money.

Inflation and government policies disabled the traditional mortgage lenders: the Federal government restricted the interest rates that could be paid on deposits and limited the investment choices of thrift institutions; State usury laws held down the rates to be charged on mortgages. The rate limits were eventually loosened by the Federal authorities

on the deposit side and preempted by Federal law on the mortgage side. But mortgage lenders still carry the burdens of the past in the form of older low-yielding mortgages that show little sign of prepayment. These mortgages simply cannot provide the revenues needed to allow a vigorous institution to enter the financial markets and outbid commercial banks, money market funds, financial conglomerates—or, indeed, the U.S. Treasury—for funds. The weight of this burden is becoming more obvious as the share of new mortgage activity by thrift institutions shrinks.

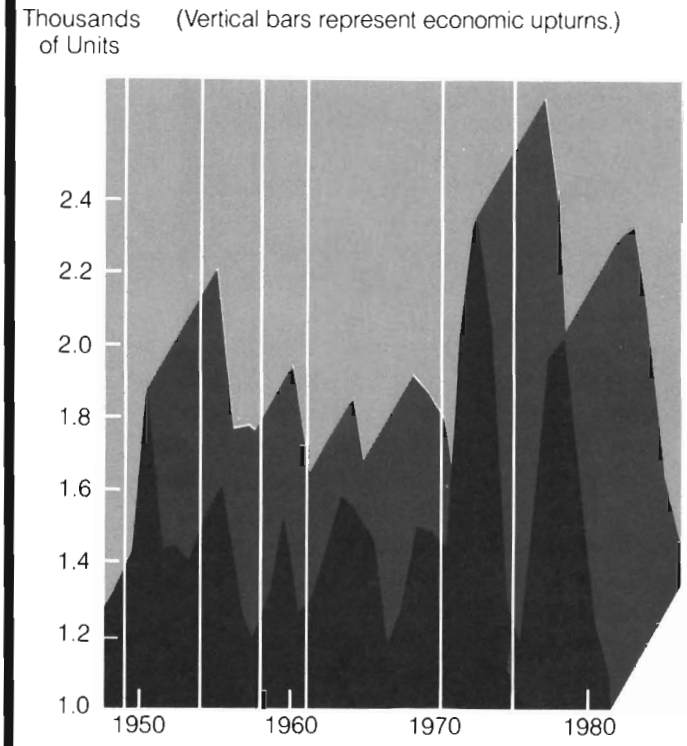
As inflation accelerated and interest rates soared, real estate transactions increasingly were financed outside the traditional channels of financial intermediation. State and local agencies stepped up their provision of below-market-rate mortgage credit in 1979 and 1980, funding their programs through the issuance of mortgage revenue bonds. In the market for existing homes, various forms of "creative" financing became common. Most of these financing techniques were based on the transfer of low-rate outstanding mortgages from home sellers to homebuyers, commonly combined with lending by sellers who provided second mortgage credit. Roughly one-half of all sales of existing homes in the past two years involved some sort of creative or seller financing.

Creative financing has often produced artificial price increases and has been facilitated by State laws and court rulings that prohibit lenders from enforcing due-on-sale clauses in existing mortgages. As a result, elements of the unstable and unsound mortgage system that shattered in the Great Depression, and that Americans thought had been eliminated forever, have been reintroduced.

It may seem callous to dwell on the abstractions of the housing finance system at a time when real homes are not being built, real workers are unemployed, and real builders and realtors are on the edge of bankruptcy. But the truth is that most of the major deterrents to the revival of housing are the roadblocks that inflation has erected between housing and its necessary funding. Inefficiencies are costly, regulation is disabling, but the lack of affordable money is murderous.

If the U.S. housing industry is in trouble, the reason lies essentially in what has happened to the economy as a whole through the inflationary binge of the 1970s. For those who feel that inflation is bearable, the current state of housing should stand as a grim and convincing lesson. A social and

Housing Cycles Become More Severe



Sources: U.S. Department of Commerce, Bureau of the Census, National Bureau of Economic Research.

Housing construction has always been a cyclical activity, dependent on the supply and price of funds in the economy. As such, housing construction has tended to peak on the upswing of the business cycle and to revive early in a recession as business demand slackens. The figure shows this pattern.

Fluctuations in housing activity have become more pronounced in recent years. Since 1970, because of continued inflationary expectations and volatile interest rates, both declines and recoveries in housing starts have been nearly twice as great (in percentage terms) as in prior housing cycles.

There has always been debate about whether a social product as important as housing should serve as a balance wheel for the economy, and the housing legislation of 1968 sought, at least in part, to insulate homebuilding from the financial markets. While these programs produced the enormous peak in housing construction in 1972, dependence on the government reduced the capacity of the housing industry to lead the economy out of a slump. Note that in 1974-75 housing continued to decline through the recession, reviving only after the rest of the economy had turned the corner.

economic subsystem of great value to the nation, painstakingly built over four decades, has been shattered by inflation and the ensuing recession in a few short years. The country cannot simply pick up these pieces and hope to reassemble them. Any cure for what ails housing can come only as part of a remedy for the inflationary ailments of the larger economy. Achieving this remedy requires short-term sacrifices in every sector, not just housing.

The recommendations of this Housing Commission therefore include devices to ease the transition from a housing supply system that has faltered because of extreme pressure to one that will work, in the context of a more productive and more stable economy.

HOUSING FOR LOW-INCOME AMERICANS

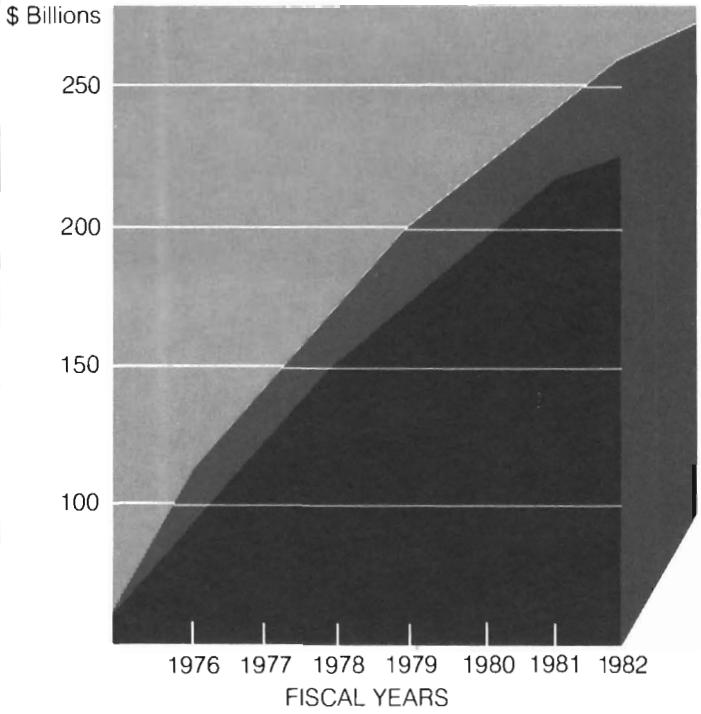
The Commission affirms in the strongest terms the national commitment to "a decent home and a suitable living environment" for all Americans, and recognizes a continuing role for the Federal government in helping those individuals that cannot achieve this goal without assistance.

But the next 20 years will call for programs quite different from those the government invented and supervised in the last half-century. When the first federally financed housing projects were planned, the national problem was a shortage of adequate housing. From the 1937 Act that created "public housing," to the New Construction provisions of Section 8 in the 1974 legislation, Federal efforts to improve the housing of the poor have concentrated on the provision of new units at reduced costs for the tenants.

Today, however, the larger problem is not the quality of the housing in which most poor people live, but its affordability. Most recent survey data indicate that a large percentage of low-income renters pay a high portion of their income for housing, and a much smaller percentage live in inadequate housing. Moreover, while quality continues to improve, inflation is making housing less affordable. The primary national need is not for massive production of new apartments for the poor, but for income supplements that will enable low-income families to live in available, decent housing at a cost they can afford.

The purpose of Federal housing programs should be to help people, not to build projects. Fiscal year 1982 figures indicate that the Federal

The Rising Costs of Federal Rental Assistance Subsidies



Source: U.S. Department of Housing and Urban Development, Office of Budget, February 8, 1982.

Federal housing subsidies for poor Americans are now tied primarily to expensive new buildings at a time when the evidence shows that twice the number of families could be helped if the government made housing payments directly to people.

Current programs to aid poor Americans are focused primarily on housing construction, and involve long-term commitments that tie down the Federal government far into the future. In the public housing and Section 8 rental assistance programs alone, as the figure shows, the government has made promises of nearly a quarter of a trillion dollars—up from $61 billion in 1975, when the Section 8 program was started. Annual outlays for these obligations are $5.5 billion and will grow to $7.8 billion by 1986 as contracts take full effect, even with no new obligations. Further, the government has contracted to keep making these annual payments for 24 years, on average, for construction programs.

While these subsidies are understandable as a device to get the private market (or public housing authorities) to take on the production and management of low-income housing, the cumulative effect of these contracts is to restrict the Federal government's flexibility in its use of housing subsidies.

government budgeted an average $425 a month for each poor family housed through the Section 8 New Construction program, but only $217 a month for each family living in existing housing under the program. A shift from project funding to people funding under this program will enable twice as many poor people to be helped by the same housing budget.

Heavy burdens have already been placed on future budgets by Section 8 procedures, which guarantee rents to builders over periods of 20 to 30 years, and to owners of existing apartments over periods averaging 15 years. The fiscal 1982 budget notes that outstanding obligations under Section 8 contracts now total $121 billion. Adding in the continuing costs of the bond issues that built Public Housing and other forms of housing assistance, the unfunded liabilities of the Federal government for housing subsidies reach nearly a quarter of a trillion dollars. The weight of these accumulated obligations has begun to restrict the amounts the government can find for assistance to other families.

As part of the 1970 housing legislation, Congress called for a study of the possible advantages of housing grants as compared with production programs. In response, the Department of Housing and Urban Development (HUD) organized an Experimental Housing Allowance Program, which eventually involved 30,000 households in 12 varied locations across the nation. The emerging data have already generated more than 300 technical reports.

This largest controlled social experiment in history has, in fact, produced answers to many of the most pressing questions about housing allowances. Allowances are less expensive to the government than new construction and more likely to reach families spending too much of their income for rent. The requirement that allowances can be spent only for units inspected and deemed adequate does stimulate the repair of minor deficiencies in existing housing, without further subsidy, but allowances are less likely to help people now living in seriously substandard housing. Landlords simply do not find the payments great enough to justify major rehabilitation, and the residents of such units are more likely to drop out of the program than to undertake the mess and expense of moving.

Clearly, then, a Housing Payments Program (HPP) for lower-income consumers is the most efficient way to help the largest number of poor families in their quest for a decent home. Equally clearly, such a program may not be sufficient in places where there is a serious shortage of adequate rental units. But the Federal government is likely to be a poor judge of what is needed, in each of thousands of cities and counties, to meet low-income housing needs. Thus, the Commission has recommended that a Housing Component be added to the established Community Development Block Grant (CDBG) program. Also, new construction should be made an eligible activity under CDBG to enable States and localities to make their own decisions as to whether new construction as well as rehabilitation is necessary to make the promise of HPP a reality.

The Commission also expects that construction of rental apartments will be stimulated by the adoption of its recommendations that States and localities cease the exclusionary zoning that has restricted multifamily development. This stimulus should be enhanced by other recommendations relating to regulatory procedures, tax laws, use of Federal public land and buildings for housing, new rules to attract mortgage investment by pension funds and life insurance companies, and temporary revival of the mortgage bonding capacity of States and localities. Moreover, reductions in interest rates will quickly benefit rental housing. With effective demand by the poor increased by grants, the Housing Component of CDBG should be no more than a safety net.

Recipients of HPP grants would negotiate their own contracts with landlords and would be permitted to spend more or less than the market rent calculated for the area. If a property were to be available within their means, a recipient family could in theory use its grant to buy a home. The only requirements would be that the units rented or sold meet standards of adequate housing, locally established where possible, and that owners abide by the principles of the Fair Housing Act, offering their apartments or houses to all comers regardless of age, sex, race, color, or creed. Federal authorities in local and regional offices would be charged with the duty of monitoring, under threat of appropriate sanctions, community enforcement of fair housing standards.

Housing Payments are not meant to be an entitlement program: the nation cannot afford yet another system of entitlements expanding endlessly out of effective control. Grants should be available first to families of very low income living in inadequate housing and paying a large portion of their income for housing, and to very low-income house-

holds subject to involuntary displacement. Roughly 1.1 million very low-income renters now have inadequate housing and spend more than 30 percent of their income for rent; their needs, by definition not met under existing programs, can and should absorb the available resources in the early years of the new program.

One way to increase these resources would be by the retrieval of some of the subsidies now pledged to Section 8 New Construction and Substantial Rehabilitation programs. At present, for example, annual grants of $100 million have been pledged to about 17,000 units in partially subsidized apartment houses not yet in construction. The retrieval of these budgeted subsidies would be enough to give housing assistance grants to more than 30,000 additional families at the average annual grant now provided in the Section 8 Existing Housing Programs.

Some 1.2 million American households are now lodged in the Low-Rent Public Housing projects built since 1937 and managed locally by Public Housing Authorities (PHA). These households are, as a group, the poorest of the poor, with average incomes at only 28 percent of the national median family income. Almost three-fifths of these households are drawn from ethnic minorities; another one-quarter are nonminority elderly; and 13 percent are neither minority nor elderly.

In its deliberations on the future of public housing, the Commission sought two objectives—reinforcement of the national commitment to decent housing for low-income Americans, and restoration of local control in the management of local housing policy. The Commission was disturbed at the extent and rigidity of Federal rules restricting the ability of local authorities to solve their own problems. Public Housing was instituted as a federally assisted local program and can fulfill its purposes best with local accountability for projects. Thus, the Commission recommended that PHAs have broader management control and that local governments and PHAs determine jointly with the Federal government the future of each public housing project.

Under this approach, projects that are valuable could be sold, with the proceeds to be retained by the Public Housing Authority and used for low-income housing purposes. Projects that are both unsuccessful in the quality of life they offer their residents and excessively expensive to maintain could be sold or demolished. For the large majority of the projects, which provide good housing at reasonable subsidy costs, the Commission recommends that HUD and the local authorities negotiate terms for the continuation of the service, keeping in mind the first responsibility of both parties to the very poor, hard-to-house residents.

HOMEOWNERSHIP

Owning a home is one of the most highly prized goods in American life. A home of one's own is a great stake in society, encouraging neighborhood stability and political participation. When he met with its members, President Reagan charged the Housing Commission to search out ways by which public policy could encourage the continued growth of homeownership in the United States. The search for such policies is, in fact, an American tradition: for almost 50 years the government has been involved in finding ways to promote homeownership.

Few pieces of social invention from the 1930s have reverberated so loudly through the corridors of time as the FHA-insured, level-payment, self-amortizing, long-term mortgage. Supplemented by VA mortgage guarantees after the war, this piece of paper and its acceptance—first by homebuyers and banks, later by insurance companies and an organized secondary market—made homeownership possible for tens of millions of Americans who would otherwise have lived out their days in rented quarters.

Like so much else that is 50 years old, FHA has become a prisoner of its own habits, and the Commission recommends that more agile private mortgage insurance institutions take over many FHA functions relating to single-family homes. But there are still pioneering tasks ahead for FHA in the Commission's scenario, in the testing of new mortgage instruments and in assistance to homeowners for whom private insurers are unwilling or unable to supply insurance.

Since the quantum leap of income tax rates during World War II, the tax code has played a major role in making homeownership more desirable. The Federal tax code allows imputed income from real assets, including housing, to pass untaxed, while allowing the deduction of mortgage interest payments and local property taxes (like other interest and taxes) from federally taxable income. This is complemented by the favorable tax treatment of capital gains on houses, with homeowners older than 55 allowed to escape capital gains taxes on up to $125,000 in profits from the sale of a home.

The Commission recommends the continuation of these aids for homeownership, along with a general review of the effects of Federal tax policy on all sectors of the economy.

In the 1970s, the government gave an additional boost to homeownership in an ultimately destructive way: by stimulating and tolerating the inflation that devastated the value of the dollar. Homebuyers bought as much house as they could manage, seeing it not only as a home, but as an attractive investment and their best hedge against inflation. In the process, savers fled the inadequate returns paid by housing-oriented thrift institutions.

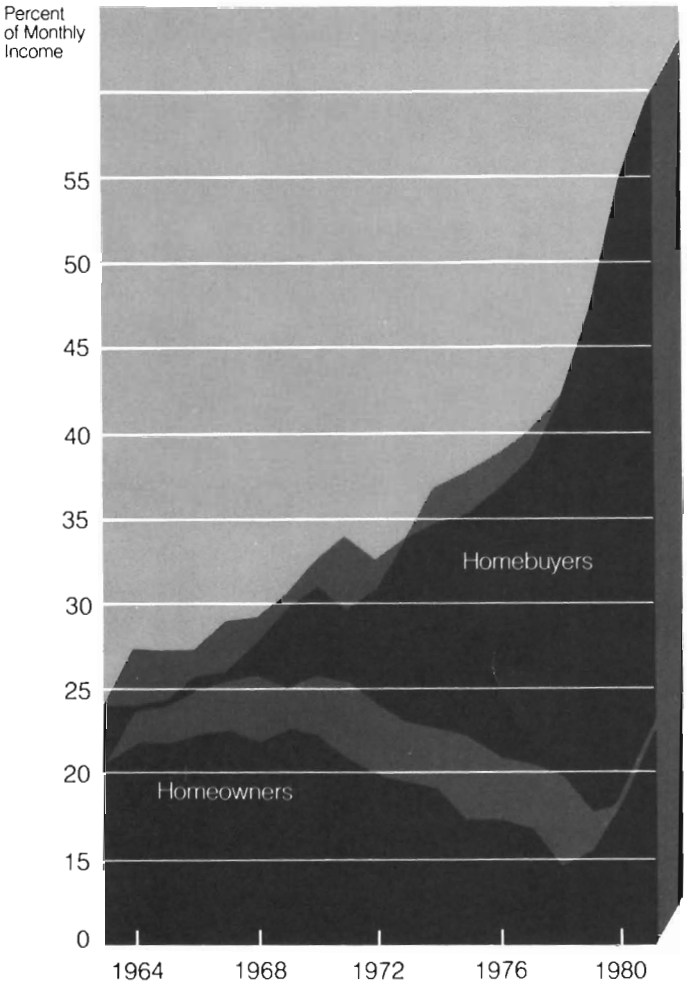
But the increased investment value of a house has its dark side. Demand for housing as an investment—as a locus for savings rather than a place to live—drove up prices and mortgage interest rates to the point where those whose income did not permit such heavy allocation to savings were unable to acquire a home of their own.

Further, young families and moderate-income households seeking to buy a first home are blocked today by their inability to meet either downpayment requirements or monthly mortgage bills. The Commission believes that government insurers and regulators of financial intermediaries can help homeowners and lenders reduce the cash flow problems associated with the standard type of mortgage, and that a case can be made (if not quite proved) for government assistance to families accumulating funds for downpayment on a house.

Mortgage payments can be reduced through new types of financing instruments. One type has already been approved and admitted to the catalogue of FHA-insured paper: the Graduated Payment Mortgage, by which homeowner payments in the early years are held below the interest charges, permitting the total loan to rise ("negative amortization"). Then a higher payment is exacted in the later years of the mortgage to pay off the larger loan. In an inflationary period, most homebuyers can expect to earn more dollars as time passes, making the future burden less severe; even without a boost from inflation, young homebuyers should be able to count on increasing income as their careers advance.

Another instrument that has gained attention is the Growing Equity Mortgage (GEM), which ties monthly payments to a general index of wages or prices. The additional payments incurred as incomes rise are applied to the outstanding balance of

The Costs of Homeownership



Source: U.S. Department of Commerce, Bureau of the Census, National Bureau of Economic Research.

For people buying homes the initial monthly mortgage payment as a percent of household income held relatively steady, with minor fluctuations, from 1963 to 1973. It then began an almost uninterrupted growth, as both home prices and interest rates rose much faster than the rate of increase in personal incomes.

For existing homeowners, however, real costs of homeownership (net costs after adjusting for inflation and taxes) continued to decline almost to the end of the 1970s. Fixed-rate mortgages insulated homeowners from the rise in interest rates; and the resale value of the home—the owner's investment—increased faster than other consumer prices, offsetting the rises in fuel bills, taxes, and maintenance. An increasing gulf therefore appeared between the initial costs for homebuyers and real costs for current homeowners.

the loan, retiring the mortgage more quickly. The GEM and two variations of mortgages that permit some equity investment by a third party have been recently proposed for FHA insurance eligibility.

One source of subsidized mortgages in recent years has been the tax-exempt mortgage revenue bond, by which States and localities raise funds partly to support home purchases by moderate-income families. Congress targeted and limited the issuance of such bonds for single-family housing in 1980, leaving it to the Treasury to fill in the details of the limiting regulations. The regulations written to govern bonds to support single-family mortgages have been so onerous that States and localities have been unable to continue this activity; meanwhile, bonds to support multifamily mortgages have been in effect prohibited by the failure of the Treasury to produce any regulations at all. While concerned about the long-term costs and fairness of Federal housing subsidies filtered through the tax-exempt mortgage bond process, the Commission recommended that, at least for the 20 months remaining in the authorization for single-family housing bonds in the 1980 legislation, the Treasury should ease its stance and permit bonds to be written and issued. On March 28, 1982, the President announced that he had issued such orders. According to the Commission, the future of this program should be considered in the context of a more general examination of State and local power to gain Federal subsidy by issuing tax-exempt bonds, with particular reference to Industrial Revenue Bonds.

Obviously, the most desirable solution to the new homebuyer's cash flow problem is the restoration of a stable, noninflationary economy in which interest rates would come down for everybody, including the homebuyer. Success for the President's economic program would be worth more to first-time homebuyers than any imaginable mortgage instrument or any shallow subsidy to reduce interest rates for mortgages. Because the inflationary dangers inherent in such subsidies conflict with the President's larger program, the Commission has been unwilling to endorse them.

Similar concerns have prevented the Commission from endorsing any of the proposals for government-sponsored incentives to renters to accumulate savings for a downpayment. The Commission does, however, offer three program options to the President for further evaluation. Two of them are plans for Individual Housing Accounts to which the government would contribute through tax credits and tax exemption, or by direct supplement. The third is an amendment to the current rules on Individual Retirement Accounts, which would permit money in these tax-benefited funds to be used for purchase of a first house.

Most purchasers reduce their downpayments and mortgage bills simply by purchasing a less expensive house. Given the importance of placing the first foot on the ownership ladder in a period when the value of equity in a home is likely to increase, the Commission believes public policy should make it easier for families to start with something other than the classic stickbuilt house on its own piece of land.

Manufactured housing, for example, has long enjoyed a considerable initial cost advantage per square foot of living space. In 1981, "mobile homes" accounted for almost 29 percent of all new single-family dwellings sold in the United States, and the great majority of these sold for less than $50,000. The construction code legislated by Congress in 1974 has ensured standards of safety and durability in these units. But the true long-term cost of such manufactured homes has been much higher than necessary, because of inequitable treatment by governments and financial institutions.

The Commission recommends that manufactured homes permanently attached to the land should be treated by local governments, Federal credit agencies, tax collectors, and lenders exactly as conventionally built homes are treated. Where manufactured houses are still potentially "mobile homes," resting on rented rather than owned land, there is no escaping the necessity to deal with them as personal property rather than as real estate. But public policy can help owners gain access to financing, tax preference, and a wider choice of locations.

Assuming enactment by the States of tenant protection provisions similar to those of the Uniform Condominium Act developed by the National Conference of Commissioners on Uniform State Laws, the Commission proposes an end to moratoria and undue restrictions on the conversion of rental properties to condominium or cooperative ownership. The Commission also supports the use of insurance-backed warranties for conversion projects and urges States to consider the possibility of relocation assistance for elderly tenants displaced from converted buildings. Discouragements to conversion now present in the tax codes should be removed.

For some years, HUD has been turning over to

localities for homesteading purposes single-family homes acquired in connection with defaults on FHA-insured loans. Now the Department should adopt similar policies to help lower-income families purchase apartments in multifamily properties either owned by HUD or held by HUD awaiting foreclosure.

A further area of concern to the Commission is homeownership by elderly couples or individuals who wish to continue to live in the housing they bought earlier in life. The maintenance of this housing may be beyond the means of people whose earned income stream has stopped. Such tragedies—and they are tragedies for the individuals involved—will become more common as the numbers of old people rise.

The Commission recommends the development of Reverse Annuity Mortgages that would enable elderly homeowners to take cash from the equity in their housing on terms that minimize the psychological damage that can be done by the vision of a dwindling asset. Tax laws should be changed to permit elderly homeowners to execute sale-leaseback transactions that would enable them to receive cash for the equity in their house while retaining the right to live there, and would grant purchasers the tax benefits of depreciation during the life of the elderly tenant.

Another possible source of income for the elderly homeowner is "home sharing" in what had been a single-family residence. Commission recommendations with regard to zoning would, among their other benefits, grant virtually universal permission for such arrangements.

Finally, one of the greatest encouragements to homeownership from the Commission's proposals would be reductions in the costs of new housing that would follow adoption of its recommended changes in zoning rules and procedures and in building codes and other regulations. For middle-income as for low-income families, the unhappy fact about the housing they want is that they can't afford it. "Affordable houses" will be much easier for builders to build if they can get on with the job instead of hassling bureaucrats endlessly for permits and approvals.

RENTAL HOUSING

More than a third of American households live in rented housing. Impediments to homebuying, which will not be quickly eliminated, will keep in the rental market households that would prefer to buy. But the private production of rental housing not subsidized by the government continues to shrink.

Rental housing suffers from a seriously inadequate net income stream. The most convincing recent study of rents in comparison with other prices shows that for a constant-quality rented home or apartment, real (adjusted for inflation) rent levels have declined by 8.4 percent in the last 20 years. Only a minority of privately operated rental properties earn their owners a return comparable to that available in the last few years from the purchase of a long-term Treasury bond.

At the same time, however, an ever-increasing majority of middle-income Americans have been persuaded by tax benefits and the investment values of homeownership to buy their homes. The upshot is that lower-income households—who have always had problems with the burdensome portion of income they must pay for rent—are becoming a larger fraction of renters.

Thus, the perception by tenants is that rents are exorbitant, and by landlords that rents are ruinously low. The result has been exacerbation of the perennial tension between landlord and tenant, declining standards of maintenance of the urban housing stock, and serious loss of civility in local government. All this has happened in a time of rapidly increasing operating costs and, of course, of interest rates—the thread of discomfort that runs through all these pages.

Three factors have kept rental housing afloat in the economy—the fact that much of it was financed with the low-rate mortgages of the 1970s; the fact that "leveraged depreciation" on buildings (the bank puts up most of the purchase money, but the owner gets all the tax breaks) has made investment in rental housing a way to shelter other income from the tax collector; and the hope that despite its failure to produce competitive earnings, the building will appreciate in value and yield a capital gain on sale.

The Economic Recovery Tax Act of 1981 increased the value of the tax benefit by shortening (to 15 years, from the average of 30 to 35 years in previous legislation) the length of time over which a rental building may be depreciated. But the other two factors are inherently in conflict in a free market—to the extent that inflation seems likely to increase the resale value of the building, higher interest rates will tend to swallow the profits. At present, indeed, the interaction of these factors works against the economic viability of rental hous-

ing: fears of resurgent inflation keep interest rates high, while the truth that the rate of inflation is declining reduces the capital gains owners can expect from the sale of their buildings.

Looming on the horizon for all potential investors in rental property is the spectre of rent control, which has survived for 40 years of alleged "emergency" in New York City and has recently been instituted in a growing number of communities across the land, from Washington, D.C., to Santa Monica. Prudent investors must therefore build into the initial rents they charge for new apartments an insurance premium against the subsequent introduction of rent control.

While blame for all urban ills can hardly be placed at the feet of rent control, New York City stands as the horrible example of the long-term results of rent control. It has by far the largest proportion of deficient housing units of any large city: with 3 percent of the nation's population, New York has 9 percent of its deficient housing. Little is built or rehabilitated without government subsidy, often several layers of subsidy, from Federal, State, and local tax receipts. Abandonment has swept bare large sections of the city, and the municipal government through tax foreclosures has involuntarily become the city's largest landlord, operating properties that burden the city budget with tens of millions of dollars in losses every year despite the fact that they pay no taxes. Although their average cost of funds is lower than that of thrift institutions elsewhere in the country, the city's savings banks, the mortgagees of this rent-controlled housing, have already required more than $1.5 billion of help from the Federal Deposit Insurance Corporation (FDIC), with more to come. Worst of all is the public attitude toward housing and neighborhoods. In the words of a spokesman for United Housing Foundation, a nonprofit organization and the largest builder of apartments in the city since World War II, "After a generation of rent control, people come to believe that rent goes to the landlord, services come from God, and deterioration . . . deterioration is something you get used to."

The cornerstone of the Commission's recommendations in support of rental housing, then, is Federal discouragement of local rent control within the context of an enlightened federalism. Because the main instrument of Federal involvement in rental housing is the insurance of mortgages and of deposits in institutions that write mortgages on properties subject to rent control, the means of Federal intervention should be the preemption of rent control for all properties financed by federally insured loans or by loans from federally insured institutions.

Rent control, however, is so dangerous and addicting a narcotic that it cannot be withdrawn cold turkey. While prohibiting rent control on new construction financed with the help of Federal insurance, the Commission's proposals envision a five-year phase-in period for preemption of controls on property covered by existing loans. Moreover, the Commission recognizes that special circumstances may on occasion justify the short-term imposition of rent control—Fairbanks, Anchorage, and Valdez in Alaska in 1974, for example, were clearly compelled to institute rent control to protect residents from drastic rent rises as the result of the influx of workers for the Alaska pipeline. In such situations, the Federal government should not interfere with local actions to meet local needs.

Higher-income households will come back to rental housing to some extent during the 1980s, pushed there by the increasing cost of homeownership and the decreasing value of the tax benefits associated with ownership in the aftermath of the cuts in marginal tax rates. Between the increase in average tenant income and the provision of housing assistance grants to low-income families, the higher rents needed to sustain viable rental housing should be feasible and bearable. Regulatory reforms to make building codes less eccentric and more uniform through the country, and reforms of zoning procedures that open up now-forbidden lands to multifamily development, should enable builders to bring down the cost of providing new units. When interest rates come down, apartment construction will rise.

Some of the necessary addition to the rental stock, however, must come from conversion of commercial and industrial buildings to residential use, and from the alteration of existing houses and large apartments to provide more rental units. The new tax law provided special credits for investors who rehabilitate commercial structures. The Commission recommends that these tax benefits be extended to residential properties as well.

FHA mortgage insurance is particularly important to the financing of multifamily properties, partly because the size of each project prevents private insurers from properly diversifying their risk. The Commission therefore recommends continuation of FHA insurance of mortgages on unsub-

sidized multifamily projects, and FHA support for innovative mortgage instruments. The Commission feels that there may be a role for FHA insurance of mortgages that give lenders some share of the equity appreciation of apartment projects, under tight safeguards to assure that both the developer and the lender remain substantially at risk.

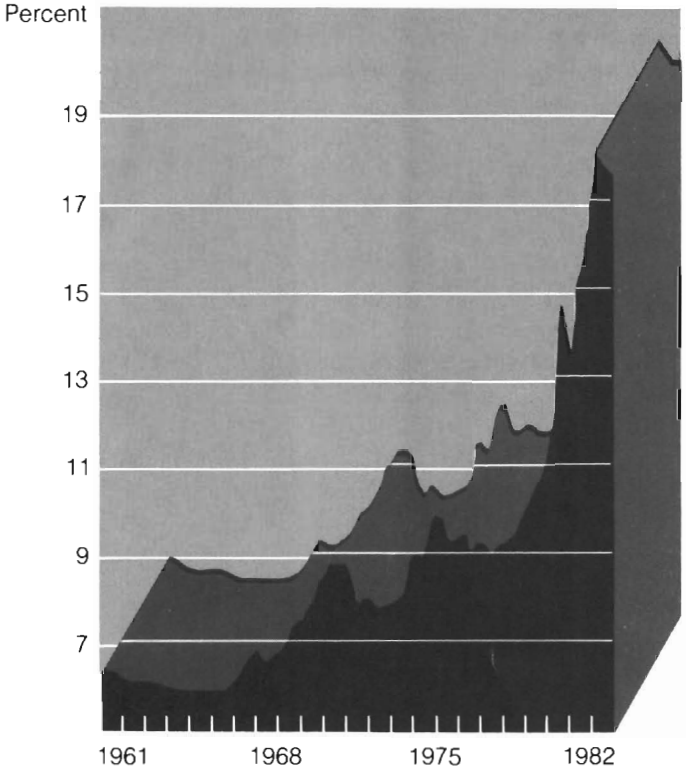
Among the discouragements to the construction of rental housing in recent years was a change in the tax law in 1976, ending the previous practice of expensing interest payments incurred and taxes paid during the construction phase of a multifamily project. The current requirement that such expenses be included in the project cost for gradual depreciation reduces the value of tax benefits to investors in rental properties at a time when such investors are hard to find. The Commission recommends that for a limited period of time, as a counterweight to the harm done by high interest rates, the Congress should restore, under appropriate controls, the rules that permitted immediate deduction of interest and taxes paid by the developer of a residential construction project during the period prior to the occupancy of the building.

FUNDS FOR HOUSING

The current crisis in housing is primarily a crisis in the financing of housing. The Commission agrees that inflation and unprecedented interest rate movements have fundamentally damaged the system of financial intermediation that so successfully supported American housing for more than 40 years, and that a broader-based and more resilient system will be needed to supply the funds a strengthened housing industry will require.

Looking toward the development of that new system, the Commission proposes an integrated package of recommendations designed to reduce the nation's reliance on specialized mortgage lenders and a single type of mortgage instrument. Thrift institutions will continue to play an important part in this system, but the thrift industry will need broader operating powers to function effectively in tomorrow's market environment. In the future, housing will not be as dependent as it has been on this limited sector of the capital market; housing will draw more funds from a wide range of private institutions, including pension funds, insurance companies, and commercial banks. To encourage greater participation in housing finance by such institutions, the Commission recommends the re-

Inflation Drives Up Mortgage Interest Rates



Source: U.S. Department of Housing and Urban Development.

As the graph indicates, mortgage interest rates have skyrocketed over the past five years. Up until 1966, mortgage rates were relatively low and quite stable. Since then, high, volatile, and rising rates of inflation have driven mortgage rates from one historic record level to another with increasingly severe variations. During 1979 alone, the rate on mortgages fluctuated over a range of 3 percentage points.

There are two major consequences of this increase in rates. First, households found it harder to sustain the cash flow necessary to pay for a house at market rates, and housing became less "affordable." Second, thrift institutions became less viable. Inflation outstripped expectations and thrift institutions found that they had loaned money for housing at rates that were insufficient to maintain the value of their investment. Because they were forced to finance these mortgage loans by paying market rates reflecting the rate of inflation, the thrifts were caught in an earnings squeeze that hobbled them as a source of housing finance.

moval of various tax, legal, and regulatory impediments to widespread private investment in mortgages and mortgage-backed securities.

Secondary markets dealing in new types of mortgage-related securities will help attract these new participants to housing finance. New forms of mortgage instruments also will serve the needs of both borrowers and investors in a changing economic environment. In the process, some of the risks associated with the need to pay market interest rates will be shared between lenders and borrowers; some will be hedged by lenders in the new and rapidly growing financial futures markets, to which housing-related paper has gained entry.

Development of a more efficient and extensive private housing finance system will reduce the need for government programs in the residential mortgage markets. The Commission foresees a future in which government should be a participant in housing finance only in those areas where the private sector cannot provide needed services at a reasonable cost to borrowers.

The most durable of consumer durables, a residential building must be paid for as a product at the time of completion, though it will yield satisfaction to occupants over the course of many years. Housing therefore requires, more than any other item of consumption, a system of finance that provides large sums of money for immediate purchase to be repaid over a long period of time. Most societies have found it proper and convenient to mobilize personal savings to facilitate personal homeownership and have developed institutions specialized in this sort of getting and lending.

In the United States the key housing finance institutions have been the thrifts—savings and loan associations (S&Ls) and mutual savings banks. Since the Great Depression, they have been heavily regulated. First at commercial banks, and after 1966 at the thrifts, ceilings were set on the interest rates that could be paid to depositors. This system for mobilizing consumer savings for housing thus required either a currency of relatively stable value, or the absence of competitive repositories for personal savings, or both. Once market interest rates rose substantially above the imposed ceilings, there was an incentive for entrepreneurs to offer higher-yielding instruments and for savers to shift their assets into those higher yields. For alert consumers, the appeal of the savings account greatly diminished, and the flow of funds to housing through thrift intermediaries was choked.

The immediate problem for the government regulator was to enable thrifts to continue to draw new consumer deposits, without lifting the interest rate on all deposits to the point where interest paid to savers would exceed the earnings the thrifts received from their seasoned long-term mortgages. For a time, the problem was solved by an ingenious collection of specified-term deposits at higher rates, with penalties for early withdrawal. But as interest rates continued to rise and inflationary expectations became ingrained, these time-deposit devices proved inadequate as a means for holding consumer savings in thrift institutions.

In June 1978, the regulators approved new short-term certificates bearing interest rates related to Treasury bill yields. By the end of 1981, well over one-half of the savings in the nation's thrift institutions had taken the form of certificates with interest rates tied to market conditions on the date of their issue. Those market conditions had only rarely in the previous two years permitted the issuance of paper carrying a yield of less than 10 percent a year—but almost two-thirds of the mortgages held as assets by the nation's thrifts carried interest rates below 10 percent. Profits vanished, and the net worth of the mutual thrifts and the capital of the stockholder-owned S&Ls were eroding in early 1982 at a rate of more than $6 billion a year. These losses exceeded those of the afflicted automobile industry, the airlines, and the agricultural equipment makers, all taken together.

These wounds need not prove fatal, especially if interest rates fall. Old low-rate mortgages are being paid off month by month, and new high-rate instruments replace them on the asset side of the thrift ledger. Because amortization provides a steady stream of incoming funds, thrifts in the absence of a financial panic will not have a cash flow problem and will be able to pay depositors who want their money back even if their net worth under generally accepted accounting principles should become negative.

The Commission recommends several actions the government could take to help thrift institutions during the transition years. Among the most important measures that can be adopted to speed the healing process is the restoration to mortgage lenders all over the country of their once unquestioned right to enforce the due-on-sale clauses written into most mortgages that are not federally insured. States and courts that deny mortgage lenders this right keep the thrift institutions from bringing the

yield on their assets into balance with the cost of their funds, denying new mortgage loans to the entire nation and destroying the actuarial basis on which the capital market rested its willingness to commit nondepository funds to housing. The Commission suggests several options for Federal action to compel or pressure States to cease their counterproductive post-hoc infringement of legitimate provisions in private contracts.

The Commission also urges Congressional action to make demonstrable the fact that Federal insurance does and will guarantee principal and interest on deposit accounts up to $100,000. Though both the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation already have sufficient resources to see the thrift industry through a severe storm —and can supplement those resources if necessary by drawing on a legally determined line of credit with the Treasury—there is certain to be concern about the extent to which insurance assets of $15 billion or so can protect $1.2 trillion of savings deposits and small denomination time deposits. Thus the Commission recommends that Congress act to back up the statements of the Secretary of the Treasury and White House spokesmen that the Federal government will stand behind the repayment of all deposits in federally insured banks and thrifts, up to the legal ceiling. What is needed is not encouraging resolutions but legislation to establish a deeper line of credit for the insurance corporations at the Treasury and/or the Federal Reserve. If the funds to back up the insurance are visible to the public, there will be no need to call on them.

In deciding whether to support troubled thrift institutions, the Commission recommends that Federal regulatory authorities should look at them as a prudent lender would look at any business: judging the institution's reasonable chances for future profit rather than its current book value. Where an institution must be merged to maintain its services to the public, the authorities should use the power the Commission believes they already have to arrange interstate and interindustry combinations.

The Commission did not recommend an extension of the "all savers" program that was enacted in summer 1981 and permitted depository institutions to offer a one-year certificate with a tax-exempt interest rate. This program drew relatively little new money to most thrift institutions, and less to housing, but was costly to the Treasury. To avoid a drain of funds from the thrift institutions when this program ends, the Commission recommends that the regulatory authorities approve a new fully taxable certificate that would offer a comparable after-tax yield to savers. To help thrift institutions retain IRA and Keogh retirement plans, the Commission recommends an increase from $100,000 to $250,000 in the maximum insured deposit account held for this purpose.

Looking to the future, the Commission expects and welcomes a major restructuring of the thrift industry. It recommends considerable expansion of operating powers for thrift institutions. It also advocates liberalized rules to ease the transfer of depository organizations from mutual to stock form and between State and Federal charter.

Congress has already legislated an end to all regulatory restraints on the payment of interest on deposits, to take effect by 1986 after a phase-out period at a pace set by the Depository Institutions Deregulation Committee. Further expansion of thrift institutions' liability powers would also seem desirable. In addition to consumer NOW accounts, for example, thrifts should be permitted to offer commercial checking accounts.

But the time has come for Congress to drop the other shoe: to relax the limits on the nature of the assets thrifts can solicit and hold. In general, the Commission believes thrift institutions should be able to serve the credit needs of all sectors of the economy. The lesson of the past half-dozen years is that mortgage investments alone will not provide thrift institutions with the flexibility they need to survive in periods of financial stress.

Congress has already recognized the strength of this lesson to a degree, loosening some of the previous restraints on thrift asset powers. But provisions in the tax code still function to inhibit diversification by thrift institutions, and these provisions must be changed if the thrifts are to take advantage of their new powers. Thrifts will continue to specialize in residential real estate lending: it is their area of expertise, the playing field on which they can demonstrate advantage in comparison with other institutions. But extended asset powers, unhindered by tax considerations, will, of course, reduce their virtually exclusive orientation toward housing investment.

The Commission therefore believes that the same tax incentive should be made available to all investors through a mortgage interest tax credit. This credit would aid the transition to a broader institutional base of mortgage supply. To minimize

the shock to thrift institutions, the current bad debt deduction should be phased out gradually. To maximize the impact on the mortgage market, the credit should apply to additional mortgage investments.

Commercial banks are already large mortgage lenders—indeed, they have increased their share of such loans during the past three years when the thrifts were of necessity leaving the market. Life insurance companies were major suppliers of funds for housing until the mid-1960s and can be induced to return; pension funds, by pursuing their own investment goals, also can help Americans meet their housing desires. The Commission notes with gratification the President's prompt adoption of its interim recommendation that Employee Retirement Insurance Security Act (ERISA) regulations be altered to permit greater investment in mortgages by private pension plans.

State legislation must be changed in some States to facilitate housing investments by public pension funds. The Commission suggests that the National Conference of Commissioners on Uniform State Laws consider a model State Legal Investment statute for this purpose. State laws should also be changed to permit consumer finance companies, already heavily involved in personal loans secured by second mortgages, to enter more directly into the mainstream of housing finance.

The regulatory authorities have already moved to permit thrift institutions and others to offer adjustable-rate mortgages (ARM), which shift from lender to borrower some (at the extreme, all) of the risk of volatile market interest rates. The acceptability of these instruments to both homeowners and financial institutions will determine their future.

What seems clear is that a viable ARM must give the homeowner a considerable degree of confidence that he will not lose his home because of what happens in impersonal money markets, and must give the ultimate lender of the funds reason for confidence that he is not subjecting himself to major risks of loss through maturity transformation by committing his money to finance housing. Lenders should be encouraged to seek original solutions to these demands. The form such instruments will ultimately take is still unknown, and it would be a mistake for the Federal government to promote just one kind of ARM at this time.

Though financial futures markets have made it possible for mortgage lenders to hedge the interest-rate risk on their holdings of fixed-rate instruments, viable ARM instruments could be an important tool in the quest to attract money for housing from the pension funds and life insurance companies. Both these "contract thrifts" have long-term obligations suitable for matching with the long-term asset of the residential mortgage. But some pension funds may have their benefits schedules altered by some form of prearranged or repeatedly negotiated indexing. Such pension funds, then, will need assets that yield increasing returns in inflationary times. Conventional mortgages do not meet these needs; ARMs do.

In secondary markets, private placement of mortgage loan packages with institutional investors like pension funds and life insurance companies, and with other financial institutions, has historically been the norm. The full potential of the mortgage market, however, will not be reached until it is fully meshed with the securities markets. The Federal government has created a number of institutions to help achieve this integration. Agencies such as the Federal National Mortgage Association (FNMA), the Government National Mortgage Association (GNMA), and the Federal Home Loan Mortgage Corporation (FHLMC)have all helped to improve the access of mortgage credit to the broader capital markets.

FHA insurance was crucial in the first large sales of home mortgages to distant investors. The biweekly FNMA "auction" of rights to sell the agency future mortgages has been an important source of commitments to lenders for a long time. More recently, the GNMA and FHLMC pass-throughs have created a very large and very active secondary market in housing-related paper. And all these institutions still have pioneering tasks to perform, by insuring, buying, and selling the new mortgage instruments, and by testing the markets to determine what housing paper will be most acceptable to investors in the years ahead.

Before a fully private mortgage-backed securities market can reach its full potential as a source of funds for housing, various regulatory, legal, and tax impediments will have to be removed. Mortgage-backed securities are not mentioned in many of the laws governing investment vehicles, because they were not in existence when the laws were written. Thus, the sort of pooling that is tax-free for the stock-market mutual fund may produce tax liabilities for a mortgage pool; and profits on the resale of a conventional mortgage-backed security (CMBS) instrument are treated as ordinary income rather than as capital gains. The Federal Reserve

Board's Regulation T, which permits the extension of margin credit on the security of corporate bonds, denies such assistance when the collateral is a mortgage-backed security. The Securities Exchange Commission does not permit registration of mortgage-backed securities under the Investment Company Act, but the State securities regulatory authorities require separate registrations under State blue-sky statutes. Many States do not consider mortgage-backed securities to be "legal investments" for State-regulated fiduciaries.

The Commission recommends that anachronistic constraints be removed from the relevant laws and regulations, permitting conventional mortgage-backed securities to compete on equal terms in the securities markets. Because FHA's imposed costs are greater than private mortgage insurance fees, the role of FHA will diminish naturally—indeed, FHA and VA together guaranteed fewer mortgages than the 15 private mortgage insurers did in 1981. With the reduction in the quantity of FHA paper, the GNMA guaranteed securities program will lose its raw material—but even before that happens, the government should plan a phasing down of GNMA issuance, carefully calibrated to match the growth of the CMBS market.

Eventually, the Commission believes, both FNMA and FHLMC should become entirely private corporations, without special access to the deep pockets of the Treasury or the Federal Home Loan Bank System. These developments, however, should be geared to the return of FNMA to fiscal health. As an institution that borrowed short to lend long, FNMA has been suffering many of the ailments of the thrifts. It will require the comfort its Federal liaison gives to the purchasers of its obligations for several more years.

REGULATORY REFORM

Growing concern about overregulation of housing has been expressed by both experts and concerned citizens. In the 1960s both the Douglas Commission and the Kaiser Committee warned that government regulation of housing would continue to increase. They identified the need to reduce unwarranted government controls in the form of building codes, zoning, subdivision regulation, and licensing. Except in the area of building codes, which have become upgraded and made more uniform across the country in the past dozen years, these warnings have come true.

A number of studies have quantified the cost of increased site-development standards, municipal fees for permits, inspection and utility tie-ins, excessive building code standards, and insufferable delays. While the quality and level of these estimates vary, they all show a significant regulatory impact on cost—adding as much as 25 percent to the price of a house. There is a steadily growing list of Federal, State, and local authorities that insist on elaborate permit-granting procedures and impact statements. Meanwhile, the clock ticks on escalating wages and prices; and builders must pay interest charges and local taxes to maintain inventories of still-barren land. Homebuyers and renters eventually must pay for it all.

The increased control by government on homebuilding has been among the more damaging results of the intense cyclicality of housing construction in the 1970s. Bursts of housing activity frightened some municipalities, which saw added pressure on public facilities resulting from large population inflows. The obvious profitability of homebuilding in boom years tempted reformers and politicians to load the costs of what seemed to them desirable changes onto the price of houses.

Productivity improvement in the construction industry has lagged behind even the generally unsatisfactory record of the economy as a whole. A number of factors aggravate this condition: local building code regulations that prevent the substitution of more cost-effective materials or procedures; Davis-Bacon Act restraints that prevent the substitution of unskilled for skilled labor on federally assisted projects; and local laws that restrictively license skilled tradesmen.

The Douglas and Kaiser panels dealt essentially with local regulation; Federal regulation had not become sufficiently intrusive to draw their attention. During the 1970s, however, the Federal regulatory presence expanded dramatically in response to grass-roots consumer, environmental, and energy movements.

Many Federal agencies adopted regulatory policies that directly or indirectly affected housing costs. Some regulations increased production costs; others limited the supply of land and materials available to satisfy the demand for housing; regulation of mortgage lenders raised credit costs; and Congress increased HUD's regulatory authority in such areas as settlement procedures and manufactured housing.

State governments also expanded their regula-

tory roles in environmental control, building controls, housing in municipal land-use plans, and energy conservation. Some State programs were created in direct response to Federal requirements or incentives; others reflected State concern over housing, energy, and environmental problems.

The pattern is clear: regulations have proliferated at all levels of government. While government has a legitimate concern about vital present and future interests, failure to consider and anticipate detrimental effects on housing has led to excesses and abuses, conflict, unnecessary costs, discouragement of innovation, and duplication. The Commission believes, however, that the public's attitude toward this sort of regulation has turned. The time has come for restraint in government regulation of housing.

The Commission calls for special Federal regulatory relief for housing. To make this a broad effort, Federal officials should consult consumer and industry groups and State and local governments when setting deregulation priorities.

Federal agencies should use appropriate private-sector construction standards and phase out their use of Federal minimum property standards, relying instead on local building codes consistent with one of the nationally recognized model codes.

Federal land-use and environmental protection regulation should be reviewed to ensure that such regulation does not unduly hinder the achievement of affordable housing. The Commission further recommends that housing construction and related infrastructure work should be excluded from coverage under the Davis-Bacon Act.

Most importantly, at the State and local level, the Commission urges governments to limit zoning restraints on housing to the achievement of "vital and pressing governmental interests." Regulators should have the burden of proof that the code meets this standard if the code is challenged in court. Further, to address this concern, the Commission also requests that the President ask the Attorney General to evaluate the "vital and pressing" standard of judicial review as applied to zoning restrictions on housing.

Exclusionary zoning regulations can have socially discriminatory effects, preventing the construction of multifamily or other housing projects that could be built for occupancy by moderate-income households. "Controlled growth" regulation pushes up the prices of existing homes in the localities imposing such quotas, largely for the benefit of existing homeowners.

Subject to vital and pressing governmental interests, the Commission recommends that:

- Density of development should be left to the marketplace;
- Discrimination against manufactured housing should be removed from zoning laws;
- The size of individual dwelling units should not be restricted;
- Growth controls should be justified by a vital and pressing governmental interest;
- Farmland regulation limiting housing should be avoided;
- Builders should be able to secure all necessary permits in a single procedure; and
- Builders should pay only such fees as relate to their own development.

In the area of code enforcement, the Commission calls on the States to require localities to adopt one of the nationally recognized model codes and to apply the HUD Rehabilitation Guidelines as a basis for the development of their standards. Occupational licensing procedures should also be relaxed to eliminate unwarranted exclusion of competent labor from the work force. State licensing laws should permit licensed craftsmen to operate throughout the State, and full recognition should be given to comparable licenses from other States.

The Commission applauds HUD's initial efforts to reduce regulatory burdens on homebuilding and the shift of minimum property standards to locally administered model codes. In addition, the Commission recommends that HUD expand its housing affordability efforts and create an Office of Housing Productivity.

For 20 years and more, the public has been fed proposals for new regulation which stress the nobility of the results that are to be achieved by government action and minimize the costs that will be imposed on business and consumers. The time has come to reverse this process, to emphasize the enormity of the costs now imposed upon activities that may not produce a clear public good, often implemented for selfish or obscure purposes.

Turning established public attitudes is never an easy task, but the Commission believes that it can be accomplished.

A FINAL NOTE

When all is said and done, government makes the rules and the private sector performs. For 30 years, from the generation that had to find its way out of the Great Depression until the 1960s, government jiggled the rules in ways that were productive for the housing sector. But the very success of housing policy through those years then provoked a change of course that shackled the housing industry while appearing to protect it.

As often happens, the prisoner came to love his chains. After 20 years of being told what to do and being paid to do it, too many members of the housing community want nothing so much as a return to the old days. "Housing," said a leader of one of the trade associations at a meeting with the Commission, "*can't* compete for funds." But of course it can; it always has. Even in the heyday of government help, the marginal dollar that sets the price was raised in the marketplace. Government gave access to markets through insurance programs, which also involved a degree of implicit subsidy. But the overwhelming bulk of government contribution was in duly authorized funds and tax incentives, and those were never more than a minor fraction of the money Americans spent on housing.

Nothing works unless the private sector works. The current housing recession began toward the end of 1979, and in the first half of 1980—when government subsidies were going full blast—starts were at an annual rate of only 1.1 million. Since the 1960s, every government-stimulated burst of housing activity has been followed by a deep decline after the initial shock of the program has been absorbed, because the health of the private economy was being sapped by inflation.

No one can say how many new housing units will be "needed" in the next 20 years. Household formations and housing units are functions of each other; neither is an independent variable. In the 1970s, the rate of household formation was faster than demographers would have predicted from the raw population figures; in the 1980s, it will be slower. The costs of starting a household were low in the 1970s; they are high today. Not all human decisions are made on the basis of economics, but the information supplied by fluctuating costs and prices deeply affects the behavior of most people most of the time. That information turned adverse to housing in the late 1970s; the condition of the housing industry, and thus consumers' housing opportunities, will improve only as this information turns favorable.

The Housing Commission seeks growth with stability. By providing the legal and economic rules for an efficient and stable system of housing finance, by placing scarce subsidy dollars where they will increase effective demand, by eliminating regulations that distort both demand and supply to achieve governmental purposes without budgeting governmental costs—by such means, the Housing Commission seeks to bring the market for housing into balance at a higher level of human satisfaction and economic production. No other course of government policy is desirable today. Very probably, no other course is feasible.

Finally, the Commission urges speed in the adoption of its recommendations. The sooner the government clears the way, the quicker the nation will gain the benefits of the homes a healthy housing system will provide.

Section I:

HOUSING FOR LOWER-INCOME PEOPLE

CHAPTER 1

INTRODUCTION: CHANGES IN QUALITY AND AFFORDABILITY

A fundamental concern of this Commission is the housing problems of low-income Americans. While there have been significant improvements in both the quality and affordability of housing since the 1940s for most Americans, there are still low-income households poorly housed or paying a burdensome portion of their income for rent. The private housing market serves most of these households, but the public sector has a role in reducing housing cost burdens and in expanding the availability of decent units for those the market does not serve. This section reviews the housing problems and needs faced by lower-income people, discusses the previous attempts to deal with the problems, and proposes alternative methods of addressing the housing needs of lower-income households.

The Federal government has dealt with the housing problems of lower-income Americans by building expensive new units for these households—from public housing construction in the 1930s to the present Federal production program known as Section 8. These programs have provided large subsidies to finance the construction and substantial rehabilitation of units and to subsidize occupancy by lower-income tenants. More than 1.2 million units of public housing have been built since the program began, and more than 1.5 million additional privately owned subsidized units have been produced.

But new construction and substantial rehabilitation programs, whether of publicly or privately owned units, have several problems: they are very expensive; they are not equitable, because they provide a few fortunate tenants very high quality housing at a price less than their neighbors pay for lower-quality housing; the bureaucratic controls associated with the programs add time and expense to the projects; and, most important, new production and substantial rehabilitation are very inefficient ways of addressing the problem of affordability.

While the public sector has provided housing for lower-income persons through new construction and substantial rehabilitation, forces at work in the private sector have produced steady and dramatic improvements in both the quality and quantity of available housing. In fact, the ability to pay for decent housing has become the predominant housing problem faced by the poor. This development represents a major change from the postwar period, when housing supply and quality were the foremost housing concern. Despite the ascendance of the affordability problem, the nation's basic response to the housing problems of lower-income persons has not changed. This chapter discusses the housing problems of lower-income households and provides a critique of the high costs and inefficiencies of the present Federal production programs. It also provides the empirical basis for the recommendations made in Chapter 2.

The nature of housing problems in the 1980s suggests that a fundamental redirection of subsidized housing is in order. The Commission proposes a consumer-oriented Housing Payments Program as the preferred alternative to production programs. Such a program directly addresses the housing affordability problems of lower-income persons by providing a subsidy to help pay monthly housing costs. With their housing payment, lower-income households are free to occupy any unit that meets the minimum standards for housing set by the program.

Although the Commission recommends that

the Housing Payments Program become the major housing program for lower-income households, the Commission realizes that the quality of housing stock in certain markets and the difficulty of housing payments in serving particular households may limit the workability of a Housing Payments Program in some communities. The Commission therefore proposes to make new construction an eligible activity of the Community Development Block Grant Program (CDBG) and to add a Housing Component to CDBG. These changes will allow the CDBG program, with its flexibility and sensitivity to local needs, to become the primary program to deal with housing availability for the poor. Chapter 2 provides guidance for the development of the proposed Housing Payments Program and for modifications to the CDBG Program.

While the Commission looks forward to a new approach to housing lower-income people, it is also aware of the nation's large investment in public housing. Public housing has had special problems in the past few years. Since the program was initiated, it has become increasingly controlled and bound by Federal regulations. Local housing authorities are required to rent to very low-income households and to limit the amount of rent charged to tenants. This mandate reduces the ability of local housing authorities to cover their operating expenses from tenant rents and forces the Federal government to provide an ever-increasing amount of money to subsidize operating costs. Many public housing projects continue to be cost effective and relatively inexpensive to operate. Other projects are very expensive to run; have serious maintenance, crime, and social problems; or are located in areas better suited to other uses, such as commercial or industrial development.

Chapter 3 calls for a restructuring of the public housing program. The changes would allow local governments, in concert with the Federal government, to undertake a project-by-project review of public housing in order to determine the best future use of the properties, while at the same time continuing to serve the low-income tenants who occupy the units.

The restructuring of the public housing program and the adoption of the two new programs proposed by the Commission will help to solve the housing problems of many lower-income households. However, the housing problems of special groups, such as the elderly, handicapped, and disabled may require additional attention. Issues and problems associated with housing for these special groups are discussed in Chapter 4.

The remainder of this chapter reviews the trends in housing quality and affordability that have emerged since the 1940s and critiques the current subsidized housing production programs in light of the present housing problems faced by poor people.

Housing Quality

Trends in Housing Quality

Basic housing data point to a continuing improvement in the housing of most Americans. The size, amenities, and condition of housing provide an important measure of how well Americans, particularly its low-income residents, are housed. Traditionally, the quality of the housing stock has been measured along two dimensions: available space and physical conditions. On both of these dimensions the quality of America's housing has vastly improved since World War II.[1] Figure 1.1 illustrates the dramatic changes:

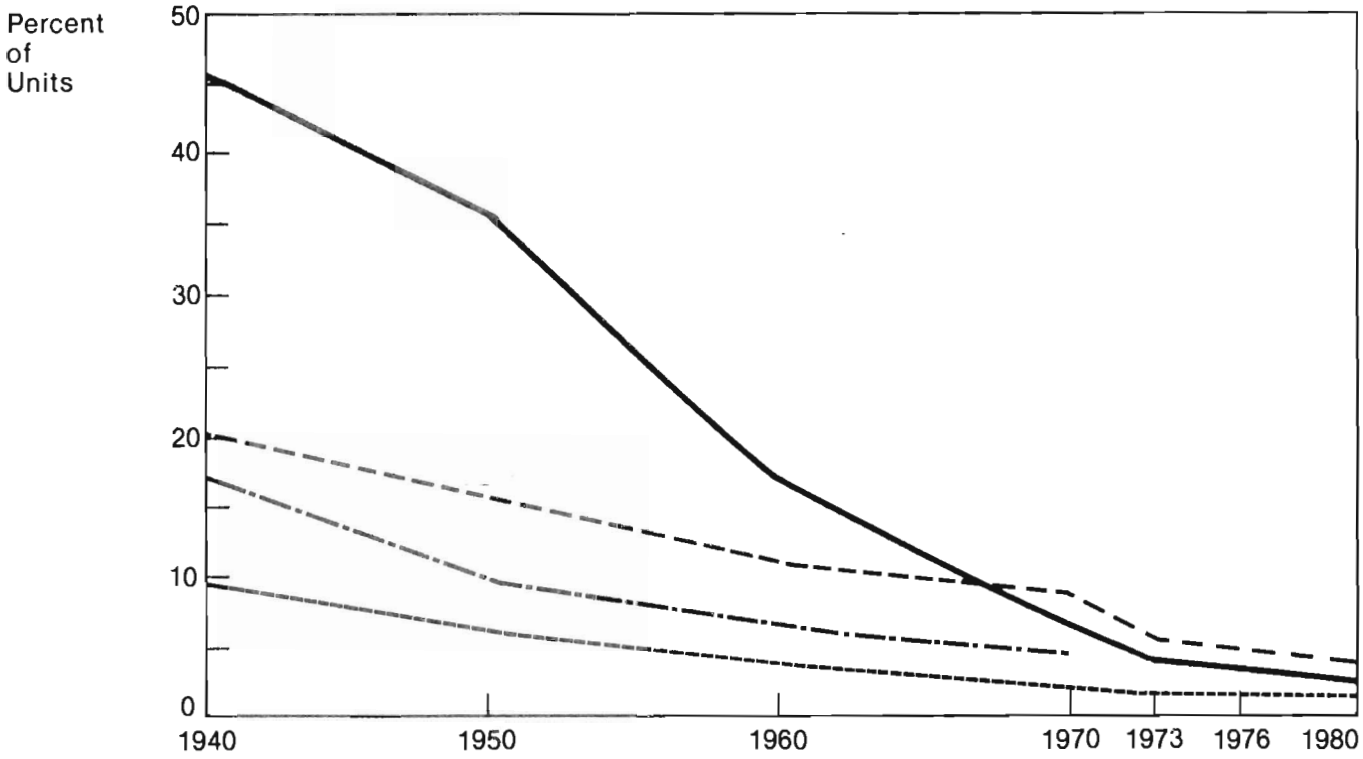
- Overcrowding (more than 1 person per room) has decreased substantially, from 20 percent of all households in 1940 to 4 percent in 1980; severe overcrowding (more than 1.5 persons per room) also has declined to approximately 2 percent;
- Housing quality measured by the lack of complete plumbing facilities has increased, with only 4 percent of all units failing to meet this criterion by 1980; and
- The stock of housing dilapidated or needing repairs has declined to less than 10 percent of the available units.

Other measures of housing quality also suggest improvements. For example, in 1940 there were fewer than 1.5 rooms for every person in the United States; by 1980 there were 2. A room, of course, may be large or small and thus this is an imprecise measure of space. But the floor area per person has also been increasing steadily. A new home in 1979 on average had twice as many square feet as in 1950. Indeed, a new mobile home in 1979 typically was as large as a new house in the late 1940s.

The improvements in housing quality apply to the population as a whole, of course, but similar improvements have occurred in the housing of various groups that often have been of special concern in housing policy. Of those in the poorest fifth of the population, for example, 61 percent lived in housing without complete plumbing in 1950, compared with 7 percent in 1978. Similarly, 70 percent of nonwhite

[1] Measures of housing adequacy and affordability are derived from U.S. Department of Commerce, Bureau of the Census, *Decennial Census of Housing*, 1940, 1950, 1960, and 1970, and, since 1973, U.S. Department of Commerce, Bureau of the Census, and U.S. Department of Housing and Urban Development, Office of Policy Development and Research, *Annual Housing Survey* (Washington, D.C.: U.S. Government Printing Office).

Figure 1.1
Measures of Housing Inadequacy



Lacking some or all plumbing.
More than 1 person per room (percent of occupied units).
Dilapidated or needing major repairs.
More than 1.5 persons per room (percent of occupied units).

Source: Compiled from data supplied by the U.S. Department of Commerce, Bureau of the Census.

households lived in such housing in 1950, compared with 5.8 percent of nonwhite households in 1980. The limited data available for Hispanic households suggest similar improvements.

Housing Quality Today

Beginning in 1973, more sensitive measures of housing quality than those used in the decennial census have become available in the Annual Housing Survey (AHS). The Survey collects data on some 30 different kinds of housing deficiencies. Questions are asked not only about the presence or absence of facilities, but also about how well they function—for example, the Survey asks not only, "Do you have complete plumbing?" but also, "Has it broken down in the last year? If so, how often? For how long?" Similar questions seek data on the heating, electrical, and other systems. Instead of asking a single question on the general physical condition of a structure, as in the decennial census, the Survey covers a number of specific structural defects, such as leaky roofs; holes in the floors, walls, or ceilings; or missing stairs in apartment buildings. Table 1.1 shows how some of these conditions have changed in recent years. Generally, the responses point to continued improvement of the housing stock.

The Annual Housing Survey has been used to

Table 1.1
Percentage of Occupied Housing Units with Specified Defects—1973, 1975, 1977

	Percent of Occupied Units Reporting the Defect		
Type of Defect[a]	1973	1975	1977
Kitchen			
Shared or not complete kitchen facilities	2.3%	2.0%	1.7%
Complete kitchen, but not all facilities usable	N/A	0.7	0.7
Electrical			
Some or all wiring exposed	4.0	3.2	1.3
Lacking working outlets in some or all rooms	5.3	3.5	2.9
Shared or no bathroom	4.3	3.2	2.8
Plumbing			
Lacking some or all facilities	3.6	2.9	2.4
Breakdown in water supply	2.5	2.2	2.3
Breakdown in sewer or septic tank/cesspool	1.1	1.0	1.1
Breakdown in plumbing equipment	2.0	1.5	1.6
Heating			
No heating equipment	0.5	0.4	0.5
Inadequate heating equipment	6.6	6.3	6.4
Breakdown in heating equipment	7.1	5.6	5.5
Water leaks			
Through roof	7.6	6.2	6.0
In basement	13.5	11.7	10.8
Interior ceilings and walls			
With open cracks or holes	6.0	5.3	5.2
With broken plaster or peeling paint	4.7	N/A	N/A
With broken plaster	N/A	3.5	3.3
Interior floors with holes	1.9	1.8	1.8

[a] The individual defects are not additive, because more than one defect within and among categories may be present in the same unit. The numbers exclude households failing to report or reporting "Don't know."

Sources: U.S. Department of Commerce, Bureau of the Census, and U.S. Department of Housing and Urban Development, Office of Policy Development and Research, *Annual Housing Surveys* (Washington, D.C.: U.S. Government Printing Office, 1973, 1975, 1977).

construct measures of inadequate housing units. One measure is that used by the Congressional Budget Office (CBO) (Table 1.2). The CBO definition divides housing defects into two categories. The first seven are structural deficiencies or major problems in the plumbing and heating systems that are likely to require either replacement or major repair. The last eight items in the table are problems that may arise periodically in any housing unit and be repaired in the course of normal maintenance activities. The measure classifies a unit as inadequate only if it has two or more of these defects.

The fraction of the housing stock classified as inadequate has dropped slightly from 8.1 percent in 1975 to 7.5 percent in 1977.[2] This decline is roughly consistent with measured declines in crowding and incomplete plumbing using the older standards in the decennial census. In overall terms, the occupied housing stock consisted of about 75 million units in 1977, and 5.6 million households lived in units that failed the CBO adequacy test. The following section tells us something about the households occupying inadequate housing.

Who Lives in Inadequate Housing?

The Commission is concerned not only with trends in quality and total numbers of inadequate units, but also with the people who live in inadequate housing. Housing policy should acknowledge specific groups within the population whose housing problems are more acute than those of the general population.

Figure 1.2 shows the incidence of inadequate housing among various segments of the population. Two basic patterns emerge: inadequate housing is far more common among renters than owners, and such housing is concentrated among very low-income families (those with incomes of 50 percent or less of the local area median income).

Neither of the above findings is surprising. Homeowners have much more control over the quality of their housing than do renters. When a problem occurs, the owner can arrange for repairs, or even fix it personally; the renter must contact the landlord. Almost twice as many very low-income renters live in inadequate housing as do very low-income owners (18.6 percent versus 9.4 percent).

[2] The Commission uses the CBO definitions of housing adequacy, but other definitions suggest similar patterns of improvements in the housing stock. For an evaluation of alternative definitions, see John C. Simonson and Richard B. Clemmer, "Trends in Substandard Housing, 1940-1980," prepared for the President's Commission on Housing, April 1982.

Table 1.2
Conditions That Cause a Housing Unit to Be Judged as Inadequate

A unit is classified as inadequate if it has at least one of the following conditions:

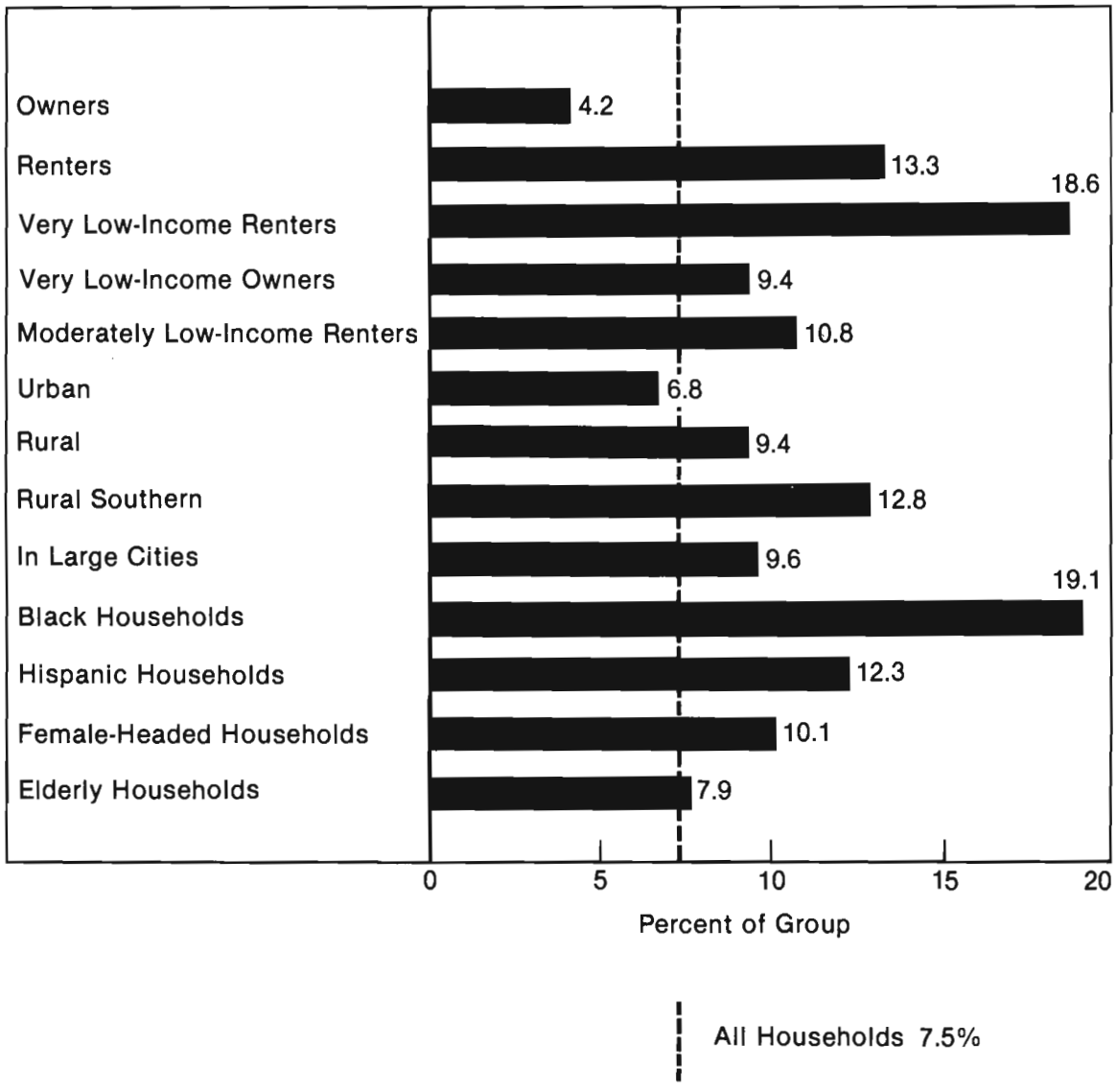
1. The absence of complete plumbing facilities.
2. The absence of complete kitchen facilities.
3. The absence of a public sewer connection, septic tank, or cesspool.
4. Three or more breakdowns of six or more hours each time in the sewer, septic tank, or cesspool during the prior 90 days.
5. Three or more breakdowns of six or more hours each time in the heating system during the past winter.
6. Three or more times completely without a flush toilet for six or more hours each time during the prior 90 days.
7. Three or more times completely without water for six or more hours each time during the prior 90 days.

or if the unit had two or more of the following conditions:

1. Leaking roof.
2. Holes in interior floors.
3. Open cracks or holes in interior walls or ceilings.
4. Broken plaster over greater than one square foot of interior walls or ceilings.
5. Unconcealed wiring.
6. The absence of any working light in public hallways for multi-unit structures.
7. Loose or no handrails in public hallways in multi-unit structures.
8. Loose, broken, or missing steps in public hallways in multi-unit structures.

Source: Congressional Budget Office, *Federal Housing Policy: Current Programs and Recurring Issues* (Washington, D.C.: U.S. Government Printing Office, 1978), pp. 4–6. CBO used the term "needing rehabilitation" in place of "inadequate."

Figure 1.2
Incidence of Inadequate Housing Among Various Housing Groups, 1977



Source: U.S. Department of Commerce, Bureau of the Census, and U.S. Department of Housing and Urban Development, Office of Policy Development and Research, *Annual Housing Survey: 1977* (Washington, D.C.: U.S. Government Printing Office, 1979); Congressional Budget Office definition of inadequate units (units in need of rehabilitation).

For both owners and renters, housing adequacy improves as incomes rise. For example, nearly one-fifth of very low-income renters live in inadequate housing, compared with slightly more than one-tenth of renters with moderately low incomes (between 50 and 80 percent of area median).

There also are some geographic concentrations of inadequate units. Such housing is found disproportionately in rural areas in the South and in older, large cities. The 1977 AHS showed that New York City and the nearby New Jersey cities of Newark, Paterson, and Jersey City had a particularly high concentration (almost 19 percent), double the average of other large cities. New York City alone accounted for more than 29 percent of all deficient housing in large cities identified in the 1977 AHS and for 9 percent of all inadequate housing in the country. Miami and Washington, D.C., both had more than a 16 percent incidence of inadequate units.

Inadequate housing also is found more frequently among certain types of households. Minority households—particularly black households—occupy such housing much more often than do nonminority households. Female-headed households and the elderly also have above-average incidence of housing inadequacy. For the latter two groups, however, inadequate housing is the consequence of their generally lower incomes. When housing inadequacy is compared for different household types, holding income constant, the elderly usually live in better housing than younger households with the same incomes.

The data presented in this section point to a growing and continuing improvement in the quality of housing. A long standing additional housing policy concern is affordability—whether housing costs constitute a burdensome fraction of household income.

Housing Affordability

Trends in Housing Affordability

The trend in housing affordability for all households, renters and owners alike, shows some improvement over the postwar period. Chapter 6 addresses affordability for homeowners. The improvement in affordability for renters is often not recognized, because the common measure of affordability—the percentage of income going to rent—does not take into account two important factors: the shift of higher income renters to homeownership and the improved quality of the housing stock. As explained below, when these two factors are considered, rental housing has actually become more affordable.

The crudest measure of affordability is simply the ratio of rents to incomes. Under this measure of affordability, households spending more than 25 or 30 percent of their income for rent are spending "too much." Rent-to-income ratios have risen since 1950, when some 32 percent of all renters paid more than a quarter of their income for rent; by 1979, this fraction had risen to 51 percent. While observers often point to this ratio as evidence of deteriorating affordability, more careful examination suggests a different interpretation. A ratio can change as a result of changes in the denominator (in this case income) as well as changes in the numerator (in this example rent). In large part, the rent-to-income ratio has risen because relative incomes of renters have fallen. Higher income renters have disproportionately become homeowners, reducing the average income of those who remain renters. Low-income people have always had difficulty paying for rent, evidenced by high rent-to-income ratios for that group in all time periods. The fact that low-income renters (with high rent-to-income ratios) are a larger fraction of the total renter population than formerly has led to a large part of the apparent decline in the affordability of rental housing. In 1950, 45 percent of the population rented; by 1980, only about 35 percent did. The decline was especially pronounced among higher income renters. Had more of these higher income households remained renters, the average rent-to-income ratio among renters would have been lower.

Another part of the increase in rent-to-income ratios is accounted for by the rising quality of rental housing. In 1950, a third of the rental units lacked complete plumbing, compared with only 3 percent in 1979. The typical rental unit in 1979 also had more rooms. The reported rent increases that have occurred reflect improved quality and greater space, as well as changes in the cost of a rental unit of given quality. Thus, rent—the numerator of the rent-to-income ratio—increased because of increased quality.

A more appropriate way of analyzing rental affordability is to compare the change in income with the change in rent on a specified type of rental unit over time. The best known measure of rent changes on units of the same quality is the residential rent component of the Consumer Price Index (CPI). The rent component is derived from rents on the same dwellings, which are resurveyed from year to year, with adjustments for major changes in the quality of the dwelling. Minor changes attributable to depreciation are not picked up, nor are cost increases on utilities paid directly by the tenant. Adjustments for both of these omissions have been made by independent housing market analysts; the following discussion of affordability uses a Con-

stant Quality Gross Rent Index which incorporates the adjustments.[3]

The importance of distinguishing between rent changes for constant-quality units and "average" changes for the actual rental stock is shown by the differences between the constant quality gross rent index and median gross rents presented in Table 1.3. Between 1950 and 1979, the constant quality gross rent index doubled, while median rents quadrupled. Quality improvements, therefore, accounted for about half of the rent increases and actual cost increases accounted for the other half.

The incomes of renters in 1979 were 257 percent higher than the incomes of renters in 1950. The increase in renter incomes was smaller than the increase in median rents (400 percent) but still larger than the change in the constant quality gross rent index (200 percent), which adjusts for quality changes. The income change for renters over the period understates the growth in incomes for particular renter households, both because of a shift in composition of renters towards very young and elderly individuals, and because higher income renters steadily shifted to homeownership to take advantage of benefits and the inflation hedge offered by homeownership. But even without any adjustment for this loss of high-income renters, the typical renter was able to afford better rental housing at the end of the period. Table 1.3 summarizes these trends since 1950, comparing incomes with actual rents and the rent index. This comparison shows that median income for all households increased faster than the constant quality gross rent index in each decade, but by the smallest margin in the most recent decade.[4] The table also shows that average renter incomes have increased more slowly than income for all households, confirming the movement of higher income renters to homeownership.

Current Affordability Problems

While adequate rental housing has become more affordable over the past three decades, it is still a major financial burden for the poor. Table 1.4 shows the incidence of excessive rent burdens for three groups of households—very low income (below 50 percent of median), moderately low income (between 50 and 80 percent of median), and all others.[5] Clearly, affordability is primarily a problem of the very low-income household. More than half of the very low-income renters pay in excess of 30 percent of their income for adequate housing. Less than a quarter of the moderately low-income households and only 2 percent of the remainder pay so much. The percentage of households paying in excess of 50 percent of income for adequate housing re-empha-

[3] Ira S. Lowry, *Inflation Indexes for Rental Housing* (Santa Monica, Calif.: The Rand Corporation, 1981) (N-1832-HUD), pp. 1–24.

[4] Rental housing has steadily become more affordable, but it has not become more profitable, so far as the limited data available indicate. The return on rental housing investment appears to have risen slightly from the mid-1960s to the early 1970s, and then declined back to the earlier level by 1979. Rental housing and policy recommendations are addressed in Chapter 7.

[5] The criterion of affordability is set at 30 percent of income. If more than this must be spent, the household is considered to have an affordability problem. The 30 percent figure is the contribution rate recently enacted for subsidy recipients in Federal housing programs. Setting the ratio higher or lower would, of course, yield different numbers, but would not change the basic conclusions about the importance of affordability problems, the concentration among the poor, or the demographic patterns.

Table 1.3
Percent Changes in Income and Rents
1950–1979

	Changes in Median Income		Changes in Median Gross Rent	Changes in Constant Quality Gross Rent Index
Years	All Households	Renters		
1950 to 1960	69%	50%	65%	32%
1960 to 1970	76	50	52	26
1970 to 1979	99	59	101	81
1950 to 1979	491	257	405	200

Sources: Median family income is from U.S. Department of Commerce, Bureau of the Census, *Current Population Reports*, Series P–60.
Median rents and renter incomes are from the decennial censuses and, since 1973, U.S. Department of Commerce, Bureau of the Census, and U.S. Department of Housing and Urban Development, Office of Policy Development and Research, *Annual Housing Surveys*.
Constant quality gross rent index is the Consumer Price Index rent component adjusted for utilities and depreciation, as in Ira S. Lowry, *Inflation Indexes for Rental Housing* (Santa Monica, Calif.: The Rand Corporation, 1981) (N-1832-HUD), p. 30. Commission staff extended the series back to 1950.

Table 1.4
Rent Burdens Among Those Renting Adequate Housing (1977)

	Lower-Income Households		
	Very Low Income	Moderately Low Income	All Other Households
Gross Rent as Percent of Income			
Over 30	51%	22%	2%
Over 50	22%	2%	0%
Thousands of Renter Households in Income Class	10,467	6,297	9,750

Note: Very low income is defined as income less than 50 percent of area median family income for a family of four; moderately low incomes are between 50 and 80 percent. Both are adjusted for other family sizes. Adequacy is measured according to the Congressional Budget Office indicator.

Source: U.S. Department of Commerce, Bureau of the Census, and the U.S. Department of Housing and Urban Development, Office of Policy Development and Research, *Annual Housing Survey, 1977* (Washington, D.C.: U.S. Government Printing Office, 1979).

sizes the concentration of the affordability problem among very low-income households. Almost a quarter of the very low-income households pay 50 percent or more of their income in rent to obtain adequate housing; virtually none of the others pay that much.

Joint Problems of Quality and Affordability

The relative magnitude of the affordability and quality problems among very low-income households is shown in Table 1.5. The table also shows the incidence of problems for low-income elderly households and for blacks. Both groups have a

Table 1.5
Quality and Affordability of Housing for Very Low-Income Renters (1977)

	Adequate		Inadequate		Total Households	
Gross Rent as Percent of Income	Number (000)	Percent of Total in Class	Number (000)	Percent of Total in Class	Number (000)	Percent of Total in Class
All Very Low-Income Households						
Less than 30	3,141	30%	854	8%	3,995	38%
More than 30	5,329	51	1,143	11	6,472	62
TOTAL	8,470	81	1,997	19	10,467	100
Very Low-Income Elderly Households						
Less than 30	1,092	35	247	8	1,339	43
More than 30	1,533	49	237	8	1,770	57
TOTAL	2,625	84	484	16	3,109	100
Very Low-Income Black Households						
Less than 30	785	31	290	11	1,076	42
More than 30	1,077	42	413	16	1,490	58
TOTAL	1,863	73	703	27	2,566	100

Source: U.S. Department of Commerce, Bureau of the Census, and U.S. Department of Housing and Urban Development, Office of Policy Development and Research, *Annual Housing Survey: 1977* (Washington, D.C.: U.S. Government Printing Office, 1979).

slightly lower incidence of affordability problems: 57 percent of the elderly and 58 percent of blacks compared with 62 percent of all very low-income renters. Comparing the elderly with other low-income renters, the most notable difference is the somewhat larger fraction of the elderly who have neither quality nor affordability problems—35 percent compared with 30 percent for all very low-income renters. For blacks, the most notable difference is the higher proportion in substandard housing—27 percent, compared with 19 percent for all very low-income renters.

The most striking feature of Table 1.5 is the comparison of the magnitude of the quality and affordability problems. Of the 10.5 million very low-income renters identified in the 1977 AHS, 6.5 million paid more than 30 percent of their incomes for rent, while 2 million lived in inadequate housing. For the very low-income elderly households, 1.8 million had an affordability problem, compared with 0.5 million living in inadequate housing. For very low-income black households, 1.5 million paid more than 30 percent of income for rent, compared with 0.7 million living in inadequate housing. Affordability has clearly become the predominant housing problem among low-income Americans.

Concerns with Producer-Oriented Programs

If affordability is the basic housing problem of the poor, then housing programs which deal directly with this problem would seem appropriate. However, for the past four decades the subsidized housing programs of the Federal government have primarily emphasized the production of new units for low-income households. The programs have provided monies both to reduce the costs of construction as well as to subsidize the rent paid by tenants.[6] However, given the predominance of the affordability problem, the heavy emphasis on production-oriented programs generally appears to be a solution to the wrong problem. In addition, a review of the production programs raises a number of serious questions regarding both their cost and equity. The following discussion highlights the problems with the present housing production program for private market, subsidized housing—the Section 8 program—and contrasts the costs associated with this program to those associated with housing programs which provide assistance more directly to people.[7]

There are several different ways to view the costs of production programs. First, the per unit subsidy for a newly constructed unit can be compared with that of assisting the same household in an existing unit. Table 1.6 provides this comparison for two programs: the Section 8 New Construction Program and the Section 8 Existing Housing program. The table shows that the costs are almost twice as much in the newly constructed unit, in part because it simply costs more to build a new unit than it does to maintain an old structure.

The rents for units in the Section 8 New Construction Program are not only much higher than

[6] The public housing program is discussed in Chapter 3. Production of federally subsidized, privately owned units has been supported through the Section 8 New Construction and Substantial Rehabilitation programs, the Homeownership Assistance Program (Section 235), the Rental Housing Assistance Program (Section 236), and the Rent Supplement Program.

[7] Unless otherwise indicated, data on the Section 8 program cited in this portion of the report are taken from a study of the Section 8 program sponsored by the Office of Policy Development and Research, U.S. Department of Housing and Urban Development. *See* James E. Wallace, Susan Philipson Bloom, William L. Holshouser, Shirley Mansfield, and Daniel H. Weinberg, *Participation and Benefits in the Urban Section 8 Program: New Construction and Existing Housing* (Cambridge, Mass.: Abt Associates, Inc., January 1981), (HUD PDR 680).

Table 1.6
Comparison of Subsidy Costs for the Section 8 New Construction and Existing Housing Programs
(1979)

Cost Category	New Construction	Existing Housing
Gross Rent	$362/month	$240/month
Tenant Payment	$112/month[a]	$110/month[a]
HUD Subsidy (gross rent minus tenant payment)	$250/month	$130/month

[a]Average tenant payments are slightly different in the two programs because average tenant incomes differ.

Source: Wallace, *et al.*, *Participation and Benefits in the Urban Section 8 Program: New Construction and Existing Housing* (Cambridge, Mass.: Abt Associates, Inc., January 1981), pp. 224, 338.

those for the Existing Housing Program but are at the high end of all rents charged for units in the housing stock. The 1979 average Section 8 New Construction rent was $362 per month. Nationally, only 4 percent of all one-bedroom and efficiency units (housing typical of that in the New Construction program) had rents higher than $350.[8]

The construction programs are consistently more costly than the consumer-oriented programs. Total costs for recently constructed public housing have been found to be similar to those in Section 8 New Construction, and are higher than costs for units in either the Experimental Housing Allowance Program or the Section 8 Existing Housing Program. An analysis of costs in West Germany found a similar pattern for the corresponding production and consumer subsidy programs there.[9]

Another way of looking at the costs of a new construction program is to compare the rent charged in the subsidized units with the rents the units would command in the private, unsubsidized market. Any excess rent being paid is a cost to the government that could be used to subsidize other tenants. In the Section 8 New Construction program it is estimated that the average rent a typical unit would command in the unsubsidized private market would be $291, compared with the $362 now charged. This means that Section 8 rents are 24 percent higher than the market value, representing a significant loss of money to the government.

The high costs of the new construction program exacerbate a problem of all subsidized housing programs: the fact that relatively few households in the eligible population obtain benefits. Because of their high costs, new construction programs serve half as many households as would be served with the same funds in a program using the existing housing stock. And the households lucky enough to participate are provided housing not only better than their neighbors with similar incomes but substantially better than what moderate income families can afford. For example, the estimated average value of units in Section 8 New Construction projects, which is $291 per month, represents housing 45 percent higher in value than that normally obtained by unsubsidized households having incomes just at the eligibility limit for the program (80 percent of area median income for a family of four).

Total government costs for the Section 8 Program are even higher than those reflected directly in the subsidy payments. Indirect costs are incurred for New Construction projects through revenue losses arising from accelerated depreciation allowances, from tax exemption for housing finance bonds, and from the subsidy needed to provide loans at below-market interest rates through the Government National Mortgage Association (GNMA) Tandem Program. The Existing Housing program also incurs costs beyond those for direct rental assistance—for depreciation in excess of true economic depreciation and for costs of local program administration. However, these indirect costs are approximately half of those incurred in new construction programs. Figure 1.3 summarizes these costs as estimated for a sample of units in the Existing Housing program and in New Construction projects.

A final cost issue associated with new construction is the budget "overhang" that results from the long-term nature of the subsidies committed to newly constructed buildings. Long-term subsidies, extending 20 to 40 years, have typically been committed for both privately and publicly owned new construction projects as a way to amortize debt service, reduce interest payments, and/or assure the availability of the units for low-income tenants. The long-term subsidy commitments of the government for housing, including public housing contracts to pay for debt service on construction bonds, the interest subsidy payments under the Section 235 homeownership and Section 236 rental housing programs, and the commitments to pay subsidies for the Rent Supplement and Section 8 programs (New Construction, Substantial Rehabilitation, and Existing Housing) are estimated to reach $250 billion by the end of fiscal year 1982.[10]

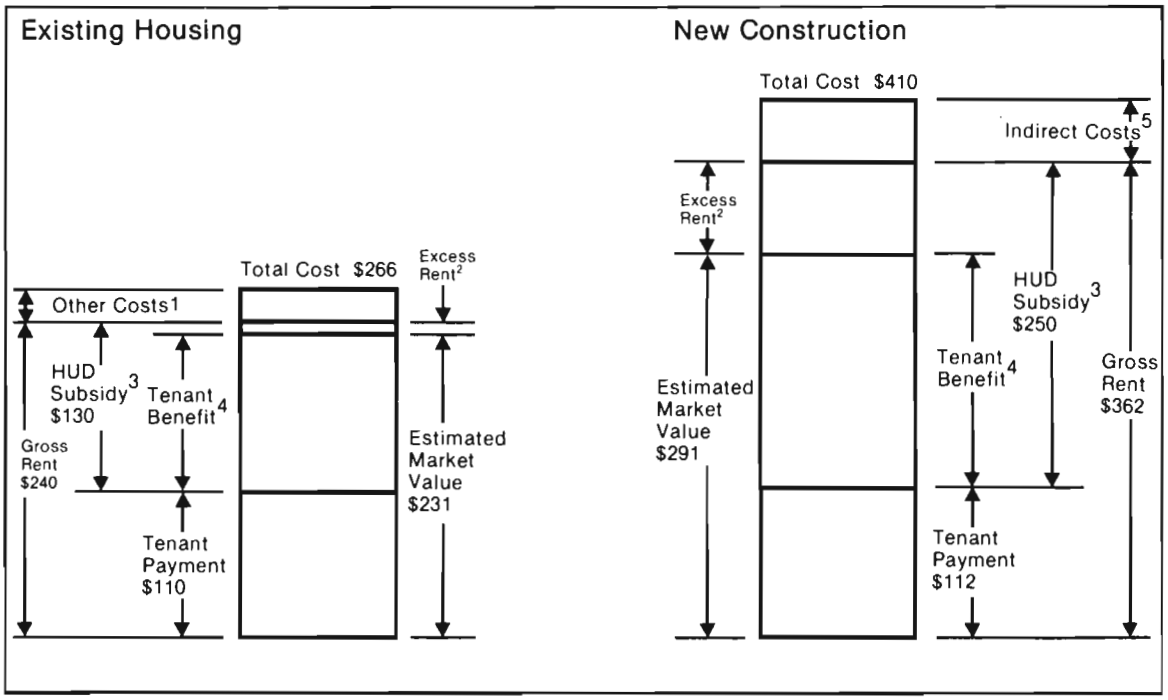
For the Section 8 New Construction and Substantial Rehabilitation programs alone, the outstanding budget obligations of the Federal government amount to $92 billion (Table 1.7). These obligations cover reservations of funds for approximately 790,000 units. By contrast, the Section 8 Existing Housing program adds another $29 billion in outstanding obligations for 973,000 units. The lower total obligations of the Existing Housing program are due both to the lower per unit costs discussed earlier and the fact that subsidies are budgeted for only 15 years, not the 20 to 40 years of the New Construction/Substantial Rehabilitation pro-

[8] In Section 8 New Construction, 77 percent of program units in 1979 were either efficiency or one-bedroom units. Annual Housing Survey data are reported in "Financial Characteristics of the Housing Inventory, Current Housing Reports, Series H-150-79, Part C" (Washington, D.C.: U.S. Department of Commerce, Bureau of the Census, and U.S. Department of Housing and Urban Development, Office of Policy Development and Research, March 1981), p. 56. The AHS average rents are based on rents of both new and existing units.

[9] Stephen K. Mayo and Jörn Barnbrock, *Rental Housing Subsidy Programs in Germany and the U.S.: A Comparative Program Evaluation* (Cambridge, Mass.: Abt Associates, Inc., September 1980).

[10] U.S. Department of Housing and Urban Development, *U.S. Department of Housing and Urban Development FY 1982 Budget (Revised)*, March 1981, p. H-25.

Figure 1.3
Components of Cost in the Section 8 Program
(Average Monthly Costs, 1979)



[1] Other costs (including local administration).
[2] Excess rent (gross rent minus estimated market value).
[3] U.S. Department of Housing and Urban Development (HUD) subsidy (gross rent minus tenant payment).
[4] Tenant benefit (estimated market value minus tenant payment).
[5] Indirect costs (including Federal revenue losses).

Source: Adapted from James E. Wallace, *et al., Participation and Benefits in the Urban Section 8 Program: New Construction and Existing Housing* (Cambridge, Mass.: Abt Associates, Inc., January 1981), Vol. 1, pp. 224, 338.

Table 1.7
Budget Authority for the Section 8 Program
(September 30, 1981)

Program Element	Units	Cumulative Obligations[a] ($billion)	Annual Average Obligations[b] (per unit)	Outstanding Obligations ($billion)
New Construction and Substantial Rehabilitation	791,000	$98	$5100	$92
Existing Housing	973,000	38	2600	29
Total	1,764,000	$136		$121

[a] Cumulative obligations are budget authority for all payment contracts to date calculated as initial gross rent (contract authority) times term of contract. This allows tenant contributions to provide an accounting reserve against which to draw in later years as project rents rise. Outstanding obligations reflect payments made and subtracted from budget authority.

[b] Assume average term of 24 years for New Construction and Substantial Rehabilitation; for Existing Housing a contract term of 15 years is assumed for budget purposes.

Source: U.S. Department of Housing and Urban Development, Office of Budget.

grams. Average annual obligations of subsidy funds for the New Construction and Substantial Rehabilitation programs ($5,100 per unit) are nearly twice the average obligation for Existing Housing ($2,600 per unit).

* * * * *

The data on the housing situation of Americans and the subsidized construction programs have important implications for housing policy. They indicate that most Americans already live in decent housing and that primary attention should be directed toward helping those of the lowest income, especially renters, to be able to pay for decent housing.

The high costs and relative inequities of new construction programs reinforce the desirability of a consumer-oriented Housing Payments Program which relies primarily on the existing housing market to serve low-income households. The next chapter reviews the experience with housing payments programs and their limitations, and makes recommendations for the design of a Housing Payments Program and complementary additions to the Community Development Block Grant Program.

CHAPTER 2

HOUSING PAYMENTS PROGRAM AND BLOCK GRANTS

The major housing problem faced by the disadvantaged in recent years has been their inability to afford decent housing. To a lesser extent, lower-income persons also face problems of poor quality housing. Production programs such as the Section 8 New Construction and Substantial Rehabilitation programs, which address the affordability and quality problems by increasing the supply of decent housing, have been the principal mechanism for providing housing for lower-income households. These programs provide a subsidy both to construct (or rehabilitate) units and to reduce the rents lower-income persons must pay for their housing.

The production programs have several problems:

- The programs are expensive, costing nearly twice as much as housing the same low-income households in existing housing units. This means that the programs are inequitable in that fewer eligible households obtain program benefits.
- The long-term subsidy commitments of 20 to 40 years required by the production programs are costly and also restrict the Federal government's flexibility to deal with changing housing needs.
- Production programs that add to the supply of decent housing are not the most direct way of meeting the major housing problem of lower-income persons: affordability.

A clear alternative to production programs is a housing payments program that provides cash assistance to households to help pay the rent for a dwelling unit that meets housing quality standards for the program. The housing payments subsidy is not tied to a particular unit, but is paid directly either to the program participant or to the landlord of a housing unit selected by the renter.

Advantages of this system are several. The affordability problem is addressed in the most direct and efficient way—providing cash assistance for housing in the private market. For any given level of program funds, a larger number of eligible households can benefit, because the subsidy per unit is less than for newly constructed units. Tenants can exercise choice in the market and are not limited to living in particular units that have received subsidies. Program administration is relatively simple and straightforward.

The idea of housing payments programs is not new. As early as 1937, opponents of the public housing legislation then under debate proposed that tenants be given certificates to help pay their rent. The Housing and Urban Development Act of 1965 provided in Section 23 for a leased-housing program. The program, administered by public housing authorities, involved direct payments to owners on behalf of tenants to make rents affordable. In 1968, the President's Committee on Urban Housing recommended a thorough test of housing payments, and two years later Congress called for an experimental demonstration of housing payments in the Housing and Urban Development Act of 1970. An ambitious experimental program—the Experimental Housing Allowance Program (EHAP)—was launched by the Department of Housing and Urban Development (HUD) in 1972. EHAP was conducted in 12 cities over the past decade to assess how a housing allowance would operate and affect participants and local housing markets.

Drawing on the initial experience gained from the EHAP and Section 23 programs, Congress cre-

ated an Existing Housing component in the Section 8 program established by the Housing and Community Development Act of 1974. The Existing Housing program has grown rapidly, now serving approximately 630,000 households.

The experience of both the Existing Housing program and EHAP attests to the cost effectiveness and workability of housing payments as a basic approach that meets the housing needs of low-income households. The results of these programs show that housing payments are highly effective in enabling lower-income households to afford adequate housing. However, these programs are less effective for the disadvantaged who live in physically inadequate housing; these programs fail to stimulate major improvements in the housing stock. Owners of units that require relatively minor repair or upgrading frequently make improvements to meet program standards, but owners of units with severe deficiencies seldom undertake major rehabilitation.

Recognizing the inability of housing payments programs to address fully the problems of housing adequacy and supply, the Commission proposes the addition of a Housing Component to the Community Development Block Grant (CDBG) program, as well as adding new construction as an eligible activity to the CDBG program. The Housing Component would allocate funds to localities, States, and territories primarily to make available adequate housing for lower-income households.

This chapter provides the background, rationale, and proposed features for both the Housing Payments Program and the Housing Component of the Community Development Block Grant Program.

Housing Payments Program Proposal

The primary Federal program for helping low-income families to achieve decent housing should be a Housing Payments Program. This program, coupled with housing supply assistance through the Community Development Block Grant program, should replace future commitments to build or substantially rehabilitate additional units under Federal housing programs.

Experience with the Section 8 Existing Housing program and the Experimental Housing Allowance Program provides substantial information on the ability of a Housing Payments Program to meet the housing needs of low-income households.[1] Before reviewing that experience, it is useful to summarize the main features of the Existing Housing program and EHAP.

The Section 8 Existing Housing program provides funds to make up the difference between the rent charged by a landlord for a standard housing unit (within program rent limits) and the rent that low-income tenants can afford within an established percentage of their income. The program permits eligible households to choose where to live, as long as their chosen dwelling meets the program's housing quality standards or can be improved to meet them. Under this arrangement, households may choose to stay in place or to move to another dwelling. Although payments are made directly to landlords on the tenants' behalf, the payment is portable; the tenant may elect to rent a qualified dwelling anywhere within the jurisdiction of the administering agency, and the rent subsidy is applied to the new unit.

The Experimental Housing Allowance Program was a carefully controlled effort to test the broad concept of housing payments assistance. The experiment began in 1972 and involved more than 30,000 households in 12 locations across the nation. In two locations, the experiment extended over a period of 10 years. The research investment, including payments to families, will amount to about $160 million and has already produced more than 300 technical reports.

The Experimental Housing Allowance Program involved three major components. The Supply Experiment was an open-enrollment program conducted in Saint Joseph County (South Bend), Ind., and Brown County (Green Bay), Wis. It in-

[1] Data on the Section 8 Existing Housing program are taken from James E. Wallace, Susan Philipson Bloom, William L. Holshouser, Shirley Mansfield, and Daniel H. Weinberg, *Participation and Benefits in the Urban Section 8 Program: New Construction and Existing Housing* (Cambridge, Mass.: Abt Associates, Inc., January 1981). For the Experimental Housing Allowance Program, data are taken from the major reports on the experiments. The summaries and final reports, in which the more detailed research reports are cited, are as follows: Administrative Agency Experiment—W.L. Hamilton, *A Social Experiment in Program Administration: The Housing Allowance Administrative Agency Experiment* (Cambridge, Mass.: Abt Books, 1979); Demand Experiment—Stephen D. Kennedy, *Final Report of the Housing Allowance Demand Experiment* (Cambridge, Mass.: Abt Associates, Inc., 1980); Supply Experiment—Ira S. Lowry, ed.,*Comprehensive Final Report of the Housing Assistance Supply Experiment* (Santa Monica, Calif.: The Rand Corporation, forthcoming); summary available as article by Ira S. Lowry, "Housing Aid for the Poor: What Priority in the 80s?"*Rand Research Review*, Vol. V, No. 1, Spring 1981, pp. 1–4; HUD Summary—U.S. Department of Housing and Urban Development, Office of Policy Development and Research, *Experimental Housing Allowance Program: Conclusions, the 1980 Report* (Washington, D.C.: U.S. Department of Housing and Urban Development, 1980); Urban Institute Summary—Raymond Struyk and Marc Bendick, Jr., ed., *Housing Voucher for the Poor: Lessons from a National Experiment* (Washington, D.C.: The Urban Institute Press, 1981).

cluded homeowners as well as renters. The program was announced publicly, and all who qualified were accepted. (As in all of the experiments, with the exception of an experimental control group, housing assistance payments were made only to income-eligible households when their chosen housing met the program housing standard.) The housing market was carefully monitored to assess changes in rents, conversions, repairs, maintenance, and new construction resulting from the program.

The Demand Experiment tested a variety of forms of housing allowances. To enable researchers to distinguish program effects from background behavior of households in the eligible population, the experiment included a control group of households that were monitored but not offered housing allowance payments. Households were contacted directly to explain the form of housing allowance offered. This experiment was operated in Pittsburgh, Pa., and Phoenix, Ariz.

Finally, the Administrative Agency Experiment tested the administrative feasibility of a housing allowance. Basic guidelines within which to operate the program were provided to eight existing public agencies, including local housing authorities, State agencies, county agencies, and local welfare agencies. This part of EHAP was conducted in Bismarck, N.D.; Durham, N.C.; Jacksonville, Fla.; Peoria, Ill.; Salem, Ore.; San Bernardino, Calif.; Springfield, Mass.; and Tulsa, Okla.

The EHAP and the Section 8 Existing Housing program experiences provide important information about the ability of a Housing Payments Program to overcome problems of housing affordability and quality. In addition, these programs offer guidance for the design and structure of the Commission's proposed program.

Housing Assistance Payments and Housing Affordability

Because affordability is the primary housing problem of the poor, it is important to ascertain if a housing payments program can adequately and efficiently address this problem. Both EHAP and the Section 8 Existing Housing program successfully serve households whose preprogram rents are a very high fraction of their income. Eighty percent of the Existing Housing program households paid in excess of 35 percent of their income for rent before entering the program. In EHAP more than half of the participants were paying preprogram rents of more than 35 percent of their income.

Part of the reason that the Section 8 Existing Housing and EHAP experiments have been so successful in solving the affordability problem is that households with excessive housing costs relative to income can be given assistance in the programs without requiring a move, if they already live in housing that is adequate or can be made adequate with minor repairs. This is true of many low-income families and individuals. For such persons, the assistance payment directly solves the affordability problem without the need to move or to obtain major repairs.

Housing Quality

The effects of housing payments on housing adequacy can be viewed from two perspectives: the capacity of housing payments to enable households previously occupying substandard housing to occupy standard units, and the effects of allowances on the overall quality of the housing stock in a community. Evidence from both the Experimental Housing Allowance Program and the Section 8 Existing Housing program suggests that housing payments do have a positive impact on the quality of housing occupied by participants, but that their ability to stimulate rehabilitation and serve households who live in units well below program standards is limited.

Households originally living in housing that does not meet the quality standards of a housing payments program have three options under a consumer-oriented housing program: they can move to housing that meets the program standards, they or their landlord can fix up their present residence to meet program standards, or they can drop out of the program. In both the EHAP Supply and Demand Experiments, many households who signed up for the program and who started out in housing that did not meet program standards were able to improve their housing. However, the failure rates (those who signed up but never received an allowance), particularly in the Demand Experiment, were significant. In the Supply Experiment, 20 percent of those who started out in units below the program's housing quality standard failed to participate in the program. In the Demand Experiment, this number was much greater: 60 percent.

The housing quality standards adopted by the Demand Experiment made participation more difficult for households starting out in substandard housing. Indeed, the Demand Experiment standards were much more stringent than those of the Supply Experiment. The result was that only 17 percent of the units passed original inspection as compared with half in the Supply Experiment. As a result, more households had to repair or move to participate in the program. Inability to locate a standard unit and/or the high cost required to improve the unit to program standards partially account for the high failure rate of the households.

Household characteristics also have had an impact on participation. Households that are most

likely to live in inadequate housing—very poor, large, or minority families—are also those who have a relatively more difficult time using the program. Data from EHAP and the Section 8 Existing Housing program support this finding. For example, although 54 percent of Section 8 enrollees failed to become recipients, 72 percent of the minority enrollees were unsuccessful. Large families, both minority and nonminority, are also more likely to drop out of the program. The failure of certain households to participate successfully in a housing payments program may be partially attributed to the level and type of repairs required.

Housing payments do stimulate repairs to the housing stock. In fact, 42 percent of the households in the Section 8 Existing Housing program and 60 percent in the Supply Experiment who were originally in units that failed to meet the housing quality standards participated in the programs by remaining in their original units and making necessary repairs. However, the improvements were relatively small and inexpensive. The average cash outlay for repairs was $70 in the Supply Experiment and less than $200 in the Existing Housing program. In both programs the improvements were minor: plaster, painting, and repairs to windows, doors, partitions, handrails, and stairs. Substantial and costly repairs, such as replacement of plumbing or electrical systems, or correction of structural deficiencies, were unlikely to occur, because the costs of correcting these problems could not usually be amortized in the rents charged to the tenants.

The severity of the housing deficiencies in units appears to affect household participation in housing payments programs. Evidence from the Supply Experiment shows that approximately 35 percent of the households living in units requiring more than four repairs—compared with 20 percent overall—dropped from the program. Similarly, households occupying units requiring costly repairs were more likely to drop out. Although the reasons for their termination can only be inferred, it is likely that many failed to become recipients because they could not find a suitable alternative dwelling unit and/or could not convince their landlords to make the required repairs.

Minority Experience and Supportive Services

Housing payments programs rely on access to the full range of choice in the private housing market. Discrimination clearly impedes the ability of minority households to make full use of the program, either in terms of access to adequate housing or of freedom of locational choice. Subsidized new construction programs have been favored by some because such programs could provide more direct access for minorities. Choices of project location can be influenced by public decisions, and local government presumably has more influence over outreach and tenant selection policies. The experience with the production-oriented New Construction programs such as Section 8 New Construction and consumer-oriented programs such as Section 8 Existing Housing and EHAP suggests that neither approach automatically ensures success with regard to minority access.

The Section 8 program provides evidence on both types of programs. Minority households appear to be fully represented in the Section 8 Existing Housing Program; they constituted 50 percent of program participants, compared with 44 percent among eligibles. By contrast, most Section 8 New Construction projects (63 percent of the 138 studied) have been located in low-minority, suburban areas and have served few minority households relative to their proportions in the eligible population. Minority households accounted for 15 percent of project residents versus 35 percent in the eligible population. Minorities are underrepresented in each age category, but most disproportionately among the elderly, who constitute 80 percent of subsidy recipients. Table 2.1 shows these comparisons.

Black households in both the Section 8 New Construction and Existing Housing programs were

Table 2.1
Participation in the Section 8 New Construction Program: Comparison of Characteristics of Eligible and Recipient Households

	Eligible Households	New Construction Recipients
Percentage Elderly	25%	80%
Percentage Minority	35	15
Percentage Minority Among Elderly Households	23	11
Percentage Minority Among Nonelderly Households	39	31

Source: Wallace, *et al.*, *Participation and Benefits in the Urban Section 8 Program: New Construction and Existing Housing* (Cambridge, Mass.: Abt Associates Inc., January 1981), pp. 33, 36.

able to move to neighborhoods with a lower minority concentration. Although relatively few minority households were involved in the Section 8 New Construction program, on average their preprogram neighborhoods had a 54 percent minority population, while the project neighborhoods were 35 percent minority for those households. The Existing Housing program had a larger proportion of minority households, but the participating households made smaller changes. The neighborhood minority percentages for movers were 55 percent before the program and 48 percent subsequently.

The Experimental Housing Allowance Program found that the patterns of movement of participants, including minority households, were not appreciably altered by participation in the program. The allowance payments apparently had no locational impact because they did not alter the way in which people looked for housing. When black or white households in Pittsburgh searched for a new place to live, they concentrated their search largely in neighborhoods with racial composition similar to their present neighborhood. Some black households did look at housing in low-minority areas, but they tended to move to the areas in which they looked at the largest number of units. Black households' information about available rentals in low-minority areas was more limited than for nonminority households, in large measure because this information often came through friends and relatives; racial separation tends to result in separate information sources as well.

The EHAP Administrative Agency Experiment provides additional information about the ability of supportive services, such as counselling, to influence minority participation in a housing payments program. Comparisons across all the Administrative Agency Experiments suggest that when minority households living in tight housing markets were provided individualized assistance, they more often qualified for the program. It is important to note that in looser housing markets, even the lowest level of services was adequate and had little effect on participation by minorities.

EHAP also provides some information about potential problems of discrimination in a housing payments program. Both the Demand and Supply Experiments provided support in cases of discrimination complaints, but little change in racial patterns was associated with participation in either experiment. In the Demand Experiment, interview responses indicated that about 20 percent of the black households in Pittsburgh and 15 percent in Phoenix reported that they were discriminated against.[2] In spite of the reported discrimination, there was little effort to challenge the discrimination legally. The experiment provided free legal services for antidiscrimination cases, but only 4 of the 22 households reporting discrimination called the lawyer. None of the cases provided enough evidence to file a formal complaint. Possibly participants felt that legal redress was unlikely to succeed or was too time consuming.

The experience from the EHAP Administrative Agency and Demand Experiments indicates that an appropriate combination of information, supportive services, and equal-opportunity support is needed. Assistance payments by themselves do not appear to extend the locational choices of minorities.

Mobility

Free choice in the marketplace and the opportunity to move to exercise that choice also are affected by geographic boundaries of the agencies administering the program. The Section 8 Existing Housing program typically is administered by local housing authorities within municipal boundaries. Although program rules attempt to encourage use of the program across boundaries of agency jurisdictions, there is some indication that the mobility of recipients has been impaired. In the 1979 evaluation of the Existing Housing program, it was found that only 3 percent of central city movers located in the suburbs. As the Existing Housing program is set up, local housing authorities often are reluctant to encourage or even permit enrollees to move to another jurisdiction. Both the fee for administration, which sometimes helps to cover other agency operations, and a program slot (money to subsidize a household) are at risk.

Regional programs are one way to facilitate mobility. A network of private agencies contracting with the Commonwealth of Massachusetts administers the Section 8 Existing Housing program on a regional basis. (This is in addition to both local and statewide administering agencies.) A sample study of 1,693 recipients showed that 17 percent had moved from one municipality to another.[3] The De-

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[2] Participant impressions could understate the incidence of discriminatory experience, according to HUD-sponsored research. When black and white auditors inquired about availability of houses or apartments for rent, the racially associated differences in treatment that were noted on comparison of their experiences were too subtle to be noticed by either auditor alone. Ronald E. Wienk, Clifford E. Reid, John C. Simonson, and Frederick J. Eggers, *Measuring Racial Discrimination in American Housing Markets: the Housing Markets Practices Survey* (Washington, D.C.: U.S. Department of Housing and Urban Development, Office of Policy Development and Research, Division of Evaluation, April 1979).

[3] Background paper submitted to the Commission by William L. Holshouser, Jr., *Interjurisdictional Mobility and Fair Housing in the Section 8 Existing Housing Program and in a Housing Voucher Program* (Boston, Mass.: Citizens Housing and Planning Association of Greater Boston, February 5, 1982).

mand Experiment component of EHAP was run as a regional program in the Pittsburgh (Allegheny County) area and in the Phoenix (Maricopa County) area. Among movers initially living in the central city, 18 percent in Pittsburgh and 33 percent in Phoenix moved to the suburbs.

Although not conclusive, these comparisons suggest that mobility can be enhanced or impaired depending on how a housing payments program is structured. Better incentives for the agency to encourage mobility and information and individual support services to program participants with special problems are essential components.

Rent Inflation and Housing Supply

Before the experiments, concern was raised about the possibility of housing payments driving up housing prices as such assistance increased effective demand for the relatively fixed supply of housing. This effect would undermine the purpose of the allowance for participants and leave nonparticipants worse off. The results of the EHAP Supply Experiment indicate that the fear of rent inflation was not justified. Indeed, the experience of the Section 8 Existing Housing program suggests that a rather large program can be operated without stimulating rent increases. The Existing Housing program now serves 630,000 households, and concentrations of as many as 20,000 program recipients in the larger cities have been successfully absorbed in the specific local housing markets without complaints of program-related inflation in rents for units not in the program.

The rent inflation resulting from housing allowances has been negligible for several reasons. Most important was the small increment in demand engendered by the assistance payments. About half the eligible households in the allowance experiments chose not to enroll. Many who did enroll already lived in adequate housing and chose to alleviate their rent burden rather than obtain better housing. Furthermore, even in the open-enrollment Supply Experiment, allowance recipients accounted for only a small part of the demand for rental housing. At most, 19 percent of renters participated at any time in that experiment, and their added demand raised total rental demand no more than 5 percent in central city areas and less than 1 percent in the total metropolitan areas. There was little difference between Green Bay, with a 4 percent vacancy rate, and South Bend, with a 10 percent rate.

It was also feared that landlords might try to raise rents in program units because their tenants were receiving subsidies. Analysis of the Supply Experiment found this to be a minor problem: rents for enrollees already living in standard housing rose 2 percent after enrollment. The payment mechanisms and competitive pressures of the private market were sufficient to keep landlords from making large increases in recipients' rents. In the Section 8 Existing Housing program, the rents increased by 6 percent above the preprogram rates for such households. Although these increases are not large, they reflect the incentive of the Existing Housing program to drive rents up to the allowable limit (the fair market rent); tenant payments are not affected, but the government pays for the difference between tenant payments and the negotiated rent. The allowance programs, in contrast, paid the household a set amount, which was calculated according to housing costs in the area but did not depend on the specific rent for the participant's unit.

The success of the Supply Experiment in assisting many households without inflating rents appears to be applicable to larger metropolitan areas. A HUD analysis of a hypothetical open enrollment program in 20 major metropolitan areas estimated that the housing stock would adjust to the augmented demand with typically only 2 percent rent inflation.[4]

Homeownership in a Housing Assistance Program

The EHAP Supply Experiment provides the only available evidence on participation in housing payments programs by homeowners. Neither the Section 8 Existing Housing program nor the other components of EHAP have allowed participation by homeowners, although tenant shareholders in cooperatives may receive Existing Housing program subsidies. Although homeowners were half the eligible population in the two Supply Experiment sites, they were less likely to participate than renters (33 percent of homeowners contrasted with 42 percent of renters).[5]

Among Supply Experiment enrollees whose dwellings were substandard, homeowners were more likely than renters to drop out, at least in part because they were less willing to move and were unwilling or unable to undertake the repairs necessary to meet program standards—especially if the necessary repairs were extensive. Homeowners who stayed in the program, however, typically made

[4] Howard Hammerman, *The Impact of Housing Vouchers on Rent Inflation*, unpublished report (Washington, D.C.: U.S. Department of Housing and Urban Development, Office of Policy Development and Research, July 15, 1981).

[5] The Supply Experiment eligibility and payment rules took into account the value of the equity in an applicant's house by imputing an annual income of 5 percent to this equity.

more repairs than did landlords of tenants in the program. Few home purchases were made by renters in the Supply Experiment, even though the payments were available regardless of tenure. Less than 2 percent of participating renters bought homes—even over a period of several years.

Features of a Housing Payments Program

The Commission believes that a Housing Payments Program should draw on the experience with the Section 8 Existing Housing program and EHAP in moving toward a more flexible program that provides maximum freedom of choice for the subsidy recipient, consistent with ensuring decent housing. The program should also take advantage of the administrative expertise that has already been acquired by State and local agencies that run the Section 8 Existing Housing program. The Commission has been guided by these considerations in addressing the more important design issues that must be resolved in the process of developing a payment system.

The following discussion indicates the general nature of the Commission's suggestions on these issues. In essential design, the proposed system is quite similar to the Section 8 Existing Housing program; primary differences involve freeing the subsidy amount from participant's housing costs and allowing direct payment to tenants. If a housing payments system is adopted, details of program design are best left to Federal, State, and local agencies charged with program administration.

Income Limits

The Commission believes that the Federal resources available for housing should be directed to those most in need. Program eligibility should be limited to households with very low incomes—no more than 50 percent of the area median income for a family of four—with adjustments for larger and smaller families, such as in the Section 8 Existing Housing program, which is already greatly directed toward this group.

Eligibility

More households fall within the proposed income limits than can be assisted with available Federal resources. Current data indicate that approximately 10 million renter households have incomes under the proposed income limit, of which at most 2.7 million are currently served by Federal housing programs. About 9 million homeowners have incomes below 50 percent of area median incomes, although substantially fewer would be income eligible once assets such as home equity are considered. Few of these homeowners are served directly by Federal housing programs (fewer than 80,000 continue to receive an interest subsidy under the Section 234 program), but many have benefited from rehabilitation assistance through the Community Development Block Grant program. In the context of limited Federal resources the Commission does not propose that the housing payments program be an entitlement program open to all eligible households. Instead, the Commission believes that priority for providing assistance should be based on income (including the income value of assets such as home equity) and on criteria such as current residence in inadequate housing, payment of housing costs in excess of 50 percent of income, or involuntary displacement—not necessarily in that order. The Commission has not attempted to develop a detailed set of priorities but believes that whatever criteria are adopted should concentrate limited resources on those most in need and complement local governments' efforts to rehabilitate existing housing in low-income neighborhoods. Whatever priorities are established should apply to renters and homeowners alike, and renters assisted by the housing payments program should be free to use their payments for home purchase, if they wish. It should be noted, however, that if a housing payments program gives priorities to low-income persons with high housing costs and residence in poor quality housing, more renters are likely to qualify than homeowners. About 1.1 million very low-income renters live in inadequate housing and pay rents in excess of 30 percent of income; less than 0.2 million homeowners have housing costs this high—and the number is even lower when asset limits or income imputed from assets (such as home equity) are considered.

Housing Quality Standards

Because the objective of national housing policy is a decent home for every American family, recipients of proposed housing payments should be required to occupy housing that meets standards of quality. At a minimum the standards must ensure the health and safety of the assisted family. Beyond that, standards must strike a balance between the competing goals of housing quality and program costs. The standards should not be so low that assisted families do not achieve decent housing, nor so high that an excessive subsidy payment is required to enable a family to meet the standards. Also, unnecessarily high standards may discourage landlords and tenants from repairing their units to participate in the program. The experience with the housing allowance experiments suggests that stringent standards are more likely to exclude the very poor, large households, and minorities.

Because local housing market conditions vary widely around the country, the Commission believes that local standards would be preferable to Federal standards. Local housing standards should be allowed where they are substantially equivalent to housing quality standards such as those used in the Section 8 Existing Housing program. But some "fallback" Federal standard like Section 8 is necessary, because many communities have no applicable housing code whatever.

Some administering agencies would find it best to have local municipal code enforcement personnel actually perform unit inspections, as do some administering the Section 8 Existing Housing program.

The Payment Formula: Relationship of Subsidy to Rent

Any housing payments program requires some formula for calculating the subsidy to be provided. The Commission endorses a payment standard approach to the housing payment, such as the one used in EHAP, that does not depend on the actual rent of a particular dwelling, rather than the rent limit approach now used in the Section 8 Existing Housing program.

In the Existing Housing program, the subsidy payment makes up the difference between the tenant payment and the rent, up to a maximum rent called the fair market rent (FMR).[6] For example, assume that the maximum FMR for a two-bedroom unit allowed under the Existing Housing program is $300, that a household's net income is $400 per month, and that the expected tenant contribution is 30 percent of income (or in this case $120). If a tenant finds a unit that costs more than $300 per month, the Existing Housing certificate cannot be used at all for that unit. If the tenant locates a unit costing $250 per month, then the amount of subsidy is $130, but the tenant payment ($120) does not change. The subsidy makes up the difference between a fixed tenant payment and the negotiated rent for the unit. If the landlord had charged $300 for the unit, the amount paid by the tenant would have remained the same, but the subsidy amount would have gone up to $180, representing a $50 increase in payment to the property owner.

It has been argued that this approach keeps pressure on HUD to make upward exceptions to its published FMR schedules, and that both tenants and landlords have the incentive to drive rents up to the FMR limit. Because tenants cannot qualify for payment in a dwelling with a rent higher than the maximum allowed by the program, the ceiling also has the perverse effect of denying assistance to households who want to spend more than the FMR or cannot find suitable housing for less.

Under the payment standard approach, the household receives a payment that is a fixed amount at a given level of household income and size but is not dependent on the rent for the dwelling. The payment amount would be calculated as the difference between the payment standard and a specified percent of income, say 30 percent, independent of the rent of the dwelling. For example, assume that the payment standard for a two-bedroom unit in a community is $300 per month, that a household's net income is $400 per month, and that the housing payments program expects a family to contribute 30 percent of their income for rent (or in this case $120). Under the payment standard approach the government subsidy is $180: the difference between the payment standard $300 and the tenant contribution of $120. The household may then use its housing payment to rent an apartment that costs more, less, or the same amount as the payment standard and thus may elect to pay more or less than 30 percent of their income for rent.

A household with zero income would receive the full amount of the payment standard. If households wish to occupy a unit costing more than the payment standard, they should be allowed to do so by paying the additional amount out of their own income—that is, more than 30 percent of income. At the same time, households should have an incentive, similar to that in the housing allowance experiments, to find housing that rents for less. The allowance experiments indicate that the payment standard approach is an effective way of encouraging tenants to shop and landlords to set rents according to market value instead of meeting a rent limit.

Establishing the Level of the Payment Standard

The basic payment level to be used in the payment standard approach should be based on an estimate of local housing costs and set at a level that allows recipients to rent units that meet the minimum housing requirements of the program. An alternative considered was using a fixed percentage of median income; the percentage could be set such that the payment level would taper off to zero at the income eligibility limit. However, a fixed percentage of median income would not be sensitive to variation in local housing costs. Care should be taken in setting the payment level and the tenant contribution requirements (percentage of income subtracted from the payment level) so that recipients are not

[6] The fair market rent is the median rent for standard units of a given size occupied by recent movers in an area.

subsidized to live in housing more costly than that of moderate-income households just above the income eligibility limit. In addition, the payment standard must be realistic if the program is to work. Too high a standard would reduce tenant contributions below the anticipated level; too low a standard, on the other hand, would impose a high rent burden upon tenants.

Finally, the payment standard must reflect the higher housing cost of larger families; the payment level, like the income limit, needs to be adjusted for various household sizes.

Equal Opportunity and Housing Access

Housing payments potentially provide much greater freedom of locational choice than do new construction programs, which have fixed project locations. However, reliance on the private market assumes an open, fully functioning market system in housing. Discrimination is both wrong and unlawful and would prevent the full realization of the potential benefits of the program. The issue of steering is also of special importance for effective operation of the program. If minorities are steered to areas of minority concentration, the exercise of free housing choice is only illusory. It is essential that full information be provided to eligible families concerning locations and types of available housing, as demonstrated by evidence from the EHAP Administrative Agency Experiment. Therefore, the Commission strongly believes that the administrative mechanism should include a substantial local support-services component for open housing and the enforcement of antidiscrimination statutes, including Federal fair housing laws.

Relationship to Welfare Programs

The housing assistance grant system should be coordinated with income transfer programs for low-income households, particularly with the Aid to Families with Dependent Children (AFDC) program that now provides a shelter component as part of the basic payment. It is not the intent of the Commission to deny housing assistance grants to welfare recipients. Noncash benefits provided by welfare programs should be further considered for inclusion in determining the assistance payments to individual households.

Administrative Mechanisms

The system should be administered through the same mechanisms and agencies as the Section 8 Existing Housing program, including State and regional agencies as well as local housing authorities. This provision would help to avoid the creation of a new structure for program administration.

The Commission is concerned that all eligible households be covered by a responsible administering agency and that participants be able to choose their housing freely and without arbitrary geographic restrictions based on jurisdictions of administering agencies. For complete coverage, the Commission recommends that the State be assigned the primary responsibility for areas not covered by a responsible administering agency. In these areas, States could choose to administer directly, to contract, or to arrange for expanded coverage (jurisdiction) of existing local agencies. The share of program funds should be allocated according to need in each area, so that all eligible households have roughly equal chances of getting into the program within the priorities set for eligibility.

Both the option of lodging complete responsibility with the State and alternative forms of local administration have been considered. In principle, State agencies would be better prepared to guarantee program coverage in all areas of the State and to provide maximum opportunity for mobility for recipients. Also, municipal governments administering the program could form consortia with other local governments to ensure both coverage and mobility opportunities. However, since the Section 8 Existing Housing program was established in 1974, a considerable body of experience has been accumulated by a large number (more than 2,000) of public housing agencies. By assigning residual responsibility to the States, the fundamental problem of lack of coverage can be addressed without disturbing the present administrative structure.

Assuring mobility opportunities to recipients, although an important consideration, is not regarded as sufficiently overriding as to necessitate a completely new administrative apparatus in each housing market area. The Commission believes that the portability of a housing payment should be facilitated by requiring agencies to advise participants of their right to use the payment anywhere and by requiring agencies to permit such mobility. Agencies processing applications would receive the Federal fees for that process. Whatever agency conducts the inspections for qualifying the dwelling units and provides ongoing administration would receive the Federal fees appropriate to those activities.

Who Receives the Payment?

The Commission believes that direct payment to the tenant should be the ultimate goal. This process should be monitored to ensure that administrative feasibility is not sacrificed in critical areas such as upholding program housing standards. In the meantime, however, the administering agency should have the option of deciding whether to make pay-

ments to the landlord or the tenant. The Commission considered both possibilities. The Section 8 Existing Housing program has had positive experience with payment to the landlord; the Experimental Housing Allowance Program made payments to tenants and again reported positive experience.

In principle, payment to the tenant allows the program operation to function more nearly as a private market transaction—and allows more tenant responsibility—than does payment to the landlord. In EHAP the tenant received the subsidy and retained all responsibility for making rent payments to the landlord. The experience in EHAP was very favorable with regard to recipients discharging this responsibility. Few EHAP landlords reported problems (delinquency or serious arrearages). Adequate controls either conditioned payments on rent receipts or held back subsidy checks on landlord complaints about rent payment.

Agencies operating the Section 8 Existing Housing program tend to favor the current system of direct payments to landlords. Agencies say that their credibility with landlords is reinforced by the assurance landlords have that at least the Federal share of rent will be received directly from a government agency. Agencies also perceive that enforcement of the housing quality standards is facilitated by agency control of the subsidy payment.

Term of Contract

The term of each payments contract with the administering agency should be three to five years. This provides the Federal government the flexibility to make short-term adjustments reflecting changing housing needs and budget priorities.

Retrieval of Budgeted Funds for a Housing Payments Program

The Commission believes that it is useful to explore the possibilities of recovering funds previously budgeted for the subsidized production programs. Any retrieved funds should be used to serve more households more cost-effectively, through a combination of the Housing Payments Program and the Housing Component of the Community Development Block Grant program (which is developed in the next major section of this chapter). As an example of the benefits of such a policy, a Housing Payments Program would serve nearly twice as many households as the Section 8 New Construction program for the same annual subsidy cost, as demonstrated in Chapter 1.

The Commission assumes that any retrieval would require the agreement of project sponsor/mortgagors, mortgagees, bondholders, and affected State and local government agencies. Feasibility of retrieving these funds in many cases would depend on favorable rulings by the Internal Revenue Service (IRS) concerning the continued treatment of these projects as "low income" for tax purposes if they were marketed without regard to tenant income levels. Similar rulings might be necessary from the IRS and from States with regard to project financing obtained through bonds with tax-exempt interest conditioned on the loan's use for a low-income project. Finally, the Commission assumes that retrievals of such funds should not deprive any existing tenant of comparable housing assistance; any tenants living in projects removed from the subsidized programs should be provided housing payments for use in the project or elsewhere and appropriate relocation assistance, as necessary.

Limitations of a Housing Payments Program

Based on the experience with both EHAP and the Section 8 Existing Housing program, the Commission recommends housing payments as the basic mechanism for enabling low-income families to afford adequate housing. However, the Commission also recognizes that for certain households and markets, housing payments alone may not adequately serve low-income households *and* improve housing quality. The Commission is particularly concerned that shortages in some housing markets may inhibit the effectiveness of a Housing Payments Program. An increase in the stock of adequate housing may be needed before assistance recipients can find decent housing, particularly in markets where the stock of lower-priced housing may be physically inadequate, or where owners are unwilling to upgrade units that fail program housing quality standards in order to serve tenants with housing payments certificates.

The available information from EHAP and the Section 8 Existing Housing Program suggests that:

- Persons starting out in housing that does not meet the quality standards of the program are less likely to participate in a Housing Payments Program than those who start out in units meeting the program standards. Participation is simple when an applicant's current dwelling satisfies the program housing standards. But the research is unclear on the difficulties faced by applicants in substandard units. These households may not be able to repair or get the owner to repair the unit, some households may be unwilling to move, or some households may be unwilling to search widely or thoroughly enough for a unit that would qualify. Obviously, these difficulties depend on financial feasibility of rehabilitating substandard units and more generally on the availability of standard housing in the community.
- Large families, single-parent households, and minority families are more likely than

other groups to live in substandard housing. Therefore these households are less likely to become program participants.

- The lower the physical quality of the housing stock in a community relative to the program housing standards, the more difficult it is for eligible households to benefit from the housing payments approach.
- These programs induce only minimal repairs—averaging less than $250 per unit in the Section 8 Existing Housing program. Thus, despite the concern of the Commission for both affordability *and* condition of the low-income stock, a housing payments program would have little stimulus on overall improvement in the number of quality units available to low-income households.

The Community Development Block Grant Program: Added Housing Component and New Construction

New Construction should be added as an eligible activity of the Community Development Block Grant Program (CDBG), and a Housing Component, weighted to local housing needs, should be added to CDBG to complement the Housing Payments Program in addressing problems of housing availability and adequacy for lower-income households. The purpose of these additions to the CDBG program is to make available standard housing to lower-income households living in substandard units.

The Commission believes that a housing payments program requires complementary assistance to some communities to assure the effective utilization of the program. Because of the greater flexibility, sensitivity to local needs, and imagination of programs operated at the State and local levels, rather than the national, the Commission believes that the Community Development Block Grant (CDBG) program, with its proven effectiveness in meeting housing needs, is the appropriate vehicle for addressing housing supply problems remaining in the presence of a housing payments program.

The Commission's desire to expand CDBG's housing activity stems in part from the recognition of the effective and innovative approaches already undertaken by State and local governments. Even with the somewhat limited scope for State and local housing program development under the current CDBG program, it is nonetheless true that many of the most innovative ideas in housing have been devised and implemented at the State and local level. These local program initiatives include Urban Homesteading, the Neighborhood Housing Services program, and—to some extent—even housing allowances. Urban Homesteading was devised in Wilmington, Del., several years before HUD began to use it as a way of reducing the inventory of Department-owned housing and of assisting community development. The Neighborhood Housing Services program in Pittsburgh, Pa., became the model for dozens of federally assisted projects elsewhere, and housing allowances were first tested through local initiative in Kansas City, Mo., a few years before the national experiment was undertaken.

Recently, local governments have also taken the lead in designing new programs to rehabilitate rental property for occupancy by lower-income tenants. Unlike the expensive Section 8 Substantial Rehabilitation program, CDBG grantees primarily use moderate levels of rehabilitation to provide housing for low-income tenants at prevailing rent levels. Tenants eligible for rental assistance receive Section 8 Existing Housing certificates so that they can afford to remain in the buildings after rehabilitation, but owners are not provided a long-term, guaranteed rent subsidy by the government. In New York City, for example, a 1 percent CDBG loan is combined with a market rate loan from a private lender to rehabilitate small apartment buildings in low- and moderate-income neighborhoods. The CDBG loan reduces rehabilitation expenses sufficiently to allow the property owner to continue to charge rents prevailing within the neighborhood. Some portion of the tenants renting the units pay market rents without assistance and others use subsidies from the Section 8 Existing Housing program to help defray costs.

A hallmark of the locally designed and initiated housing programs has been their flexibility and responsiveness to local needs and markets. Unlike the Federal categorical programs, CDBG housing activities have been carefully tailored to local situations. Interest rate subsidies have been varied rather than fixed as in national programs; the red tape and processing procedures required by the Federal Housing Administration (FHA) have been avoided; moderate, rather than substantial, levels of rehabilitation have been permitted; and small as well as larger buildings have been accommodated.

Local governments not only have been imaginative in their development of CDBG housing programs but also have demonstrated a capacity to carry out high levels of activity, especially in rehabilitation of single-family homes. In 1975, only 10,000 units were rehabilitated; by 1980, annual rehabilitation activity had increased to 180,000 units per year—far more than categorical Federal housing rehabilitation programs produced in the comparable period. Localities have also succeeded in attracting private funding to supplement CDBG rehabilitation efforts. In fiscal year 1980, an estimat-

ed $400 million in private funds were added to the $1 billion of CDBG housing rehabilitation expenditures.[7]

State governments, particularly through the activities and programs of State housing finance agencies (HFAs), have also made major contributions to the field of subsidized housing rehabilitation and new construction. Housing finance agencies have played key roles both alone and in partnership with the private sector and government in the construction of housing, the rehabilitation of existing units, and the provision of resources for energy conservation. For example, several States have developed innovative programs in conjunction with CDBG cities to subsidize the rehabilitation of homes owned by lower-income households. The State HFAs have issued bonds to raise monies for home improvement loans, and CDBG funds have been used to reduce the interest rates. In the past 10 years the 32 HFAs have financed nearly 300,000 single-family homes and 500,000 multifamily rental units. Through their activities, they have developed extensive experience in lower-income housing development and established strong relationships with the private sector and local communities.

To enable the CDBG program to help overcome local housing supply problems even more effectively, the Commission recommends two related changes in the program: (1) the addition of New Construction as an eligible activity; and (2) the addition of a Housing Component to the CDBG program as a replacement for previous categorical programs.

New Construction as an Eligible CDBG Activity

New Construction is one of the few housing-related activities not generally permitted under the CDBG program.[8] In many communities this has hampered the government's ability to address the full range of local housing and community problems with a coordinated strategy. Neighborhoods with new streets and sidewalks as well as rehabilitated housing may still have empty lots that are both eyesores and nuisances. Rural areas with virtually no housing to rehabilitate may require new units to house families living in poor quality dwellings. Yet, CDBG funds cannot now generally be used to meet these and other locally identified needs for new construction. By allowing New Construction within the CDBG program, local governments would be free to address these special housing problems within the framework of a basic plan established by the community.

Housing Component of the CDBG Program

The Commission recommends that a Housing Component be added to Title I of the Housing and Community Development Act of 1974 (as amended) as a replacement for the categorical assisted housing programs of both HUD and the Farmers Home Administration (FmHA). This addition would allow the CDBG program to become the primary vehicle for dealing with the supply of adequate housing for low-income households.

The majority of the Commission consciously included the FmHA subsidy programs in this proposal. The Commission recognizes that there are special housing problems in rural areas that are different from those of urban communities. Specifically, rural areas have a higher incidence of substandard housing, and the necessary institutions for mortgage finance, construction, and maintenance are diffuse and often lacking entirely. However, the preponderant lower-income problem, even in rural areas, is that of affordability. This problem is best addressed through a program of housing payments to lower-income households. And, as in urban areas, the payments program may not fully address the problems of adequate housing supply. Households may have difficulty using housing payments when no standard housing exists within a reasonable distance or where rehabilitation expenses are more than can be recovered through a housing payment. In such cases, rehabilitation and/or new construction may be required to ensure the successful operation of a housing payments program.

State and local programs can be more flexible and responsive than Federal housing production programs. Therefore, the Commission believes that the appropriate way to meet housing supply problems in rural areas is also through a block grant approach. Through a block grant approach, States would have maximum opportunity to design housing programs that meet their particular needs. Other special housing concerns, such as housing of Native Americans, may also be appropriately addressed under the block grant format.[9]

Some Commissioners believe the Commission's recommendation to fold FmHA programs

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[7] Michael M. Ehrmann and Douglas Ford, "CD Rehabilitation: Analysis Reveals Dramatic Growth, Successful Local Programs," *Journal of Housing*, Vol. 30, No. 6, June 1981.

[8] New Construction was omitted as an eligible CDBG activity in the 1974 Housing and Community Development Act because Section 8 of Title II of the act provided explicitly for housing construction. Although amendments to the act have permitted neighborhood and nonprofit groups under certain circumstances to undertake new construction, activity has been limited.

[9] Whether the special housing needs of Native Americans would best be served by the block grant approach is not clear. Native

(footnote continued next page)

into the proposed Housing Component does not adequately respond to rural needs. Rather than decentralize the Farmers Home Administration program, these Commissioners believe that it should continue to be administered at the national level because the local offices have too little, not too much, national guidance and direction.

Although the specific design of the Housing Component in the CDBG should best be left to Federal, State, and local agencies, the following discussion indicates the Commission's suggestions for the program.

Program Administration. Administration of the Housing Component of the CDBG program should closely parallel that of the larger block grant program in order to assure the administrative capacity to carry out the program, to minimize overhead costs, and to maintain coordination with other activities such as improvement of streets, provision of public facilities, and delivery of services. This means that in general, Housing Component activities should be carried out directly by central cities, communities of more than 50,000 population, urban counties of more than 200,000 population (entitlement areas), and State and territorial governments for use in localities and rural areas that do not receive a direct allocation of CDBG funds (nonentitlement areas).[10] The rural program could be supervised either by HUD (as part of CDBG) or by the Department of Agriculture (presumably through FmHA).

While the general CDBG administrative network should be employed to plan and implement housing activities, the Commission recognizes that housing markets and housing problems, unlike other CDBG activities, may require regional and even statewide interventions. Therefore, the Commission suggests consideration of the following additions to the basic CDBG administrative network:

- CDBG entitlement localities and adjacent nonentitlement communities, at their discretion, should be able to form consortia to carry out housing activities on an areawide basis. This approach would permit smaller cities or suburban areas to receive a direct fair share allocation of Housing Component resources to be used in conjunction with those of a CDBG entitlement area. A consortium would be able to run an efficient program that meets the needs of the extended geographic area. Likewise, States should encourage consortia of rural localities to carry out housing activities supported through the State's allocation of Housing Component resources. Very small areas could pool their resources and limited staff capacity to run programs with some economy of scale.
- State housing finance agencies (HFAs) have actively provided financing to help meet low-income housing needs and have developed a strong administrative capacity to implement programs. To maintain their institutional capacity and allow them to continue to serve a statewide function, the governors and mayors of entitlement communities may mutually decide to allocate some portion of the housing component funds to an HFA. Governors or State legislatures may also decide to use HFAs to operate housing programs for nonentitlement areas.
- In many States, the FmHA has established a delivery system and network of technical services to provide housing opportunities in rural areas. To assure continued delivery of housing assistance in small communities and rural areas, FmHA offices should be considered an alternative administrative channel for the rural portion of the Housing Component.

Fund Allocation. Funds allocated for the Housing Component of the block grant program should be allocated on the basis of objectively measurable housing needs, particularly the need to rehabilitate housing for lower-income households. A formula similar to HUD's housing fair share approach, which can be updated and calculated annually, should be used to provide for equitable distribution of funds. Funds identified by Congress as the Housing Component of CDBG should be allocated strictly according to housing need without an arbitrary split such as that used in CDBG, where 70 percent

Americans have been served by a special Indian housing program and by other categorical programs as well as by a special set-aside for Indians within the CDBG program. Although opinion is mixed on the desirability of continuing the categorical programs versus converting housing and other categorical programs into a comprehensive Indian housing block grant, testimony at Commission hearings was clear on the need for special programs to address Indian housing needs. A special Interagency Task Force on Indian Affairs chaired by the Assistant Secretary for Indian Affairs in the Department of the Interior is reviewing these and related issues. Other groups with special housing needs, such as migrant workers, may also require special attention beyond the broad proposals for a housing payments program complemented by block grant support for housing. The special housing needs of elderly households are reviewed in Chapter 4.

[10] For the definition of eligible CDBG grantees, see 24 CFR 570.3.

goes to entitlement grantees and 30 percent to the States for nonentitlement areas. Care should be taken to adjust the formula for any regional or local differences in rehabilitation and construction costs, and to reassess the formula periodically to ensure that it is appropriately measuring the need for program funds.

The annual funding and three-year authorization features of the CDBG program should be incorporated into the Housing Component. These features provide some assurance of a continuity of funding and allow localities and States to develop effective programs as well as staff capacity to carry them out. This arrangement also forces grant recipients to finance chosen activities within the amount of the grant, because they cannot assume a continued Federal contribution. Although this requirement may limit the scope of activities that can be financed, it also limits Federal budget exposure.

Use of Funds. The Housing Component of the CDBG program should be used to help overcome housing supply problems of lower-income families living in inadequate units. This would be particularly helpful in overcoming housing supply problems that impede the successful implementation of the Housing Payments Program. Although communities would be free to provide housing through rehabilitation or new construction, it is likely that most localities would choose to repair units. Rehabilitation is usually more cost effective per dollar of subsidy than new construction in making available units of standard housing. Rehabilitation also allows lower-income households to remain in their buildings and neighborhoods, rather than having to move, to use a housing payments certificate.

Although it is the Commission's intent that Housing Component funds be used for the above purposes, the majority of the Commission recommends that no specific restrictions should be placed on the use of funds in entitlement cities. In fact, most CDBG entitlement communities already spend a substantial portion of their block grant on housing and are expected to continue to do so. By encouraging but not requiring that funds be used to support housing, CDBG communities would have maximum flexibility to design and operate programs. For example, many localities would continue to direct their CDBG program to rehabilitation of owner-occupied, single-family homes and use housing component funds to repair the rental buildings in low-income neighborhoods. Others may use regular CDBG funds to subsidize the costs of renovation and Housing Component funds to help Housing Payment Program recipients to purchase them.

Funds that are allocated to the States or territories for use in nonentitlement areas are a replacement for categorical housing funds of both the FmHA and HUD that were previously spent exclusively on housing in small towns and rural areas. Because of this, the Commission recommends that the Housing Component funds allocated to the States and territories be used to support lower-income housing activities, particularly those that complement the Housing Payments Program.

Other Commissioners believe that Housing Component monies allocated to both entitlement cities and States should not be used for other CDBG purposes. Instead, these Commissioners believe that funds should be directed solely to provide housing, either through rehabilitation or new construction, to households eligible for housing payments who are living in poor quality housing. There is evidence that housing payments, and the private market, serve minorities, large families, and households in poor quality housing less well than they serve others. Without effective Federal priorities for and constraints on the use of Housing Component funds, some Commissioners fear that the needs of these households would not be met and that the Commission would fail to recommend any kind of realistic program to add to the supply of housing for those with the most critical housing problems in areas where the private sector simply cannot respond.

Whatever the precise uses of the funds, State and local housing program resources can be combined with private sector funds and other resources such as FHA insurance, mortgage revenue bonds, and housing payments. By combining public funds with other resources, limited dollars can be stretched. In addition, by including lenders, underwriters, and insurers in housing programs, private market skills and disciplines can be used to help operate publicly subsidized programs.

Performance. The Housing Component activities, because they must meet the same statutory objectives as the CDBG program, would be targeted to lower-income households. However, to ensure that benefits are appropriately directed, Housing Component activities should be carried out according to locally determined Housing Assistance Plans. These plans should reflect the State, city, or county's lower-income housing availability needs by household, tenure, and housing type. In addition, all grantees should comply with the fair housing and equal opportunity provisions of Title VI of the Civil Rights Acts of 1964 and Title VIII of the Civil Rights Act of 1968. The Federal government should play an active role in monitoring civil rights and fair housing performance and in the delivery of program benefits.

CHAPTER 3

PUBLIC HOUSING

Since 1937, the Low-Rent Public Housing program (popularly known as public housing) has been the primary Federal assistance mechanism for housing low-income families. The program now houses 1.2 million households with average incomes of 28 percent of median family income. The private market has been unwilling or unable to house many of these families, including many single-parent, minority, and large families. Although demands for Federal subsidies were modest and local responsibility was paramount during the early years, public support for the program has eroded over the past two decades, while subsidy needs and Federal control have increased.

This chapter describes background factors leading to the conclusion that major program change must be made; proposes a policy direction to effect such change; and discusses specific options for the future use and disposition of public housing projects, taking into account the interests of tenants, local governments and public housing authorities (PHAs), and the Federal government.

Within a specified period of years, public housing should be restored to local management and control, passing to public housing authorities and local governments responsibility and choice in the use and disposition of public housing projects. The future use of each public housing project should be determined on the basis of a joint local-Federal assessment considering a broad range of options in light of each project's physical, economic, and social characteristics.

Background

The public housing program was enacted in the United States Housing Act of 1937 to assist the States and their political subdivisions in providing decent, safe, and sanitary dwellings for families of low income. In its declaration of policy the act called for vesting in local public housing authorities[1] the maximum amount of responsibility for administration of their housing programs. The primary Federal role was a simple one: the Federal government would enter into Annual Contributions Contracts with local housing agencies to provide the funds for repaying bonds sold by the local agencies for construction costs of public housing units. These contracts to provide debt service on housing agency bonds would run for up to 40 years. With local housing agencies responsible for owning and operating the resulting public housing for the benefit of low-income tenants, funds for operation and administration were to be obtained through charges to the tenants ("tenant contributions"). The effective Federal subsidy to the tenants was that they did not have to bear the capital costs of their housing.

Increased Federal Control

Initiated as a federally assisted local program with considerable local flexibility in development and administration, public housing has evolved over the past four decades, becoming increasingly subject to Federal control, with concurrent reductions in local responsibility and accountability. Federal law and regulations now extend in significant detail into virtually every aspect of PHA ownership and operations. For example, Federal regulations prescribe policies and procedures for accounting, labor agreements, contracting, tenant selection, grievances, and evictions.

Probably the most important Federal control limits PHA ability to obtain and keep income and to determine the use and disposition of projects. Any income generated by the PHA reduces the subsidy otherwise payable by the U.S. Department of Housing and Urban Development (HUD). Further,

[1] Now the term "public housing agency" (PHA), as defined in the Housing and Community Development Act of 1974, is used to conform terminology across both local housing authorities and other agencies authorized to administer the Section 8 Existing Housing program.

Federal law restricts occupancy primarily to households with incomes below 50 percent of the median income, and specifies that no more than a given percentage (now required to move toward 30 percent) of a household's net income may be charged for rent. HUD also has limited a PHA's ability to sell or demolish projects to those instances "where it can be convincingly demonstrated that continued operation as low-income public housing cannot be justified."[2] Local control, responsibility, and accountability are necessarily impaired by these intrusions of Federal regulation and control over major and minor management decisions.

Increasing Costs

Federal subsidies to public housing have increased dramatically over the past decade. Initially, Federal subsidy of public housing was limited to full payment of all debt service costs; tenant rents were expected to cover operating costs. In the 1950s, the income of tenants served by the program began to decline relative to household incomes in the general population (Figure 3.1), partially because public housing was often built to house those displaced by slum clearance under urban renewal programs. Housing authorities had increasing difficulty assessing rents that would cover their operating costs yet remain affordable for their tenants. In 1969, Federal law mandated that tenant affordability be assured by setting a maximum rent charge of 25 percent of net tenant income. Now Federal law requires the eventual imposition of a 30 percent tenant payment.

Federal subsidy of operating costs was available on a very limited basis prior to 1969, when program-wide subsidy of operating costs began. Since then, subsidy needs have increased dramatically, as operating expenses increased and as the percentage of operating costs covered by "capped" tenant rents has decreased (Table 3.1).

Although public housing subsidies are large, averaging $174 per unit month in 1981, average public housing costs are no greater than the cost to house the same households in standard housing in the private rental market in the Section 8 Existing Housing Program (Table 3.2, column "Operating Subsidy and Debt Service Cost as a Percentage of Section 8 Existing Housing Program Costs").

Average monthly Federal outlays (debt service plus operating subsidy costs) for public housing in 1981 were approximately equivalent to the direct Federal subsidy that would have been required for public housing tenants had they been in the Section 8 Existing Housing program. The Section 8 Existing Housing program subsidizes low-income renters who lease units in the private rental housing market and obtain housing at rents approximating those in the unsubsidized market (see Chapter 2). The comparisons in Table 3.2 suggest that, while Federal costs have risen, the average cost is not out of line with private rental housing. Some projects provide housing for low-income tenants at less cost than private market housing and represent efficient use of Federal resources, but some projects have much higher direct Federal costs than private market housing.[3]

[2] 24 CFR 870, Preamble.

[3] These comparisons use only direct Federal costs and make no attempt to take into account the total resource costs of public housing, which would include both direct and indirect costs. Important indirect costs include Federal revenue losses from tax-exemption of the interest on public housing agency bonds and local government revenue losses because public housing projects make a payment in lieu of local property taxes that is typically less than the usual amount of property taxes. While

(Footnote continued on p. 35)

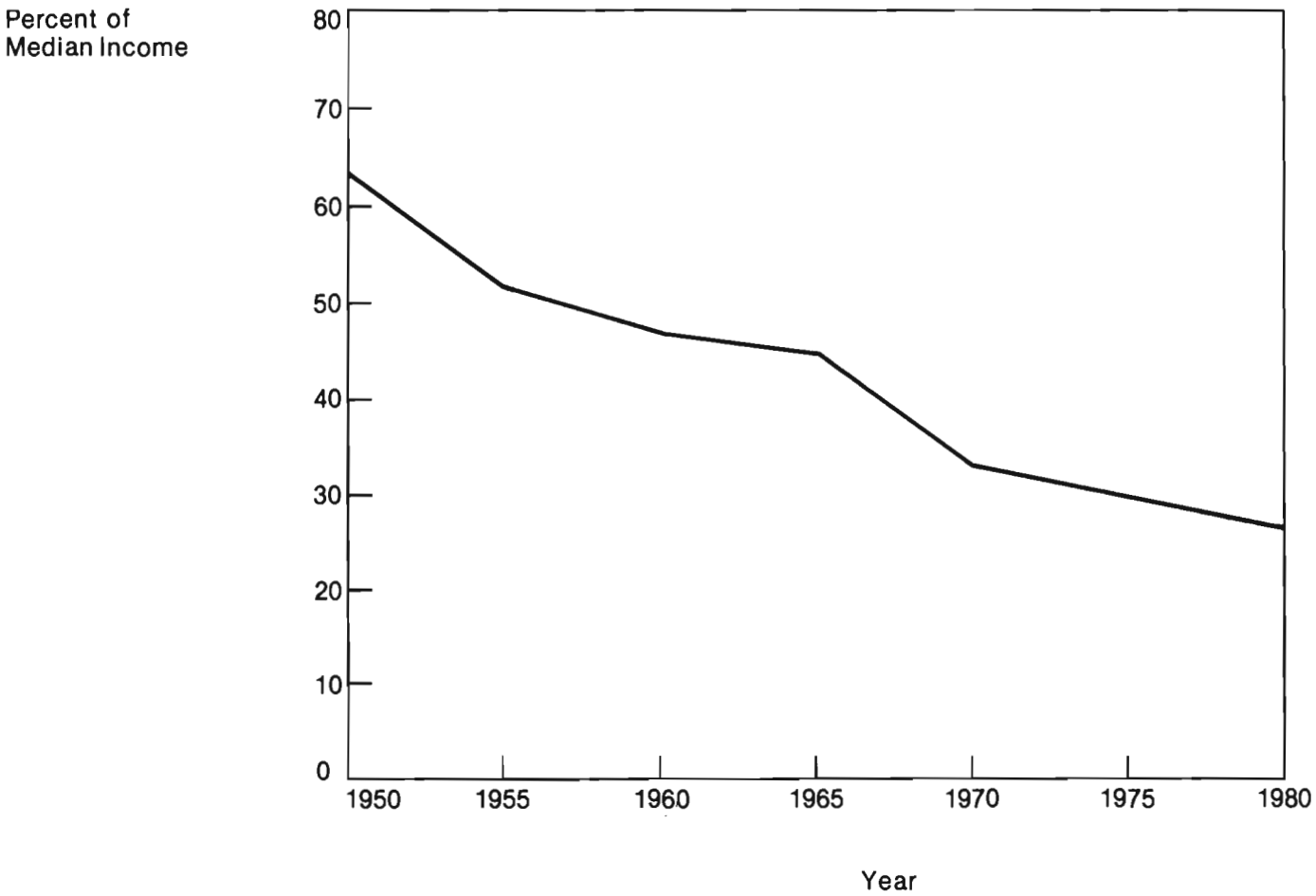
Table 3.1
Growth in Public Housing Operating Costs, 1969 and 1970
(Total Operating Expenditures Per Unit Month)

	1969	1980	Percent Growth
Extra-Large PHAs[a] (over 6500 units)	$58	$203	250%
Large PHAs (1250–6499 units)	49	141	187
Medium PHAs (500–1249 units)	43	126	191
Small PHAs (100–499 units)	37	109	193
All PHAs	$50	$157	217%

Sample: 237 PHAs in 1969, 314 PHAs in 1980.
[a] Public housing authorities (PHAs).

Source: U.S. Department of Housing and Urban Development, "Alternative Public Housing Subsidy Systems," draft report, (Washington, D.C.: HUD, March 1982).

Figure 3.1
Median Public Housing Tenant Income as Percent of National Median Family Income, 1950-1980



Source: Adapted from U.S. Department of Housing and Urban Development, "Alternative Public Housing Subsidy Systems," draft report, March 1981.

Table 3.2
Average Per Unit Monthly Costs for Selected PHAs (FY 1981)

	Average Number of Units Under Management	Total Monthly Operating Costs	Monthly Tenant Contribution	Monthly Operating Subsidy	Monthly Debt Service Subsidy[a]	Total Monthly Federal Outlays[b]	Operating Subsidy and Debt Service Cost as a Percentage of Section 8 Existing Housing Program Costs[c]
Large PHAs (5,000 units and over)							
Birmingham, AL	6,702	$132	$61	$66	$60	$126	56%
Boston, MA	12,757	274	67	206	101	307	96
Chicago, IL	38,627	211	58	150	81	231	63
Los Angeles, CA	8,213	163	101	55	56	112	38
New York, NY	147,288	277	140	131	77	207	75
Medium-Sized PHAs (1,000–4,999 units)							
Greensboro, NC	2,175	142	84	52	80	132	66
New Bedford, MA	1,648	188	97	83	90	174	80
Peoria, IL	1,925	150	61	86	116	204	80
Small PHAs (1–999 units)							
Inkster, MI	855	142	118	21	80	111	42
Miffin County, PA	220	120	102	14	111	134	97
Temple, TX	326	77	71	− 1.	109	107	52
National Averages	1,200,000	NA	$91	$68	$99	$174	93–100%

[a] Includes amortization of costs of rehabilitation (modernization), including an assumed level for 1981.
[b] Includes operating subsidy plus debt service subsidy.
[c] This is a weighted estimate that corresponds with Section 8 outlays associated with serving low-rent public housing tenants during FY 1981.

Source: Joseph Riley, "Integration of Public Housing With a Housing Voucher Program—An Overview," unpublished report (Washington, D.C.: HUD, December 1981), pp. 15 and 16. Revised by Commission staff.

Variation Among PHAs and Projects

The social and physical problems among public housing projects vary considerably. Some projects are in good condition with few or no significant problems; others must be considered troubled because of their general condition and/or management problems stemming from tenant characteristics, project design and site, neighborhood, and project costs and funding. A 1979 HUD study found that 67 percent of all public housing projects were untroubled, with another 26 percent relatively untroubled. Although only 7 percent of the total inventory was deemed "troubled," 28 percent of large, older, family projects were so classified.[4]

Operating costs also vary widely among PHAs and among projects within any given PHA. Tables 3.2 and 3.3 give examples of operating costs for large, medium-sized, and small PHAs and for several family and elderly projects within two PHAs, respectively. These data illustrate a range of PHA operating costs, from $77 per unit month in Temple, Tex., to $277 per unit month in New York City. Larger PHAs appear to have higher operating costs. Project data from Birmingham, Ala., and Chicago, Ill., illustrate an even more important phenomenon: within any given PHA, operating costs may vary widely—for example, between $82 and $358 per unit month in Chicago.

Average debt service costs differ by PHA because of variations in both development and financing costs, relating in part to the age of the projects (Table 3.2 column "Monthly Debt Service Subsidy"). Even wider variations would be evident if accounting records were kept for individual projects so that project level debt service costs were known; accounting records are presently aggregated at the PHA level and therefore costs are not easily allocated to particular projects. From these observations about differences among PHAs and projects it is clear that conditions and costs vary widely and that program changes must take these variations into account. Sweeping, single-strategy "solutions" could be mistaken in many cases.

Tenant Composition of Public Housing

By program rules, public housing has been targeted to low-income households. It often has provided housing of last resort for people with special difficulty locating adequate, affordable housing in the private market, particularly large families, single-parent families, and minority families (see Table 3.4). Experience with the Section 8 Existing Housing program shows that these very types of households have special difficulty locating housing within program requirements. Nearly half (46 percent) of public housing tenants are elderly households. Changes in the program must be made in ways that are sensitive to the reliance these households now place on public housing and to their ability to function in the private housing market.

Proposal for Program Change

To address the problems of increasing Federal operating subsidy and undue Federal control, the Commission has developed a proposal for program change that takes into account the wide variation among PHAs and projects. In a primary departure from previous Federal policies for public housing, the Commission proposes project-by-project determinations rather than a sweeping, single-solution policy. This is a common sense approach in the world of private real estate, and it would offer Federal and local governments a fresh opportunity to consider the best interests of all parties, especially public housing tenants.

The proposal is based on the fundamental commitment of the Federal government to continue assistance to low-income households. Subject to this basic commitment, the objectives of the proposal for program change are to:

- Reduce the level of Federal control and regulation of public housing;
- Maximize local control and accountability in the management of public housing and the determination of the future use of each project; and
- Maximize the effective use of current and future Federal resources available to the program by imposing a Federal cost constraint on each project's operating costs, encouraging efficient management, and requiring that any revenue which results from the program change be used for low-income housing purposes.

Before outlining the proposed options for program change, some important constraints must be

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the data reported here cover only direct costs, the indirect costs should also be considered when estimating cost effectiveness of public housing projects. One study estimated that tax revenues forgone on public housing bond interest comprise 15 to 20 percent of Federal costs in public housing (see Stephen K. Mayo, Shirley Mansfield, David Warner, and Richard Zwetchkenbau, *Housing Allowances and other Rental Housing Assistance Programs—A Comparison Based on the Housing Allowance Demand Experiment, Part 2: Costs and Efficiency* (Cambridge, Mass.: Abt Associates, Inc., June 1980), p. 123, prepared for the Office of Policy Development and Research, U.S. Department of Housing and Urban Development).

[4] U.S. Department of Housing and Urban Development, *Problems Affecting Low Rent Public Housing Projects* (Washington, D.C.: U.S. Government Printing Office, 1979).

Table 3.3
Average Per Unit Monthly Cost For Selected Projects (FY 1981)

	Project #1	Project #2	Project #3	Project #4	Project #5	Project #6	Project #7
Location	Birmingham	Birmingham	Birmingham	Chicago	Chicago	Chicago	Chicago
Type Project[a]	Elderly	Family	Family	Elderly	Family	Elderly	Family
Tenant Contibution	$48	$72	$67	$66	$118	$119	$70
Total Operating Expense	92	112	172	82	358	289	106
Operating Subsidy	44	40	105	6	238	164	35
Average PHA Debt Service[b]	53	53	53	74	74	74	74
Total Federal Subsidies	97	93	158	80	312	238	109
Operating Subsidies as Percent of Section 8 Existing Costs	23%	16%	40%	70%	70%	71%	9%
All Direct HUD Subsidies as Percent of Section 8 Existing Costs	51%	36%	60%	28%	91	103%	28%

[a] Some "family" projects are occupied only by elderly. The designations provided are based on the official designation of project type rather than tenant characteristics data.
[b] Amounts given are PHA Debt Service averages rather than project debt service amounts.

Source: Joseph Riley, "Integration of Public Housing With a Housing Voucher Program—An Overview," unpublished report (Washington, D.C.: HUD, December 1981), Attachment 1. Revised by Commission staff.

Table 3.4
Household Type and Racial Composition of Public Housing Tenants

Household Type	All Households	Nonminority Households	Minority Households
Single Nonelderly	7%	6%	8%
Single Elderly	36	58	20
1 Adult with 1–3 Children	18	8	24
1 Adult with 4+ Children	5	1	8
2 Adults with 1–3 Children	13	7	18
2 Adults with 4+ Children	6	2	8
2 or more Adults, Elderly	10	14	7
2 or more Adults, Nonelderly	6	4	7
Total	101%[a]	100%	100%
Percent of All Households	100%	41%	59%

[a] Total is larger than 100% due to rounding.

Source: Compiled from data of U.S. Department of Housing and Urban Development, Research Inquiry System.

noted. These include legal considerations, need for administrative support, and data availability.

Because of the complexity and size of the public housing program and the task of making any major changes, it is essential that HUD provide executive leadership and adequate staffing to support the program. Organizationally, the program should be elevated in status, creating an Assistant Secretary for Public Housing, to ensure the required level of direction and attention.

Because operating cost data are now available only for selected PHAs and as aggregated national data, and because no data on project marketability are currently available, HUD is conducting a study that is expected to yield data on the characteristics of public housing projects in relation to their operating costs, estimates of rents that could be charged to the general public, and estimates of the number of projects that fall in various categories of operating costs. The data now being generated by HUD, and information that would be generated by the transition process itself, should serve further to define appropriate policy direction.

Notes and bonds issued to finance the construction, acquisition, and modernization of public housing projects involve long-term contractual relationships between the Federal government, the local issuer, and the note/bond holders, based on Federal, State, and local law. These legal constraints must be taken into consideration in undertaking program change.

Finally, the objectives of local control and cost effectiveness and the emphasis on program change should not be construed as proposals for wholesale change across all public housing projects. For some tenants and some projects, public housing is the most cost effective means to sustain the Federal commitment to continue assistance to low-income households.

Proposal

The Commission recommends that over a specified period of years, the Low-Rent Public Housing Program be restored to local management and control, passing to local governments and their PHAs responsibility and choice in the use and disposition of public housing projects within the objectives stated above.

During the transition period, local governments and PHAs, jointly with the Federal government, would conduct project-by-project assessments, and the Federal government would provide continued support and resources (outlined later under the discussion on transition). On the basis of these assessments the PHA could exercise, at any point within the transition period, one of the following options for any specific project, with Federal approval required for implementation of Options 2 through 5:

- *Option 1: Retain the project* under public ownership for occupancy by households with incomes below 50 percent of the median income, paying a modest portion of their income for rent; Federal payment of debt service under the Annual Contributions Contract would continue; operating subsidies would be provided through an annual payment limited to the lower of: (1) the level of subsidy attributable to the project under the existing formula for operating subsidy at the time of transition, or (2) the difference between the payment under a Housing Pay-

ments Program[5] and the debt service payment. (In further discussion the payment under a Housing Payments Program is simply referred to as a housing payment.)

- *Option 2: Sell the project or convert to homeownership.* Any net proceeds of sale remaining after payment of indebtedness would be dedicated to low-income housing purposes. This option could also include conveyance of land only, condominium and cooperative conversion, or tenant purchase. Tenants would be protected with relocation assistance and guarantee of a housing payment to enable them to be housed in the converted project units or the private market.
- *Option 3: "Deprogram" the project*, that is, sell or demolish, at a loss, a project whose social, financial, and physical viability is so poor that it cannot be maintained at reasonable cost. This option is one of cutting losses. Again tenants would be protected with relocation assistance and housing payments.
- *Option 4: Free up project rents*, allowing the PHA to charge rents that cover operating costs and continuing only Federal debt service subsidy. Tenants would receive housing payments, that is, they could use the payments to pay public housing project rents or to obtain private market housing.
- *Option 5: Develop an alternative* that is tailored to the unique circumstances of the project and mutually agreeable to local government, the PHA, and the Federal government, such as operating subsidy levels exceeding the cap. This option may also involve continued Federal payment of debt service and may require relocation assistance and/or housing payments for tenants.

Transition Period

The transition period should cover a reasonable number of years prior to the effective date of the Federal cost constraint. During that period, there should be:

- Continuation of operating subsidies under a revised operating subsidy formula that recognizes and rewards cost-effective management and provides predictability of funding;
- Continuation of funding to improve the physical condition or operating efficiency of the existing public housing stock (modernization);
- Maximum reduction of Federal requirements and administrative constraints over management and operations while preserving the Federal interest in *only* (1) tenant eligibility and (2) tenant rent/income limits;
- Collection of data on the economic, social, and financial characteristics of all projects and a project-by-project assessment by HUD and local officials to determine the feasibility of various options concerning each project; and
- Implementation of actions to sell, convert, or deprogram units when local and Federal officials concur.

At the end of the transition period one of the five options should be in force. The total annual Federal subsidy to any project, including debt service and an annual block grant to subsidize operating costs, generally should not exceed the cost to assist the same households through housing payments. In projects that continue to receive a grant to subsidize operating costs, the grant would permit continuation of a Federal limit on the percentage of income paid by tenants for rent. In projects where other options are chosen, tenants would receive housing payments that enable them to remain in the housing project or move to housing in the private market as they chose.

In some cases, otherwise infeasible projects might be rehabilitated, converted from family to elderly use, restructured to provide better layouts, "thinned out" by partial demolition, or otherwise made more viable through physical or management changes during the transition period. Similarly, extremely high operating costs may be a function of energy inefficiencies that can be remedied during this period. These remedial actions might enable otherwise infeasible projects to be retained as public housing.

Description of PHA Options

In choosing a strategy for any particular project, opportunities and limitations are conditioned by three market factors and the relationships among them: (1) the value of the property, (2) the maximum rent that can be successfully charged by that project to the general public, and (3) the debt service and operating costs of the project. The strategy selected would depend on the joint local-Federal assessment of each project's potential. This assessment would determine the project's future use that was most appropriate, given the objectives stated previously, particularly to continue serving households occupying or eligible for public housing and to provide

[5] Chapter 2 proposes a Housing Payments Program as a variation of the Section 8 Existing Housing program. Payments would be determined by household income and an estimate of local housing costs and set at levels that allow recipients to rent private, unsubidized housing.

such assistance in a cost-effective manner. In some cases a higher level of operating subsidy could be approved; in others, sale, deprogramming, freeing up rents, or other options could be chosen. How the opportunities and limitations of individual projects could be addressed by the various options is detailed below.

Option 1: Retain the Project in Public Ownership

The Federal government should remain willing to continue annual support to a project to enable it to remain in public ownership as low-income housing as long as the total cost to the Federal government is within limits defined below, the PHA agrees to continue serving low-income households—those with incomes below 50 percent of median income—and tenants are required to pay only a modest portion of their income for rent. The cost constraint should limit the Federal subsidy of operating costs to the lower of: (1) the amount required by the project according to the formula effective at the time of transition, or (2) the difference between the cost of aiding the same households through provision of housing payments and the debt service payment.

For example, if:

- debt service on a project is $110 per unit month, and
- the housing payment subsidy for the average unit size in the project with average tenant income is $200 (housing payment standard of $300 minus $100 tenant contribution), then
- the operating subsidy could not exceed $90 ($200 minus $110).

If the project would have received $80 under the operating subsidy formula at the time of transition, it would continue to receive that amount, annually adjusted. On the other hand, if the project would have received $108 under the formula, it would be reduced to $90—the difference between the housing payment subsidy and the debt service.

Under this option the local government and PHA could choose to retain in public ownership those projects that have total costs not exceeding the Federal cap. Localities may also choose to continue operating projects that are costly by covering deficits beyond the operating subsidy from other sources of income, when continued operation of a project is ascertained as the most cost-effective means of housing a project's tenants. For example, a PHA might sell some projects with high private market value to generate sufficient funds to support projects that are not viable without a subsidy above the level provided by the Federal government.

Option 2. Sell the Project or Convert to Homeownership

Many public housing projects are currently located on land that could be used for other purposes, either because the area is not a suitable residential environment but could well serve commercial, industrial, or public purposes, or because other possible uses of the land and/or buildings make it attractive to private-sector interests. For example, some public housing has been built in areas that have become increasingly industrialized over time, increasing the land's value for industrial purposes but rendering it less desirable for housing.

Similarly, some projects are located in neighborhoods that have appreciated dramatically and now are attractive for unsubsidized residential use. These could be sold to private interests through conversion to condominiums or cooperative ownership or for private rental housing.

If a locality wishes to sell such projects, the Federal government should allow such disposition as long as the indebtedness is paid off by the proceeds of the sale, continued assistance to the tenants is provided through housing payments, and any surplus of funds generated by the sale is dedicated to low-income housing purposes. However, local officials should not be permitted to sell a project unless, prior to the sale, there is satisfactory provision for relocation and continuation of assistance for the current tenants.

For example, a given 125-unit project may have a market value of $5 million, but an outstanding indebtedness of only $2 million. Since the Federal government would be likely to continue to pay an operating subsidy as long as such support was necessary to continue to provide assistance to the tenants, the cost of changing the nature of the assistance to housing payments is the difference between the operating subsidy and the housing payment subsidy. If the average cost of housing payment subsidies for the tenants is $200 and the operating subsidy is $110 per unit month, the net additional cost to the Federal government per unit month is $90. If the project were sold to private parties at the full market value, the $3 million gain, invested at 13 percent, would provide annual interest nearly three times as much as the net annual Federal cost and could be used to assist many additional households.

A subcategory of this option would include sale of units to tenants as individual units or under condominium or cooperative terms of ownership. For example, units in a project could be sold to tenants with a very low downpayment. Tenant purchasers also could receive housing payments to assist with the costs of ownership for as long as they were eligible.

Option 3: Deprogram the Project

Some projects have extremely high operating costs and/or serious social and physical problems, so that they are not good candidates for continued operation by the PHA. In these cases the restructuring or rehabilitation of the project is not cost effective, or the likelihood of correcting the project's social problems is considered remote. When this determination is made by the local government and PHA, the Federal government may agree to allow the PHA to deprogram the project, demolishing it or selling it for whatever price it brings, even though this might not be enough to pay off the indebtedness, simply to cut further losses.

For example, a severely troubled 300-unit project with operating subsidy of $250 per unit month and outstanding principal indebtedness of $3 million ($10,000 per unit), payable over a remaining bond term of 20 years (at 6 percent interest), may have no sales value at all, considering demolition costs. If costs to rehabilitate are $15,000 per unit or $4.5 million, to be financed under typical modernization terms of 20 years at an interest rate of about 10 percent, then the per-unit cost to operate the project after rehabilitation would be $473 per unit month ($73 in original debt service, $150 to amortize the rehabilitation, and $250 in operating subsidy). If the housing payments subsidy is $275 per tenant, it would be cost effective to demolish the project, to continue paying off the bonds, and to make housing payments to all the tenants at a continued per-unit cost of $348 ($73 to pay off bonds on a project no longer in existence and $275 in housing payments subsidy costs).

The Federal government should agree to demolish a project only if a continuously healthy physical and social environment cannot be provided at a reasonable cost, even with appropriate physical and management changes. Again, local officials should not be permitted to deprogram a project until provision satisfactory to HUD has been made for the relocation and continued assistance of project tenants.

Option 4: Free up Project Rents

Another option would retain the project in public ownership with the Federal government providing a debt service subsidy only (eliminating operating subsidy) and allowing the PHA to charge rents that cover operating costs. For some projects, this approach would be feasible and desirable.

Because of continued Federal subsidy of the debt service payment and legal restrictions associated with project financing, such projects should maintain some limits on tenant income eligibility. In most if not all cases, the Federal and State laws governing the issuance of project notes and bonds limit the use of the funds for housing low- and moderate-income households. However, established Federal rent income ratios would not be appropriate under this option because PHAs would need freedom to set a rent that covers operating costs, yet remains competitive in relation to the quality and location of the project and affordable by households within the eligible income limits.

The rent could be a "flat rent" (the same dollar amount charged to all tenants), or it could be adjusted according to income as in the current system; in any event, new rents would generally exceed current rates. Because public housing operating costs in 1980 averaged only $137.61 per unit per month, a very substantial portion of all projects should be able to charge amounts sufficient to cover operating costs while continuing to serve low- and moderate-income households.

The Federal government should provide housing payments to all present tenants of the projects. The tenants could use the housing payments to remain as long as they wished in the project or to move elsewhere in the community to publicly or privately owned housing. To the extent that the tenants gradually moved to other locations in response to changes in economic circumstances and family composition, the units would have to be marketed to the general public without any subsidy other than the project debt service.

This approach would provide a housing payments subsidy to all the tenants, whether they chose to remain in the project or not, and continue fully subsidized debt service. The total costs to the Federal government, therefore, would be higher than housing payments costs alone, although the cost per household might actually be smaller; in addition to all the previous tenants receiving subsidy, any new tenants moving into the project would benefit from the debt service subsidy.

Option 5: Alternatives Tailored to Unique Circumstances

Given the wide range of circumstances of individual projects—in market value, in attractiveness as rental property, and in debt service and operating costs—as well as the wide range of opportunities and limitations presented by a PHA's inventory, local government, the PHA and the Federal government should be free to work together to develop the best options for each project, not limited to a prescribed set of identified options. The guiding principle of this creative undertaking should be to provide adequate housing for low-income households in the most cost-effective manner. In some cases it may be appropriate to allow the operating subsidy to exceed the cost constraint.

Although generally all projects that would continue to receive operating subsidy should be constrained by the Federal subsidy cap, there may be cases where this constraint would result in an inadequate flow of funds to the project. In some such cases, the other alternatives discussed might not be feasible or attractive, and a slightly higher operating subsidy may be the most cost-effective approach.

For example, the project discussed under Option 1, which had operating subsidy of $108 per unit month and debt service of $110 per unit month, would be reduced to a $90 operating subsidy if the housing payment amount were $200 (the housing payment subsidy of $200 minus the debt service subsidy of $110 is $90). It might not be feasible to operate the project at $18 less per unit month, even with major deregulation and serious efforts toward management efficiency.

Options 2 and 3 might also not be appropriate. The project might be in good physical condition and relatively free of social problems. In addition, it might have indebtedness that exceeds its market value because the project is new and is located in a low-income area where property values are low. The loss that would result from selling the property and providing housing payments to the tenants could exceed the cost of providing a slightly higher operating subsidy to the project. For example, if sale of the property produced a yield that retires only half the remaining indebtedness, the cost of debt service plus the housing payments subsidy would be $55 plus $200, or $255 per unit month. The cost of retaining the project and paying the additional $18 per unit month above the operating subsidy cap would equal $110 debt service plus $108 operating subsidy, or $218 per unit month. Further, because the debt service is fixed, the future subsidy costs could increase with inflation at a lower rate than housing payments costs, which reflect average rent increases in the local market, taking into consideraton both financing and operating costs. Similarly, under Option 4, the cost of continuing to provide debt service and freeing up rents to cover operating costs while making housing payments to protect tenants would also be relatively costly ($110 debt service plus $200 housing payment, or $310 per unit month).

In such cases, the most cost-effective way to provide standard housing for the project's tenants may be to provide a level of operating subsidy that exceeds the cap.

Under this option, other special circumstances could be accommodated. For example, a more gradual deprogramming than feasible within the transition period may be more cost-effective in the long run. This option also could take into account households particularly unlikely to find adequate housing in the private market.

Feasibility of Available Options

In assessing the potential of each project to determine its future use, three primary perspectives are relevant—those of the tenants, the local government and PHA, and the Federal government. Each has considerable interest in the particular project's future and could view quite differently the attractiveness of any given option. Although local governments, PHAs, and the Federal government are sensitive to the impact on tenants, their assessment must also be influenced by issues of cost and feasibility.

Tenant's View

Tenants are the people most directly affected by change in the use of a project. The tenants would necessarily be concerned about any option that reduces available operating subsidies or results in the sale or demolition of a project. If projects are sold, either for a profit or at a loss (deprogrammed), tenants would be provided relocation assistance and continuing assistance through housing payments.

Any tenant's chance of successfully finding a unit in the private market is likely to be related to his or her race and family composition. Table 3.5 shows the difficulty of Section 8 households in becoming recipients within 60 days after they have been certified as eligible. During this period the eligible household must locate a dwelling that is within the rent limits and that meets or can be repaired to meet the program housing quality standard. The data do not give an absolute measure of

Table 3.5
Section 8 Enrollees (Certificate Holders) Failing to Become Recipients within 60 Days by Household Type

	Minority	Nonminority
1 person elderly	50%	42%
1 person nonelderly	54	51
elderly couples	66	50
younger couples	67	45
1 parent, 1–3 children	75	56
1 parent, 4 + children	78	76
2 parents, 1–3 children	60	57
2 parents, 4 + children	72	75
Totals	72%	52%

Source: Compiled from data of the U.S. Department of Housing and Urban Development, Office of Policy Development and Research, 1982.

failure because many agencies allowed more than 60 days to find a unit. It does, however, show that minority and single-parent households have more than a 50 percent likelihood of failure to locate a qualifying dwelling in the first 60 days, and that households with both characteristics—minority, single-parent households—have at least a 75 percent likelihood of failure. This evidence is confirmed by findings from one of the Experimental Housing Allowance sites, where 31 percent of all eligible applicants did not become participants, but the failure rate among minority single-parent households was 65 percent.[6] The composition of public housing tenants by race and household type was shown on Table 3.4 earlier; almost 60 percent of public housing tenants are members of minority groups, and 32 percent of these households have the added burden of single parenthood.

If PHAs choose not to continue to receive any operating subsidy in order to charge rents that covered their operating costs, the necessary rent for any unit would be significantly higher than the rents now charged the poorest tenants under the new statutory standard (30 percent of net income).

The Commission believes that to prevent any hardship to current public housing tenants, tenants should receive housing payments, either to pay the new public housing rents or to pay rents in the private market. The local government and the PHA should be responsible for assuring access to standard housing for tenants choosing to rent in the private sector. So that tenants could afford standard housing on the private market, the value of the housing payment available to public housing tenants entering the private market should be the same as that available to any other Housing Payments Program recipient in similar financial circumstances.[7] However, because debt service would continue to be paid by the Federal government, the full value of the housing payment should be withheld until the tenant moves into the private market, in order to prevent a windfall to the tenant. (A full discussion of the Commission's recommendations on housing payments appears in Chapter 2.)

Eventually, normal household decisions would lead many of the housing payments recipients to attempt to move, but the composition of public housing tenancy and private sector resistance to such tenants probably would make such movement relatively slow. It may be the case that the number of housing payments recipients in public housing would always be somewhat higher than in privately owned projects, assuming a greater willingness of public housing managers to serve these groups.

Because of the continuing Federal subsidy to the project in the form of debt service, PHAs would have to limit eligibility to low- and moderate-income tenants and charge rents that they were able to pay. Table 3.6 compares operating costs and tenant contributions. Clearly, the rents needed to cover operating costs are substantially higher than 1981 tenant contributions. Further, the operating costs (and necessary incomes) could be significantly cantly higher than currently is the case, once projects were dependent in part on unsubsidized tenants. This development could occur because a higher level of maintenance might be required to

Table 3.6
Comparison of Tenant Contributions and Operating Costs for Selected PHAs (FY 1981)

	Monthly Tenant Contribution	Total Monthly Operating Costs
Large PHAs		
Birmingham, AL	$61	$132
Boston, MA	67	274
Chicago, IL	58	211
Los Angeles, CA	101	163
New York, NY	140	277
Medium-Sized PHAs		
Greensboro, NC	84	142
New Bedford, MA	97	188
Peoria, IL	61	150
Small PHAs		
Inkster, MI	118	142
Mission County, PA	102	120
Temple, TX	71	77
National Average[a]	$91	$168

[a] 1980 statistics.

Source: From data presented in Joseph Riley, "Integration of Public Housing With a Housing Voucher Program—An Overview," unpublished paper (Washington, D.C.: HUD, December 1981).

[6] Sheila Nateraj Kirby and G. Thomas Kingsley, "Helping Enrollees Meet Program Housing Requirements," working draft (Santa Monica, Calif.: The Rand Corporation, February 1982), p. 22, Table 240.

[7] If the housing payments were tied to the units, they would simply be a new form of operating subsidy on an alternative formula. HUD is currently examining such market-based subsidy options, which do not fall within the concept of a housing payments program based on privately owned units, market competition, and tenant locational choice.

market the project and also because, if modernization funds were not available to such projects, the PHA would have to establish a maintenance reserve account. Because a rent equal to average operating costs is only a small fraction of the median rent of private units, most public housing projects could be expected to be a "good deal" for low- and moderate-income renter households in most markets, even though the rents would be higher than those currently charged. This would be true even for those projects that are not particularly attractive or well located.

As the low-income tenants now in public housing gradually used their housing payments to move out of public housing, the new occupants would be comprised of somewhat more moderate-income tenants, low-income tenants with housing payments, and low-income tenants moving in without housing payments and paying a relatively high percentage of income for rent.

View of the Local Government and PHA

To assure continued provision of adequate housing for the tenants, a locality must be primarily concerned with financial feasibility—that is, whether the project can remain viable as public housing under the cost constraint, can continue as housing without operating subsidy, or must be sold. Such a determination depends on the value of the property, the rent that could be charged to the general public, the operating costs and debt service, and the housing payments standard in the locality.

The data currently available do not provide an adequate basis for prediction of the number of projects that would be feasible under any of the options, but some general observations can be made of the feasibility of various options for low- and high-cost projects.

Projects with Relatively Low Total Costs. According to a draft HUD study, 85 percent of the PHAs have average costs less than the cost to serve the same households with the Section 8 Program.[8] If the payment standard for the housing payments program (and thus the cost constraint for public housing) is set at the Section 8 Fair Market Rent, most of the projects in these PHAs would be feasible under Option 1 (retaining the project in public ownership with an operating subsidy). In other PHAs whose average costs are higher, there would be many projects whose costs were within the cost constraint. If the payment standard is set below the current Fair Market Rents, fewer projects would be feasible under the option. For example, if the standard were lowered 7 percent (about $20 per month on average), there would be 76 percent of PHAs with average costs below the cost constraint.

In addition, it is likely that most, if not all, such projects would be feasible under Option 4 (free up project rents, retaining debt service subsidy only). If debt service coverage remained, rents would have to cover only operating costs. Because their overall costs would be low, their operating costs would also probably be relatively low, and therefore only modest rents would be required.

Projects with relatively low operating costs could also be considered for sale or deprogramming (Options 2 and 3), depending on their market value and their social and physical condition. If the project had a high market value, the proceeds could cover the cost of retiring the bonds and provide significant additional funds for new low-income housing activity by the PHA. The desirability of deprogramming depends on the cost of continuing to operate the project with any needed modernization (provided by the Federal government through Annual Contributions Contracts), as compared with the cost of making housing payments over some period of time and paying off that portion of the debt service not covered by the proceeds of the sale. In considering the deprogramming of severely troubled projects, PHAs should consider the likelihood as well as the cost of restoring the project to good physical condition and establishing a healthy social environment on a sustained basis.

During the transition period, the local and Federal governments could also explore comprehensive local plans in which higher Federal costs for some projects were offset by relatively lower Federal costs for others. For example, a locality could propose to have unrestricted rents (and no operating subsidy) in some projects, to generate sufficient surplus income to support other projects receiving operating subsidy within the Federal cost constraint. Sale and deprogramming could also be considered and might be relatively efficient or costly, depending on the unique circumstances of each project, as well as the total PHA inventory.

Projects With Relatively High Total Costs. Fifteen percent of all PHAs have average costs above the Section 8 Fair Market Rent. Many of the projects in these PHAs as well as some projects in other PHAs with lower average costs could not be retained for public ownership with Federal subsidy of debt service and operating costs within the cost constraint.

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[8] Information provided by Office of Policy Development and Research, HUD.

Operation of many relatively high-cost projects would be feasible under Option 4 (free up project rents, retaining debt service subsidy and providing housing payments to tenants). As long as the operating costs did not require a rent larger than both housing payments recipients and unassisted tenants would pay, the project would be able to pay its bills. Because most housing payments recipients would remain in the project, temporarily at least, the willingness of unassisted tenants to pay rents that cover operating costs would be felt only gradually. Sale or deprogramming could also be considered.

The Federal Government's View

The Federal interest in assessing the options for any given project is to continue to serve low-income households, but to do so in a cost-effective manner. Figures 3.2, 3.3, and 3.4 illustrate the cost impact of the various options on projects with low and high operating costs.

Low-Cost Projects. In most cases, low-cost projects would be most cost-effectively operated under Option 1, and could, within the Federal cost constraint (the housing payments subsidy cost), provide adequate housing for very low-income households.

Option 2 (sale of the project) might yield significant proceeds with which low-income housing activity could be conducted. If a locality wished to propose such action, the Federal government would have to weigh the disadvantage of higher per-household costs for the tenants previously housed in the project (because housing payments costs in this case are larger than the sum of the previous debt service and operating costs) against the benefit that could flow from the proceeds of sale. The PHA's proposal to sell, for example, might be approved on the condition that HUD financing of housing payments for the tenants would be limited to the amount of the previous subsidy, requiring the PHA to make up the difference to provide a full housing payment. (See Chapter 2 for a discussion of payment levels in the proposed Housing Payments Program.)

Option 3 (deprogramming) might be considered even for low-cost projects if they had significant physical and social problems and if modernization could not create a healthy environment likely to be sustained at reasonable cost. Federal costs would increase, as compared with previous costs for the project, both because housing payments costs would exceed the sum of debt service and operating subsidy and because deprogrammed projects might not yield sufficient returns at disposition to pay off their current indebtedness. As compared to the cost of rehabilitating the project and continuing operation, deprogramming could be less costly.

Option 4 (freeing up project rents) is a very attractive option to tenants because it provides tenants the choice of staying in the project or moving, both with subsidy. This approach would also likely be attractive to PHAs for many projects because it permits the PHA to charge a flat rent to subsidized and unsubsidized tenants without raising the contribution of current tenants, who would be protected by housing payments. However, from the Federal government's point of view, it would be less attractive because it is extremely costly. The full housing payments cost on top of debt service would significantly increase costs in any project that was previously a low-cost project. Conceivably, however, if the project were attractive enough to be operated at a substantial profit, and such profit could be used to offset costs in another project that had no viable alternative within the cost constraints, Federal approval might be forthcoming. This option also has an additional benefit. Although the apparent per-unit cost is high, the per-household cost may not be high; if the housing payments recipient moves out of the project and is replaced by another tenant, two households are subsidized, one by the housing payments, and one by the debt service only.

Option 5, which is not shown on the figures, is simply the opportunity for the Federal and local governments to develop subsidy and management alternatives other than those described here.

High-Cost Projects. The desirability of various options for high-cost projects, from the Federal point of view, would be largely determined by how high the operating costs are and the extent to which the project can be maintained in good condition at the same or lower cost under the possible options.

Option 1 is attractive because it could result in significantly lower costs; however, it may not be reasonable to expect that the project can be operated at the level of the cost constraint. For example, the project's relatively higher costs might reflect that it is new and therefore has large debt service resulting from the higher interest and construction costs typical of newer projects. Because such costs cannot be reduced, the project would not be feasible under Option 1.

Options 2 and 3 (sale or deprogramming) may be appropriate, depending on the value and viability of the project. Depending on how high the current project subsidy costs are, these options might or might not result in significant savings.

Similarly, Option 4 (freeing up project rents) might or might not be cheaper, depending on current project costs. In the case of those high-cost projects that are severely troubled, it is not likely that unassisted tenants could be attracted to move in and pay

Figure 3.2
Current Federal Costs in Low- and High-Cost Projects

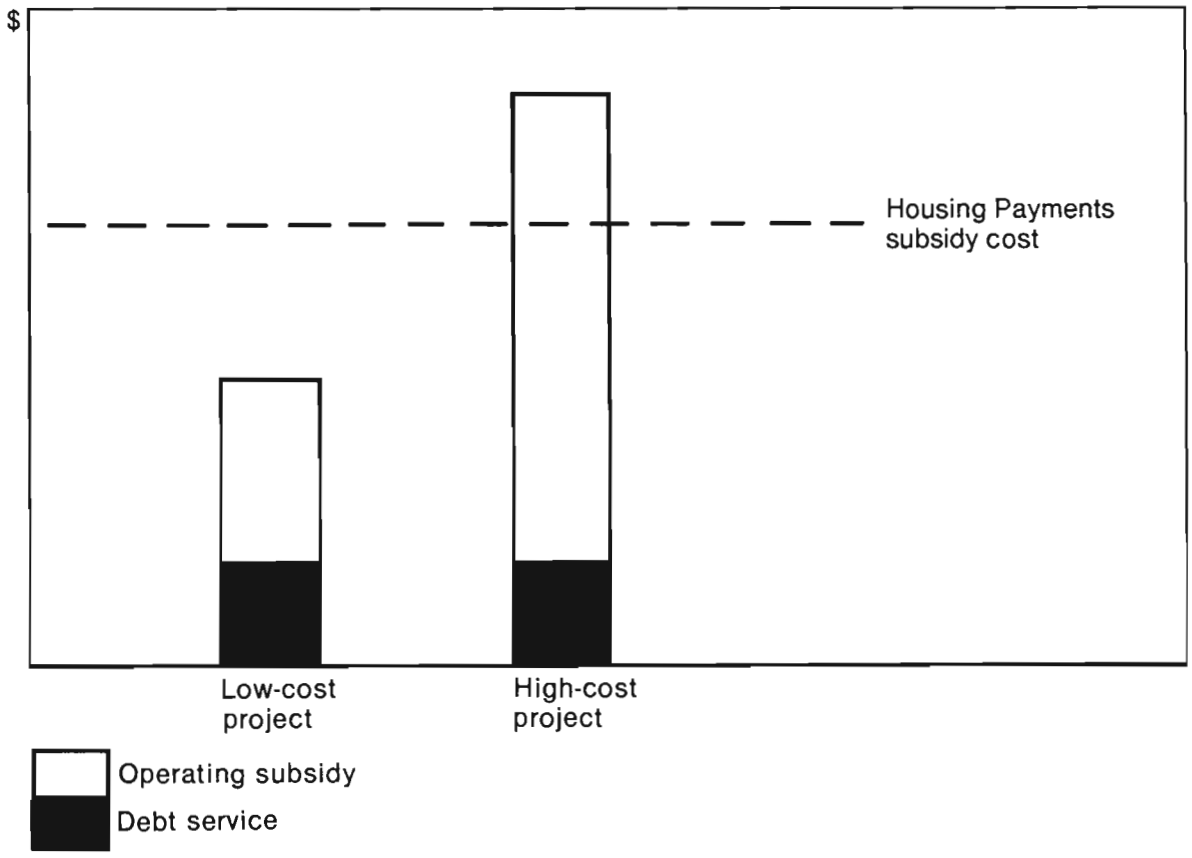
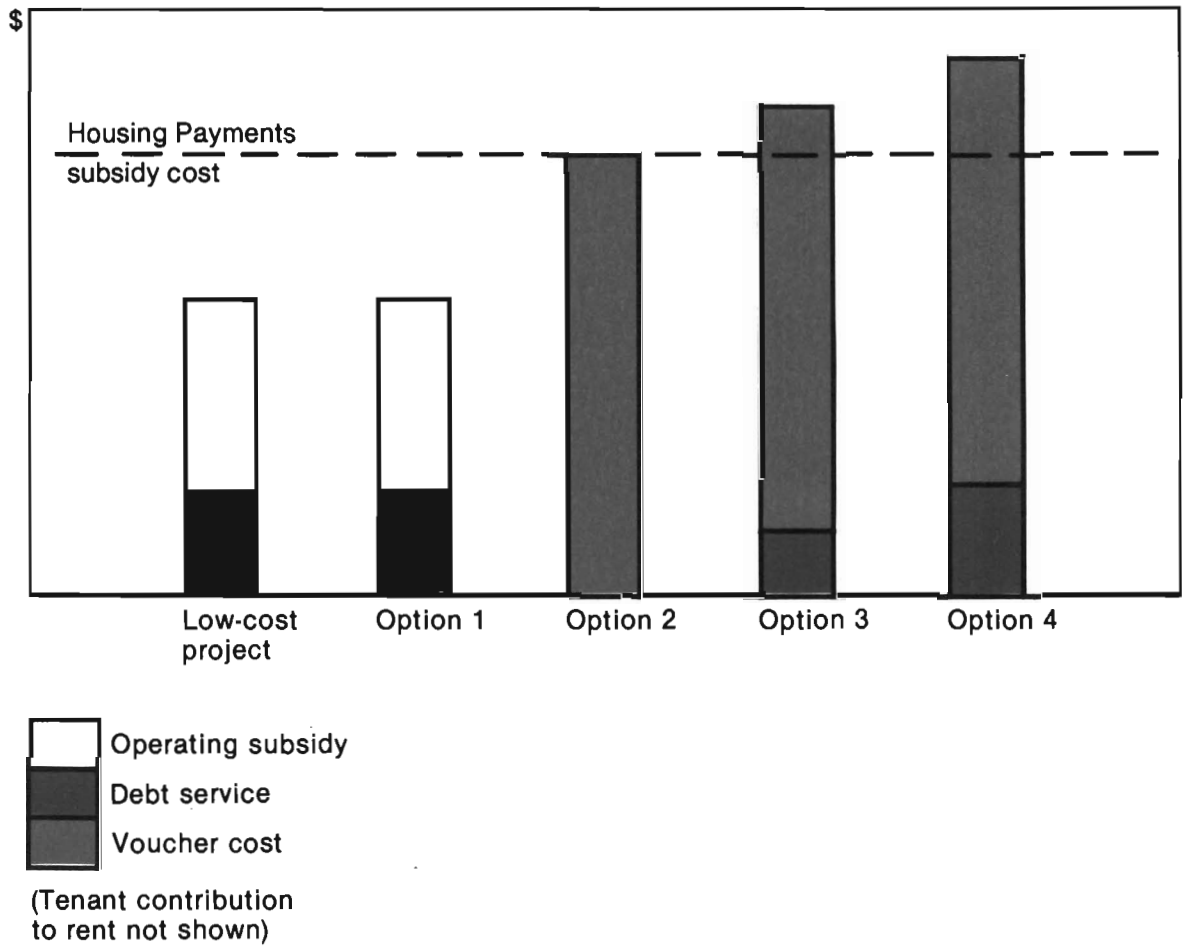
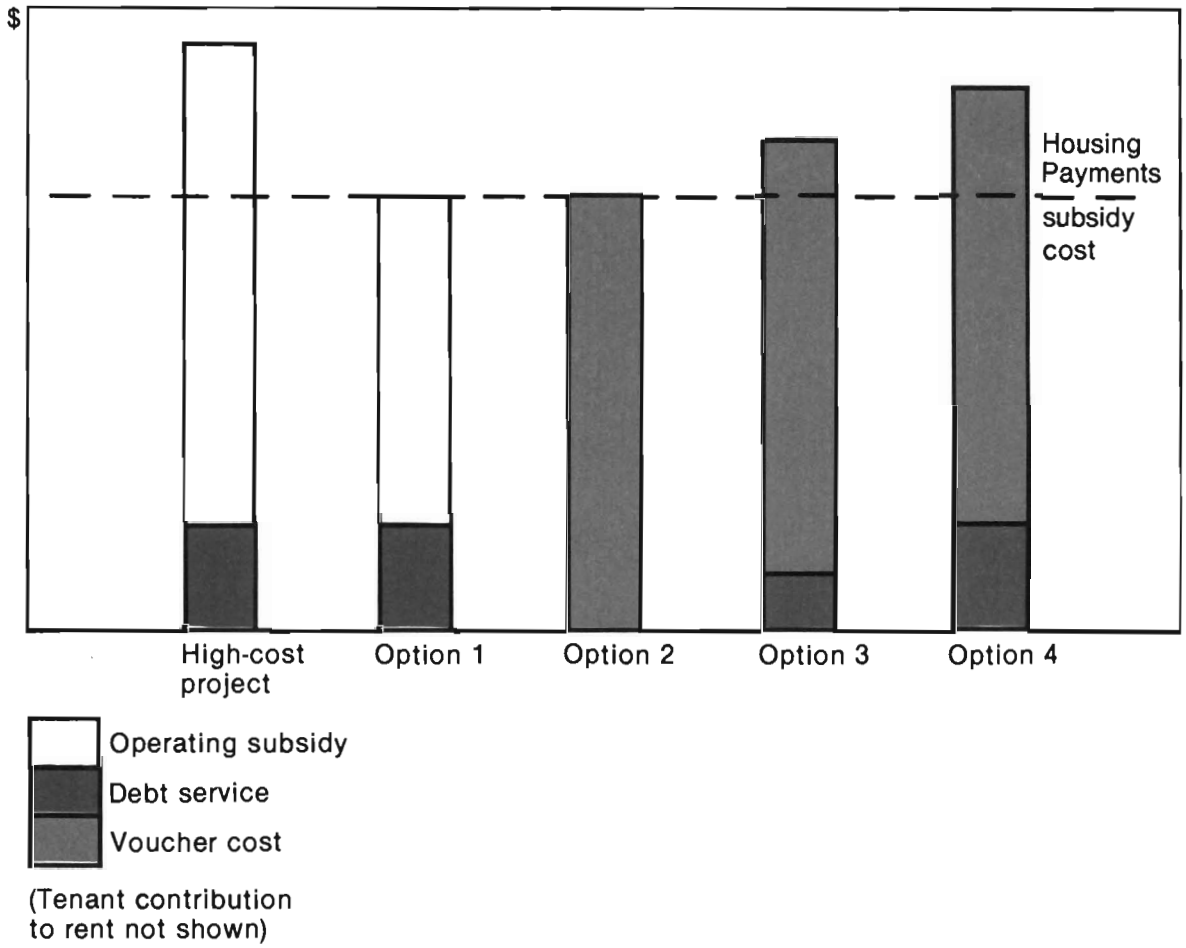


Figure 3.3
Cost Impacts of Various Options on Low-Cost Projects



Option 1	Retain projects as they currently operate and continue to serve same households.
Option 2	Sell projects for other use at cost that pays off indebtedness; housing payments to tenants; cost shown may be offset in whole or in part by proceeds of sale.
Option 3	Sell at cost that pays off only part of the indebtedness; housing payments to tenants.
Option 4	Continue with debt service in place and give housing payments to tenants.

Figure 3.4
Cost Impacts of Various Options on High-Cost Projects



Option 1	Retain projects as they currently operate and continue to serve same households.
Option 2	Sell projects for other use at cost that pays off indebtedness; housing payments to tenants; cost shown may be offset in whole or in part by proceeds of sale.
Option 3	Sell at cost that pays off only part of the indebtedness; housing payments to tenants.
Option 4	Continue with debt service in place and give housing payments to tenants.

rents sufficient to cover operating costs. Further, if such rents were charged in such projects, low-income tenants receiving housing payments might well look to the private market for units that provide a better environment for the cost and thereby create vacancy problems in the project. On the other hand, high-cost projects that are new, well-located, and/or relatively untroubled might be able to charge rents that cover their operating costs and result in lower total Federal costs.

Option 5 (an open-ended, local-Federal negotiation) may well be the best course of action for many high-cost projects. For example, it might be possible to reduce the need for operating subsidy well below current costs but not to the level provided by the cost constraint, and the most cost-effective option consistent with continuing to serve current tenants might be a level of operating subsidy that is somewhat above the cost constraint. The development of feasible and cost-conscious options for the use or disposition of the relatively high-cost projects would be a difficult task, challenging the creativity and commitment of both local and Federal governments.

CHAPTER 4

SPECIAL HOUSING PROBLEMS OF THE ELDERLY AND HANDICAPPED

For the most part, the Commission's proposals to assist low-income households apply equally to the elderly. Those proposals consist of housing payments to address the problem of affordability and a Housing Component in the Community Development Block Grant (CDBG) to address problems of adequacy and availability.

In the Experimental Housing Allowance Program, elderly households had greater success in moving from application to participation than did the nonelderly. As one study noted: "Even among those planning to move, elderly enrollees were more successful than the nonelderly in some locations. Some data suggest that, in tight housing markets, the elderly benefited from preferential treatment in the market; landlords perceived them to be more stable and desirable tenants than the nonelderly, and preferred to rent to them when market conditions allowed a choice."[1]

In the Experiment, elderly households searching for a suitable rental unit received considerable help from friends and relatives, telling them of available places, driving them around to look at units, and assisting them in dealing with the potential landlord.[2] However, low-income elderly homeowners, the frail elderly, and the handicapped have housing problems that require special approaches. These problems—physical and mental impairment, and low-income, high-equity financial status—are the subject of this chapter.

The number of people with such problems is likely to increase because Americans are living longer and growing older in record numbers. The "baby boom" of past decades will become the "senior boom" of the next century. At present, 11.2 percent of the population is 65 years or older. Census Bureau projections suggest that the proportion of elderly in the population will rise to nearly 20 percent by the year 2030.

Based on present trends, it is expected that the numbers of very old elderly—those over the age of 85—also will increase substantially (Figure 4.1). By 1999, there will be an estimated 1.4 million more very old people than at present. Many of these people will have chronic or long-term disabilities or illnesses that reduce their ability to live independently. The 1979 Annual Housing Survey indicates there were 6 million elderly headed households with one or more members with mobility impairments or health problems that limited their ability to move around in the home and to use normal household equipment and hardware.

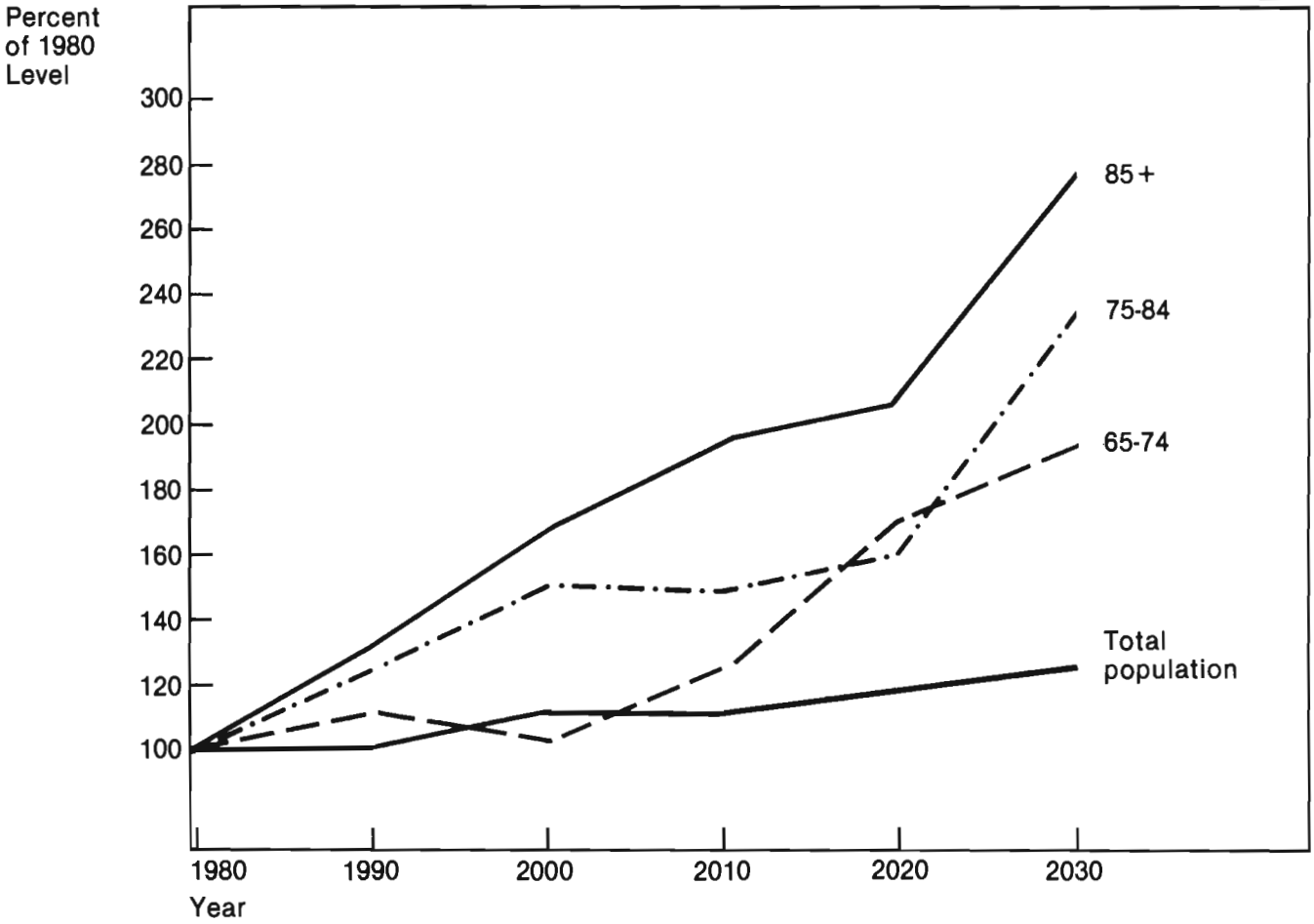
It is projected that the percentage of elderly with activity limited by some chronic condition will rise from 10 to 23 percent by 1990. Potential candidates for institutionalization, if unable to obtain needed services, are expected to increase by up to 3 million.

The frailties of old age need not result in institutionalization if accessible housing and adequate supportive sources are available. Similarly, non-

[1] Marian F. Wolfe, William L. Hamilton, and M.G. Trend, *Elderly Participants in the Administrative Agency Experiment* (Cambridge, Mass.: Abt Associates, 1977), p. ii.

[2] *Ibid.*, p. 36.

Figure 4.1
Projected Growth of Elderly Population Age Groups, 1980-2030



Source: U.S. Department of Health and Human Services, Health Care Financing Administration, "Long-Term Care: Background and Future Directions" (January 1981), p. 11.

elderly handicapped people may require specially equipped or designed housing and/or residential facilities that address both housing and social service needs in a setting that stresses independence.

The rate of homeownership among the elderly has increased steadily since 1950; as adults born after World War II reach age 65, the proportion of elderly homeowners is expected to be extremely high. Increasingly large numbers of elderly singles and couples will occupy relatively large homes, which often provide more space than is desired or necessary and have maintenance needs and utility expenses that may present serious difficulty.

Often, elderly homeowners are cash poor, although they may possess a significant amount of equity. Table 4.1 identifies the tenure of elderly households by income, showing that more than 11 million elderly households are owners, of whom more than 5 million have incomes below 50 percent of the median income. Many of these households pay a large proportion of their incomes for housing costs and/or have housing that is substandard (Table 4.2). Such elderly households need financial arrangements that allow them to use the equity in their homes to increase their incomes and to repair and rehabilitate their property.

This chapter discusses the housing needs of the frail elderly and handicapped and presents two recommendations addressed to the situation of low-income, high-equity elderly households—home-sharing and conversion of home equity into income. The recommendations are consistent with positions taken by the White House Conference on the Aging.

Table 4.1
Elderly[a] Headed Occupied Housing Units, 1978
(Units in Thousands)

Percent of Area Median Family Income[b]	Total Occupied Units	Owner Occupied Units	Renter Occupied Units
All	15,844	11,283	4,561
0–30%	4,629	2,610	2,019
31–50%	3,978	2,761	1,216
51–80%	3,303	2,655	648
81–120%	2,099	1,716	383
121% +	1,835	1,540	295

[a] Age 65 or older.
[b] The national median family income in 1978 was $17,640.

Source: Data computed by the U.S. Department of Housing and Urban Development from the *Annual Housing Survey* (Washington, D.C.: U.S. Government Printing Office, 1978).

Frail Elderly and Handicapped

The Commission recognizes the special housing needs of the frail elderly and the handicapped and recommends that these needs be addressed by special programs. The Commission further recommends that a White House task force be established to develop a policy framework for addressing these housing needs in the context of the social and health needs of this group.

The nation's frail elderly and nonelderly handicapped citizens range widely from those who require full-time supervision in an institution to those who can live independently if appropriate services or accessible housing are provided. Mobility-impaired persons require housing that permits access and ease of movement by wheelchair and without stairs, as well as safe and convenient bathroom, kitchen, and other facilities. Persons with other handicaps, such as blindness or deafness, also require special housing facilities. The chronic mentally ill and the retarded handicapped comprise a large population whose treatment and care in recent years has shifted from institutional settings to integration into the larger community. The provision of community-based care often depends on the availability of small group residences that provide supportive services as well as opportunities for independence.

The housing needs of many frail elderly or handicapped persons could be met through a combination of housing payments and block grants. For example, many such households could receive housing payments to address affordability problems and live in conventional rental housing with modest adaptations to building features or provision of health and social services in the home. Adaptations such as ramps and widened doorways could be funded through the Housing Component of CDBG, and services such as visiting nurses and delivery of hot meals could be funded through health and social services grants. However, such an approach will not always be the most cost-effective or satisfactory method of meeting the needs of this group for accessible building design and supportive health and social services. Other approaches that allow for new construction that includes special services and facilities to meet these special needs should be explored.

Categorical new construction programs of the Department of Housing and Urban Development (HUD) and the Farmers Home Administration (FmHA) have served many elderly households. In fact, HUD's Section 8 New Construction program—including projects utilizing Section 8 subsidies in combination with private financing insured by FHA and tax-exempt financing provided by local and State housing agencies—has primarily served elderly households. Among the elderly households

Table 4.2
Income and Housing Conditions of Elderly Homeowners, 1978[a]

	Total	0–30% of Median Family Income	31–50% of Median Family Income	51–80% of Median Family Income	81–120% of Median Family Income	121%+ of Median Family Income
Occupied Units (in thousands)	11,283	2,610	2,761	2,655	1,716	1,540
Inadequate[b] Percentage	10.6%	21.1%	10.9%	7.3%	5.3%	3.7%
Adequate but crowded[c] Percentage	0.5	0.2	0.3	0.6	0.8	0.5
Adequate and uncrowded, but housing costs exceed 30% of income[d] Percentage	11.0	30.4	12.4	3.1	0.9	0.5
Total: Inadequate, crowded, and/or housing costs exceed 30% of income Percentage	22.0	51.7	23.5	11.0	6.9	4.7

[a] Age 65 or older.
[b] A housing unit is physically inadequate when there are plumbing, maintenance, public hall, heating, electrical, or sewage defects and flaws. This measure differs from the CBO definition of inadequacy used elsewhere in this report.
[c] A unit is crowded when there is more than one person per room.
[d] Housing costs exceed 40 percent of income for owners paying into mortgage principal.

Source: Data computed by U.S. Department of Housing and Urban Development from the *Annual Housing Survey* (Washington, D.C.: U.S. Government Printing Office, 1978).

served, as well as the nonelderly households, a fairly large number are reported to be disabled or handicapped, terms that would include many frail elderly. Eleven percent of the tenants in the Section 8 New Construction program[3] and 13 percent in public housing[4] are handicapped or disabled.

The Section 202 program, which is a direct Federal loan program for the elderly and handicapped utilizing the Section 8 program for tenant subsidies, provides units accessible to those with various degrees of disability. Since 1977, program emphasis on the nonelderly handicapped has resulted in the reservation of over 10,000 units for such use.

However, the new construction programs, including Section 202, have primarily served households that do not have physical or mental impairments requiring the special design and service features that can be provided through new construction. And, as discussed in Chapter 1, the construction programs have been very expensive, serving a limited number of households at a very high cost to the government. The Section 202 direct Treasury loans also increase the total amount of Federal borrowing, which competes with private borrowing on the capital markets and provides an implicit Federal subsidy in that the interest rate is lower than it would be without the direct backing of the Federal government. Some programs specifically designed to provide specialized housing do meet the needs of the frail elderly and handicapped, such as the HUD Congregate Housing Services Program and the FmHA Congregate Housing demonstrations; these programs are being evaluated by the sponsoring agencies to determine their impact on residents and as housing options. The Commission notes the importance of these evaluations and suggests that other programs also be evaluated to determine their effectiveness in serving specialized residential and supportive needs.

The projected growth of the elderly population indicates the prospect of rapidly increasing health, social, and housing needs that the nation has just begun to recognize. Further investigation of housing program alternatives for the frail elderly and the handicapped is warranted. The Commission recommends that special programs be developed to meet the housing needs of this group in the context of their broader needs for special services.

Home-Sharing and Accessory Housing

State and local authorities should act to permit home-sharing by elderly homeowners, including rental of rooms and construction of accessory apartments.

Obtaining additional income through sharing of the space in one's home is not a new idea, but it is one of the ways in which elderly homeowners can use their resources to meet needs for cash and for companionship and assistance while maintaining a home. The current term "home-sharing" spans such possibilities as renting rooms and adding kitchen and bath facilities to create accessory apartments. Such conversions can allow elderly homeowners to afford to stay in their homes. On the other hand, communities often are concerned about the extent to which conversions might affect parking, health and safety, or simply neighborhood character.

Alternative housing arrangements include new, separate living units, termed "accessory apartments," created from excess space within existing single-family housing owned by elderly people. They also include specially designed modular housing units that can be located in the yard space of a home owned either by an elderly person or by people wishing to provide such arrangements for elderly persons. Such housing arrangements would help many elderly people to maintain their self-sufficiency and independence, provide additional income from rental, increase security and companionship, and diminish premature or inappropriate institutionalization at high private and public cost.

The potential for home-sharing is demonstrated by data from the Annual Housing Survey. In 1979, there were 12.2 million one- or two-person homeowner households headed by persons 55 or older living in homes of five rooms or more. Individuals and married couples in this age group are likely to be living alone, with their children grown and gone. These older people need greater flexibility in choosing ways to use their homes as a resource.

The Commission encourages local governments to relax zoning and/or land-use regulations, while maintaining requirements for health and safety, to allow greater flexibility so that elderly people can meet their housing needs through home-sharing and accessory apartments. This approach is consistent with the Commission's recommendations on regulations, which call for the elimination of zoning restrictions except where a vital and pressing need exists.

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[3] Tabulated from data in Abt Associates, *Participation and Benefits in the Urban Section 8 Program: New Construction and Existing Housing* (Cambridge, Mass.: Abt Associates, Inc., January 1981), p. 77.

[4] Public housing tenant data, 1977, Research Inquiry System, HUD.

The Conversion of Home Equity into Income

The Commission endorses the use of mechanisms to enable older homeowners to convert their home equity into income while remaining in their homes, and recommends that the Department of Housing and Urban Development, the Federal Home Loan Bank Board, and the Internal Revenue Service facilitate and encourage the use of such mechanisms.

The Commission believes that the private market will make available reverse-annuity and deferred-payment loan programs and sale-leaseback arrangements for elderly homeowners wishing to use them. The Federal government should facilitate this process and provide information and model programs that would ensure that such programs do not create unnecessary risks for either the borrower or the lender.

Lenders and private companies have begun experiments on a number of ways to achieve this objective, including reverse-annuity mortgages, sale-leaseback arrangements, and deferred-payment loans. According to some estimates, the present potential market for such home equity arrangements totals $30 billion to $40 billion. Further, this market can be expected to grow as the number of older Americans increases and as the idea of home equity conversion gains acceptance.

Most American homeowners prefer to remain in their homes unless they become too ill. They would be best assisted by alternatives that maximize the use of their own assets and resources, including their home equity. Through equity-financing techniques, innovative debt instruments enable the elderly owner to exchange equity in a home for continuous cash payments from a lending institution or an investor, without selling the home. The homeowner gains supplemental income and the investor gains a claim to a portion of the property's value.

The reverse-annuity mortgage (RAM) is a secured real estate debt instrument that allows the homeowner to draw against home equity as an asset, giving the homeowner-borrower additional income. RAMs can be structured to provide monthly payments for a fixed term of years or for the remainder of the borrower's life. All RAMs involve, in one form or another, purchase of annuity contracts with funds received from nonamortizing mortgage loans (the term "annuity" refers to any series of payments made or received at regular intervals of time). The lender makes periodic payments to the borrower under the annuity and is repaid in the future from the property value. RAMs must be carefully planned and tailored to prevent any unnecessary risks to lenders or borrowers.

Across the country, a handful of lenders are testing this new lending approach by making RAM loans for fixed terms. These efforts should be carefully evaluated to obtain the actuarial and lending risk data needed to assess the interaction of longevity, prepayment, appreciation, and property risks, and to provide the basis for developing this tool for wider use.

Deferred-payment loans are another innovative technique that can be used to assist elderly owners in maintaining and repairing their homes. Such loans are simply a variation on the reverse annuity, providing a lump sum, rather than periodic payment, repayable with interest at the time of sale. A recent study by the Administration on Aging estimated that the homes of at least 2 million low-income older people need major repairs. Other elderly homeowners require funds to make modifications to accommodate a wheelchair or to provide for other self-help or mobility needs so that they can continue to care for themselves in their own homes. Most of these homeowners are reluctant to borrow or would not qualify for home repair loans because their monthly cash incomes are too low. Deferred-payment loans permit elderly homeowners to defer payment of all principal and interest until their homes are sold, and thus preserve existing housing without increasing the housing cost burdens of low-income elderly homeowners.

Another alternative for elderly homeowners is the sale-leaseback or split-equity arrangement. Under these techniques, an investor buys out the homeowner and leases the property to the owner rent-free for life or for a fixed term. The elderly owner benefits by having all or part of the cash value of the house immediately available for current needs. The investor becomes responsible for paying off any existing mortgage debt, for making a cash down-payment settlement, and for paying an annuity to the owner for life. Or the investor may make a full cash settlement for the acquired equity, the proceeds of which are used to buy an annuity or are otherwise invested for the owner. The owner becomes a renter with the right to continued occupancy and, perhaps, with obligations to maintain and care for the property. Upon termination of the rent-free lease, the investor may dispose of the property and receive all proceeds from the sale. The position of the Internal Revenue Service on sale-leaseback and split-equity arrangements should be clarified, as suggested below.

All of these various equity-conversion arrangements—reverse annuity, deferred-payment loans, sale-leasebacks—can be used singly or in some combination, depending on the needs of the individual homeowner. Research and experimenta-

tion should be continued in these areas, and services should be developed to provide information, counseling, and homeowner protection.

Regulatory and other barriers now prevent the widespread use of equity-conversion arrangements. Further study, and government action, are required to overcome these barriers. As discussed below, three Federal agencies can be useful in facilitating the use of home equity by the elderly.

Department of Housing and Urban Development

The Department of Housing and Urban Development should convene an advisory committee to determine how best to develop a meaningful, effective, private market for a suitable variety of equity-conversion instruments for elderly homeowners. Members should be drawn from a broad spectrum of financial, legal, and other backgrounds, including representatives of elderly groups. The committee should make recommendations about development of appropriate model instruments and of programs for reverse-annuity and deferred-payment loans, use of mortgage insurance for such loans, and development of a secondary market for such loans.

Federal Home Loan Bank Board

Federally chartered savings and loan associations may make RAMs under wide discretionary authority provided in recently issued Federal Home Loan Bank Board (FHLBB) real estate lending regulations. Certain disclosures are required of the borrower, and any annuity must be purchased from an insurance company authorized to engage in such business and supervised by the State in which it is incorporated.

At present, however, FHLBB real estate lending regulations do not permit lump-sum disbursements. The regulatory description of reverse annuity mortgages, issued by the FHLBB, specifies disbursements in monthly payments; it does not explicitly permit one-time, lump-sum disbursements with payments deferred until maturity, or lines of credit secured by home equity. Although associations can invest up to 5 percent of assets in loans not conforming to regulatory requirements, they prefer to use this authority for high-yield investments. Associations also can invest up to 20 percent of assets in consumer loans, which can be lump-sum loans with payments deferred until maturity, or line-of-credit disbursements. However, for such loans, interest rates are likely to be higher, terms shorter, and loan amounts smaller than for real estate loans. In order for the elderly to obtain lump-sum disbursements against their home equity, lump-sum payments or line-of-credit disbursements should be authorized. Payments in such forms would facilitate rehabilitation and maintenance by owners under deferred-payment loan arrangements.

Internal Revenue Service

The Internal Revenue Service should issue regulations authorizing depreciation deductions for buyers and excludability of capital gains for elderly sellers for sales with leaseback provisions or, if necessary, submit appropriate legislation to clarify this issue and to facilitate sale-leaseback arrangements.

This alternative should permit the elderly owner-seller to take the allowed one-time capital gains tax exemption (up to a $125,000 gain for persons aged 55 or older), while permitting the investor-buyer to deduct depreciation on the property rented to the elderly owner-seller.

For a sale-leaseback to be a financially viable transaction for both parties, the buyer must be able to depreciate the property. But the depreciability of the property depends on the precise form of the transaction. Specifically, it depends on what is sold and what is retained by the seller. At one extreme, the homeowner could sell the house outright, retaining no legal rights to the property whatsoever. In this case, the buyer would immediately own the home fully, as the seller once did. The seller could rent the house, but would have no secure right to do so. In this transaction, the buyer clearly can claim depreciation on the property.

At the other extreme, the owner could simply sell the remaining interest in the home. In this case, the seller would retain title (technically a life estate) and would be fully responsible for the home throughout the life of the seller, after which the buyer would become the owner. In this transaction, the buyer clearly could not claim depreciation on the property as long as the seller lived. Neither of these examples is an acceptable sale-leaseback transaction for both parties. In the first case, the buyer obtains depreciation rights but the seller has no occupancy rights; in the second, the buyer is unable to claim depreciation. Workable sale-leaseback arrangements need both.

Present Federal tax law is silent on such arrangements, and the sale-leaseback remains in limbo between the seller's capital gains deduction and the buyer's depreciation deduction. Internal Revenue Service regulations do not clearly describe the precise conditions that must be present if the buyer is to depreciate the property. Until this tax question is clarified, private investors will show little interest in sale-leasebacks. This uncertainty is the most serious roadblock to private market use of sale-leaseback agreements. Legislation may be necessary to clarify the tax status of sale-leasebacks. The

revenue implications of this clarification cannot be estimated because it is not known how many elderly homeowners would avail themselves of this option. However, it is likely that many homeowners might consider this alternative safer than a reverse-annuity mortgage.

Section II:

HOUSING OPPORTUNITIES IN THE PRIVATE SECTOR

CHAPTER 5

INTRODUCTION: THE DYNAMICS OF THE PRIVATE HOUSING MARKET

The President's Executive Order charged the Commission to develop housing options that strengthen the ability of the private sector to maximize opportunities for homeownership and provide adequate shelter for all Americans. Most people meet their housing needs in the private, unsubsidized housing market, whether renting or owning. Although homeownership has long been an ideal, and a substantial majority of the nation's households now own their own houses, many continue to choose to rent or find that they simply cannot afford to buy their own homes. Both homeownership and rental housing were concerns of the Commission.

For much of the past four decades, the nation has made steady and substantial progress toward the goal of adequate shelter for all Americans. Each decade has seen a new record volume of housing production. Today, the American dream of owning one's own home is a reality for two of every three households, compared with fewer than half in 1940. The quality of American housing has been improving, and the vast majority of Americans now live in decent housing — primarily because of the capacity of the private sector to respond.

In recent years, however, a series of problems have beset housing, largely due to weakness in the overall economy. As a result of inflation and high interest rates, homeownership has become increasingly difficult to achieve for those who are not already owners. First-time homebuyers face large downpayments and high monthly cash costs, and both professional studies and media reports have focused on the "affordability" problem for these buyers. The most important task is to correct the problems of the economy. The primary contribution government can make to housing is to bring down the rate of inflation and to reduce mortgage and other interest rates.

Along with improvements in the economy, homeownership opportunities can be aided in other specific ways. Changes in the system of housing finance are needed, as outlined in Section III. The problem of saving for a first downpayment also requires consideration. Costs of housing need to be kept down by curbing excessive regulation, as described in Section IV, and opening up alternative forms of homeownership, including condominium and cooperative ownership and access to manufactured housing. In Chapter 6 the Commission examines a number of ways to encourage the continued availability of homeownership through the private market.

The rental housing market also deserves review. During the past 20 years, residential rents have not kept pace with general prices, consumer income, or operating and construction costs for rental units. In essence, rental housing owners are suffering from the exodus to homeownership of higher-income renters and from a squeeze on operating cost margins. While these trends have benefited renters, rent levels have not been high enough to sustain new construction or adequate maintenance of existing properties in many areas. Rent controls have complicated the situation in a number of communities and have further undercut incentives to produce or continue to provide rental housing. A sufficient supply of adequate, affordable rental housing depends on investment. If rental

housing is to be a viable form of investment, rents must rise to cover increasing operating and financing costs. Without such market incentives, present rental housing will not be maintained, new rental units will not be produced, and significant shortages of rental housing may occur in some areas. The Commission's analysis and recommendations related to rental housing are found in Chapter 7.

In addressing the concerns of homeowners and renters, it is essential that the nation take full advantage of its existing resources, especially the country's land and existing housing stock. Land has become an increasingly important component in the total cost of housing. While this is a nationwide trend, it is particularly acute in growing Western States, where housing and community development are sometimes severely limited by surrounding publicly owned land whose release for development can be ill-timed and poorly managed, thus contributing to inflation in land costs. Moreover, although new construction is essential to meet the nation's housing requirements, the existing stock of housing in the country provides a resource that should be better utilized in meeting both current and future housing demand. Just as the existing rental housing market provides the most cost-effective housing for those who need Federal assistance, most unassisted households will meet their housing needs through housing that is already built. Chapter 8 therefore examines opportunities in the private market to improve utilization of the nation's public and surplus lands and existing housing stock.

The remainder of this chapter reviews basic trends in the market for homeownership and rental housing. Shifts in the population and the economy can have profound influences on the housing market and the choices open to homeowners, renters, and suppliers of housing. Demographic trends show that the postwar "baby-boom" population will continue to form households and demand new housing during most of the 1980s. Given the low number of housing starts for the past several years, this demographic demand should sustain a strong level of housing production for much of this decade. Other demographic trends will also influence housing in the future, and these are examined below. The chapter first reviews recent trends and then discusses the future housing market.

Recent Trends in the Housing Market

Shifts in Homeownership and Rental Housing

The percentage of households owning their own home has increased steadily in the past two decades. Although the rental stock has expanded significantly, the rate of increase in owner-occupied units has been greater. Today, 66 percent of all households own their homes; this compares with a 60 percent homeownership rate in 1960 and below 50 percent for most of the first half of this century. The stock of owner-occupied housing increased from 32.8 million in 1960 to 39.9 million in 1970 (a 22 percent increase) and to 51.8 million in 1980 (a further increase of 30 percent). The occupied rental housing stock increased from 20.2 million in 1960 to 23.6 million in 1970 (a 16 percent increase) and to 28.6 million in 1980 (a 21 percent increase).

The difference in the growth rates of owner-occupied and rental housing reflects several factors, including rising incomes, inflation, and tax preferences accorded to owner-occupied housing. During the 1960s and 1970s, homeownership became an increasingly attractive investment because of capital gains and tax savings, and many rental households became homeowners. This increased homeownership demand led to conversion of the higher-quality rental stock to condominiums and cooperatives, as suppliers adjusted to changing market conditions. This tenure shift (from renting to owning) also led to a decline in effective demand for rental housing that, in turn, eventually led to reduced levels of rental housing construction and more rapid decline and abandonment of the lower-quality stock.

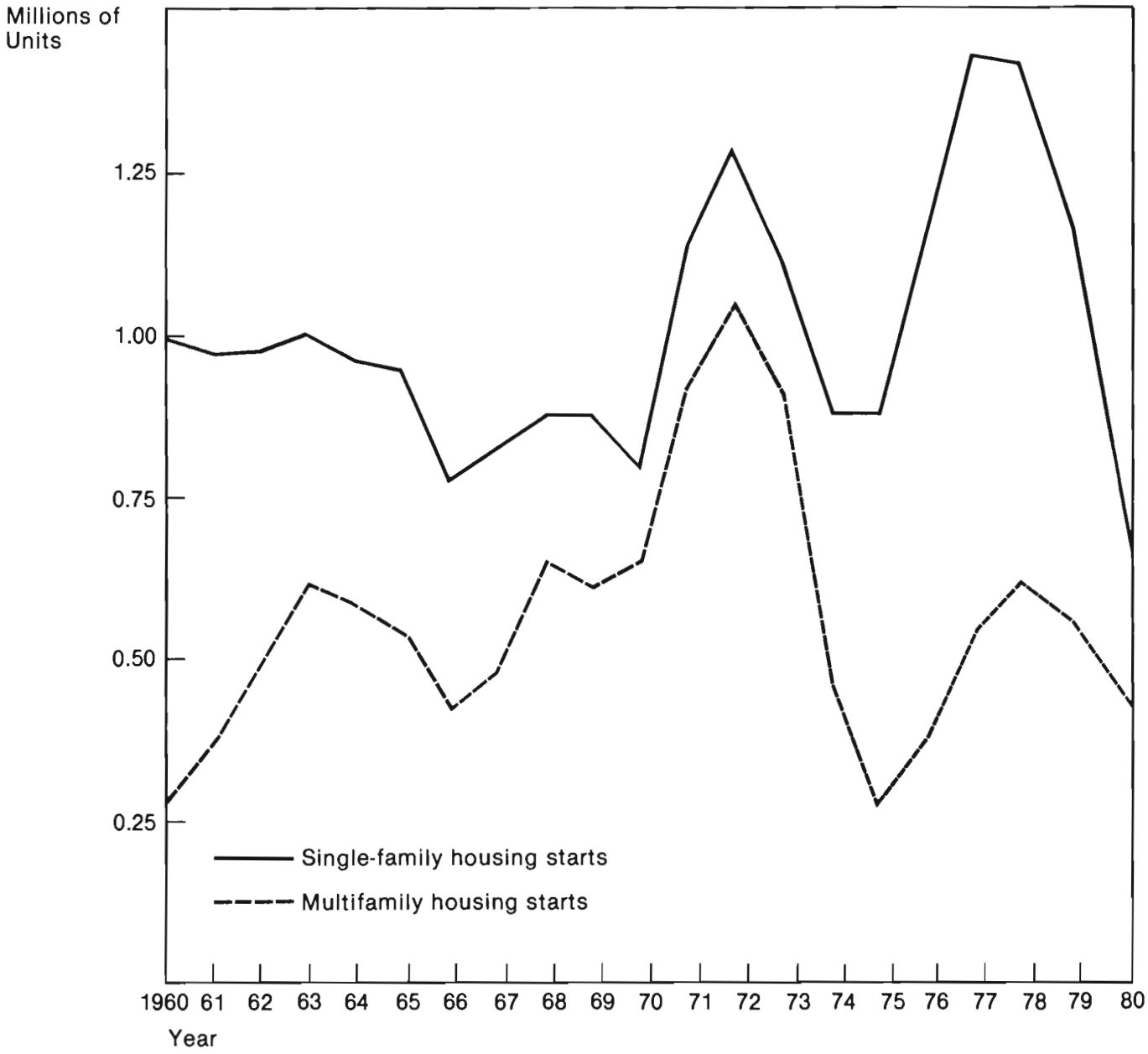
Rental housing production did not begin to respond to the shift in demand until the 1970s. Multifamily housing construction peaked during the 1968–72 period, at least in part because of Federal subsidy programs, and then fell quite sharply during the recessionary period from 1974 to 1976 (Figure 5.1). The proportion of total housing starts that are multifamily has been relatively constant since that time.

However, the proportion of total multifamily housing starts that are federally assisted has been rising since 1973, reflecting a decline in private, unsubsidized new construction (Figure 5.2). The decline in the private market share of multifamily construction reflects both the supplier response to declining rental housing demand and the substitution of federally assisted construction for private, unsubsidized construction. This substitution occurs primarily when federally assisted projects compete with unsubsidized projects for conventional sources of mortgage money. Subsidized single-family starts represented over a fifth of single-family starts in 1970 but declined during the mid-1970s to less than 10 percent.

Changes in Sources of Housing Supply

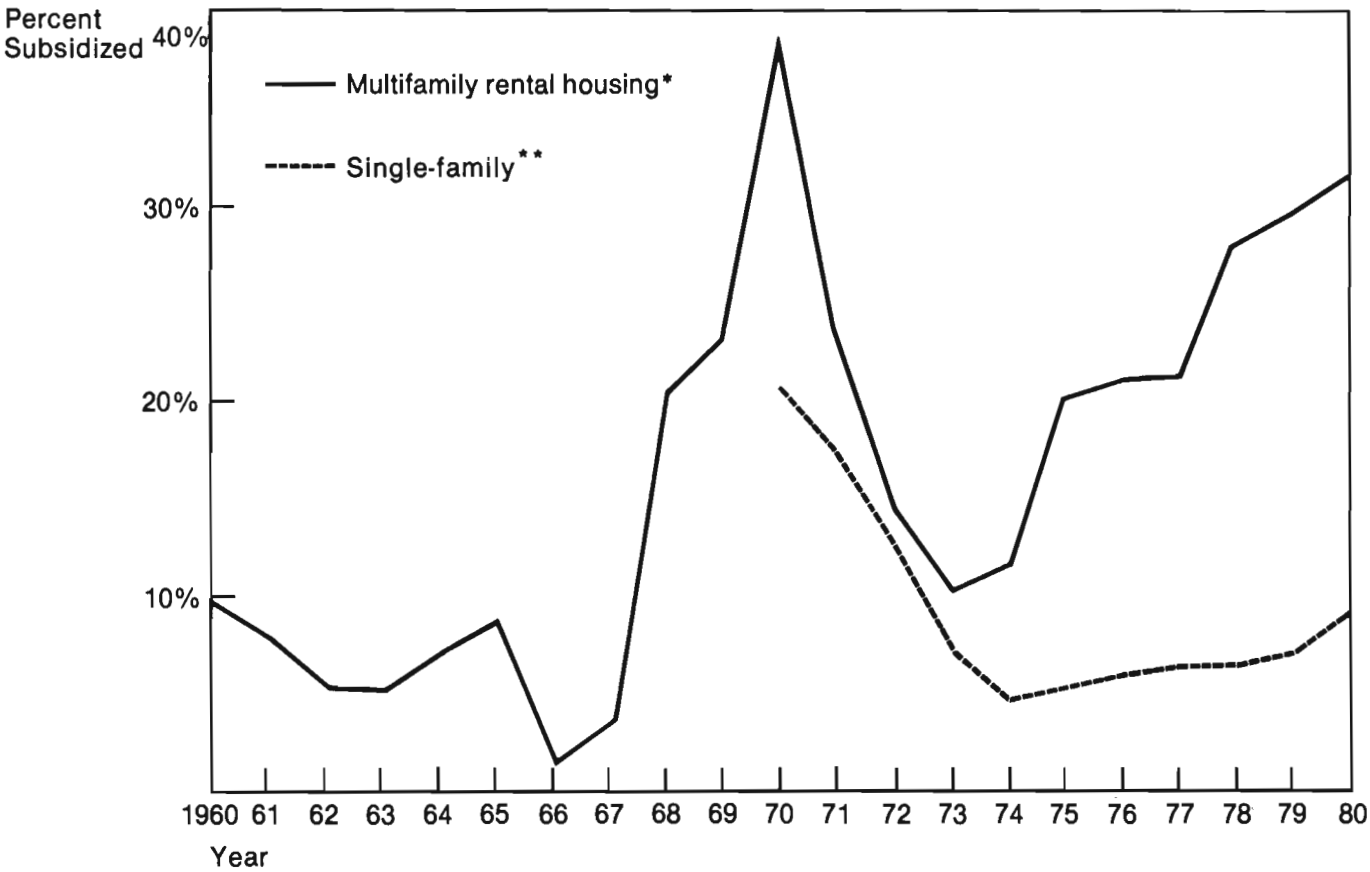
New housing production is an important source of housing, whether it be for renters or owners.

Figure 5.1
All Housing Construction Starts, 1960-1980



Source: Prepared from data provided by the Division of Housing and Demographic Analysis, Office of Policy Development and Research, U.S. Department of Housing and Urban Development.

Figure 5.2
Percent of Housing Construction Starts that Are Federally Subsidized, 1960-1980



* Includes Public Housing, Section 8, Section 202, Section 221(d)3 BMIR, Rent Supplement, and Section 236.
** Section 235.

Source: Prepared from data provided by the Division of Housing and Demographic Analysis, Office of Policy Development and Research, U.S. Department of Housing and Urban Development.

However, growth in housing supply results from a series of complex interactions between additions to the stock (through new construction or changes in the use of existing structures) and losses to the housing stock. Over the past three decades, almost 2 million units a year have been added to the housing supply. Although new construction is the primary source of additional units, other additions resulting from changes in the use of existing structures have become increasingly important (Figure 5.3). Use of these additional units includes the accommodation of new households (the primary use), replacement of units lost from the supply when a household's unit is demolished or otherwise removed from service, and contribution to the stock of vacant units. In any year, the additional supply from new and existing sources equals the uses — requirements from new households, replacements, and vacancy additions. That is, sources of additional units match uses of these units.

Looking first at sources of additional housing units, in the 1950s and 1960s new construction accounted for about 90 percent of the housing units added to the stock (Figure 5.3). In the early part of the 1970s (1970–73), the role of new construction increased dramatically — to almost 98 percent of units added. In the latter part of the 1970s (1974–79), new construction dropped to 76 percent of the units added. The remaining 24 percent (588,000 units) was provided by other additions to the stock — primarily restoration of previously uninhabitable housing units; conversion of large, obsolete units into several smaller, upgraded units;[1] and conversion of older nonresidential structures to residential use. Within the new construction category, mobile homes averaged 6 percent of all housing production in the 1950s and grew to 17 percent of production in the 1970s.

Uses of additional housing units also vary considerably over the years, although less dramatically, as shown in Figure 5.3. Household growth is the most commonly understood factor requiring additions to the housing stock. Over the past three decades, household growth has fairly consistently required about 60 percent of the average annual additional units supplied.

Replacement of losses from the housing stock is another important use of additional housing units. Some losses are permanent, and some are retrievable. Permanent losses include units demolished by fire, flood, or planned public or private action. Losses that are retrievable include units temporarily combined into larger units; converted to nonresidential uses; or rendered uninhabitable or condemned because of damage from natural causes or from abandonment, vandalism, or misuse. Losses from the housing stock were relatively high in the 1960s, averaging nearly 700,000 units annually, so that 36 percent of annual average additions to the stock were required for replacement. In the 1950s and 1970s, less than 30 percent of additions were accounted for by losses.

Despite relatively stable average annual losses in the 1960s and 1970s, in 1979 and 1980, annual losses declined to 450,000 a year. This underscores the role of conservation of the existing stock. The decline in annual losses from 700,000 to 450,000 represents a shift of a fraction of a percentage point in the rate of loss from the total housing stock -- from just over 1 percent a year to just under 1 percent.

Some units added to the supply remain vacant. Some level of vacancy is essential to permit mobility, so a net increase in vacant units is an important use of additional units (Figure 5.3).

These data clearly show that the increasing housing needs of the nation can be met in a variety of ways, and that both new construction (including manufactured housing) and reinvestment in existing stock are important sources of housing supply. Further, it is clear that in recent years (1974–79), reinvestment in the existing stock has played a large and significantly increased role by providing nearly a quarter of all additional housing units. The Commission's recommendations seek to support new construction and better utilization of the housing stock and to eliminate unnecessary barriers to development and reinvestment in housing. In particular, new construction should benefit from the Commission's recommendations on housing finance (Section III), housing deregulation (Section IV, especialy on zoning and building codes), and expensing of construction period interest and taxes for rental housing (Chapter 7). Use of existing stock is addressed in the recommendations for accessory housing (Chapter 4), allowing conversion and support of homesteading (Chapter 6), rehabilitation tax credits (Chapter 7), and use of public land and encouragement of neighborhood and historic preservation (Chapter 8).

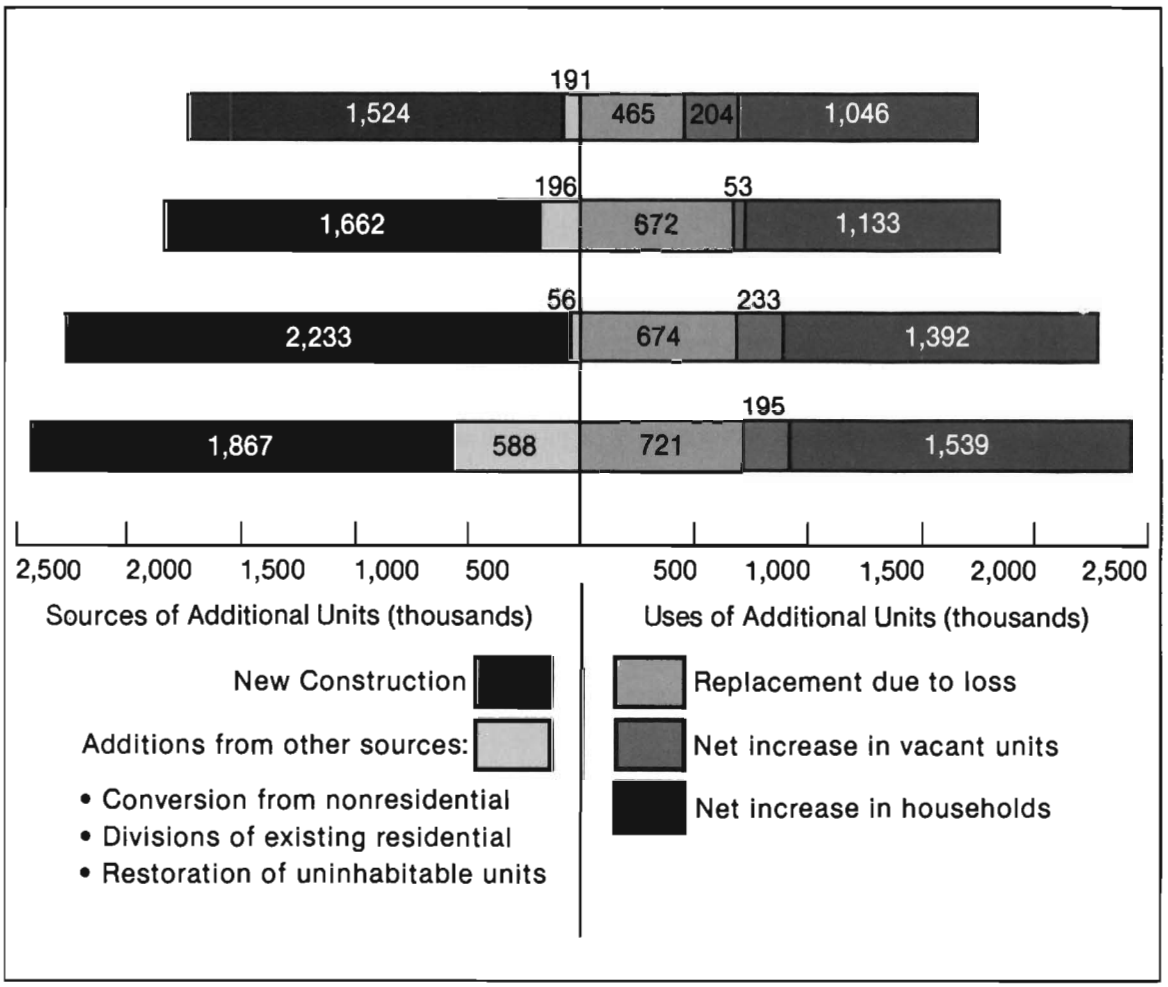
The Future Housing Market

Demand from Population Growth and Demographic Changes

Total demand for housing in the country ultimately is determined by the size of the population, but it is

[1] For example, approximately 318,000 apartments in buildings with two or more units were converted from single-family dwellings between 1970 and 1978, according to an estimate provided to the Commission by Ray Struyk and Thomas Thibodeau of the Urban Institute.

Figure 5.3
Additions to the Housing Supply: Sources and Uses
(Annual Averages, 1950-1970)



Note: The total for uses of additions to the housing supply equals the total for sources. The changes in occupied and vacant units are adjusted for the 1970 Census undercount of 900,000 occupied and 600,000 vacant units.

Source: Prepared from data in Duane T. McGough, "Housing Inventory Losses As a Requirement for New Construction," unpublished report (Washington, D.C.: U.S. Department of Housing and Urban Development, January 1981) p. 15.

the total number of households to be housed that more directly influences housing demand. Household formation is affected primarily by the age distribution in the population, but many factors influence the extent to which people at any age establish new households or maintain existing ones.

Household formation is strongly affected by the number of persons in the prime household-formation years — ages 20 to 35. Young people in the "baby-boom" generation reached adulthood in the 1970s during a time of rapidly expanding economic opportunity; the initial baby-boom surge in the demand for rental housing in the early 1970s was gradually transformed into strong demands for homeownership during the latter part of the decade.

Economic conditions and lifestyle factors also influence household formation. Economic conditions will, for example, influence the behavior of young people who are deciding whether to get their own apartment or to continue living in their parents' homes. The enormous growth in the number of persons receiving additional income through Social Security and welfare benefits has permitted a substantial number of additional households to live independently. Lifestyle changes also influence both the number of households and their structure. The marked increase in the divorce rate has led to more and smaller families.

These factors have combined to produce extraordinarily rapid increases in the number of households in recent years. The average annual increase in the number of households grew dramatically from an average of 927,000 households between 1960 and 1965 to a high of 1.6 million households between 1975 and 1980 (Figure 5.4). From 1960 through 1980, the number of households increased at an annual rate of 2.1 percent, greatly exceeding the rate of growth in total population over that same period, which averaged about 1.2 percent per year.

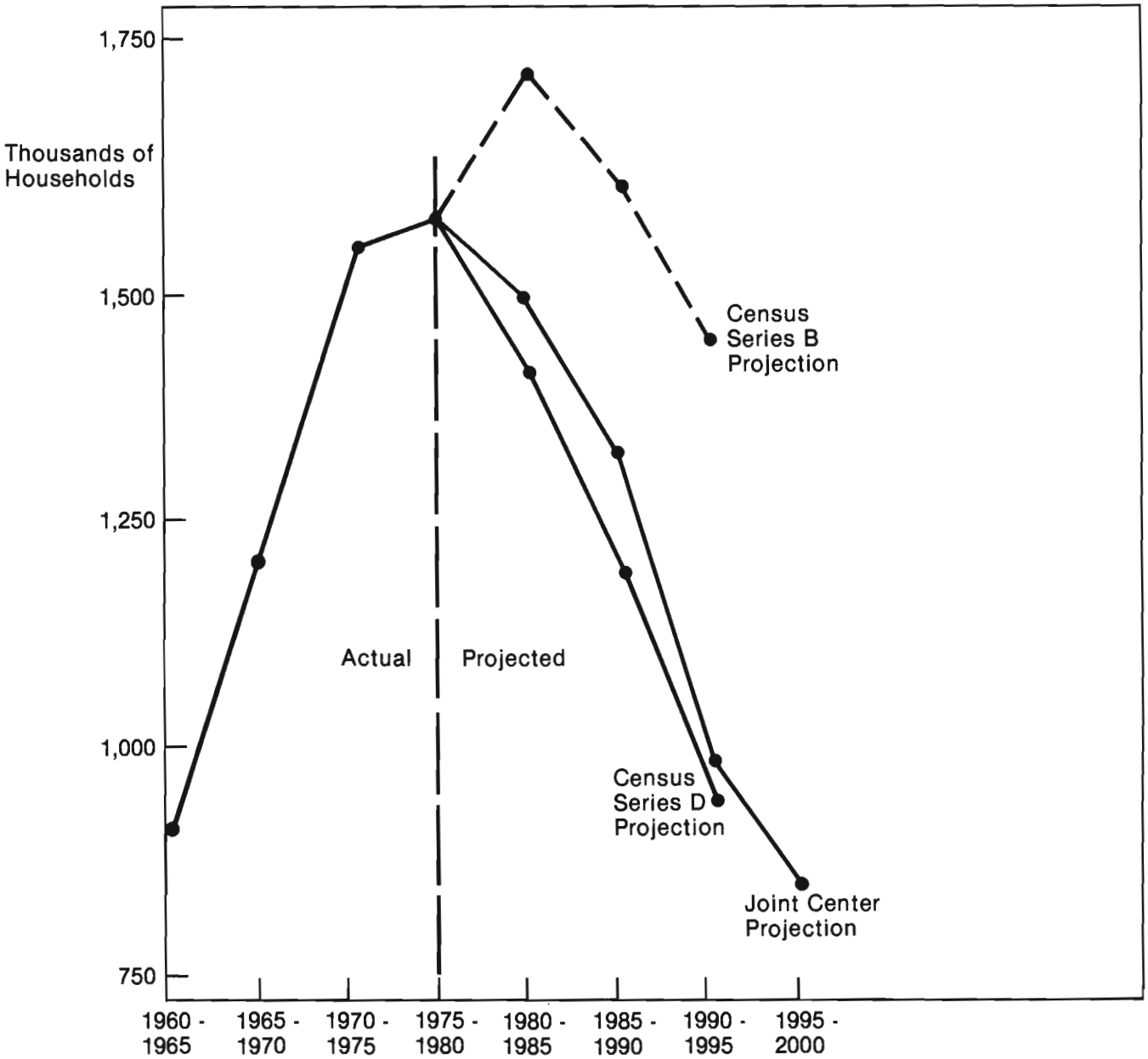
Although it would be helpful to be able to predict future housing demand, projections of household formation rates are risky. Past efforts to set forth future housing needs have not been notably accurate, and the exercise is more useful for understanding housing markets retrospectively than in gaining any firm foreknowledge about the course of housing production.[2] However, awareness of the age distribution of the current population as well as trends in regional distribution and tenure choice can shed some light on likely household formation. The Commission requested the Joint Center for Urban Studies of Harvard and MIT to prepare a background paper on trends and demographic factors. It projects net household formations to the year 2000. Their projections, as well as two sets of projections prepared by the Census Bureau, are shown in Figure 5.4.

Some fundamental observations can be made about likely household formation in the remainder of this century:

- The rate of household formation and resulting demographic demand through the 1980s will remain high, primarily because the population in the critical household-formation years (under 35) is projected to remain at the highest level in history over the decade of the 1980s (Figure 5.5). In 1960 there were 35 million young adults (under 35); just 20 years later — in 1980 — the number had risen dramatically to 58 million. This number is expected to increase to 61 million in 1985 and to remain high (60 million) in 1990. Annual additions to the housing stock recently have been far below the average annual additions of the late 1970s, despite demographic factors indicating strong potential for household formation. As this potential demand continues to accelerate, one can expect a strong market for new housing production and conversions throughout the coming decade.
- Although net additions of new households remain strong through most of the 1980s, the number of young households formed will decrease by 1990. For years, the housing market has been sustained by a strong inflow of new households. Population projections (both those of the Joint Center and the Census Bureau) now show that this flow will drop off. By 1990 to 1995, only about 1 million new households a year are projected by the Joint Center and Census Series D — a full half million less than the average during the 1970s.
- Household growth will be extremely uneven across the nation. Some areas will actually experience continued population losses (some North Central and Middle Atlantic States), while others will have the lion's share of the total national growth (the South and West). In fact, according to estimates by the Joint Center, three regions of the country — the Mountain, the West South Central (around Texas), and the East South Central (around Mississippi and Alabama) — are expected to account for more than 60 percent of the growth in population over the coming decade. The country will therefore have available housing units in some areas

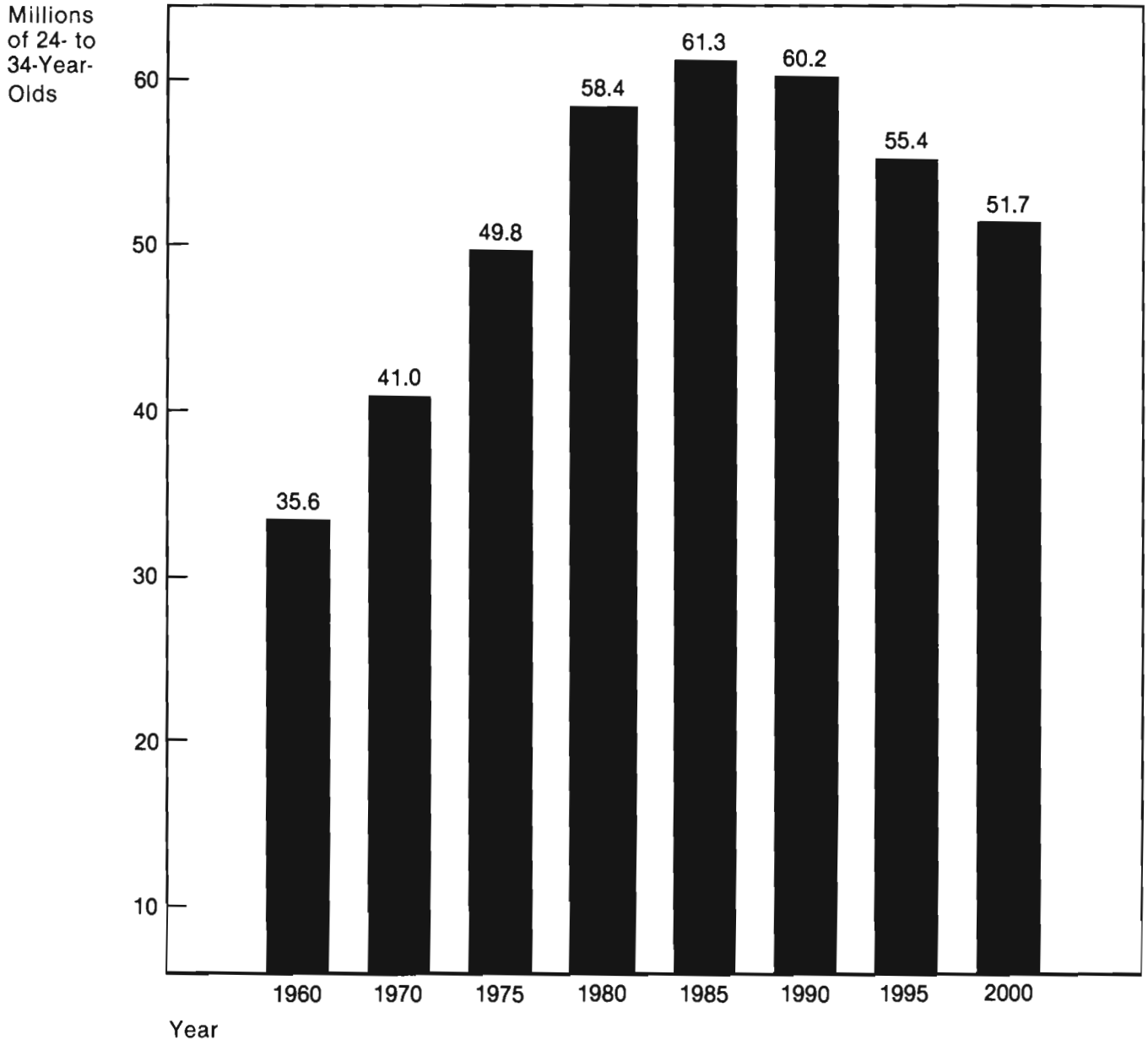
[2] Duane T. McGough, "Housing Needs and Housing Supply: The Effectiveness of Estimates and Responses," in *The Housing Delivery System*, Symposium Proceedings (Columbus, Ohio: The Ohio State University, October 1979).

Figure 5.4
Average Annual Increase in Number of Households (For 5-Year Periods): Comparison of Joint Center and Bureau of the Census Projections



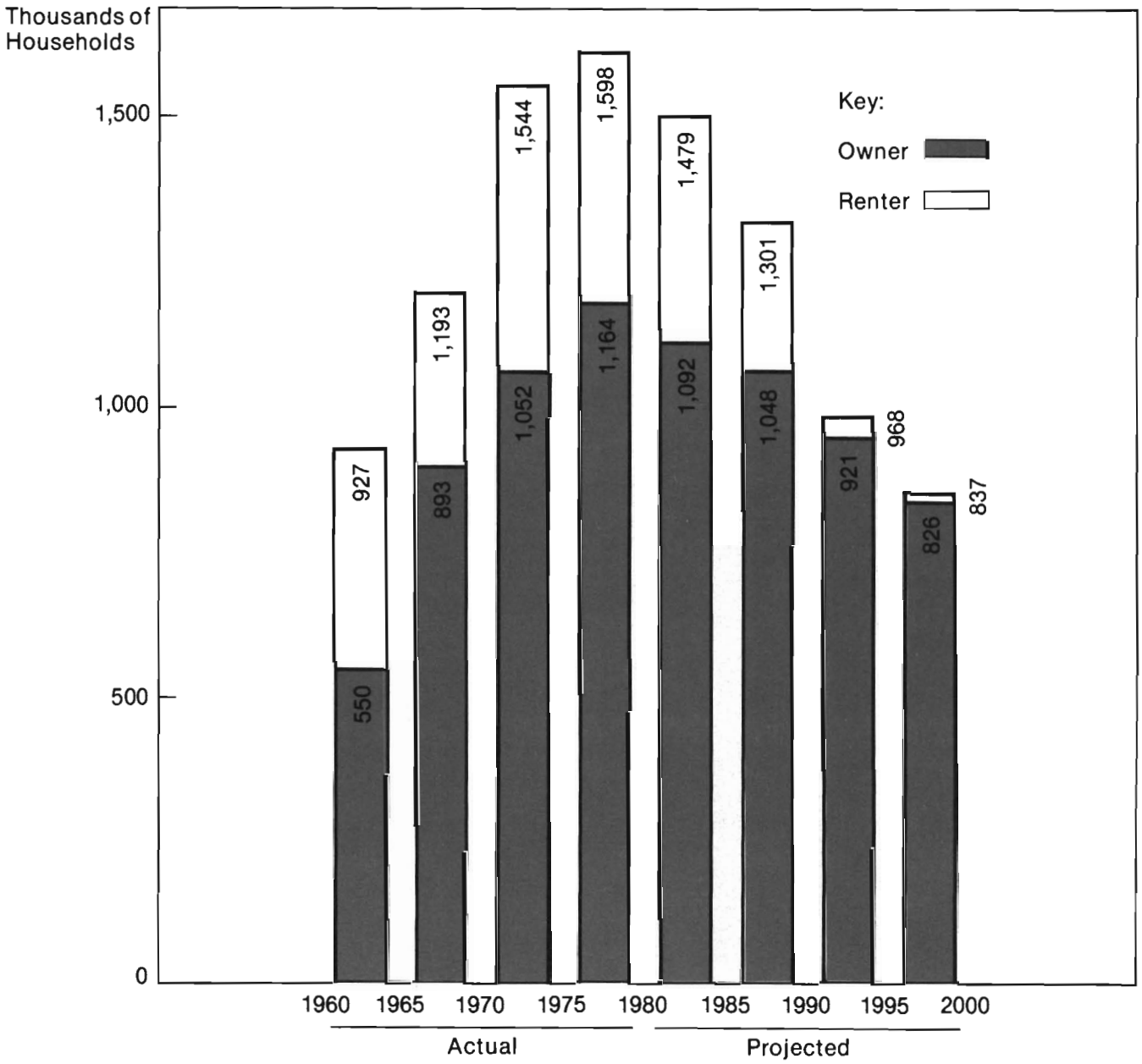
Source: Joint Center for Urban Studies of MIT and Harvard University, "Trends in Housing and Demographic Factors," unpublished report (Cambridge, Mass.: February 1982), p. 36.

Figure 5.5
Number of Young Adults (Under 35), 1960-1980 and 1985-2000, Projected



Source: Joint Center for Urban Studies of MIT and Harvard University, "Trends in Housing and Demographic Factors," unpublished report (Cambridge, Mass.: February 1982), p. 28.

Figure 5.6
Average Annual Increase in Number of Owner and Rental Households



Source: Joint Center for Urban Studies of MIT and Harvard University, "Trends in Housing and Demographic Factors," unpublished report (Cambridge, Mass.: February 1982), p. 20.

with very low demand and high demand in other areas with a relatively small base of existing stock. A higher national rate of new construction may be needed than one would expect from simply reviewing aggregate national household growth projections, because in high-growth areas, new construction will have to play the predominant role in housing the growing population.

Such regional variations highlight the hazards of establishing housing policy at the national level. The market should be allowed to respond to local supply and demand pressures, and, consistent with the concept of enlightened federalism, local and State governments should be encouraged to develop policies that complement private market actions.

Demand for Owned Homes and Rental Units

From the standpoint of forming housing policy, a critical aspect of housing demand is tenure choice — that is, the household decision whether to own or to rent. In making projections on tenure choice, the incidence of homeownership was assumed to rise only gradually. A substantial portion of the increase in homeownership during the early 1970s undoubtedly was attributable to speculative investment in housing caused by high inflation rates and the tax treatment of homeownership. As inflation starts to abate, speculative investment in housing should also become a less important factor. In addition, homeownership's relative tax advantage has been reduced by the general decrease in tax rates provided by the Economic Recovery Tax Act of 1981.[3] The after-tax costs of owning will no longer be as favorable, particularly for moderate-income households.

The Joint Center projection of the likely split between additional owner and renter households is presented in Figure 5.6. These projected changes are caused primarily by impending shifts in the age structure of the population. They are influenced to a much less extent by particular assumptions about consumer choices between owning and renting or about the nature and timing of household formation. The demand for rental housing has generally been driven by the number of young persons under 30, a group that is expected to decline even more rapidly and sooner than the 30- to 35-year-old group. Assuming that age continues to be an important factor in determining the potential number of renters, the demographic demand for additional rental units is expected to decline in the 1980s and to the end of the century. However, the demand of owners is projected to fall much more gradually. Both trends result primarily from the movement of the baby-boom generation through different stages in the life cycle.

* * * * *

New construction and additional investment in existing units will continue to be necessary for provision of owner- and renter-occupied units, both to provide for additional households and to replace units lost from the inventory. Demand will be based on the overall growth of the population and the propensity of people to form new households in response to demographic, social, and economic conditions, which cannot be foreseen now with great accuracy.

In the past, housing commissions have sometimes made specific projections of housing demand and treated the estimates as measures of "housing need" that the government should try to meet. The evidence of the past is that the private housing market adjusts to provide homes in changing numbers, size, and tenure as the needs of households both grow and change. The Commission has confidence that this process will continue and therefore did not attempt to make any finding of a specific numerical "need" for future housing units. However, the Commission believes that its recommendations will encourage private market actions to build and rehabilitate, and will eliminate unnecessary barriers to housing development and reinvestment.

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[3] Michael Lea, *Is There Too Much Capital for Housing?* (Washington, D.C.: U.S. Department of Housing and Urban Development, 1981).

CHAPTER 6

HOMEOWNERSHIP

Encouragement of homeownership has traditionally been a major objective of housing policy at all levels of government. One of the primary responsibilities of the Commission was to examine the continued importance of homeownership in the nation and to develop options to strengthen the ability of the private sector to provide this opportunity, especially for first-time homebuyers.

For many Americans, homeownership is the most important factor in their overall economic well-being. As President Reagan has said, "Owning one's own home means far more than merely having shelter. It is a concept deeply rooted in the hearts of our people, for it carries with it a whole constellation of values—family, neighborhood, community, independence, self-reliance, citizenship, faith in our country and its future."

Throughout the postwar period, homeownership has increased, largely as a result of the continued economic progress of most Americans and low interest rate mortgages. Figure 6.1 shows that about two out of three American households own their own home today, compared with fewer than half in 1940. The improvement in housing quality is even more striking. Chapter 1 demonstrates the decrease in the number of physically inadequate homes. The quality of new homes has risen markedly as well. In 1978 new conventional single-family homes averaged 1,700 square feet, an increase of 20 percent since 1964. Average size seems to have leveled off since 1978. Similarly, the percentage of new conventional (single-family detached) homes with air conditioning more than doubled during this period, and the percentage with two or more baths increased from 46 percent in 1963 to 73 percent in 1980.

The improvement in conventional homes is only part of the story. The past few decades have been marked by fundamental changes in the available forms of homeownership. Condominiums and cooperatives have provided the opportunity for homeownership to well over a million American families. The availability of manufactured housing (mobile and modular homes) has provided a similar opportunity to 3 million more households. These alternatives to the traditional single-family home will continue to be important avenues to homeownership in the future, in many cases providing a lower-cost alternative.

Although there has been substantial progress toward the goal of greater homeownership, obstacles remain. Many regulations inhibit—and raise the cost of—various forms of homeownership. Moreover, in the past several years, as a result of high interest rates and inflation, homeownership has become increasingly difficult to achieve for those who were not already owners.

Determining the costs and affordability of housing for owners is more complicated than for renters, and inflation has compounded this complexity. Renters simply pay the rent and perhaps utility bills. Homeowners make direct payments for mortgage principal and interest and taxes, as well as insurance, maintenance, and utilities. However, they also benefit from the income tax deductibility of interest and property taxes, which partly offsets the direct outlays. Also, homeowners typically sell their houses at prices higher than the purchase prices, and may not have to pay tax on the capital gain; a home often is an investment as well as a place to live. Failure to consider any of these components in determining the net costs of homeownership can create a misleading picture.

In the 1970s, accelerating inflation, especially of house prices, made capital gains from homeownership a major consideration for the homebuyer, while simultaneously creating higher monthly mortgage payments. This situation created a divergence between cash outlays for homeownership and the effective cost of homeownership. Preoccupation with the current cash payments made by homeowners caused at least some observers to overlook much of the motivation for buying a home during this period. But buyers, considering the effective

Figure 6.1
Homeownership in the United States, 1900-1980

Source: Compiled from data in U.S. Department of Commerce, Bureau of the Census, *Decennial Census of the United States* (Washington, D.C.: U.S. Government Printing Office, 1900–1980).

cost of homeownership including appreciation, continued to sustain the housing market despite the burden of higher monthly payments.

Homeownership has four distinct cost elements. The first is the "net effective" cost of homeownership after taking into account the tax savings and the anticipated value of the appreciation in value of the home.[1] The second is the size of the monthly payment for homeownership. Third is the downpayment, which has become higher in recent years relative to the income of prospective purchasers. Finally, there is the underlying price of conventional homes and the costs of alternatives to traditional forms of homeownership.

This chapter deals with costs of homeownership and with programs designed to mitigate their impact. The first section reviews the trends and current conditions in the costs of homeownership. The chapter then addresses both the problems of high monthly costs (the cash flow problem) and high downpayments together with policies designed to overcome them. These policies include the tax treatment of mortgage interest, alternative mortgage instruments, the provision of Federal and private mortgage insurance, and the possibility of special incentives to save for a downpayment. The final part of the chapter examines other forms of ownership that can provide additional flexibility in the provision of homeownership opportunities. Included here are condominium and cooperative ownership, homesteading, and use of manufactured housing.

Trends in Homeowner Costs

The trends in both current costs and net costs of homeownership are depicted in Figure 6.2. Current cash costs are often used by lenders in qualifying households for mortgage loans. As current costs rise, they increase the difficulty of qualifying for a mortgage loan and create an important barrier to homeownership. (This problem is discussed in the next part of the chapter.) However, once a household does qualify for a mortgage loan, it is the pattern of net effective cost of homeownership that is of most concern.

Since the mid-1960s, the current cash costs of homeownership have risen constantly, while the net effective costs first declined—reaching a low in 1978—then increased sharply. The net effective costs are sensitive to the situations of particular households, and those shown in Figure 6.2 are estimates for a typical household, in terms of income, household size, tax bracket, and geographic region. Since the effective cost of homeownership depends on the household's expectation about changes in the value of the house over time, the costs shown in the figure assume that the homeowner expects the price patterns of the past eight years to continue into the future. Since house prices have been rising, this reduces net effective cost as the homeowner expects to sell the house for a price higher than he paid for it. The basic pattern shown in Figure 6.2 holds for nearly all demographic groups in each region, and different assumptions about homeowner expectations will not affect the trends.

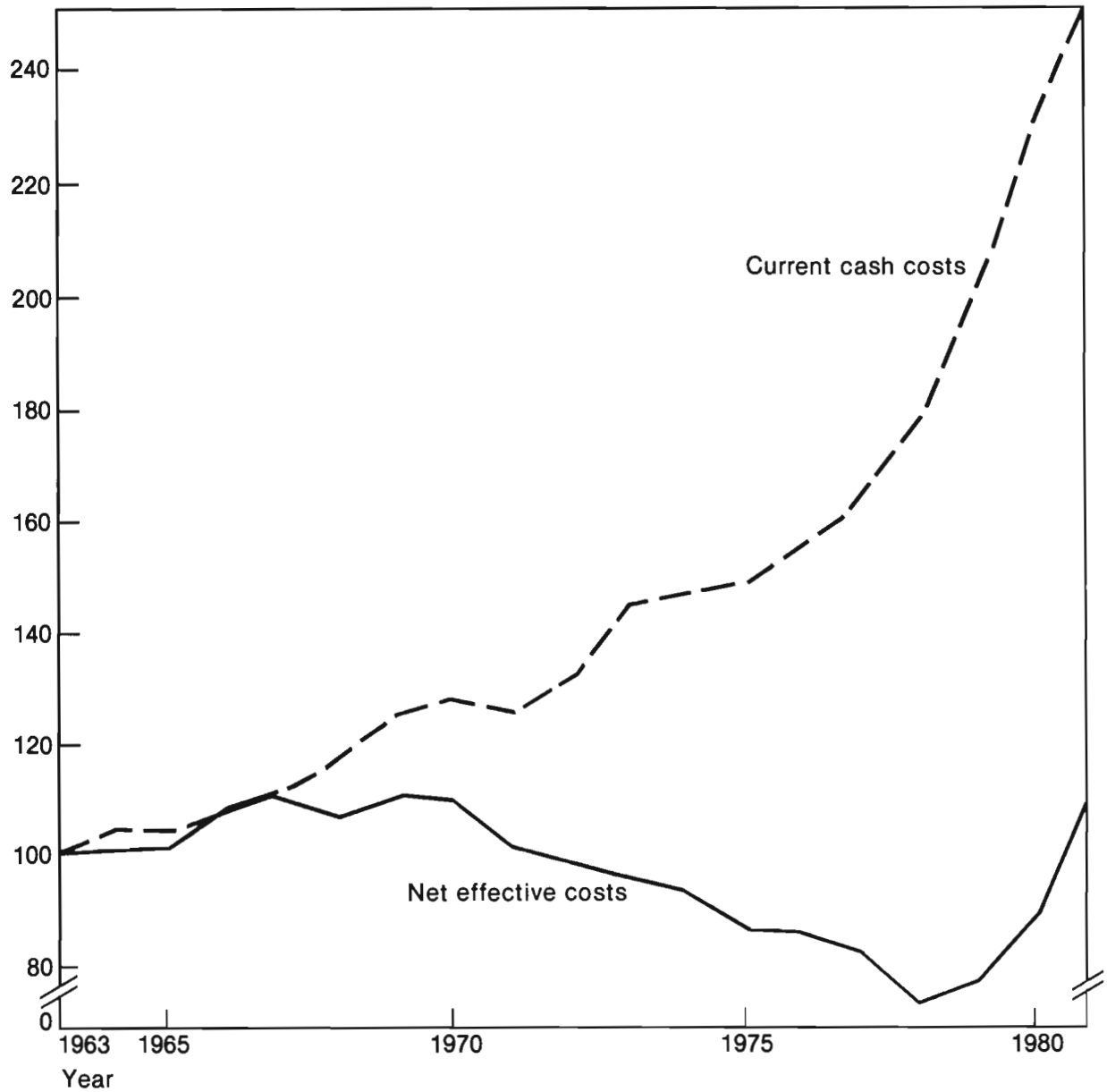
From 1963 to about 1970, both current and net effective costs of homeownership rose slowly and were quite similar. This reflected a low rate of house price inflation, generally low property taxes and steady interest rates. Between 1970 and 1978, current cash costs rose dramatically, while net effective costs actually fell. The rise in cash costs was generated by a rapid increase in the rate of inflation that pushed up house prices and interest rates. At the same time, this inflation stimulated homeowner expectations of yet higher house prices, dropping effective costs of homeownership. Inflation also pushed more households into the more rapidly rising range of income tax rates, giving greater value to the tax advantages of capital gains and the tax savings from mortgage interest deductions. These financial gains were not outweighed by the sharp increases in real home prices or by the higher real costs of operation, with a resultant drop in net effective costs.

The net effective cost of housing for a homeowner reached what may have been a postwar low in 1978, when costs fell to almost 30 percent below those in 1963. The primary reason for this drop can be documented through some simple calculations. The average mortgage interest rate in 1978 was 9.6 percent while the price of a constant-quality house had risen by more than 8 percent every year since 1972. This implies that for any household in at least the 17 percent tax bracket—which includes nearly all taxpayers—the net effective cost of borrowing (for taxpayers itemizing deductions) was negative, because the cost of mortgage interest net of taxes was less than the increase in the value of the house. In this case, the only real cost of owning a home would be the operating costs.

Net effective homeownership costs show a

[1] Long-term financial decisions such as buying a house depend on estimates of future costs and of financial gains. Because these estimates are the basis for the homebuying decision, "net effective costs" are based on such estimates. As with all long-term investments, future increases in value may not accord with original estimates, and certain costs (such as property taxes) also cannot be estimated with precision. Because true future costs and gains are unknown at the time of the investment, the investment decision, and the concept of net effective cost, is based on estimates of these future costs and gains.

Figure 6.2
Indices of Current Cash Costs and Net Effective Costs of Homeownership



Index of net effective costs is based on the sum of mortgage interest, property taxes, utilities, insurance, maintenance, and repair expenses, reduced by tax savings and expected capital gains, for a constant-quality (1974) house. Index of current cash costs includes the above except for tax savings and expected capital gains.

Source: Expanded and adapted from D. B. Diamond, Jr., "Taxes, Inflation, Speculation, and the Cost of Homeownership," *Journal of the American Real Estate and Urban Economics Association*, Fall 1980.

sharp rise beginning in 1978. To a great extent, this reflects the catching-up of interest rates to inflation. The unusually low real interest rates in the 1970s helped to buffer the sharp rise in the real price of houses, but when these low rates disappeared, the impact of the 30 percent rise in real house prices over the decade became the dominant factor in setting effective costs. Thus at present, interest rates include a premium for the expected rate of inflation that greatly offsets the expectations of appreciation in house prices.

Homeowners who made purchases on the basis of the future sale value of their homes in fact took the risk of possible deterioration in the residential real estate market. If home prices do not continue to rise, the real burdens assumed by homebuyers in the past few years may prove much heavier than expected at the time of purchase. In the long run, this problem can be solved only through the lower interest rates that will follow the reduction of inflation.

The Cash Flow Problem

Throughout the 1970s, monthly payments on new level-payment, fixed-rate mortgages rose because interest rates were rising. Continued high inflation and rising incomes meant that these mortgage payments were paid in cheaper dollars and were a smaller portion of income for the homeowner. But the higher home prices were also pushing up initial mortgage payments. Coupled with higher interest rates, these rises strained the immediate "cash flow" of financial resources for the homebuyer. In fact, many families are not able to afford to buy homes because their incomes are not high enough to qualify for financing. Figure 6.3 shows the initial monthly payment on a typical new house as a percent of median family income for the 1963-1980 period. This ratio passed 25 percent in 1978 and was verging on 40 percent at recent interest rate levels. This trend may begin to moderate soon as inflation is brought down and interest rates follow, leading to lower initial monthly payments.

While Figure 6.3 provides evidence of increases in monthly costs for homebuyers, comparisons of median new house prices and median income tend to overstate the extent to which households fail to qualify for financing a home. The median priced newly built home is seldom purchased by the first-time buyer. Such homebuyers generally purchase lower-priced "starter" homes, which may or may not be newly constructed. In addition, all comparisons of income with the costs of conventional housing ignore the existence of alternatives to conventional homes such as manufactured homes, cooperatives, and condominiums, which are often much less costly than median-priced new conventional homes. Still, cash flow remains a problem for buyers of all types of housing.

The Commission considered several items that serve to reduce the burden of monthly payments and thus reduce the cash flow problem for homeowners. Among these are the deductibility of interest and property taxes for Federal income tax purposes and new forms of mortgage instruments. These factors and the associated Commission positions are addressed below.

Deductibility of Interest and Taxes

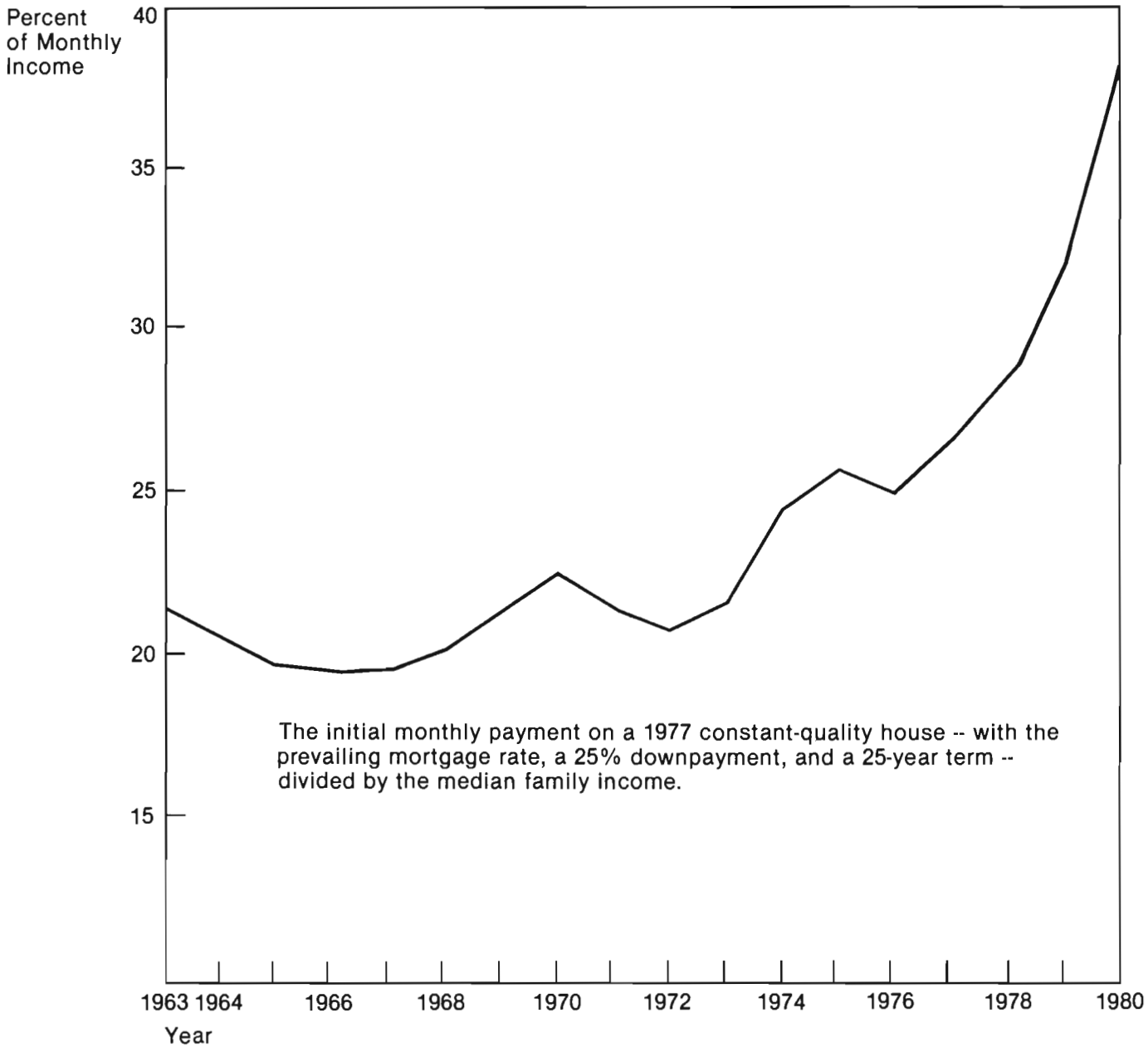
The Commission reviewed the current tax deduction for mortgage interest and property taxes. It recommends that there be no changes in the current system at this time. The Commission also recognizes the broad scope of this issue and recommends that any further analysis of this topic be considered only within the context of a thorough review of the U.S. tax system.

Tax benefits have had a positive impact on promoting homeownership. These advantages result from the deductibility of mortgage interest and property taxes, along with the fact that the imputed rental value of a home need not be reported as income. When the net effective costs of homeownership are calculated (as in Figure 6.2), it is apparent that they have reduced the effective monthly costs of homeownership.

It should be clear that the deductibility of mortgage interest and property taxes is not limited to owner-occupied housing. All interest payments and most taxes are deductible, whether related to housing or not. Moreover, owners of rental housing not only deduct interest and taxes from gross rental income but also have other tax advantages not accorded homeowners, such as deductibility of depreciation. Were it not for these provisions in the Internal Revenue Code, rents would be higher, and renters adversely affected. Although renters do not personally take deductions for property taxes and mortgage interest, they generally benefit from these provisions, because market forces translate these deductions into lower rents. In fact, some renters benefit from the current system more than if they were able personally to deduct their share of the landlord's deductions (instead of the landlord taking the deductions). Income tax deductions are useless to those who find the standard deduction more favorable, or who pay little or no income tax. Both renters and homeowners benefit from the tax laws, reflecting the importance of decent housing as a national goal.

The total dollar value of the tax incentives for homeownership is considerable. The Congressional Budget Office estimated the tax revenue loss for the

Figure 6.3
Initial Monthly Mortgage Payment Burden for a Constant-Quality Housing Unit
(New Houses, 1963-1980)



Sources: Compiled by staff from data in U.S. Department of Commerce, Bureau of the Census, *Construction Reports*, Series C–27, and *Current Population Reports*, Series P–60, (Washington, D.C.: U.S. Government Printing Office) and *Journal of the Federal Home Loan Bank Board*.

mortgage interest deduction at $19.8 billion in 1981, and the revenue loss for the the deductibility of property taxes at $8.9 billion in that year; these tax losses were projected to more than double by 1986.[2]

Moreover, most of the tax benefit goes to middle- and upper-income taxpayers. The Congressional Budget Office estimates, for example, that the 63 percent of taxpayers with incomes below $20 thousand in 1981 received only 7.6 percent of the tax savings from mortgage interest tax deductions. It should also be noted that this characteristic is not unique to homeownership, but applies to any deduction from income tax liability.

In addition to the tax advantages of the deductibility of interest and taxes, homeowners receive liberal tax treatment of the capital gains generated by house appreciation. If a home of equivalent or greater value is purchased within two years of the sale of the previous residence, no capital gains tax is incurred. Once a taxpayer reaches 55 years of age, up to $125,000 of capital gains from the sale of a home may be excluded from taxable income. The effect of these various tax provisions has led many households to become homeowners, and has induced homeowners to invest more capital in their homes.

In order to maintain strong and continued support for homeownership the Commission recommends that the deductibility of mortgage interest be maintained. The social, economic and political stability inherent in homeownership is an important offset to the revenue losses noted earlier. The Commission did consider alternatives to the current mortgage interest deduction, such as converting the deduction to a tax credit, limiting the deduction through some type of cap, or weighting the deduction to provide greater benefits for first-time homebuyers. While these alternatives deserve continued study in the future, any change in this incentive should only be considered as a part of a thorough review of the effects of the tax system on the allocation of the nation's capital resources among competing investment demands.

Alternative Mortgage Instruments

In periods of high and volatile inflation, the standard long-term, fixed interest rate mortgage instrument presents a problem for the homebuyer. Since its rate is fixed for the long run, lenders will attempt to build into the rate a premium for what they expect to be the course of inflation. This protects the lender's capital. High inflation thus is associated with high mortgage rates. This means that homebuyers who use the standard, fixed-payment mortgage have to allocate a high portion of their income to mortgage payments in the early years of homeownership, and the burden of high monthly payments is severe. However, if the income of the buyer rises over time, the ratio of the monthly payment to income decreases and the cash flow burden declines. The result is that mortgage payments levy the heaviest burden when they are least affordable, and present a serious problem to the borrower in the early years of a mortgage. Alternative mortgage instruments can address this problem, "tilting" the stream of mortgage payments by providing lower payments in the beginning and higher payments later, thus more closely matching income patterns. One attempt to provide a better match is the Graduated Payment Mortgage, which offers smaller payments in the early years of the mortgage in return for increased payments later.

Section III of this report discusses alternative mortgage instruments as they relate to borrowers and lenders. In particular, the Commission would like to see the private sector develop new mortgage instruments that reduce initial payment levels to borrowers while providing lenders some protection against inflation. Three instruments are noted as deserving particular attention: (1) a graduated-payment, adjustable-rate mortgage; (2) a dual-rate mortgage (incorporating a lower payment at the outset and possible negative amortization); and (3) a growing equity mortgage. These three mortgage instruments are discussed in detail in Chapter 11.

Another form of mortgage instrument, which offers the possibility of homeownership to households that otherwise do not have sufficient cash flow, is the shared-appreciation mortgage (SAM). With a SAM the homebuyer agrees to share the property's appreciation with the lender in return for an interest rate somewhat below market. One result is lower monthly payments. However, this form of mortgage is not without drawbacks and risks. At the end of a designated period, such as 7 or 10 years, the homebuyer must refinance or pay off the portion of the increased value that has been given up. Thus, mortgage payments may increase sharply at some point in the future, and a family may not have sufficient cash flow to meet these payments, necessitating sale of the home. This hazard is increased if interest rates are high at the time of refinancing.

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[2] *The Tax Treatment of Homeownership*, Congressional Budget Office, September 1981, p. 7. In addition, owners of homes and other consumer durables derive benefits (in-kind income) from the use of these assets, which are not recognized as income for tax purposes. Owner-occupied housing generates the largest of these forms of "income," which may be termed net imputed rental income—the gross rental value of the home minus the deductions that could have been taken if it were rented. Potential gains in Treasury revenue from taxing imputed net rents from homes were estimated at $14 to $17 billion in 1979. See John C. Simonson, "Existing Tax Expenditures for Homeowners," unpublished paper, U.S. Department of Housing and Urban Development, July 1981.

Even so, the family will have gained a portion of the appreciated value of the home, which may provide a substantial downpayment on another home. It is essential that a household enter into this type of mortgage only if both the advantages and the risks are fully understood.

A similar idea that deserves attention is shared-equity financing, in which investors other than the homeowner pay part of the downpayment and, if necessary, a portion of the debt service (monthly payments). In return, the investor gains tax advantages including depreciation, plus a share of the home equity. (This type of mortgage has increased in popularity since the 1981 tax law improved the depreciation benefits for residential as well as commercial property.) Under these arrangements, the occupant trades partial ownership in the property for lower monthly payments.

The Downpayment Problem

High house prices are invariably associated with high downpayments. Even if a household has an income sufficient to qualify for a high-rate mortgage, it must accumulate sufficient capital to provide the downpayment on a house. The problem of the downpayment may be mitigated, at least in part, by mortgage insurance, either private or Federal. If the mortgage debt is insured, lenders will allow borrowers to make a lower downpayment, since they need less protection in the form of buyer equity. Although it usually leads to slightly higher monthly payments, mortgage insurance, public or private, can provide significant help in overcoming the hurdle to homeownership represented by the downpayment. Another approach is to encourage would-be homebuyers to accumulate a downpayment by means of tax or other form of incentives. Each of these approaches is discussed below.

Mortgage Insurance

In order to assure the safety of home mortgage loans, lenders typically require downpayments in the amount of 20 to 25 percent of purchase price, so that in the event of default an uninsured loan could be repaid with the proceeds of the sale of the property. This large downpayment can constitute a considerable barrier to first-time homebuyers; mortgage insurance substitutes for this lender-required "equity shield" and allows for much smaller downpayments. While the default risk for an individual loan with a smaller downpayment cannot be borne by an individual lender, the risk can be spread among a number of such loans by mortgage insurance companies, and loans with downpayments of 10 percent or less become feasible. Thus mortgage insurance provides, and should continue to provide, a significant vehicle for lowering the downpayment barrier.

The Federal government has played an important role in this area with the mortgage insurance and guarantee programs of the Federal Housing Administration (FHA) and the Veterans Administration (VA). During the Great Depression, private mortgage insurance disappeared because of falling housing prices, widespread defaults and foreclosures, and the overall state of the economy. FHA revived the notion of mortgage insurance and encouraged the use of the fully amortized, long-term mortgages with moderate down payments—generally averaging 5 percent down, but sometimes as low as 3 percent—thus improving the opportunity of homeownership for many American families.

The lesson of FHA was learned by the private sector. Since the late 1950s private mortgage insurance (PMI) companies have returned as a significant force in the housing market and have been an important factor in allowing lower downpayments. The typical form of private mortgage insurance is 90/20: the loan is restricted to 90 percent of the value of the property, and the top 20 percent is insured against default. Thus private mortgage insurance companies allow for downpayments of 10 percent (and sometimes less, under alternatives to 90/20). By offering mortgage insurance with less than 100 percent coverage and by charging lower premiums than FHA, the private mortgage companies have been able to replace FHA insurance in many cases.

Chapter 12 will discuss the relationship of FHA to the private mortgage industry and outline the Commission's recommendations in this area. In general, the Commission calls for a continuing role for FHA, but with FHA complementing rather than competing with the private market.

Downpayment Assistance for First-Time Homebuyers

The Commission has reviewed a number of alternatives to assist the first-time homebuyer in accumulating a downpayment. It finds the evidence concerning costs and benefits of these alternatives to be inconclusive. Further evaluation is appropriate, and the Commission recommends that three options discussed below be forwarded to the President for full review as to their cost and incremental impact.

If the downpayment necessary for homeownership cannot be reduced enough, the potential homebuyer may need assistance to accumulate the downpayment more rapidly. The exemption from tax of savings earmarked for home purchase and the interest earned on those savings, for example, provide both an inducement to save and greater rewards to

saving than under current arrangements. As part of its investigation into ways of encouraging homeownership, the Commission considered the use of the tax system.

An incentive for first-time homebuyers to accumulate a downpayment might take three forms—a separate system of individual housing accounts (IHAs) with contributions eligible for an income tax credit; a separate system of IHAs with Federal matching of contributions to the account; or the modification of the existing individual retirement account (IRA) program so that funds in these accounts could be withdrawn for first-time home purchase. Each option would provide a subsidy for the first-time homebuyer, and each has advantages and drawbacks.

Beginning in 1982, the IRA program allows participation by all wage and salary earners—an almost universal eligibility. This program has important implications for the establishment of a separate IHA program. For lower-income families, IHAs would compete with IRAs for savings, while for higher-income families, they would offer additional tax incentives. The key question is the extent to which potential IHA contributors would also be IRA contributors. With little overlap, opening up IRAs for downpayment purposes would differ little from a separate IHA program with deductible contributions and tax-exempt interest on the account. With substantial overlap, the tax revenue implications and the effect on homeownership may differ considerably from a separate IHA.

Option 1. *A separate system of individual housing accounts, with contributions eligible for a credit against Federal income taxes, and with interest on the account tax exempt.*

The general features of this option include a tax credit for the contribution, tax-exempt interest, and a penalty if the account were used for other purposes. Compared with a deduction for contributions to the IHA, a tax credit provides greater incentives to moderate-income households, who are more likely to need assistance in acquiring a downpayment. A deduction, which necessarily confers greater benefits on those with higher income, would not be as well targeted. A typical IHA program might include provisions such as the following: the program would allow individuals to contribute up to $1,500 annually ($3,000 for a couple) to an account, this contribution forming the basis for a tax credit of 25 percent of the contribution. Those not currently owning a home, and who have never had an IHA in the past, would be eligible to open such accounts, which would terminate when a home were purchased (or after 10 years if no home were purchased). Withdrawals for purposes other than home purchase would be taxed as ordinary income, plus a 10 percent penalty.

One advantage of a separate IHA is that it might appeal to a group different from those saving for retirement, who are attracted to the IRA program. This was the consensus of experts who testified before the Commission's Task Force on Homeownership. A distinct IHA program is able to use a tax credit on contributions, compared to the IRA, which allows contributions to the account to be deducted from income. The IHA with the tax credit feature would be less attractive to higher-income taxpayers than would a deduction, but more attractive to those of moderate income, as previously discussed. Also, the percentage that is allowed for the credit can be adjusted to balance the issues of tax revenue loss and incentives to homebuyers.

Expert opinion is divided on the economic effects of IHAs, that is, the extent to which they permit additional families to become homeowners as opposed to providing subsidies to those who would have bought homes anyway. Clearly, some portion of the tax subsidy would go to those not needing an inducement to homeownership, particularly among higher-income households. For several years, Canada has had a similar program, known as the Registered Home Ownership Savings Plan (RHOSP). This program permits the deduction of up to $1,000 per year from income for deposits into RHOSPs, which are open to anyone not currently owning a home. The increase in homeownership in Canada since the beginning of the RHOSP program has been roughly equal to the trend in the United States, which has no such plan.[3]

Although opinion is divided on the impact of an IHA program on homeownership, estimates of revenue loss to the Treasury for current IHA proposals are much more in agreement. These estimates are based on different proposals, but if adjustments are made to account for differing amounts of contributions allowed, an IHA with deductible contributions of $1,500 per year ($3,000 per couple) would probably cost between $2.5 billion and $4 billion per year after the program had been in existence for a few years. Table 6.1 compares these estimates, of which only Weicher's takes account of the "universal IRA" system now in place. The IRA system will tend to reduce the revenue cost of the IHA, because more IHAs would be opened than if there were no IRA in existence.

All of the above estimates are based on contributions that are deductible from income, and therefore may overestimate the revenue impact associ-

[3] See John C. Weicher, "The Individual Housing Account: Inferences from the Canadian Experience" (Washington, D.C.: The American Enterprise Institute, February, 1982).

ated with the tax credit recommended under Option 1. The Urban Institute compared the effects of a 25 percent tax credit to the deductible contributions evaluated in Table 6.1. As would be expected, there was a considerable redistribution of benefits toward those of lower income, but the overall impact was to reduce revenue losses by about 7 percent per year.

Table 6.1
Tax Revenue Costs of an IHA With Deductible Contributions of $1,500 Per Year ($3,000 per Couple) (in Billions of Dollars)

	First Year Impact	Long Run Annual Cost
National Association of Homebuilders[1]	—	2.8
Kenneth Rosen[2]	0.6	3.0
Division of Housing Finance, HUD[3]	—	4.5
Urban Institute[4]	2.0	over 3.0
John Weicher[5]	—	2.1–2.8

[1] Testimony of Frank Napolitano, Homeownership Task Force, Dec. 3, 1981.
[2] Paper prepared for the Committee on Housing Programs, 1981.
[3] Based on estimates by Robert Buckley, prepared in 1977.
[4] From the paper entitled "The Desirability of Individual Housing Accounts," by John Tuccillo, July 1981.
[5] From the paper entitled "The Individual Housing Account: Inferences from the Canadian Experience," by John C. Weicher, February 1982.

Option 2. *A separate system of individual housing accounts, with contributions made from income after taxes to be matched directly on a one-to-four basis using appropriated funds from the Federal government, and all interest on the account fully taxable.*

This option is a version of Option 1, but with two important differences: interest on the account would be taxable, reducing the tax expenditure of this option; and instead of a tax credit, a depositor would receive a grant from the government paid directly into the account.

Because Option 2 calls for appropriations, it could be restricted to some fraction of those who would respond to an entitlement program, although with the attendant problem of rationing the matching grants. As a result, the budgetary cost could be a fraction of that implied by Option 1. Even if Option 2 were proposed as an entitlement program, however, the options differ after the initial contribution, because Option 2 calls for taxable interest as opposed to the tax-exempt interest of Option 1. This feature would eliminate any tax revenue losses associated with the IHA and reduce the overall cost substantially. The total cost to the Federal government is estimated at less than half of the amounts in Table 6.1. At the same time, fewer households might participate, because the benefits would be lower. Compared with Option 1, this approach focuses benefits more closely on those in need of homebuying assistance, because it is less likely to appeal to high tax-bracket households.

Option 3. *Allow tax-free use of funds from individual retirement accounts for the purpose of applying these funds to the downpayment on a first home.*

Under this option, first-time homebuyers could make tax-free "withdrawals" from their IRAs and apply these funds to their downpayment. (This downpayment might be construed as an allowable IRA investment subject to repayment at sale.) The effects of this option on homeownership and tax revenue losses depend on the extent to which potential IHA holders would be IRA holders under the current legislation. Some time will pass before the extent of IRA participation is known, because the full effect of the first year will not be recorded until April 1983.

At one extreme, if potential IHA participants are a different group from IRA holders, the economic effects and the tax revenue effects would be approximately the same as a separate IHA with deductible contributions as shown in Table 6.1. At the other extreme, if all potential IHA holders would otherwise participate fully in the IRA program, the loss in tax revenue would be negligible. The withdrawal would reduce the tax basis of the house, increasing the capital gains subject to taxation if the house were sold and not replaced with another home purchase. Under the IRA as it now stands, withdrawals would be taxed as income, but at postretirement rates (if withdrawn after age 59½). Also, this taxation would occur many years in the future, so that its effect may be similar to the tax on the capital gains on a dwelling.

The overall effect of this option on inducing homeownership is harder to estimate than a separate IHA. Experts differ in their assessments of this impact, because these assessments are based on evaluations of the separate IHA, modified by uncertainty about the use of the IRA program for home purchase.

The main advantage of this option is its relative simplicity. It would require fewer legislative and regulatory changes than a new system of IHAs, although substantial changes would still be required. The IRA system is already established, and modifications of this system would be easier than developing a whole new set of rules and regulations. The primary disadvantage of Option 3 is that the

incentive (deduction of deposits from income for tax purposes) is more valuable to higher tax bracket households and does not target benefits to those of moderate income.

The estimates in Table 6.1, with the exception of those made by Weicher, do not account for the existence of the "universal IRA" system now in place. It is likely that the use of the IRA system for home purchase would involve lower revenue costs than those shown in the table. To the extent that an overlap would occur between IHA and IRA holders, use of the IRA for home purchase would result in lower tax revenue losses.

Before turning to possible explicit Federal help for homeowners in saving for downpayments, it is important to recognize three factors that have reduced the real return to savings and that have exacerbated the problem of saving for downpayment. These factors are (1) nominal returns to passbook savings in thrift institutions have been held to levels below what they would have reached as market interest rates have risen with inflation; (2) marginal tax rates paid on all kinds of income increased as taxpayers were pushed into higher tax brackets by inflation; and (3) even though part of the interest paid on any savings is partly an adjustment for inflation, the full amount of the interest is taxed as though all of it were real income. The first two of these have been at least partly corrected: Interest rate ceilings on rates depository institutions may pay are scheduled for eventual elimination, and the Economic Recovery Tax Act of 1981 eliminates future increases in marginal tax rates on ordinary personal income that might otherwise have occurred with inflation.

New Forms and Reduced Cost of Homeownership

The potential for lowering the overall cost of a home, thereby reducing the cash flow burden and the downpayment constraint, should not be overlooked. Many alternatives to traditional home purchase have become quite popular in recent years, including condominiums, cooperatives, and manufactured homes (also known as mobile or modular homes)—all of which provide flexibility and possibly lower costs for homeownership.

Housing quality has increased dramatically over time; home sizes have increased and amenities have proliferated. However, the rise in current cash costs of homeownership may indicate the appropriateness of smaller homes or houses built simply and designed for future expansion or improvement. Another alternative to reduce the cost of housing is the factory-built manufactured house. Certainly the market for low-cost new housing is dominated by manufactured housing, and no discussion of the cost of housing or the availability of homeownership is complete without a discussion of that form of home.

Manufactured houses, though, are not the only means of reducing the costs of homes. Condominiums and cooperatives allow the potential homebuyer the option of purchasing a smaller, full-amenity home at relatively modest cost; and homesteading provides access to relatively large dwellings that have few amenities. One problem with these forms of homeownership is that legal and regulatory barriers have restricted their use for homeownership. Finally, there is the nagging suspicion in the minds of some prospective homebuyers that small, inexpensive, or partially equipped houses are shoddy and will not endure. One way of addressing these doubts is the use of homeowner warranties—a program widely used by the private sector.

In discussing new forms of homeownership, this chapter will examine four areas: condominium and cooperative housing, homesteading, manufactured housing, and warranty insurance on new homes.

Condominium and Cooperative Housing

The Commission recognizes the property rights of owners of rental housing and the substantial benefits to the individual and the community of the homeownership opportunities created by conversion to condominium and cooperative ownership. The Commission has also considered the concerns of tenants affected by such conversion, including the needs of low-income elderly households. On the basis of this analysis, the Commission supports conversion to condominium or cooperative ownership and opposes undue restrictions thereon.

Conversion of multifamily units to cooperatives or condominiums enables many people to become homeowners who otherwise would not have this opportunity. The Commission believes that homeownership is beneficial not only for those who occupy the units, but also to the community as well. The substantial numbers of units that have been purchased under this form of ownership provides evidence of public awareness of the benefits. As the size and nature of households change, the attraction to condominiums and cooperatives is expected to grow.

There are, however, conflicting interests here. The Commission believes that potential homebuyers must continue to be served by the conversion option. Public policy must also protect the rights of apartment owners to dispose of their property. At

the same time, the Commission recognizes that there may be important social consequences for those low-income tenants, particularly the elderly, who cannot afford homeownership and therefore must relocate. The Commission supports governmental policies that permit owners to convert while protecting tenants against undue disruption. Public policy should not interfere with free choice in the marketplace. The recommendations here are intended to allow conversions in response to market pressure.

Nationwide, 366,000 rental units were converted to condominiums and cooperatives during the 1970–79 period; 71 percent of these conversions (260,000) occurred during 1977–79. The number of condominiums and cooperatives increased annually through 1979, during which 135,000 units were converted. Compared to the entire rental stock, the number of conversions is relatively small (1.3 percent). Although concentrated in larger metropolitan areas, where conversions are roughly split evenly between the central cities and the suburbs, some evidence shows that the conversion phenomenon may be increasing in smaller metropolitan areas.

The benefits of conversion to the community as well as to homebuyers are considerable, but many demands have been made for imposition of government restrictions on conversions. One reason is the concern that rental housing is being removed, with adverse consequences to renters, who tend to be lower-income people. However, the mere number of gross conversions overstates the impact on the rental market. The conversion of rental units to ownership coincides with a movement of renters to ownership, which in large part is a voluntary movement. In addition, many units are purchased by investors and rerented. Therefore, some conversions do not represent reductions in the rental housing supply. In fact, the HUD report on condominium conversions indicated that the net impact of conversion—the reduction in the stock of rental housing relative to the number of remaining renters—is 5 units or less per 100 preconversion units.[4]

Although evidence indicates that most people moving from converted buildings experience little long-run hardship, the process of conversion can be stressful—especially for the elderly. Although great variation exists, tenants of converting buildings typically are given about 70-days notice to decide whether to buy. Nearly three-fourths of those who moved from converting buildings—but only one-fourth of those who remained—have stated that they felt pressured by the conversion experience.

In response to these concerns, by 1981 about one-half of the States had taken at least limited action to regulate conversions, and about one in five localities with conversions had adopted regulatory ordinances. Such regulations include those designed to protect tenants of converted buildings, those intended to protect buyer/owners of converted units, and those developed to preserve the supply of rental housing and/or housing for low- and moderate-income households. The most common regulations are those requiring advance notice to tenants and granting them the right to purchase before the units are offered to the public. Also common are provisions designed to protect tenants from disturbance during conversion, to protect buyers against possible unfair sales practices, and to provide assistance in moving if necessary.

Aside from the various procedural safeguards that might be afforded tenants during the conversion process, consideration has been given by some States—and should be given by all States—to relocation assistance or in-place financial assistance, in particular for the low-income elderly. Although the Commission recognizes that equity considerations may require this form of compensation, State legislatures should determine the nature and amount of such assistance, provided that any such requirements do not unreasonably constrain the right of the owner to convert.

The Commission urges States to consider favorably the adoption of conversion procedures generally in accordance with those established in the Uniform Condominium Act, with comparable coverage for cooperatives.

The Commission finds that the model Uniform Condominium Act (UCA), developed by the National Conference of Commissioners on Uniform State Laws, attempts to balance the rights of owners to convert with the concerns of tenants about the hardships brought on by conversion. The development of the UCA involved extensive research, consultations with affected parties, and much debate, thus incorporating many diverse interests. It was adopted by the National Conference in 1977, approved by the American Bar Association in 1978, and transmitted to each State for consideration. To date four States have adopted the UCA; many others are considering its adoption.

Because the UCA covers certain aspects of the condominium form of ownership that are not of concern to the Commission, all aspects of the act are not endorsed. However, the Commission agrees

[4] U.S. Department of Housing and Urban Development, Office of Policy Development and Research, "The Conversion of Rental Housing to Condominiums and Cooperatives," June 1980.

with the principles embodied in the UCA, in particular the following:

- There should be advance notice of conversion to tenants, and advance notice of eviction.
- Tenants should have the right of first refusal for a reasonable period after conversion.
- Sale to a third party, at more favorable terms, should be prohibited for a specified period after notice of conversion.
- Buyer protections should include disclosures in a public offering of an engineer's report, outstanding building code violations, budget provisions, and legal documents.
- Buyer and tenant remedies should include provisions concerning unconscionable agreements or terms in contracts, punitive damages, and class actions.
- Provisions for express and implied warranties should be created.
- The buyer should have the right to cancel the contract of sale within 15 days of receipt of public offering or up to the time of sale, whichever is later.

While the UCA provides these protections to tenants, it also guarantees the owner the right to convert, without tenant approval. Furthermore, the UCA forbids local governments from using land-use regulations to prohibit condominiums or from imposing other restrictions that do not apply to identical, noncondominium developments. Thus the UCA represents a balancing of the interests of owners and tenants regarding the conversion process.

By using the term "undue" restrictions in the broad recommendations on conversion, the Commission means to signal its opposition to requirements that would prevent landlords from undertaking conversion, except for those limited requirements contained in the UCA and, where necessary, reasonable provision for relocation of low-income elderly tenants. The Commission is firmly opposed to all other restrictions on conversion such as moratoria and requirements to obtain tenant approval.

No model code comparable to the UCA presently applies to conversions to cooperative homeownership, although the National Conference is in the process of developing one. The Commission believes that similar protections for tenants and rights of owners as found in the UCA are appropriate in the case of cooperative conversions.

The Commission considered taking a position on the question of insurance-backed warranties for conversion projects. The concern was with the converter who inadequately renovates or fails to disclose problem conditions. The Commission believes that an insurance-backed warranty system would impose little burden on the legitimate developer while protecting buyers (and the reputation of the industry) from the occasional "bad actor." However, the Commission believes that the concerns of adequate disclosure and liability will be sufficiently addressed under a law such as the UCA. As discussed above, the UCA requires an engineer's report, certain express or implied warranties, and other safeguards to the buyer.

In the sale or conversion of rental property, disincentives to the seller should be removed. The Commission further recommends that incentives be provided to facilitate sale of rental housing to tenants, particularly when a substantial portion are of low or moderate income. Restrictions on the types of income allowed cooperatives should also be relaxed to allow freer choice of this form of homeownership.

condominiums and cooperatives may offer the best opportunity for many renters to become homeowners, especially if tenants can accomplish the conversion themselves and cut down on their acquisition costs. However, elements in the Federal tax code and in Federal regulations discourage owners from selling their rental units directly as condominium units. Other tax provisions and regulations cause impediments to the organization and operation of condominiums and cooperatives.

The Commission cites two examples of changes in tax regulations that could facilitate and encourage tenant conversions: (1) treatment of gain from direct sales to tenants; and (2) revision of the recapture provisions of the Internal Revenue Code.

The Code presently discourages owners from selling condominiums directly by taxing such sales as ordinary income, rather than at capital gains rates. In effect, owners are treated as "dealers" rather than investors, and as such do not qualify for capital gains treatment. The Code should be changed to permit capital gains treatment for conversions by owners, and remove this barrier.

Under current law, when an owner sells a rental building, the owner pays tax on the difference between the sale price and original cost less depreciation taken. At least part of the accelerated depreciation taken is taxed as ordinary income (recaptured), while the rest is subject to the lower capital gains tax rates. Providing owners with some reduction in the taxes due upon sale to tenants may encourage owners to consider tenant purchases of their buildings as an alternative to outside sale for developer-sponsored conversion, and selling a rental building to tenants may stop the cycle of rapid depreciation and tax loss on the converted building.

Another incentive for owners to sell to a tenant group is the "leasing partnership." In a leaseback agreement, owners enter into a partnership arrangement with a tenant group—either a cooperative or a condominium association—in which the partnership actually owns the property, receiving the depreciation deductions, and then leases the property to the tenant group, which acts as a co-managing or general managing partner. The limited partners have no management responsibilities, but receive depreciation deductions. After a certain amount of time, the property is sold to the tenants at an agreed price.

A legal barrier exists, however, under current tax regulations. The Internal Revenue Service (IRS) considers that if a resale price is pre-set, the agreement is a financing mechanism and the building owner is functioning as a lender. Tenants would benefit from an agreed purchase price, without which they have no guarantee that the building would not be sold at the end of the lease. An IRS ruling that such an agreement would not impair the tax benefits to a partnership could facilitate tenant conversion and eventual purchase. Legislative authorization might be necessary.

The homeowner deduction section of the tax code for cooperative members (Section 216) restricts cooperatives by limiting to 20 percent the gross income that a cooperative corporation may receive from sources other than its tenant members, thus constraining the income that can be derived from renting commercial space to uses such as groceries, pharmacies, and day care centers. But such space provides both useful neighborhood services as well as potential income to reduce the effective housing costs for tenant shareholders. In some cases, tax law has caused cooperatives to rent out commercial space at below-market rents to avoid violation of the 20-percent rule. There does not appear to be a significant potential for tax abuse should 50 percent be allowed, but to eliminate any doubt, the IRS should adopt regulations to ensure that the interest and tax costs are properly allocated between residential and commercial facilities owned by the cooperative.

Section 277 of the tax code—which requires separation of membership and nonmember income and expenses for social clubs and other membership organizations, including housing cooperatives—should be revised to permit interest income earned on required reserves to be classified as membership income for tax purposes. In some cases, cooperatives have removed reserve funds from interest bearing accounts to avoid the reporting difficulties under this requirement. This seems an unnecessary burden, particularly for low-income cooperatives.

Various impediments to the financing of cooperative purchase should be removed, such as (1) the lack of a secondary market for membership share loans; (2) the failure to implement FHA insurance on membership share loans; and (3) the 30-percent cap on housing loans by the National Consumer Cooperative Bank.

At present, neither the Federal National Mortgage Association (FNMA) nor the Federal Home Loan Mortgage Corporation (FHLMC) provides a secondary market for mortgage loans on individual cooperative shares, which considerably restricts the availability of such loans. In 1979, the Federal Home Loan Bank Board changed its regulations to permit savings and loan associations to issue loans for cooperative share purchase on the same basis as other real estate loans. Lenders have been slow to implement this change, in large part because of a lack of a secondary market for these loans.

Both FNMA and FHLMC provide secondary markets for loans on individual condominium units, but neither have implemented their authority to establish a secondary market for cooperative share loans. Within the past several months, FNMA has been considering the development of a program to purchase share loans, but current legislation prevents action by FHLMC without Congressional action.

Section 203(n) is an FHA insurance program for cooperative share loans. Although passed by Congress in 1974, restrictions in the Department of Housing and Urban Development (HUD) regulations have limited its use. To facilitate acceptance of cooperative share loans in a secondary market, HUD should take the steps necessary to ensure full implementation of Section 203(n). In addition, the present statutory restriction of Section 203(n)—limiting coverage to cooperatives where FHA insures the blanket mortgage—should be removed. The financing of shares in all cooperatives should be eligible for FHA insurance, which should not be tied to the remaining term of the underlying mortgage, as is the case presently.

When the National Consumer Cooperative Bank was established by Congress in 1978, a cap of 30 percent (which becomes effective in 1985) was placed on the amount of the Bank's portfolio that could be held in housing loans. On January 1, 1982, the Bank became a private institution. The cap on its housing loan activity should be removed so that the Bank is free to operate in the marketplace like any other prudent lender, without requirements to limit its activity in any sector, and to meet the market demand for cooperative housing loans.

Homesteading

The Commission endorses single- and multifamily homesteading as a means of providing homeownership opportunities to low- and moderate-income renters.

HUD should continue to make available its single-family properties, acquired by FHA default, for use by local governments in homesteading programs. The various urban homesteading programs have demonstrated the utility of providing homeownership by offering people the opportunity to purchase abandoned and foreclosed properties. The single-family homesteading program offered many young families, who were renting, the opportunity to become homeowners sooner, by trading mortgage payments for their own work to rehabilitate the properties.

Multifamily homesteading would provide similar opportunities for apartment renters to become owners of either cooperatives or condominiums. HUD should implement a wider program of homesteading of its multifamily inventory for conversion to cooperatives and condominiums. The use of existing buildings considerably reduces some of the costs attendant to the creation of condominiums or cooperatives, lowering the acquisition costs to the tenants. Homesteading of multifamily buildings could make homeownership options available to lower-income people, including those presently receiving rental subsidies and those eligible for housing assistance payments.

The homesteading of multifamily properties, however, is a more complicated and difficult process than single-family homesteading and models must be developed by wider experience and practice. Among the problems that must be overcome are the legal complexities in acquiring properties, the architectural and engineering problems of rehabilitating large buildings, and the financing of cooperative or condominium purchase, particularly for low-income families. Even given all of these and other potential difficulties, however, it is appropriate to consider multifamily homesteading as a viable option when considering homeownership for low- and moderate-income families.

The Commission further recommends that HUD, in cooperation with local governments, take the initiative to develop a policy of turning appropriate government-held properties over to tenant cooperatives and condominiums, other nonprofit groups, or other purchasers in order to encourage homesteading. Section 246 of the National Housing Act already authorizes HUD to develop a systematic policy of assisting tenants in multifamily properties to develop cooperatives. In some cities, HUD properties represent a substantial portion of existing housing units under control of a single owner, affording a significant opportunity for low-income ownership. HUD has acquired more than 30,000 units through foreclosure and holds another 270,000 in buildings awaiting foreclosure, some of which might be appropriate for a homesteading program. In addition, there are nearly 10,000 HUD-insured and subsidized multifamily properties amounting to more than 1 million units. HUD should require that appropriate properties be evaluated for homeownership opportunities should they become available.

Manufactured Housing

The nature of the manufactured housing industry has changed remarkably over the past 40 years. At one time, the standard unit produced was usually a "house trailer," a small unit that could be towed behind a medium-sized family automobile. As the units became larger, they became known as mobile homes, and innovations in manufacturing led to larger "modular" homes and "double-wide" mobile homes that were joined together at the site. The "mobile home" designation became less and less appropriate as such units were increasingly installed permanently at the home site. As a result, the term "manufactured housing" has come to designate what were once called mobile or modular homes, whether or not permanently attached to a site. More recently, large components of buildings, such as entire walls, have been manufactured in factories and shipped to the site for permanent installation. Such components, or the assembled buildings, sometimes have been designated manufactured housing. In this report, the term "manufactured housing" applies to dwellings formerly designated as mobile or modular homes, whether or not they are permanently attached to a site.

The Commission believes that manufactured homes permanently attached to the land qualify as real property and recommends that Federal and State government and quasi-government agencies provide the regulatory and legal framework necessary to permit permanent mortgage financing of such property on the same basis as other real property loans.

Manufactured housing is a significant source of affordable housing for American families, particularly first-time homebuyers, the elderly, and low- and moderate-income families. Manufactured homes accounted for almost 36 percent of all single-family homes sold in the United States in 1981, and for the vast majority of those sold for under $50,000.

Manufactured housing has competed effectively in a national housing market characterized by a vast array of Federal credit programs, institutional financing facilities, and regulations that favor conventional housing competitors. However, special limitations on the financing of manufactured housing continue to place serious inhibitions on what could be a valuable and affordable source of housing for millions of Americans. The Commission believes that the disincentives that now characterize

the manufactured housing sector should be removed in order to make full use of this resource.

Manufactured housing has undergone major changes since the early 1970s: a new nationwide construction code (1974), supervised by HUD, has improved quality, durability, and safety; and Federal credit insurance and guarantees have been extended to manufactured housing in both FHA and VA programs. Many of the remaining impediments to a free choice of manufactured housing are the result of Federal policies, while others are the result of actions at the State and local levels. In Chapter 15, the Commission recommends removing zoning provisions that discriminate against manufactured housing.

The Commission's recommendations are designed to achieve reasonable parity for manufactured housing finance with that made available for conventionally built housing. Specific actions recommended by the Commission include:

- Implementation of FHA insurance and VA guarantee programs for real property loans for manufactured housing.
- Continued development of FNMA and FHLMC secondary market programs for such loans.
- Revisions in State and Federal regulations of financial institutions to permit the use of standard fixed-rate and alternative-mortgage instruments similar to those available for conventionally built housing.
- Inclusion by the Department of Labor of manufactured housing real property loans in Employee Retirement Income Security Act (ERISA) regulations that apply to mortgage investment by private pension plans, and similar inclusion in State regulations applicable to public pension plans.
- Review of Federal tax laws and regulations to assure that manufactured housing real property transactions are treated equally with conventionally built housing transactions—for both homeownership and rental income investments.

With regard to manufactured homes that are not attached to the land, more broadly based access to the credit markets should be developed for the financing of manufactured housing held as personal property.

Special problems exist for the financing of manufactured housing held and titled as personal property separate from the land holding. This still represents the dominant form of holding, largely because discriminatory zoning often confines manufactured housing to mobile home parks. (Of course, mobile home parks also represent a free choice for some.)

Many Federal, State, and local policies and programs favorable to housing—in areas such as financial structure, regulation, direct and indirect subsidies, and tax preferences—have conceived of housing as existing only in the form of "real property," i.e., as structures permanently attached to land under a single title. Thus, the public policy priority for housing sometimes inadvertently fails to provide even-handed access to financing, tax preference, and location choices in cases where housing is held and titled as personal property.

Specific actions recommended by the Commission include:

- FHA and VA programs for manufactured housing should be continued until private sector insurance or guarantee programs are developed.
- A secondary market for manufactured home loans should be continued. Until private sector alternatives are developed, GNMA mortgage-backed securities program for FHA or VA manufactured home loans should be used.
- Private sector alternative personal property financing mechanisms should be developed similar to those evolving in the mortgage finance area. When necessary, State and Federal laws should be enacted or regulations promulgated to permit use of these new instruments.
- Manufactured housing personal property loans should be eligible for investor bad debt reserves (or mortgage interest tax credit if enacted).
- Private mortgage insurers should develop credit insurance for loans secured by liens on manufactured housing titled as personal property.

Warranty Insurance on New Homes

Congress should amend the law to require that the present mandatory warranty protection on newly constructed homes insured or guaranteed by FHA, Farmers Home Administration, and VA be administered through private sector programs, where adequate private programs exist, provided they do not discriminate on the basis of the homebuyer, neighborhood location of the home, or other criteria irrelevant to construction quality. The homebuyer should have the option to decline warranty coverage on such newly constructed homes.

All home builders should consider offering insurance-backed warranties as an option with the sale of new homes.

Since 1954, the Federal government has required builders of federally assisted or insured

housing to provide buyers with a one-year written warranty stating that the house conforms to the builder's plans and specifications. Ten years later, HUD was authorized to compensate homebuyers for major structural defects if a claim is filed within four years of construction. VA received a similar authority in 1968, and Farmers Home Administration (FmHA) received similar authority for claims filed within 18 months of purchase. Since the Federal warranty programs were established, the private sector has developed insurance-backed warranties that serve a large part of the new home market.[5]

The largest of these programs is the Homeowners Warranty (HOW), a mutual company owned by its approximately 16,000 participating builders. To date more than 923,000 new homes have been covered by HOW, and more than 13,000 claims filed, totalling $41 million—a frequency of 14.7 claims per thousand policies and an average loss per claim of $4,000.

Under the HOW program, participating builders purchase 10-year warranty/insurance on newly constructed single-family homes, townhouses, and condominiums. The builder warrants the building to be free of defects of materials and workmanship during the first year, and to be free of other major defects for the first two years. If the builder fails to perform its warranty obligations during these first two years, HOW assumes the responsibility. During years 3 through 10, HOW insures the home against major defects.

In addition to HOW, other private and public-insured warranty programs are in operation. The Family Protection Plan, Inc., has been offered in New Jersey and Pennsylvania since 1974. This program accepts only large-scale builders with excellent reputations. As of May 1980, the program had approved only five builders, with coverage of about 800 homes.

New Jersey established a State-insured warranty program in 1979. The State has authority to collect insurance premiums and to raise premiums as necessary to replenish the insurance fund. All builders must register with the State and either belong to the State program or to an approved private plan, such as HOW. To obtain a building permit, builders must show a registration card; there are penalties for selling a home without a warranty.

The New Jersey model is directly applicable to the present Federal warranty requirement for FHA-, FmHA-, and VA-insured homes. Rather than itself undertaking the necessary inspections, insurance function, and other activities, the Federal government could merely certify private warranty programs to undertake these tasks. However, to give the homebuyer a free choice and possibly to reduce the cost of the purchase of a new home, the Commission recommends that under all types of warranties, the purchaser be notified of the cost thereof prior to purchase and have the option of accepting or declining such insurance coverage. This provision for voluntary coverage would replace the mandatory requirements now contained in the various Federal programs described above.

The Commission recommends that all homebuilders consider offering insurance-backed warranties as an option with the sale of new homes. Virtually all States have imposed (either judicially or legislatively) an implied warranty of habitability on builders and sellers of new homes. The insurance-backed warranty is one way to make explicit the terms of implied warranties. Coupled with a dispute settlement system, this can save both builder and buyer the costs of a protracted legal dispute.

Given the strong demand for such warranties by homebuyers, the Commission finds that the insurance-backed warranty may offer a marketplace solution to a consumer problem that in the past has led to calls for government action. The Commission therefore urges builders to consider offering insurance-backed warranties as an option to their customers.

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[5] For a full discussion of new home warranties, see Thomas H. Stanton, "Consumer Protection and National Housing Policy: The Problem of New Home Defects," *Case Western Reserve Law Review*, Vol. 29, No. 3 (Spring 1979), pp. 527–549.

CHAPTER 7

RENTAL HOUSING

Rental housing is an important source of shelter for many Americans. Both the number and quality of rental units have increased in recent decades. But the rental housing market is suffering from high interest rates and declining real rents. Given the conditions that exist in this market and the projections of future trends in the market, the Commission has formulated proposals that address the primary problems confronting the rental housing market while allowing local flexibility to deal with the problems.

The Commission feels that primary emphasis should be given to private market solutions to the problems of the rental housing market. Rents have been depressed in recent years, lagging the general increase in prices as well as the specific costs of construction and operation of rental units. If rental housing is to be a viable form of investment, rents will have to rise to cover increasing operating and financing costs. But as higher income renters opt for homeownership, those who continue to rent are more likely to have difficulty paying higher rents. Recognizing that rent increases may be particularly burdensome to lower income households, the Commission has recommended the adoption of a Housing Payments Program (Chapter 2) that is designed to enhance the purchasing power of low-income households and allow such households to function more effectively in the private rental housing market. Complementing the Housing Payments Program is the proposed Housing Component of the Community Development Block Grant program (Chapter 2), which is designed to replace existing categorical programs, and which gives the option to local communities of augmenting rental supply by upgrading existing units or through new construction. A combination of income assistance, Federal insurance, tax incentives, and block grant funds creates support for private market provision of rental housing.

This chapter provides a review of the current status and outlook for unsubsidized rental housing. In order to improve the functioning of the rental housing market, several recommendations are offered.

- In view of the market distortions caused by rent control, the Commission recommends eliminating or minimizing the extent of rent control. States are urged to act to remove local rent control and the Federal government is urged to use its preemptive powers to remove from rent control rental housing financed by a lending institution whose deposits are insured by a Federal agency, and rental housing financed by the Federal government or which has a mortgage insured or guaranteed by the Federal government or its agencies.
- Tax incentives for construction and rehabilitation are proposed to provide for more equitable treatment of rental housing in the tax code.
- Related Commission analyses and recommendations regarding the rental housing market are also discussed, including financing and mortgage insurance for multifamily housing and regulations in such areas as zoning, building codes, and condominium conversions.

The Current Status of Rental Housing

Rental housing plays a major role in the U.S. housing market, sheltering over one-third of all households. The vast majority of rental housing, over 88 percent, is not subsidized but provided by the private market.[1] Private rental markets are dominated

[1] Michael Lea, Department of Housing and Urban Development, Office of Policy Development and Research, *Rental Housing: Condition and Outlook* (Washington, D.C.: U.S. Government Printing Office, 1981). This paper is the basic source of the empirical work in this chapter. Anthony Downs also contributed useful insight.

by small-scale operators, with about 60 percent of all rental units in structures with less than five units; 31 percent of rental units are single-family homes.

During the last decade many middle- and upper-income households have switched to homeownership; these households have higher incomes than the typical renter. The remaining renter population has been increasingly composed of younger households, single individuals, and female-headed households—all of whom tend to have relatively lower incomes than the renter populations in previous years. The result is that, as a whole, the current renter population has a relatively lower rent-paying ability than in the past.

Contrary to the perceptions of many, residential rents have not increased as fast as general prices, consumer income, or operating and construction costs for rental units during the past 20 years. It has been estimated that real rent levels, on average, have fallen about 8.8 percent in the past 20 years.[2]

While falling real rents have benefited housing consumers, rent levels have not been high enough to sustain new construction or maintenance of existing properties in many areas. Lagging rents, coupled with rising interest rates and operating costs, have made refinancing of rental properties more difficult and contributed to profitability problems in existing rental housing. Rent control, while not the sole cause of lagging rents, has contributed to the decline in profitability of rental housing. This will be discussed in detail later in the chapter.

The lack of favorable financing available to rental owners in the past has exacerbated the problems of rental housing development and operation. In the late 1960s and early 1970s lenders offered long-term fixed-rate mortgages at rates of interest which failed to anticipate rising inflation. Therefore, borrowers with such mortgages benefited from after-tax interest rates which were near or below the rate of inflation—real interest rates near or below zero percent. Investors anticipated price appreciation due to the possibilities of converting rental units to condominiums and through the growth in demand for units in desirable areas. This, in turn, persuaded investors to pay higher prices for rental units than could be justified by their current earnings from rents alone. However, towards the end of the decade, interest rates rose to reflect anticipated inflation, which contributed to decreasing rates of construction of rental units.

Tax benefits, principally accelerated depreciation, helped offset low net operating incomes because losses allowable for tax purposes benefit high-bracket investors who shelter other income. Tax benefits also are typically amplified through borrowing most of the cost of each investment so that a small amount of equity supports, or leverages, a large investment. Positive tax benefits of depreciation allowances and increases in property values are multiplied because investors receive tax benefits and capital gains on total value, including both borrowed and equity funds.

The tax advantages to rental investment were significantly improved by the Economic Recovery Tax Act of 1981. The reduction in depreciable life from an average of 30 to 35 years to 15 years will increase the present value of depreciation benefits by 50 percent for new rental housing and 35 percent for existing rental housing. However, the tax law changes were even more beneficial to nonresidential investment. The combination of increased nonresidential investment demand and tight monetary policy may keep interest rates high and offset the increased tax advantages for rental investment.

The tax benefits for low-income rental housing may be significantly larger than those for conventional rental housing. Low-income housing enjoys a small advantage with a higher depreciation rate and a potentially large advantage with the expensing of construction period interest and taxes (as opposed to 10-year amortization for conventional properties). The magnitude of this difference depends on interest rates. The higher the construction period interest rates are, the greater the advantage of expensing. However, these tax advantages alone have not been sufficient to overcome current high interest rates and have not attracted capital to new construction for low-income rental housing.

Outlook for Rental Housing

Rents may rise in the near future for several reasons. Although the renter population became increasingly concentrated in the lower end of the income distribution during the 1970s, this trend may be altered to some degree in the 1980s if middle-income households increasingly choose renting over homeownership. Unsubsidized construction is typically targeted at middle-income groups; their increased presence in the rental market would facilitate more new construction. Further, renter demand should be sustained during the next few years due to pressures from new household formation. However, because rents have increased more slowly than construction and operating costs, rents will have to rise significantly in order to generate new construction. Rising rents also will generate increased supply from the existing stock through division of larger properties into smaller units, conversion to residential from

[2] See Ira S. Lowry, *Rental Housing in the 1970: Searching for the Crisis* (Santa Monica, Calif: The Rand Corporation, 1982), Appendix Table A.

nonresidential uses, and the rehabilitation and upgrading of existing properties.

Both rental consumers and suppliers would respond to rising rents. With rising housing costs, household formation would be slowed, primarily reflecting decisions by young people and the elderly not to live as independent households. In addition, there would be pressure to economize on space generally, resulting in more splitting up of large units and more construction of smaller units. Conversion of nonresidential space into housing, retrieval of units temporarily removed from use, and division of large units into a greater number of smaller ones were very significant sources of rental units in the late 1970s, as indicated in Chapter 5.

The factors that prompted a more intensive use of the existing housing stock in the 1970s were the rising real construction cost of new housing units (including acquisition of land); the declining average household size (which triggered conversions from single housing unit structures to multiunit structures); and the greater returns on structures in housing rather than industrial use (which induced conversions from commercial to residential properties).

Other factors may influence the supply of new rental housing in the next few years. Investors will no longer benefit from low real interest rates caused by unanticipated inflation. Lenders have adopted new instruments that pass the interest rate risk to borrowers, such as variable-rate loans and renegotiable loans. Lenders may also participate in joint ventures, sharing the leverage benefits with the other investors.

Production of new rental units depends crucially on both rents and interest rates. Production of new rental housing units may continue to be very low in the near future because of high interest rates and the continuing lag of rents far below levels needed to support new building. The timing of new construction depends upon how fast rents rise in relation to construction costs and interest rates.

The desire of rental suppliers to produce or upgrade units relies on their ability to charge higher rents. For lower income households, ability to pay will depend on the degree of assistance available to meet rent payments. In this light, the Commission's proposal for assistance to low-income households through a Housing Payments Program takes on special significance. Without such assistance, local pressure for rent control will intensify and landlords will be reluctant or unable to pass on higher operating and financing costs in the form of higher rents. Market shortages may appear in many areas, and, if such conditions persist, the quality of the rental stock undoubtedly will be diminished.

Several other potential obstacles interfere with the private market's ability to meet the demand for rental housing. These obstacles are imbalances in tax treatment of rental property which may act as a disincentive for rental housing investment, the cost and availability of financing and insurance for rental investment, and regulations by local governments (in addition to rent control) that inhibit new supply or increase the costs of supplying rental units. The Commission has addressed each of these obstacles to the functioning of the private market.

Recommendations

In keeping with the discussion above, the Commission's recommendations for rental housing will be grouped into four areas: rent control, tax incentives, financing and insurance, and regulation.

Rent Control

The Commission finds that rent control causes a reduction in the quality of the existing rental housing stock and discourages investment in new rental property. Therefore, the Commission opposes, in principle, rent control at Federal, State, and local levels.

The most evident interference in the ability of the private market to supply rental housing is rent control, which is now in use in over 200 cities and affects a substantial percentage of the nation's multifamily rental housing stock.[3] Rent control is not simply an attempt to protect lower income persons. More generally it has been a device for redistributing inflation-induced capital gains from landlords to tenants, regardless of tenant incomes. As rents rise, pressure for the local regulation of rents will increase from tenants of all income levels.

Rent control acts as a severe disincentive to investment and mortgage lending and therefore inhibits the provision of rental housing in the private market, a point forcefully made at the Commission public hearings in Los Angeles, Washington, D.C., and New York. Frequently, it is not just the enactment of rent control that deters rental investment; even the discussion of potential enactment can create a disincentive. Rental housing is a long-lived commitment. Investors make decisions about new construction or the rehabilitation of rental housing based on their expectations. If investors anticipate the future enactment of rent control, even in a relatively nonbinding form, it will affect their predic-

[3] Thomas Thibodeau, "Rent Regulation and the Market for Rental Housing Services" (Washington, D.C.: Urban Institute, November 1981), p.9; background paper prepared for the Commission.

tions about future income flows and expenses as well as their decision to invest.

After rent control is enacted, landlords tend to disinvest from their real estate ventures. This disinvestment either takes the form of conversion to cooperative or condominium forms of ownership, deferred maintenance, or, in extreme cases, abandonment. The Commission finds that rent control causes a reduction in the quality of existing rental housing stock and discourages the investment of capital in new rental property.

Moreover, rent control essentially yields an income redistribution from landlords to tenants by implicitly taxing landlords for the benefit of tenants. In general such a tax is inefficient and inequitable. Rental property owners are often small-scale investors who do not have large financial resources. More importantly, such a tax ignores the fact that individuals can move to another area to avoid or take advantage of local redistribution programs. Over time, a tax on landlords in the form of rent control will cause landlords and investors to leave areas with rent control. The result will be a lack of new construction and a deteriorating stock of existing rental housing. In the long run, tenants lose. Tenants may also move to try to take advantage of rent-controlled units; this may create an excess demand for controlled units and perhaps a black market method of allocation. For example, a new tenant may be required to buy furniture from the previous tenant at a highly inflated price.

The Commission does recognize that there are special circumstances in which rent control is warranted. For example, in 1974 the Alaskan cities of Fairbanks, Anchorage, and Valdez enacted rent control to protect residents from dramatic rent increases occurring as a result of the influx of workers for the Alaska pipeline. The controls were terminated when the pipeline was completed in 1977. By contrast, New York City imposed rent controls under "emergency" legislation passed in 1943. The Commission finds such long term allegations of "emergency" to be a serious abuse of the term. We doubt that the original wartime conditions giving rise to the legislative finding of an "emergency" have persisted. The nature of an emergency which gives rise to rent control should be periodically reviewed. Only if this is done can rent control be justified as an explicitly short-term measure to prevent excess profits from accruing to existing landlords. In most cases, the adoption and continuation of rent control does not coincide with emergency conditions and has deleterious effects on the housing market.

In order to discourage rent control, the Commission recommends both State and Federal actions.

State Actions. **The adverse effects of rent control spread far beyond the boundaries of municipalities. Therefore, the Commission urges that states pass legislation removing the power of counties, cities, and all other local jurisdictions to adopt ordinances controlling rents.**

Rent control affects the operation of the private housing market. If the private market is to provide rental housing, it must be allowed to function in a relatively unfettered environment. It is contradictory to rely on the private market to provide housing and allow local regulations that unduly inhibit its operation. In metropolitan areas, the housing market frequently extends beyond the borders of the locality adopting the rent control ordinances. Therefore, rent regulation by one locality will have spillover effects on the housing markets in neighboring jurisdictions. The Commission opposes rent control except when true emergencies exist as defined by State legislatures.

The Commission considered a range of options to deal with the rent control issue. The preferred option is for the States and localities themselves to resolve the problem without Federal involvement. While some form of partial decontrol may succeed at the local level, it is politically unlikely that many localities with rent controls will deregulate. State governments appear to be in a far better position to undertake meaningful reform. Such reform has occurred in a few States, principally Arizona, Colorado, and Florida where they either deny localities the power to enact and enforce rent control laws (Arizona and Colorado) or limit the exercise of rent control powers to apartments in the lower rent ranges (Florida). New York State has enacted a vacancy decontrol requirement for multifamily housing that allows owners to raise the rents of vacant units to so-called stabilized rent levels (another form of control), although not necessarily to market levels.

Wherever rent controls are allowed to continue, States should also be urged not to waste Federal funds for housing in such communities. Over the years the Federal government has made substantial direct investments in grants and subsidies for urban housing running well into the billions of dollars. During this same period the government has witnessed the devaluing of some of these investments and loans because of disinvestment by owners and abandonment in areas with rent control. For example, if Community Development Block Grant (CDBG) funds are used to rehabilitate rental structures which later fail and go into default or are abandoned as a result of rent control, the purposes of the Federal investment are no longer met. These funds could have been used more efficiently for some other eligible activity, or by some other lo-

cality without rent control. A similar argument applies to use of other housing funds in places with rent control. Problems of undermaintenance and abandonment can be precipitated or exacerbated by rent control, and the Commission considers it counterproductive and inefficient to use limited Federal funds to attempt to offset the effects of rent control by subsidizing the rescue of abandoned buildings, such as those held by municipalities after tax foreclosure, or otherwise to put at risk these funds in areas with rent control. States are therefore urged—but not mandated—to allocate Federal resources to purposes and in places where they are not exposed to the effects of rent control.

Federal Actions. **The Commission recommends that the Federal government should preempt the application of any State or local government rent controls on rental housing financed by a lending institution in which deposits are insured by a Federal agency, and on rental housing financed by the Federal government or which has a mortgage insured or guaranteed by the Federal government or its agencies.**

Although the rights of States (and within the power of States, localities) to control internal affairs is essential to the American political arrangement, those rights do not entitle States or localities to do irreparable harm to Federal financial interests within their boundaries.

A basic Federal interest involves its contingent liabilities. In the case of FHA insurance, the Federal government is prepared to step in and make good a mortgage in foreclosure, either through use of the insurance funds or, where necessary, Federal appropriations. The Federal government has therefore acted to protect HUD insured projects, subsidized and unsubsidized, by asserting preemption over the application of local rent control ordinances to all subsidized projects and on a case-by-case basis for unsubsidized projects. The rationale is that rent control should not interfere with the mortgagor's need to achieve a level of residential income necessary to maintain and adequately operate the project, which includes sufficient funds to meet the financial obligations under the mortgages.[4] This assertion has been upheld in the courts, and this right of preemption should be exercised for all FHA-insured loans as well as direct loans under the Section 312 rehabilitation loan program and the Section 202 elderly housing program.

A parallel form of Federal financial interest is a loan made by a lending institution whose deposits are insured by the Federal government. In this case the Federal interest is in the continued viability of the lending institution and the contingent liability of the insurance funds of the Federal Deposit Insurance Corporation (FDIC), the Federal Savings and Loan Insurance Corporation (FSLIC), and the National Credit Union Administration. Erosion of the financial strength of federally insured institutions because of bad mortgages would constitute an increased risk of loss to the insurance funds. The use of preemption to protect HUD-insured projects has been established; the Commission recommends that the preemption principle be extended to include property on which loans are made from federally insured institutions.

During public hearings, the Commission was encouraged to terminate all Federal funding and insurance and guarantees to those communities with rent control laws. The Commission rejects the use of such sweeping actions. The Commission believes that only those Federal financial interests which are placed at risk because of rent control laws should be affected.

The proposed method of ameliorating the effects of rent control would simply follow the approach currently used by HUD to preempt the application of such controls to subsidized, insured projects. The Commission does not consider such actions as inimical to the concept of federalism; rather these actions are necessary to protect the taxpayers' interest in the responsible and efficient use of Federal funds and to protect the financial security of the loans made by federally insured institutions. The Commission's recommendation would preserve the right of local communities to continue rent control policies, but would exclude from rent control all property on which loans are issued by federally insured lenders or which has a mortgage insured or guaranteed by the Federal government or its agencies. The benefit of this approach would be to allow use of these mortgage-funding sources and of Federal mortgage insurance and guarantees for rental housing in rent control communities without the lender and investor fearing that their investment will be jeopardized by rent control measures, without exposing lending institutions to needless financial risk, and without the Federal government incurring a higher risk of loss due to its contingent liability position for insured funds and mortgages.

Although the justification for this proposal rests primarily on protecting the Federal government's contingent liability for insured deposits and mortgages, the actual implementation of the recommendation may require actions on the part of the Federal regulators and insurers of financial institutions, including the Federal Deposit Insurance Corporation, Federal Home Loan Bank Board, Federal

[4] 24 CFR 403.

Savings and Loan Insurance Corporation, Federal Reserve Board, Comptroller of the Currency, and the National Credit Union Administration. Regulatory agencies may already have the statutory authority to implement such regulations. Should additional authority be needed the President should seek such authority from Congress.

This recommendation would apply to new mortgages created after the effective date of the preemption regulations, and to existing mortgages. However, for property covered by existing mortgages, a phase-in period of up to five years should be provided to ameliorate potential problems of sudden rent increases and tenant displacement. The Commission recognizes that individuals in rent-controlled apartments in some cities might face hardship if rent controls were precipitously terminated. A transition period, including immediate vacancy decontrol when a unit is vacated, is appropriate. The nature of the transition must be tailored to the form of rent control in place in each locality. While a reasonable period of time would be needed for transition, the Commission believes that no more than five years should be allowed before full decontrol is reached on all properties having mortgage loans issued through federally insured lending institutions.

The Commission adopted this proposal in its entirety, although two Commissioners expressed reservations. One reservation was that Federal financial interests in protecting regulated institutions or the Federal liability for insured deposits are not sufficiently direct to warrant the use of preemption. Another was that the preemption should not apply to existing loans, but only to loans issued after the effective date of the preemption provision. If the preemption applied only to such loans, which include many newly constructed buildings, the provision would be easier to implement and administer, because many communities already exempt new construction from rent control.

Tax Incentives

Expensing of Construction Period Interest and Taxes. **All rental housing should be eligible for expensing of interest costs and taxes incurred during construction. Section 189 of the tax code, which requires 10-year amortization of these rental housing expenses except for low-income housing, should be suspended through 1984 to create an incentive for all rental housing production.**

Tax treatment of multifamily new construction has important implications for the owner/developer's equity position. Typically, new rental housing projects are financed through a combination of mortgage financing and equity investment. The equity investment is frequently raised through the sale of shares of a project by the developer to outside or passive investors (limited partners). The equity contributions of the passive investors are an important part of the development incentive in that the amounts invested (contributed to the partnership) may provide an immediate profit to the developer. This happens when the amounts invested exceed the cash needed for the project beyond the mortgage loan. When a passive investor purchases a share of a rental housing project, he or she purchases a share of the tax benefits, net operating income, and expected capital gains associated with the project. The tax benefits for rental housing investment, primarily through accelerated depreciation, allow investors to shelter other income and are a primary incentive for such investment. These benefits are typically larger during the early life of the project and act to somewhat offset the low cash return during the construction period and early "rent-up" period.

Prior to 1976, investors could expense (deduct from current income) construction period interest and taxes. The deduction of these expenses creates an additional source of tax savings for individual investors during the construction period. The 1976 Tax Reform Act eliminated this expensing of construction period interest and taxes for rental housing but not for corporate property. Section 189 of the Internal Revenue Code now requires that, except for low-income housing, these costs be amortized over a 10-year period, rather than deducted in the year incurred. The 10-year spread of deductions has less value to investors than when the expenses can be claimed immediately as a deduction.[5] This change in the tax law may have contributed, along with rising interest rates and decreasing effective demand, to the decline in rental production during the latter part of the 1970s. Restoration of the pre-1976 tax treatment of construction expenses would increase the after-tax return on new rental housing investment, provide comparable treatment for corporate and residential development and therefore provide an incentive at the margin for the production of rental housing.

Expensing of interest costs will be more valuable in periods of high interest rates (since interest costs are higher then) and offset part of the adverse impact of the high financing costs. The Commission believes that this aid is necessary to relieve the current burden of high interest rates from rental

[5] An immediate tax savings of $1,000 can earn interest, and is more valuable than a $1,000 tax savings occurring in the future. That is, the present value of current year expensing exceeds the discounted value of the same dollar deductions stretched out over 10 years.

production. The Commission recommends that through 1984 all rental housing should be eligible for expensing of interest costs and taxes incurred during construction. The need for this incentive should be reexamined at that time.

The cost to the Treasury of this incentive likely will be small, and will be offset by the benefits of the incentive. Estimates based on rental housing production and interest rate assumptions as of mid-1981 by the Joint Committee on Taxation indicate that the net revenue loss (difference in discounted present value) will be modest. The Committee estimated that if a general exemption had been made effective as of January 1, 1982 with no sunset provision, revenue losses (in present value terms) would be $113 million in fiscal year 1982 and range between $225 million and $260 million through 1986. These estimates will vary with assumptions made about the interest rate, production, and length of construction period.

Changes in the tax treatment of construction period interest and taxes will primarily affect new production. Another element of the tax code, the granting of tax credits for rehabilitation of real estate, affects existing housing, and if left unchanged, may act as a disincentive to the rehabilitation of rental, as opposed to commercial, structures.

Rehabilitation Tax Credit. **Owners of residential rental structures should enjoy the same investment tax credit for rehabilitation expenses as that for owners of nonresidential real estate.**

Changes in the tax law in the Economic Recovery Tax Act of 1981 provided for special investment tax credits for the rehabilitation of commercial structures. Specifically, the tax code allows for 15 percent credit for structures at least 30 years old, 20 percent for structures at least 40 years old and 25 percent for certified "historic" structures. Other than historic structures, existing residential structures do not qualify for this credit. The unequal treatment of residential and commercial structures may be detrimental to the preservation of existing rental housing.

An extension of the nonresidential rehabilitation tax credit to ordinary rental housing would provide an appropriate, broadly available incentive for investment in rental housing. This incentive would further encourage rehabilitation to be undertaken with funds from the Housing Component of the Community Development Block Grant program. In addition, it would provide a more generally available incentive to upgrade residential property than the accelerated depreciation allowed under Section 167 (k), which is limited to structures occupied by low-income tenants.

An additional rationale for Federal support of existing rental housing exists with respect to the benefits associated with preservation of the rental stock. The problems of abandonment are well known and documented. Not only does abandonment affect residents within a building but it also affects the safety and well-being of neighboring residents and the financial investments of neighboring property owners. Abandonment also frequently endangers Federal investments in low-income areas and may lead to increased municipal expenditures to maintain or demolish abandoned structures. A rehabilitation tax credit, by providing an incentive for upgrading existing units, may reduce some of the problems associated with residential decay and abandonment.

The Department of the Treasury has calculated the increase in project value provided by an extension of the nonresidential rehabilitation tax credit to rental housing. The increase in value resulting from the rehabilitation tax credit, like that for all tax credits, is largely insensitive to the tax bracket of the investor, so long as the investor's tax liability exceeds the credit, but is sensitive to the amount of rehabilitation undertaken. For a project in which rehabilitation costs equal the value of the original structure (the smallest qualifying rehabilitation expenditures under the commercial portion of the 1981 act) the 20 percent credit raises project value 6 to 7 percent. For a more substantial upgrading, where rehabilitation costs are three times the original structure value, the 20 percent credit raises project value 9 to 12 percent. Incentives of these magnitudes should be large enough to encourage the upgrading of deteriorating rental housing.

Because the gain in project value arises from reduced tax liability, the loss of Federal tax revenue approximately equals the gain in the project value. Thus, in the above case where rehabilitation costs equal the value of the original structure, revenue losses to the Treasury would amount to about 6 or 7 percent of total project value. (Revenue losses and value increases cannot be calculated simply as the amount of the tax credit, because other tax advantages, such as accelerated depreciation, are reduced by use of the credit.) Most, but not all, of the revenue loss occurs in the year the rehabilitation takes place. Total revenue losses to the Treasury depend on how many qualifying rehabilitation projects are undertaken as well as the revenue loss per project.

Preservation of the existing housing stock creates housing opportunities for citizens of all income levels. In recent years, there has been a great resurgence in the upgrading and preservation of the existing stock, particularly historic buildings.

Historic Investment Tax Credit. **The Commission recommends that, as part of the certification process for the 25 percent historic investment tax credit, the Secretary of the Interior be authorized to exempt certified historic preservation projects from the substantial rehabilitation test and from the requirement that the building retain at least 75 percent of the existing external walls.**

Recent changes in Federal tax law increase the economic attractiveness of private rehabilitation efforts in connection with historic structures. The Economic Recovery Tax Act of 1981 provides substantial new incentives for rehabilitation of older buildings. As of January 1, 1982, expenditures for qualified housing rehabilitation efforts are eligible for a 25 percent investment tax credit against the owner's tax liability when they take place in an historic structure (of any type, including commercial and residential property) certified by the Secretary of the Interior.

The rehabilitation tax provisions include a test for "substantial rehabilitation" and a requirement for retention of 75 percent of existing exterior walls. In application, it has been discovered that both of these tests have some unintended and undesirable results, which disqualify some historic rehabilitations or unnecessarily increase rehabilitation costs. These problems have been recognized by Congressional tax committees, and several solutions are being considered. The recommendation contains the solution recommended by the National Trust for Historic Preservation as the one most appropriate for preservation needs. For qualifying structures, the proposed treatment would provide a more advantageous alternative than the rehabilitation tax credit in the previous recommendation. It should be recognized that the use of tax credits for rehabilitation of historic structures depends on having a workable system for identifying candidate properties, qualifying entries for the National Register of Historic Places (maintained by the Department of the Interior), and providing technical services to owners of historic structures that are listed in the Register. Further consideration of the role of the National Trust for Historic Preservation and of the role of the existing housing stock is developed in Chapter 8.

Financing and Insurance

An important factor in the ability of the private market to supply rental housing will be the cost and terms of financial capital available for rental housing investment. If the returns to rental housing investment are sufficiently high, funds can be expected to flow from traditional sources, such as life insurance companies and lenders. Proposed modifications in ERISA (see Chapter 11) should make more pension fund resources available for rental investment.

Rental housing benefited from the issuance of fixed-rate, long-term mortgages in the 1960s and early 1970s. Because lenders did not correctly anticipate inflation, most rental projects benefited from the low or even negative real interest payments. Therefore, decreasing real operating returns were offset in part by decreased real interest costs. For the foreseeable future, lenders can be expected to pass the risk of rising interest rates on to investors through fixed-rate mortgages at rates incorporating expectations about inflation or through variable-rate and renegotiable-rate mortgages. This increase in financing costs and interest rate risk may be somewhat offset through shared appreciation mortgages or joint ventures if lenders attempt to share in the returns from rental housing investment. Some improvement in the match, over time, of rental income with mortgage payment expenses might also be realized with graduated payment mortgages, but private lenders have been reluctant to experiment with them.

Insurance is also an important element in the production of multifamily housing. In Chapter 12 the Commission recommends that the FHA should continue to insure unsubsidized multifamily mortgages and should perform a demonstration role with respect to innovative forms of multifamily mortgage instruments. This would include experimental authority for FHA to issue insurance for graduated payment multifamily loans. The Commission also recommends that interest rate ceilings on multifamily mortgages be eliminated and that regulation of developers of FHA projects be minimized.

Regulation

Building Codes. Local land use and building code ordinances inhibit the provision of rental housing and can increase the cost of providing units of rental housing. In Chapter 15 the Commission urges state and local governments with existing building codes to limit building codes to basic health and safety issues and to adopt one of the three nationally recognized model building codes with little or no amendment. This change will reduce the present significant variation among local codes. Standardization of local building codes will allow builders and suppliers to take advantage of economies of scale to serve a larger potential market.

Chapter 16 also recommends that the Department of Housing and Urban Development and the Farmers Home Administration should, in their multifamily condominium and cooperative ownership housing programs and multifamily housing programs, phase out their use of multifamily Minimum

Property Standards and depend entirely upon locally enforced building codes that are consistent with one of the three nationally recognized model building codes. In the case of federally subsidized projects, standards beyond those found in the model codes should be added only if HUD can demonstrate that such standards are necessary to protect the Federal interest from unreasonable risk.

Zoning. Local zoning and land use controls inhibit rental investment by reducing the supply of land available for multifamily development. Frequently, they prohibit development in many desirable locations and increase costs in other areas through minimum lot size or development controls. Zoning is a complex matter as evidenced by the recommendations and discussion on regulation in Section IV. There are certainly valid reasons to control land use in order to protect local residents from conflicting land uses and to reduce congestion. However, local zoning ordinances are frequently used to enhance the fiscal condition of local communities at the expense of neighboring jurisdictions, and at times to exclude certain households (such as those with lower incomes than households currently residing in the community). Frequently, this exclusion is aimed at multifamily rental development. More flexible and innovative types of zoning, particularly those which involve mixed-use development, can serve to diminish the negative impact of zoning on rental development. Also, the zoning process can be streamlined in order to reduce costly delays in obtaining permission to commence development. Zoning laws and housing codes also can be modified to encourage division of large, older multifamily homes into multiple dwellings, where reasonable standards of health and safety are maintained.

Conversion Controls. Another form of regulation of rental housing markets by local governments is in the form of restrictions on the conversion of rental units to condominiums and cooperatives. The option to convert rental property to condominium and cooperative housing is important to developers who are planning to build multifamily housing. Local, State, or Federal laws which restrict the potential for conversion increase the risk of rental housing investment and reduce the expected return, thereby leading to reduced investment (as compared to levels expected if conversions are allowed). Moratoria on condominium or cooperative conversion can therefore lead to a reduced rental housing supply over time. Chapter 6, which discusses condominium conversion in detail, recommends that local communities generally follow the Uniform Condominium Act, that communities not place conversion moratoria on rental housing, and that the Federal government remove from the tax code certain disincentives for conversion by owners.

CHAPTER 8

OTHER OPPORTUNITIES

Several additional Federal programs that present opportunities for the development and preservation of housing are discussed in this chapter. They include use of federally owned land—an important resource for housing development, particularly in the Western States—and preservation of housing resources in older existing neighborhoods through public/private cooperation.

PUBLIC LANDS AND FEDERAL SURPLUS PROPERTIES FOR HOUSING NEEDS

Land currently owned by the Federal government could be important in meeting the community expansion and housing needs of many communities. In developing areas, the land most suitable for the development of housing, either due to proximity, terrain, or other factors, is often owned and managed by the Federal government. In areas already developed, some parcels of Federal property are in excellent locations for housing and may contain housing or other buildings no longer needed by the Federal government. Consistent with its interest in increasing housing opportunities, the Commission examined the policies and procedures governing the availability of Federal property for housing and community expansion.

Federal ownership of land is of two types: public domain land, held as a national resource and generally acquired by treaty, purchase from another nation or conquest; and property acquired to carry out the mission of Federal agencies, usually developed with buildings and infrastructure. The laws, regulations and procedures for disposal of the two types of Federal property differ greatly.

Federal public land comprises about one-third of the land area in the 50 States. However, more than 90 percent of this land is located in the 11 Western States and Alaska, where the Federal government controls an average of 52 percent of each State (Figure 8.1). Most is administered by two agencies: the Bureau of Land Management (BLM), Department of the Interior (about 340 million acres); and the U.S. Forest Service (USFS), Department of Agriculture (about 188 million acres). Table 8.1 details holdings by the Bureau of Land Management in the 10 Western States. Local and State governments as well as private persons desiring to own Federal public land may apply to the appropriate agency, which will then weigh the current and future benefits of continued Federal ownership against the proposed alternative ownership and use.

In addition, the Federal government owns or controls large amounts of real property, land, and buildings used by Federal agencies for purposes

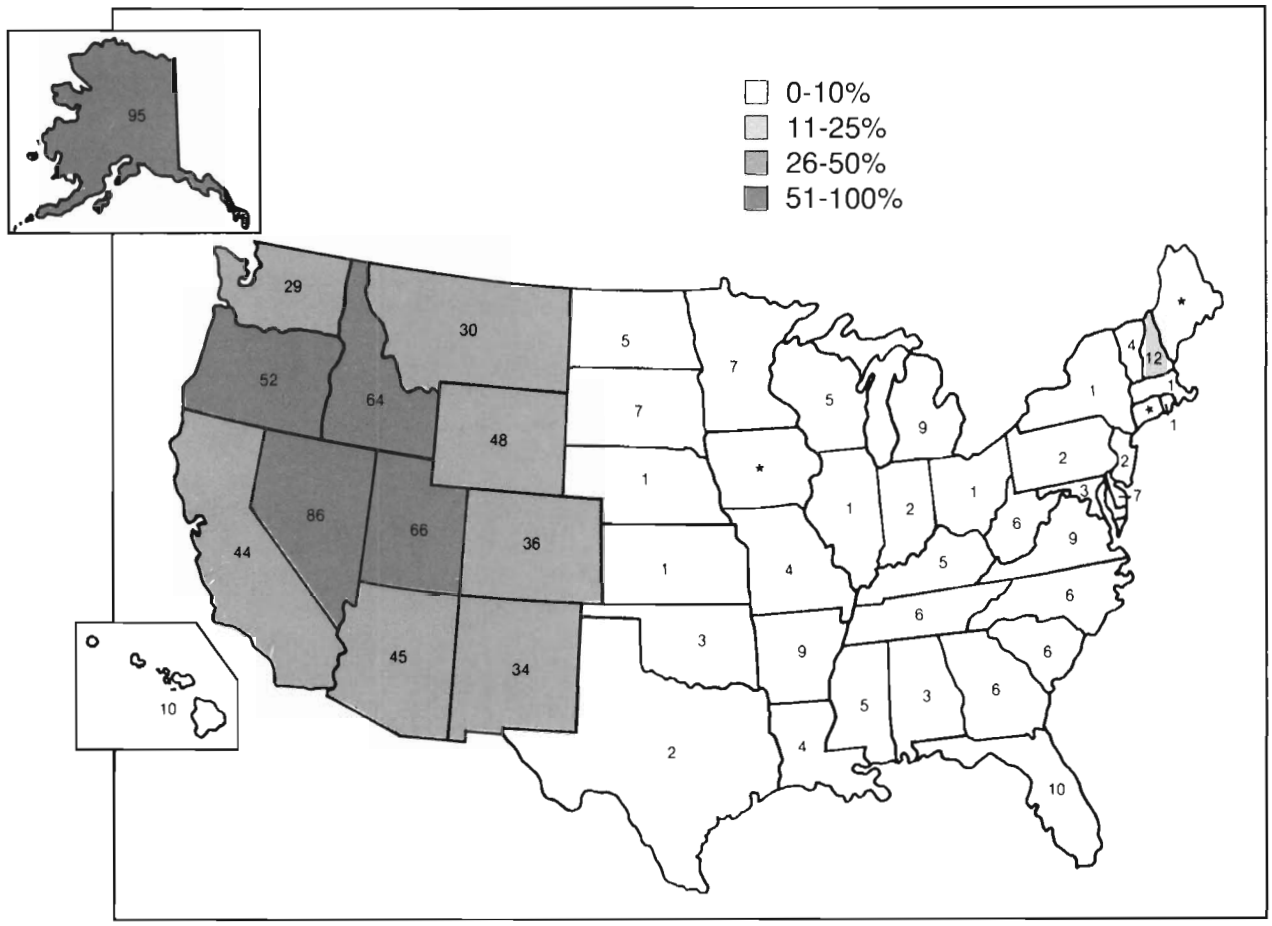
Table 8.1
Lands Under Exclusive Jurisdiction of the Bureau of Land Management in 10 Western States, 1979[a]

State	Acres
Arizona	12,588,901
California	16,598,125
Colorado	7,993,935
Idaho	11,945,888
Montana	8,141,620
Nevada	48,844,645
New Mexico	12,839,781
Oregon	15,741,018
Utah	22,052,564
Wyoming	17,793,098

[a] The State of Washington is not included in the table because of token public land acreage under BLM jurisdiction—approximately 300,000 acres. Public lands in Alaska have been the subject of recent legislation and will, in part, be transferred out of Federal ownership.

Source: *Public Land Statistics*, Bureau of Land Management, 1979.

Figure 8.1
Percentage of State Land Owned by the Federal Government



*Less than 1 percent

Note on Alaska: After statutorily mandated transfers to Alaska natives and the State, approximately 60% of land will remain in Federal ownership.

Source: Comptroller General of the United States, *The Federal Drive to Acquire Private Lands Should be Reassessed,* CED 80–14, December 14, 1979, p. 2.

ranging from military bases and public health complexes to individual office buildings and scraps of vacant land remaining from Federal highway acquisitions. From time to time, this property is declared to be surplus and is sold by the General Services Administration (GSA).

This part of the chapter discusses the Commission's recommendations to make public lands and surplus Federal property more readily available for community expansion and housing use. The Commission strongly endorses the sale of public lands and Federal surplus properties to State and local government and private parties for development of housing, including low- and moderate-income housing, and applauds the recent creation of a White House-level Property Review Board to facilitate sale of Federal land and properties.

The Commission considered the larger question of the extent to which Federal public lands should be held or disposed of beyond its housing-oriented charge. Similarly, the Commission has not tried to assess the relative merits of availability of public land and surplus property for housing and nonhousing purposes.

However, the Commission was concerned with the disposition of public lands needed for housing by communities and private individuals. For this reason, the recommendations call for procedural and policy changes in the sale and leasing of public land by the Bureau of Land Management and the U.S. Forest Service, for increased use of Federal surplus properties for housing, and for consideration for housing use of land owned by States and localities.

Sale and Leasing of Federal Public Land

Over 1 billion acres of land passed out of Federal ownership during this country's first 200 years of existence. Under the various Homestead Acts, a family could acquire title to 160 acres or more of public land by making improvements, cultivating it, and living on it for five years. About 287 million acres of land were transferred to individual private ownership in this way.

By 1900, Congressional attitudes began to shift toward a recognition of the need to conserve and retain some of these lands in Federal ownership, and National Parks and Forests were created. Although Federal laws and policies favoring disposal over retention of public lands continued well into the 1960s, the trend of legislation and policy shifted toward conservation and permanent retention of public domain lands for use by the nation as a whole, rather than private use. The Public Land Law Review Commission was created by Congress to make a comprehensive and systematic review of Federal land laws and policies.

In 1970, the Public Land Law Review Commission's final report recommended that in the future, disposal of Federal lands should be restricted to those lands "that will achieve maximum benefit for the general public in non-Federal ownership, while retaining in Federal ownership those (lands) whose values must be preserved so that they may be used and enjoyed by all Americans." This philosophy was enacted by Congress in the Federal Land Policy and Management Act of 1976 (FLPMA). The Act formally established a Federal policy that the remaining unreserved public lands are to be managed in perpetuity as natural resources, and required a comprehensive inventory and land use planning system. FLPMA made acquisition of public lands by States, localities, or private individuals contingent on a decision by the Bureau of Land Management or the U.S. Forest Service to sell or exchange land under their management.

Delays in implementing the procedures required under the Act have made it difficult for States, localities, and private individuals to acquire land needed for community expansion and housing. At the same time, population and development pressures are mounting in the Western States, and many communities anticipate additional population growth from the development of large coal, gas, and oil resources. In February 1981, the Secretary of the Interior announced his intention to eliminate such delays, announcing a "Good Neighbor" policy to facilitate BLM transfer and disposal of public lands for community expansion needs and other public purposes. The Secretary invited Governors of the Western States to identify the parcels of federally owned land which were needed by localities. In response, the States submitted requests for about 950,000 acres, with more than half of these requests related to community expansion.

Some procedural and policy changes discussed below can help promote the implementation of the "Good Neighbor" policy within the larger property management initiatives of the President. The two primary recommendations emphasize the need for the expeditious completion of the land inventory and classification of public lands and the need for close cooperation and coordination between the Federal government and State and local governments in the orderly disposition of land. In addition, four recommendations address specific issues relating to sales by the Forest Service, land exchange, leasing, and appraisal.

Inventory and Land Use Classification

To facilitate purchase and exchange of land, the Bureau of Land Management should accelerate

completion of land inventory and classification and complete all necessary land use plans, giving consideration to the expansion needs of communities adjacent to public lands and identifying land available for disposal to meet those needs. In addition, these land use plans should provide for cooperative management, consolidation and exchange of checkerboard public lands with State and private land holdings.

The Bureau of Land Management has not completed the inventory, classification, and land use plans for all of the lands under its management as required by Section 201 of the 1976 Act. Under present schedules, BLM land use plans will not be completed in this decade. The Commission recommends that these inventories and land use plans be completed within five years to the extent possible within available staffing resources. Priority should be given to identification of lands needed by communities adjacent to public lands for community expansion and housing. The States, and through them local governments and private individuals, should be provided this planning and inventory data on a regular basis. This will facilitate State and local land use planning, provide needed information for applications for acquisition of Federal public lands, and assist in ownership consolidation of Federal and State lands. In the absence of an inventory classification and land use plan for a specific tract, BLM by law cannot approve the purchase or exchange of that tract. When such a tract is applied for, BLM must execute individual *ad hoc* plans and analyses. This delays acquisition of land by communities and individuals, frequently resulting in increased costs. Therefore, completion of the inventory and land use plans will speed the processing of requests from communities and private purchasers.

The checkerboard lands in the Western States are a particular disposal problem; many of the public lands do not lie in discrete, large tracts, but are intermingled with State and private lands. Grants to the States took the form of township sections, two to four sections per township, surrounded by Federal land. Grants to the railroads were in the form of alternate sections on each side of the right-of-way. As a result, the pattern of Federal land ownership looks like a giant checkerboard in many places, with some stretches as much as 60 miles wide and hundreds of miles long. These checkerboard blocks should be consolidated through exchange or sale in order to ease conflicts in access to both private and public lands which resulted from such intermingled ownership and increase administrative and management efficiency on public lands. A tentative program to consolidate State and Federal public lands into discrete parcels, through exchange, has begun in Utah—titled Project Bold. Also, the recently approved California Desert plan provides for such consolidation. Similar programs need to be developed in other States to facilitate exchanges and sales of lands needed for community development.

Cooperation and Coordination with State and Local Government

In disposing of Federal land for housing and community development, the Federal government should be responsive to requests for land from States and localities and should provide for local and State land use plans.

In cooperation with the States, the Bureau of Land Management should develop procedures which will speed up the processing of requests for land from localities and the private sector. The Bureau of Land Management is developing procedures with individual States, e.g., Nevada and Idaho, for processing of land transfers that designate the responsibilities of BLM, and State and local entities, as a step to developing better coordination and cooperation.

A further step in selling land would take cognizance of limited staff resources at BLM and variations in the usefulness of specific parcels for development purposes. BLM would invite requests for land within a designated area known to be of interest to public or private parties. After all requests were received, land planning and analysis would occur for the affected area as a basis for decision on the availability of individual parcels. This approach would focus resources on areas of particular interest, and reduce the need for planning and analysis of large areas in order to respond to individual land requests.

In regard to large blocks of land, planning at the State and local levels prior to the sale or exchange of the land is essential. BLM should continue to work with local and State governments so that the future use of the land as governed by State and local law and regulation can be known at the time of land disposal. Such a process can help to assure orderly and responsible land use. At the local level, communities should consider the potential availability of public lands in their community development planning and the expenditure of Community Development Block Grant funds for acquisition and improvement of public lands.

The Commission recommends that BLM sell public lands classified for community expansion use to qualified State and local government entities at appraised fair market value, without a competitive bid procedure. The Secretary of the Interior is authorized to waive the requirement for sale by competitive bid and permit direct sale by noncompetitive procedures where this will better achieve equitable distribution or implement equitable con-

siderations of public policy. Direct purchase is one way for State and local entities to acquire the public land needed for community expansion. Because local and State governments must appropriate funds, sell bonds or otherwise raise money for land purchase in full public view, it is difficult for them to bid successfully in open competitive situations against purchasers who can take advantage of this public information. In addition to increasing the access of State and local governments to public lands, direct sales can serve several important public purposes. For example, direct sales to governments would facilitate transfer of very large parcels and permit coherent infrastructure development, national land use, and better use for housing. All direct sale arrangements should include safeguards to ensure that the Federal government receives full market price for the property.

Any change in public land sales policy to benefit housing should consider the desirability of permitting public entities to delay payment for the land until it can be sold to private owners for development in conformance with local plans. At present, the Federal government must receive full cash payment within 30 days on all sales. It would facilitate sales if BLM were permitted to execute contracts of sale which allow the purchasing government entity to delay payment to the Federal government for a reasonable time until the land is transferred by sale or lease to private ownership.

In addition, BLM, HUD, and FmHA should cooperate to facilitate large-scale public land transfers for "townsteading" (the development of new communities to meet special growth and housing needs). The use of public lands for this purpose is provided for in Section 723 of the New Communities Act of 1970. The major problem in townsteading is the developer's cost of acquiring and holding a sufficient quantity of land. For this reason, where suitable public lands are available, they represent a significant resource of large tracts of land under consolidated ownership. The Commission's proposals dealing with land use planning and sales also would be of significant help in townsteading efforts on public lands. Since large amounts of land are necessary, the Federal government should require the entity purchasing the land to produce a rational plan for community development.

Forest Service Sales

The Secretary of Agriculture should encourage land conveyance for housing use under the Townsite Act and endorse the passage of legislation to permit the Forest Service to sell or exchange small tracts of land.

The Forest Service allows the National Forest Townsite Act of 1958, as amended by Section 213 of FLPMA, to be used to convey land for parks, water or sewage treatment plants, or similar "public" purposes. While regulations make provision for conveyances for housing purposes, only in rare instances has this been allowed. To meet energy expansion and community development needs in many Western communities, the Secretary of Agriculture should encourage land conveyance.

The Forest Service also needs specific authority to transfer small tracts of land, because FLPMA repealed the Small Tracts Act of 1938, which authorized the lease and sale of tracts of public land up to five acres for residential, recreational, and business development. Congress is considering several pieces of legislation to provide such authority.

Land Exchange

Where the land is being acquired by a public entity for public purposes, including community expansion and housing, the Secretary of the Interior and the Secretary of Agriculture should be authorized to permit payments in excess of the statutory 25 percent of appraised value to equalize the difference in valuation between a parcel of public land and a parcel of private land of different size and value offered in exchange.

Exchange historically has been a major means by which the Bureau of Land Management and the Forest Service have transferred land. Under the land exchange system, anyone wanting to acquire public land must own a parcel of land desired by the government in trade. This policy makes public land available for private use without diminishing the size of public holdings. Park and forest land often is acquired in this fashion. However, would-be purchasers may not own land appropriate for BLM or Forest Service purposes which is exactly equal in value to a Federal parcel available for exchange, and may have difficulty acquiring such land. To ease this problem, Section 206 of the Federal Land Policy and Management Act of 1976 permits parties acquiring public lands to pay up to 25 percent of the total value of the lands to be transferred out of Federal ownership, to equalize the difference in value of the lands exchanged. Where land is being exchanged to meet community expansion needs, the value of the government land located near the community frequently is significantly greater than the more remote parcel desired by the government in exchange. To make up for the difference in value, much more private land must be provided in exchange for the public parcel in order not to exceed the 25 percent limitation in FLPMA. It would, however, make sense to permit the cash difference to exceed the present limit of 25 percent of value, where this would facilitate a community expansion

transfer. Further, given the awkwardness of exchange as a method of land disposition, greater efficiency can be achieved by both BLM and the Forest Service by using sales rather than exchanges wherever appropriate.

Leasing

The Secretary of the Interior should direct the Bureau of Land Management to develop a program for the leasing of land for a definite time period for housing use to State or local government entities or non-profit groups which have proposals meeting the requirements of the Recreation and Public Purposes Act.

Leasing may be a more practical alternative to the outright sale of public lands in areas where natural resource development is expected to be of the "boom and bust" variety. Leasing may be the most appropriate way to provide public land for temporary housing in some areas with rapid population growth and housing pressures. The conditions of land use can be specified in a lease, and provision made for removal of the housing at the end of the lease.

In many Western communities, energy development has an immediate local impact on housing, both for construction workers and the new residents and their families. Vacant housing is quickly occupied in communities surrounding the energy development, and incoming workers turn to motel units, tents, or other alternatives. Good housing becomes very costly, and even less-than-adequate housing is crowded and expensive. An immediate solution to these housing pressures would be buildings or mobile homes sited on leased public land. This would provide adequate shelter for the large number of workers at such sites, while making only a temporary intrusion on the public land and avoiding the expense of permanent infrastructure which burdens surrounding, permanent communities.

BLM has the authority to lease or convey public domain land to States or their political subdivisions and to nonprofit corporations or associations for recreational or public purposes. However, BLM has interpreted public purposes to include only such things as parks and sewage treatment plants and to exclude any form of residential housing. The Commission suggests that housing be included as a public purpose for leasing.

Appraisal

The Bureau of Land Management and U.S. Forest Service should consider methods to mitigate prices where Federal leasing or land policies have contributed to escalating land costs.

Actions of the Federal government contribute to inflation in land values in several ways: Federal leasing of mineral and other development rights in the area stimulates demand for land for development; failure to sell or otherwise make available Federal land where it comprises a significant portion of the developable land near a community restricts supply; and slowness in processing requests for land allows land costs to increase significantly during the processing period. The most appropriate way to address price increases resulting from failure to sell or slowness in processing requests is the implementation of responsive Federal disposal policies and procedures as discussed in this chapter.

However, where the Federal government has contributed to rapid escalation of land costs, the BLM and Forest Service should consider price mitigation through changes in the appraisal process. For example, appraisal could be made as of the date of application and held constant until sale or transfer, not to exceed one year. Some mechanism would then need to be developed to assure that the first purchaser did not achieve a windfall profit when the land was transferred again.

Federal Surplus Properties

The White House Property Review Board should ensure the prompt disposal of Federal surplus property, thus making more property available for housing use.

The General Services Administration is responsible for the disposal of virtually all Federal properties which are reported as excess and declared surplus by departments and agencies of the Federal government. After a property is declared surplus by an agency, the General Services Administration must first offer it to other Federal agencies. If no other Federal agency wants the property, State and local governments and institutions are notified that the property is surplus. If no public agencies are interested in the property, it is offered for sale to the general public on a competitive bid basis. In the past, surplus properties have been transferred to public entities at discount prices and, for certain uses, without any charge. However, the Administration proposes to eliminate virtually all conveyances at less than fair market value to State and local governments, except for use as correctional facilities.

As of June 30, 1981, the General Services Administration's Office of Real Property reported that it had 131 excess properties, worth $2,138,534,000, and 415 surplus properties worth $1,215,830,000. By far the majority are military facilities which include existing housing or build-

ings. Many surplus properties—military bases, public health hospitals and other Federal installations—are in locations where they are usable and needed by communities for housing. Such properties often have existing buildings and infrastructure, which are immediately habitable or need only minor repairs and could be made available for housing at reasonable cost. Under present disposal procedures, these properties frequently sit vacant and deteriorating for many months or even years before they are sold. The White House Property Review Board should speed up the disposal of these Federal surplus properties, making more properties available for local development of housing.

State and Local Lands

States and localities are encouraged to review their policies with regard to sale and transfer of land and to identify parcels of their own public land which might appropriately be sold for housing use in both urban and rural locations.

In many States and cities, there are parcels of public land which lie vacant and could be used for housing construction. States and localities could consider donation of this land for public use, or sale at reduced prices, which would reduce the cost of construction of low- and moderate-income housing and could benefit first purchasers through price limits on land conveyed for this purpose.

Some States have undertaken comprehensive inventories and plans for the improved management and disposal of public lands to private control. For example, Arizona convened a State Urban Lands Task Force to study the impact of State lands on community development needs of Phoenix and Tucson and recommended lands to be assessed for disposal to meet these needs.

NEIGHBORHOODS AND EXISTING HOUSING STOCK

Chapter 5 examined the important role of reinvestment in the existing stock in adding to and sustaining the total supply of housing. In addition to new construction, additions to the housing supply occur through conversions of nonresidential structures to residential use; subdivision of existing large units into more, smaller units; and restoration of uninhabitable units. Because new construction provides less than 3 percent of the housing stock in any year, preservation of existing stock is crucial to meeting the housing needs of the nation. Continued maintenance and upgrading of housing quality are also important to the supply of housing because they help prevent losses from the inventory. Reinvestment activity which creates more units or which extends the life of existing units enhances the neighborhoods in which the units are located, creating value and providing a further economic rationale for neighborhood housing preservation.

The Commission has made many recommendations which will continue to support the exceptionally high level of private reinvestment in the housing stock that has been typical in recent years. These recommendations would assist elderly homeowners, homesteaders, owners of rental housing, and those who would seek to rehabilitate both historic and nonhistoric property.

Several special types of activity merit additional attention because of their potential contribution to neighborhood and housing revitalization. A commendable role has been played and should continue to be played by nonprofit organizations, by the Neighborhood Housing Services, and by the National Trust for Historic Preservation. Their efforts underscore the importance of including housing in the planning of enterprise zones.

Neighborhood Preservation

Private foundations, religious groups, and other private institutions are encouraged to continue their sponsorship and financing of innovative programs in housing construction and rehabilitation and access to homeownership. Neighborhood preservation activities should continue to be used to preserve and upgrade housing in older areas with every effort made to benefit low-income people and to avoid displacing them.

Consistent with the President's support of voluntary efforts to deal with major human needs, the Commission wishes to encourage continued involvement of churches, foundations, neighborhood development organizations, and others in efforts to meet housing and community development needs. Although such groups had mixed success in the subsidized housing programs of the late 1960s and early 1970s, their contributions to low-income housing in recent years have been substantial. They have been particularly successful when they have worked with private entrepreneurs by forming joint ventures to capture a portion of the money which high tax bracket investors are willing to contribute in exchange for the project's tax shelter benefits (because of the depreciation tax losses available on the buildings). These funds, called syndication proceeds, are then used for the benefit of the residents of the facility.

Because of their commitment to the quality of life of low-income households in rural and urban areas, nonprofit groups are often particularly suited to play an important role in housing and neighbor-

hood improvement efforts. The Commission recognizes that its proposals would curtail some direct development activity that these groups have sponsored under Federal programs such as deep-subsidy new construction programs. However, limited Federal resources now make voluntary efforts increasingly important. There are a number of roles that private institutions can continue to play in concert with Federal, State, and local housing programs. In particular, the availability of a Housing Component within the Community Development Block Grant program will broaden the range of activities in which local groups and local governments can work together on neighborhood improvements and housing efforts. Many groups will want to continue their joint developments with for-profit sponsors of both rental housing and cooperatives and utilize subsidies available through the CDBG program to do so. Local revolving loan programs and other supportive service programs may continue to be available because they have alternative sources of funds. Other groups that have successfully managed to rehabilitate properties will find that they can continue to do so and also obtain housing payments to assist the low-income tenants in the buildings.

One example of successful public/private/neighborhood partnership is the Neighborhood Housing Service (NHS) program. The partners—private lenders, residents, and local businesses—work with NHS offices to revitalize neighborhoods. NHS makes below-market interest rate loans to neighborhood residents who cannot afford or obtain private financing, and also provides supportive services such as financial counseling, property inspections, and construction monitoring. Where NHS programs have operated in neighborhoods, they have been a stabilizing factor, stimulating rehabilitation and preventing displacement of lower-income homeowners in the neighborhood.

In over 120 cities, the Neighborhood Reinvestment Corporation, a Congressionally chartered public corporation, has brought together the NHS partnerships, provided assistance to the local volunteers in marshaling private and public resources, and continued to offer training and technical assistance so that NHSs remain effective local revitalization mechanisms. One of the newer strategies developed by Neighborhood Reinvestment is the NHS/Apartment Improvement Program, which has utilized over $27 million in conventional financing to rehabilitate rental properties without displacing low- and moderate-income families. Neighborhood Reinvestment has also been instrumental in establishing a secondary market to purchase local NHS loans, which includes participation by private insurance companies.

The Commission encourages States and localities to develop financing programs, public/private partnerships, and other mechanisms to help preserve older neighborhoods, but every effort should be made to avoid displacement of low-income people in this process. Many older residential structures have not been kept in good condition, although these buildings could provide a source of standard housing for lower-income households if appropriate resources were available for their renovation.

Historic Preservation

The Commission endorses the efforts of the National Trust for Historic Preservation to further the goal of local and private sector historic preservation and further endorses its efforts to preserve the valuable resources represented by our nation's buildings and districts.

The National Trust for Historic Preservation has been an important resource for preservation activities since it was chartered in 1979. The National Trust is a private, nonprofit organization that is supported by over 135,000 members and contributions from corporations and foundations. The National Trust has aided the search for ways of preserving our architectural and historical heritage through education and demonstration programs.

The National Trust has addressed specific problems that have hindered private-sector housing preservation. In cooperation with the Department of Housing and Urban Development and the National Bureau of Standards, the National Trust has developed guidelines for local communities to make their building codes more accommodating to housing rehabilitation. When unnecessary restrictions are reduced or eliminated, it becomes more economically feasible to rehabilitate older housing.

National Trust programs have aided housing preservation efforts. For example, the Trust's National Preservation Revolving Fund has provided more than $1.5 million in housing related loans to organizations in 38 communities. When this loan money is repaid, it is recycled into other preservation projects. In addition, the Inner-City Ventures Fund provides assistance to not-for-profit neighborhood development corporations that are undertaking housing rehabilitation projects primarily benefiting minority and low-income families.

Enterprise Zones

The Commission endorses the concept of enterprise zones as a method of encouraging community revitalization and new business investment in declining urban neighborhoods and rural communities. Any enterprise zone program should include incentives, similar to those

provided for business, for investments in rehabilitation and new construction of housing in order to complement economic development in the zone, minimize displacement of existing residents, and provide housing for new workers attracted by zone businesses.

Enterprise zones seek to stimulate economic activity by removing barriers to business and development activity and by creating a system of economic incentives which will encourage creation of new business and utilization of dormant production capacity. In enterprise zones the approach is to relax governmental controls, reduce taxes, modify regulations, and remove other inhibitions on business investment. Although enterprise zones have not yet been fully tested, supporters argue that reduction of taxes and government interference will attract private investment and stimulate business activity as well as employment in declining areas.

Proponents of enterprise zones have concentrated on ways to encourage formation of new businesses, particularly the creation and preservation of small companies, in urban areas. However, little attention has been focused on the existing infrastructure and services needed to support business expansion and development. Without adequate housing, services, crime protection, and a generally supportive neighborhood, it is likely that businesses in enterprise zones will have a difficult time getting started.

Adequate housing for zone residents and in surrounding areas may be important to the success of an enterprise zone. In recognition of the importance of housing to revitalization, housing should be treated as a critical zone element and receive essentially the same type of regulatory relief and tax incentives that apply to the commercial and industrial sectors. For example, the complexity of local regulations, such as zoning, building codes, and occupational licensing serves to increase the cost of housing both directly and by the cost of delays. The simplification of these laws and regulations in enterprise zones will encourage housing rehabilitation as well as new construction, particularly when these housing activities are supported with other resources such as CDBG and UDAG funds.

Relaxation of Federal laws and regulations in enterprise zones will also have a positive effect on housing. Modification of Davis-Bacon would, for example, reduce housing rehabilitation costs for many projects. Changes in the law would also permit use of local labor at whatever salaries and supervisory levels are dictated by the local situation. Similarly, elimination of capital gains tax on zone investments, including housing, will stimulate development.

While the Commission applauds the utilization of enterprise zones to encourage economic and neighborhood revitalization, it is also concerned about the possible displacement of zone residents. Such displacement might occur because of an influx of new residents attracted by the economic activity or as a result of business activity that converts housing to industrial or commercial uses. Any zone plans should therefore take into account possible displacement of residents by assuring that adequate and affordable housing is available with minimum disruption.

Section III:

FINANCING AMERICA'S HOUSING

CHAPTER 9

INTRODUCTION: THE CHANGING SYSTEM OF HOUSING FINANCE

In recent years, dramatic changes have taken place in the nation's financial system. Indeed, the system of housing finance, driven by economic and financial market pressures, is already in transition, and further change is inevitable. Within this shifting environment, a more broadly based and revitalized system of housing finance is essential if the nation is to meet the housing demands of the 1980s and beyond.

Recognizing this situation, the Executive Order that established the Commission called for an assessment of the nation's current housing finance system and the development of options that strengthen the ability of the private sector to maximize homeownership opportunities and provide adequate shelter for all Americans. This section of the report responds to that mandate, focusing on actions designed to foster a more reliable supply of residential mortgage credit over the long term. The Commission believes that the recommended steps are important ingredients of a well-rounded national housing policy. These recommendations will be fully effective, however, only if the Federal government can achieve both fiscal responsibility and monetary stability.

The Commission's recommendations concerning housing finance are designed to influence the ongoing process of change. Implementation should lead to a strong and resilient system providing a more stable and growing supply of mortgage credit, at competitive market interest rates, with minimal Federal involvement. Because the financial system is an integrated and interdependent mechanism, individual recommendations should be considered as elements of a complete package. Past experience has amply demonstrated that piecemeal adjustments to the housing finance system can be counterproductive.

This chapter develops the background and framework for the Commission's recommendations on the housing finance system that are provided in Chapters 10 through 12. The discussion describes the structure and operation of the current housing finance system, identifies the major problem areas as well as the sources of the problems, and presents the Commission's perspective on the need for change.

Market Processes and Participants

The current housing finance system in the United States includes myriad private and public institutions and several levels of market activity. In simple terms, the process involves the provision of housing credit to borrowers by investors who hold housing loans in their portfolios. However, a number of institutions may take part in the process between borrowers and ultimate investors, and the characteristics of the mortgage instrument may be transformed along the way as insurance and guarantees are attached and as financial securities replace the original mortgage loans.

The Process

Mortgage loans are made, or originated, in "primary" markets where lenders and borrowers transact business. In these markets, short-term construction loans are made to builders, and long-term, or "permanent," mortgage credit is extended to owners and buyers of homes or rental properties. Repayment of loans made in primary markets may be insured or guaranteed by a government agency or by private insurance companies. The need for such

coverage depends on the financial status of the borrower, the size of the loan relative to the value of the property, and the expected appreciation rate of the property serving as collateral.

Institutions operating in primary mortgage markets may hold the mortgages they originate, adding them to their asset portfolios. In many cases, however, originators sell their loans on secondary markets, thereby replenishing their supplies of loanable funds. Institutions that originate and sell mortgages as a matter of course perform a "mortgage banking" function and derive their income from loan origination fees paid by borrowers and from loan servicing fees paid by investors who buy the loans.

Secondary market transactions may involve the sale of loans from originators to investors, with or without another institution serving as intermediary or broker; the standardization of mortgage instruments provided by government or private mortgage insurance and guarantees helps to make these loans acceptable to secondary market investors. Mortgage originators may also sell their loans through the securities markets. One of the most common methods is to pool homogeneous groups of loans and sell shares in these pools by issuing pass-through securities that entitle holders to a portion of the flow of principal and interest payments on the underlying mortgages in the pools. The payments to securities holders may be guaranteed by government or private institutions, even when the mortgages in the pools backing the securities carry insurance or guarantees against default loss.

Agencies at all levels of government are involved in the residential mortgage process, operating programs intended to bolster the growth of housing credit, to reduce the cyclicality of mortgage credit, and to provide mortgage loans to borrowers at below-market interest rates. Various Federal programs underwrite credit risks on primary mortgages, guarantee payment on mortgage pass-through securities, operate secondary markets in mortgages, and channel funds from bond to mortgage markets via direct intervention in these markets. State and local governments operate various programs that channel funds from tax-exempt securities markets into residential mortgage loan markets.

Primary Markets

The purchase of residential property traditionally has been financed by long-term, fixed-rate mortgage loans with level payments that fully pay off (amortize) the principal over the term of the loan. Two types of this standard mortgage form have evolved—those that are insured or guaranteed by the Federal government, and those with no government coverage (so-called "conventional" loans). Depending on the requirements of the lender or investor, conventional mortgage loans may be insured by a private mortgage insurance company. In many cases, conventional loans contain clauses that give lenders the option to require full payment of the loan when the property is sold (due-on-sale clauses), as well as provisions that permit lenders to assess a cash penalty for early repayment of the loan (prepayment penalties).

New forms of both conventional and government-underwritten mortgage loans recently have emerged to serve the needs of both borrowers and lenders in an environment of inflation and interest rate instability. These alternative mortgage instruments modify, in one way or another, the basic characteristics of the standard long-term, fixed-rate, level-payment mortgage.

Borrowers obtain mortgage loans in primary markets mainly from depository institutions or mortgage banking companies, that maintain lending offices in communities throughout the country. The savings and loan industry typically has been the major originator of residential mortgages, followed by mortgage banking companies, commercial banks, and mutual savings banks. Depository institutions ordinarily hold most of the loans they originate, while mortgage banking companies originate for resale, financing their mortgage inventories with short-term bank loans and commercial paper.

Except for certain subsidized lending programs, the Federal government does not lend directly to mortgage borrowers. However, the government does insure or guarantee loans made by private primary market lenders, mainly under the insurance programs of the Federal Housing Administration (FHA) and the guarantee programs of the Veterans Administration (VA). In recent years, FHA/VA loans have accounted for roughly one-fifth of the total dollar volume of home mortgages originated.

Since the early 1970s, private mortgage insurance has become an important factor. Indeed, private companies recently have insured about the same amount of home mortgage credit as FHA and VA combined. However, noninsured conventional mortgages—ordinarily contracts with loan-to-value ratios below 80 percent—still account for about 60 percent of all home mortgage credit originated in this country.

Secondary Markets

Secondary markets in mortgage loans (whole loans or loan participations) are maintained by mortgage banking companies, private mortgage brokers, subsidiaries of private mortgage insurance companies, securities dealers, and federally related credit agen-

cies. Markets in mortgage pass-through securities are maintained by securities dealers who stand ready to buy both new and outstanding issues.

The major development in secondary mortgage markets during the past decade has been the introduction and growth of federally related pass-through securities issued against pools of government-underwritten and conventional residential mortgage loans; as shown in Table 9.1, these types of instruments accounted for an eighth of all residential mortgage debt outstanding at the end of 1981. The predominant pass-through securities are those guaranteed by the Government National Mortgage Association (GNMA). These securities, which represent shares in pools of federally underwritten mortgages (primarily FHA-insured and VA-guaranteed), are issued by private mortgage originators (generally mortgage banking companies), and are held by depository institutions and a variety of capital market investors. Major securities dealers make markets in these securities. Moreover, futures markets in GNMAs have been organized on major exchanges, and exchange-traded GNMA options are on the horizon.

Pass-through securities issued and guaranteed by the Farmers Home Administration (FmHA) also have opened a channel between mortgage markets and the broader capital markets, even though these securities are not held by private investors. The securities are issued against pools of residential mortgages acquired by FmHA through its rural home loan programs. In recent years, the securities have been sold exclusively to the Federal Financing Bank, with the proceeds replenishing a revolving fund used by FmHA to acquire additional mortgages. This program thus has been channeling substantial amounts of funds raised by the Treasury into FmHA's subsidized and unsubsidized loan programs operated by FmHA.

The Federal Home Loan Mortgage Corporation (FHLMC) issues and guarantees pass-through securities backed by pools of unsubsidized conventional residential mortgages. The mortgage pools consist of loans acquired by FHLMC through various purchase programs, primarily from savings and loan associations. Most of the securities are marketed to private investors through a syndicate of securities dealers. Although savings and loans were the primary investors in FHLMC-guaranteed pass-throughs in the early days of the program, a variety of capital market participants—including retirement and pension funds—now purchase substantial amounts of these instruments.

In 1981, the Federal National Mortgage Association (FNMA) began to issue and guarantee conventional mortgage-backed securities. The mort-

Table 9.1
Federally Underwritten Mortgage Pass-Through Securities (Amounts Outstanding in Billions of Dollars)

	Guaranteed by				
End of Period	GNMA[a]	FHLMC[b]	FmHA[c]	Total	Total as Percent of All Residential Mortgage Debt Outstanding
1970	$ 0.4	$ 0.0	$ 2.3	$ 2.7	0.7%
1971	3.1	0.1	3.7	6.9	1.7
1972	5.5	0.4	5.2	11.1	2.4
1973	7.9	0.8	5.6	14.3	2.8
1974	11.8	0.8	6.9	19.5	3.6
1975	18.3	1.6	9.5	29.4	5.0
1976	30.6	2.7	10.8	44.1	6.7
1977	44.9	6.6	12.2	63.7	8.3
1978	54.4	11.9	14.5	80.8	9.1
1979	76.4	15.2	17.1	108.7	10.8
1980	93.9	16.9	19.3	130.1	11.8
1981	105.8	19.8	21.8	147.4	12.7

[a] Government National Mortgage Association.
[b] Federal Home Loan Mortgage Corporation.
[c] Farmers Home Administration.

Sources: Data compiled by staff from information supplied by the Government National Mortgage Association, Federal Home Loan Mortgage Corporation, Farmers Home Administration, and Board of Governors of the Federal Reserve System.

gage pools consist of conventional home loans purchased by FNMA from lenders, and the securities have been marketed either by these lenders or through securities dealers. By the end of March 1982, FNMA had issued $2.8 billion of the securities, and most were sold to nontraditional mortgage investors such as pension funds.

To date, the volume of mortgage pass-through securities issued by fully private financial institutions and backed by pools of conventional residential mortgages has been quite limited, despite the immense size of the conventional mortgage market and efforts of major financial intermediaries and the securities industry to develop this pass-through market. Only about 50 institutions have issued private pass-through securities since the first offering was floated by the Bank of America in 1977, and the total volume of offerings has reached only about $3 billion.

Mortgage Investors

Changes in the composition of mortgage holdings, by type of institution, are traced in Table 9.2. As is customary, the mortgage pools associated with federally guaranteed pass-through securities are shown separately, because these securities are not reported as mortgage assets by their holders. The table clearly indicates that the dominant private mortgage investors have been depository institutions. On average, savings and loan associations have held nearly 40 percent of total residential mortgage debt outstanding during the past 20 years; this number rose close to 45 percent in the mid-1970s but has declined to around 40 percent in the past several years.

Mutual savings banks have also held an important position in the mortgage market, although their activity has decreased during the past two decades—from nearly 15 percent to just above 7 percent. Commercial banks, on the other hand, have played an increasingly important role in the mortgage market. The bank share of mortgage debt outstanding rose from 12 percent in the mid-1960s to more than 16 percent by the end of 1981, making them the second largest holders of mortgage debt. Together, thrift institutions (savings and loan associations and mutual savings banks) and commercial banks hold nearly two-thirds of total residential mortgage debt outstanding.

The dominance of thrift institutions as mortgage asset holders is even more evident when federally related pass-through securities are included. On this basis, the thrift share of total residential mortgage assets has averaged around 55

Table 9.2
Percent of Total Residential Mortgage Debt Outstanding, by Type of Institution

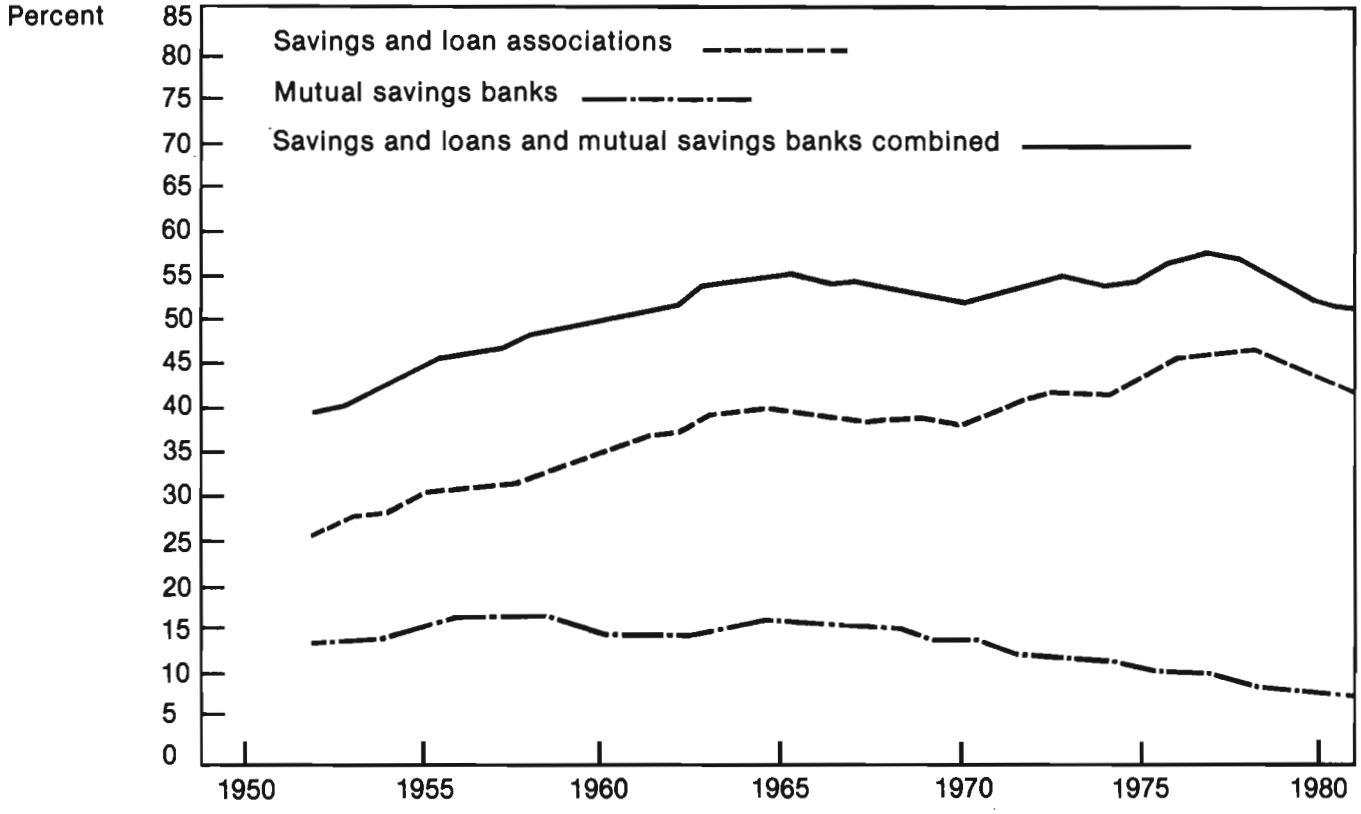
	Depository Institutions						
End of Period	Savings and Loan Associations	Mutual Savings Banks	Commercial Banks	Life Insurance Companies	Federal and Related Agencies	Mortgage Pools[a]	All Others[b]
1950	24.14%	12.76%	18.87%	20.06%	2.73%	0.00%	21.45%
1955	29.85	15.18	15.49	20.68	3.31	0.00	15.48
1960	35.47	14.98	12.55	17.71	5.03	0.00	14.26
1965	39.72	15.56	12.57	14.90	2.90	0.02	14.33
1970	38.75	13.94	12.74	11.92	7.03	0.72	14.90
1975	42.19	10.79	14.03	6.29	8.49	4.96	13.25
1976	43.76	10.18	14.27	5.34	7.24	6.66	12.57
1977	44.70	9.51	14.89	4.37	6.27	8.29	11.97
1978	44.22	8.93	15.72	3.77	6.40	9.11	11.85
1979	42.83	8.20	15.93	3.52	6.60	10.77	12.15
1980	41.69	7.61	15.77	3.41	6.95	11.84	12.73
1981	40.53	7.23	16.11	3.17	7.02	12.67	13.27

[a] Mortgages in pools backing pass-through securities issued and/or guaranteed by the Government National Mortgage Association, Federal Home Loan Mortgage Corporation, and Farmers Home Administration.

[b] Includes mortgage banking companies, real estate investment trusts, private pension and retirement funds, State and local government credit agencies and retirement funds, credit unions, and individuals.

Source: Data compiled by staff from information supplied by the Board of Governors of the Federal Reserve System.

Figure 9.1
Residential Mortgages at Thrift Institutions as a Percent of Total Mortgages Outstanding



Note: Federally related pass-through securities are included in both residential mortgages at thrift institutions and total mortgages outstanding.

Sources: Federal Home Loan Bank Board; National Association of Mutual Savings Banks; and Board of Governors of the Federal Reserve System, Flow of Funds Accounts.

percent since the mid-1960s (Figure 9.1). In recent years, however, the thrift share of mortgage assets has been declining.

Net funds supplied to residential mortgage markets by major groups of institutions—either directly through acquisitions of mortgages or indirectly through acquisitions of pass-through securities—are shown in Figure 9.2. As indicated, the flow of mortgage credit supplied by thrift institutions has fluctuated over a wide range since the late 1960s. The thrift share declined from nearly three-fourths in 1975 to less than one-third in 1981 as interest rates soared and the financial position of most thrift institutions deteriorated.

The share of residential mortgages held by Federal and federally related credit agencies has more than doubled during the past three decades, although their share of total mortgage credit has remained relatively constant, on balance, since the late 1960s (Table 9.2). In the current downswing, Federal agencies have provided a lesser share of funds for mortgage and housing activity than in other recent declines—such as 1969–70 and 1973–74 (Figure 9.2). The relative weakness in Federal support primarily reflects limited mortgage acquisitions by FNMA and a lack of Federal programs to provide below-market rate financing to homebuyers.

Residential mortgage credit has been provided at below-market interest rates by State and local governments and agencies, which raise funds in tax-exempt securities markets by issuing general obligation and revenue bonds. As shown in Figure 9.2, mortgage acquisitions by State and local agencies picked up substantially in 1979 and 1980, as market interest rates climbed substantially. Changes in Federal law and regulation have limited the volume of tax-exempt housing revenue bonds since late 1980.

Major Problem Areas

Since the mid-1960s, the ability of the housing finance system to meet the needs of borrowers has deteriorated markedly on several occasions, and this system currently is in a serious state of disrepair. The volume of residential mortgage lending naturally reflects changes in financial market conditions because the sensitivity of demand for mortgage credit to changes in interest rates is high relative to interest rate sensitivity in other major sectors of the economy. However, the increasingly wide swings in residential mortgage and housing construction activity also are traceable to structural shortcomings in the housing finance system.

As inflation accelerated and interest rates underwent unprecedented change, two major problem areas emerged in the housing finance system. First, the traditional process of mortgage lending and investment through primary and secondary market mechanisms began to deteriorate. Mortgage originators became less willing to write the types of loan agreements ordinarily offered to borrowers, and secondary market investors became reluctant to enter into traditional mortgage purchase contracts with originators. In addition, increasing proportions of real estate transactions were financed outside normal institutional lending channels, to the detriment of the health of traditional mortgage finance institutions.

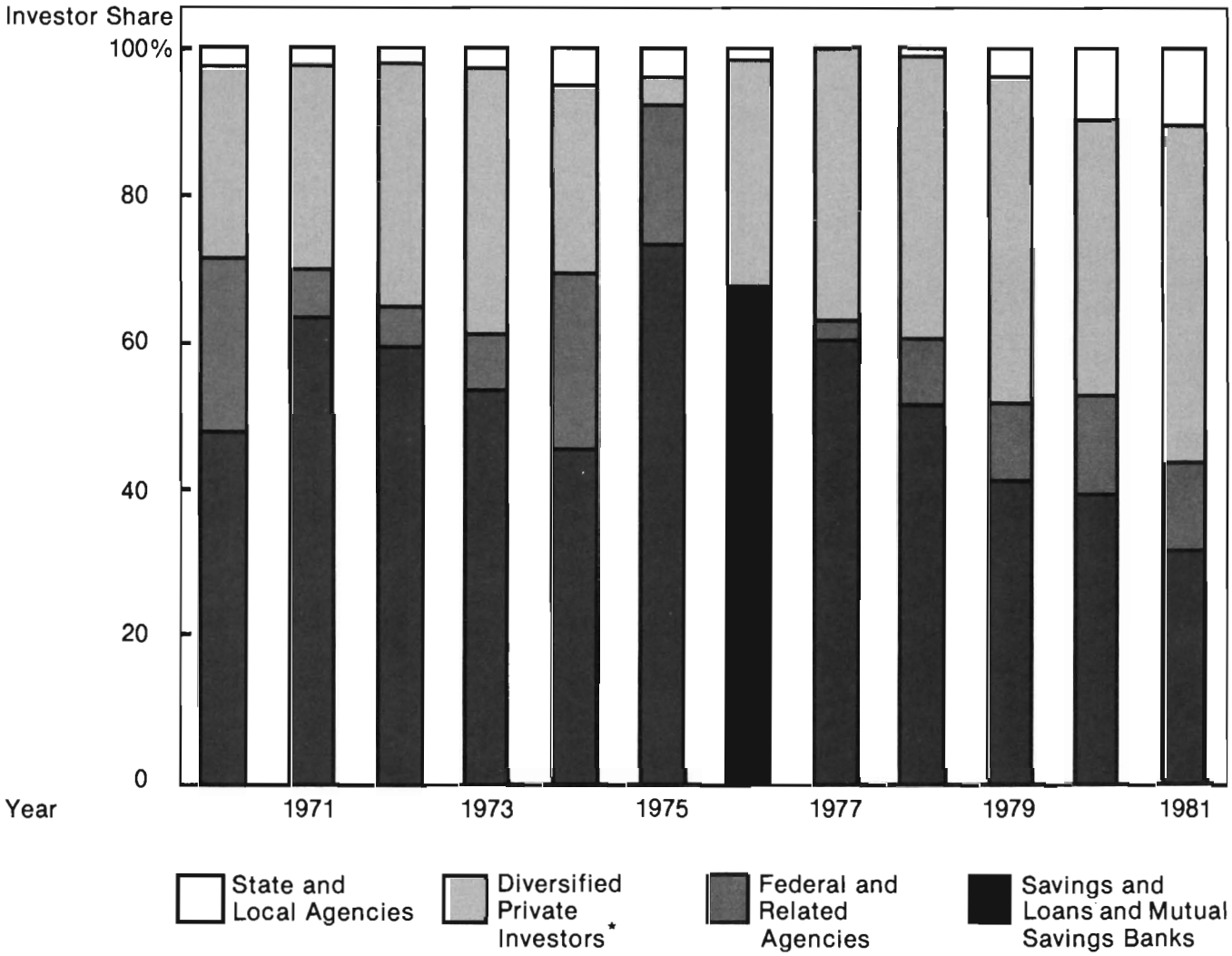
As the established market process of the housing finance system began to crumble, another problem surfaced: a weakening in the base of private investors in mortgage assets. This situation stemmed from an inability of the specialized mortgage finance institutions to perform their historically important role, from legal and regulatory impediments to the flow of funds into housing from diversified private institutions, and from growing reluctance by many types of investors to acquire traditional forms of long-term mortgage instruments.

Market Mechanisms

Increasing interest rate volatility has prompted mortgage originators to adjust their lending policies, largely to the detriment of borrowers. Mortgage originators typically have written commitments to provide long-term credit to borrowers well before the funds are scheduled for disbursement. These commitment contracts traditionally have specified a rate of interest, and use of the commitment has been at the option of the borrower. This type of commitment can expose originators to large losses when interest rates rise rapidly unless they can protect themselves with similar types of commitments written by mortgage purchasers in the secondary markets.

During recent years, many mortgage originators have become less willing to issue standard fixed-rate, optional-delivery commitments to prospective borrowers. Adjustments by originators generally have involved: (a) imposition of larger nonrefundable commitment fees to discourage cancellations when market interest rates fall, (b) shortening of periods over which a stated interest rate on commitments will be offered, or (c) use of interest rates tied to market indicators. These adjustments have been made partly because of reduced availability of purchase commitments in the secondary market. Greater volatility in interest rates has resulted in the disappearance of some of these types of commitments or imposition of larger commitment fees by secondary market purchasers such as

Figure 9.2
Net Change in Residential Mortgages by Type of Holder



*Includes commercial banks, life insurance companies, mortgage banking companies, real estate investment trusts, public and private pension and retirement funds, credit unions, and individuals.

Note: Mortgages in pools backing issues of federally guaranteed pass-through securities have been allocated to the holders of the securities.

Sources: Board of Governors of the Federal Reserve System, Federal Home Loan Bank Board, National Association of Mutual Savings Banks, and Farmers Home Administration.

FNMA and dealers in GNMA-guaranteed pass-through securities.

Record levels of market interest rates and changes in the mortgage origination process have prompted circumvention of the normal financing channels in the primary market and have stimulated growth of "creative" financing techniques that often involve participation in the financing process by sellers of existing homes. The most common of these techniques involves the transfer of outstanding low-rate mortgages from home sellers to homebuyers (loan assumptions), often in combination with second mortgages written by sellers. Another technique uses a "wraparound" mortgage—a single instrument that encompasses the outstanding first mortgage and the amount of additional financing needed by the buyer. The increased incidence of loan assumptions and wraparounds in the primary home mortgage market has had significant adverse implications for institutional mortgage investors: the turnover rate of outstanding home mortgages has slowed, supplies of loanable funds have been reduced, and the earnings of these institutions have been held down.

The Investor Base

As discussed above, the U.S. system of housing finance has been heavily dependent on specialized mortgage investors (thrift institutions), despite striking innovations in the secondary mortgage markets. The basis for this supply structure can be traced largely to public policy concerning the thrift institutions. Federal regulations and tax incentives have led savings and loan associations and mutual savings banks to allocate large proportions of their assets to long-term residential mortgages and mortgage pass-through securities. At the same time, the liabilities of thrifts have been limited by regulations primarily to short- and intermediate-term deposits. The thrift institution practice of borrowing short and lending long, in conjunction with large and unanticipated movements in interest rates, recently has led to widespread earnings problems at these institutions. As a result, the viability of the industry and its ability to serve the nation's mortgage credit needs have been drastically reduced.

The limited participation in mortgage finance by private investors with diversified portfolios can also be traced largely to public policy concerning the thrifts. Because of the tax code, the after-tax rate of return on mortgage assets has been greater for thrift institutions than for all other types of investors. Other important factors also come into play: legal and regulatory constraints on the investment policies of some types of institutions, and artificial impediments to the development of secondary markets for mortgages and mortgage pass-through securities that do not carry Federal insurance or guarantees. These factors have hindered diversified institutions from moving smoothly into mortgage investments during periods when specialized housing finance institutions have been unable to maintain their mortgage investment activity.

In an environment of heightened interest rate uncertainty, many private investors also have been reluctant to acquire the long-term, fixed-rate mortgage loans that households prefer and regulators traditionally have favored. Investors with a preponderance of short-term liabilities naturally have become wary of the interest-rate risk associated with the acquisition of long-term assets. In addition, many investors have objected to the yield and cash-flow uncertainties associated with assumable and prepayable mortgage loans. Borrowers traditionally have had the right to prepay (or refinance) their mortgages when interest rates fall, and those using FHA/VA loans have been able to permit the assumption of their loans by homebuyers when interest rates rise. And recently, many State courts and legislatures have ruled that conventional loans are assumable, even when the mortgage contracts contain due-on-sale clauses. Such rulings have created widespread uncertainties in secondary markets and have made it difficult for mortgage sellers and buyers to determine proper prices for conventional loans.

Causes of the Problems

Outdated laws and regulations have been largely responsible for the deterioration of the housing finance system described above. The statutory framework for much of this system was enacted in the early 1930s in response to the Depression and has not changed substantially since. The Home Owners' Loan Act of 1933 authorized the creation of Federal savings and loan associations, and the Federal Savings and Loan Insurance Corporation was established to insure the deposits at savings and loans. The Federal Home Loan Banks and the Federal Home Loan Bank Board were set up to serve as an external source of liquidity for home mortgage lenders and to provide a regulatory mechanism. The Federal Housing Administration also was formed to help increase the flow of funds through mortgage markets. FHA patterned its long-term, direct-reduction loan after the model established by the Home Owners' Loan Corporation, which required such contracts under its purchase programs. This step led to widespread acceptance of the fully amortized, fixed-rate, level-payment mortgage that has become the dominant mortgage instrument.

The measures adopted during the 1930s to strengthen the housing finance system established

the highly regulated system of specialized private mortgage finance institutions—savings and loan associations and mutual savings banks. Since that time, regulatory constraints and tax laws have led savings and loan associations to hold long-term, fixed-rate residential mortgages as their principal assets and to rely on household deposits as their major source of funds. Mutual savings banks have a similar structure, although they are less committed to mortgages in their asset portfolios.

This system of housing finance—heavily dependent on financial institutions that concentrate their investments in long-term, fixed-rate residential mortgages—was highly successful until the 1960s. Since then, these mortgage lending specialists have suffered frequent and increasingly severe financial shocks, and there have been serious lapses in the ability of the thrift institutions to serve the housing credit needs of the country.

The inadequacies of the legal and regulatory structure have been pointed out by numerous commissions and studies, beginning with the report of the Commission on Money and Credit in 1961. During the past two decades, the topic has received increasing public and private attention because of pressure created by market developments. In 1970, the President appointed a Commission on Financial Structure and Regulation (Hunt Commission), largely in response to difficulties faced by the housing and mortgage finance industries during the 1966 and 1969 episodes of financial instability. The Hunt Commission recommended the substantial restructuring of financial institutions, especially savings and loan associations and mutual savings banks, but the recommendations were largely ignored in the highly expansionary economic environment that developed at the end of 1971.

The issue reappeared in the wake of the financially violent recession of 1974–75. At that time, the Senate passed the Financial Institutions Act of 1975, and the House Committee on Banking, Currency and Housing developed and held hearings on a set of discussion principles entitled "Financial Institutions and the Nation's Economy." Both efforts envisioned a substantial restructuring of thrift institutions, primarily through the authorization of new asset and liability powers. As before, however, the urgency of the moment diminished as the economy recovered by late 1975, and Congress abandoned the effort for extensive legislative change.

The comprehensive financial reform proposals developed during the first half of the 1970s failed to become law largely because they were opposed by various segments of industry and society. On each occasion, the primary questions debated were essentially the same: Would the elimination of ceilings on deposit rates create financial chaos for institutions and result in higher costs for mortgage credit? Would broader asset powers for thrift institutions result in diversion of funds from the housing market and put upward pressure on mortgage rates? Would mortgage contracts that enable lenders to reduce their interest rate risk—e.g., through adjustable-rate features—put borrowers in an overly vulnerable position? These were matters of great contention, and lack of agreement prevented development of the consensus necessary for passage.

Although the movement toward comprehensive legislative reform developed slowly during the 1970s, a number of important changes occurred in the marketplace as well as through specific regulatory and legal actions. Most of these changes affected the liability side of the balance sheets of depository institutions as deposit rate ceilings came under growing attack for reasons of equity and efficiency. First, the adverse effects of rate ceilings on depositors with modest amounts of savings were widely denounced. Second, it became increasingly obvious that deposit rate ceilings, by denying funds to thrift institutions, tended to constrain the volume of mortgage lending during periods of rising interest rates, perhaps increasing—rather than lowering—the cost of mortgage funds. This phenomenon became more pronounced as the ingenuity of the private sector spawned market instruments designed to appeal to rate-sensitive depositors.

In response to these pressures, regulatory and legislative changes were made to reduce the effect of deposit rate ceilings. During the late 1970s, financial regulators authorized a number of savings instruments with variable rate ceilings. In 1980, Congress enacted the Depository Institutions Deregulation and Monetary Control (DIDMC) Act, which established the Depository Institutions Deregulation Committee (DIDC) to manage a phased removal of all deposit rate ceilings by 1986.

Variable-ceiling deposit certificates have been attractive to savers. As a result of the success of such certificates, however, the maturity structure of thrift liabilities has shortened considerably, and the cost of funds for these institutions has become much more sensitive to movements in market interest rates. Despite this significant restructuring of liabilities, the assets of thrifts remained under strict regulatory control until quite recently.

The asset powers of thrift institutions traditionally have been limited by law and regulation. Indeed, the authority of federally chartered savings and loan associations to acquire adjustable-rate mortgages was removed by regulation after 1966, when home financing institutions began to look away from total reliance on long-term, fixed-rate assets. Recently, this prohibition has been largely

repealed by regulatory adjustments, and the DIDMC Act of 1980 granted federally chartered thrift institutions broader authority to acquire nonmortgage assets. The recent adjustments to asset powers, however, have come at a late date and have fallen far short of both the substantial deregulation that has taken place on the liability side of thrift balance sheets and the further deregulation mandated by legislation already enacted. The net result is that thrift institutions' current liability structure must sustain the pressure of open market forces, while they must continue to vie for funds with limited asset and earnings flexibility against highly diversified competitors.

The piecemeal and delayed responses of the statutory and regulatory structure to sweeping market developments not only have altered the competitive balance among regulated depository institutions, but also have placed these institutions, as a group, at a serious disadvantage vis-a-vis other participants in the financial system. Investment banking firms, consumer finance companies, insurance companies, commercial and industrial firms, and participants in international markets have increased their shares of the financial transactions that take place in this country because of the heavy burden of regulation and the lack of flexibility imposed on the depository institutions.

Laws and regulations not only have severely reduced the ability of specialized housing finance institutions to function, but also have interfered with the free flow of funds to housing markets from other types of private institutions. Some laws and regulations have prevented specific types of investors—such as pension funds—from acquiring mortgage assets, while others have disadvantaged secondary mortgage instruments relative to other types of investments available in capital markets. Regulatory restrictions on the types of mortgage contracts that can be offered to borrowers also have been a problem, as diversified investors with relatively short-term liability structures have become more reluctant to acquire standard fixed-rate, level-payment loans.

Finally, State legislative or judicial actions to restrict the enforcement of due-on-sale clauses in outstanding mortgage contracts have seriously damaged mortgage holders and have interfered with the operation of the national secondary markets for conventional loans and conventional pass-through securities. A vital mortgage finance system must be based on enforceable contracts upon which both lenders and borrowers can rely.

Commission Perspective on the Need for Change

Clearly, the nation can no longer rely so completely on a system of highly regulated and specialized mortgage investors and a single type of mortgage instrument if the strong underlying demand for housing credit is to be met. A new legal and regulatory structure should be developed, and a broader-based, more resilient system of housing finance is essential. In the future, resources to finance housing should be provided by unrestricted access of all mortgage lenders and borrowers to the money and capital markets, and mortgage market participants should have reliable methods to manage interest rate risks. Sweeping policy measures to change the structure of the housing finance system are essential.

Broader operating powers clearly are essential to the long-term health of the thrift industry. Despite expanded operating powers, the thrift industry undoubtedly will remain a significant participant in the nation's future housing finance system. These institutions have a strong community orientation, have built up a considerable competitive advantage in the origination and servicing of mortgage loans, and would not be likely to give up these profitable activities. Thrift institutions also could continue to hold mortgages that they originate while absorbing or shifting interest rate risk in various ways. New, flexible mortgage instruments would allow institutions to share interest rate risk with borrowers. Portfolio risk also could be hedged in the rapidly developing financial futures markets where speculators seek to profit by bearing risk. Or the thrifts could continue to accept interest rate risk associated with investment in long-term, fixed-rate mortgages, bolstering their capacity to handle this risk by building larger capital buffers.

Management of interest rate risk through such methods is not a cost-free process, however, and many thrift institutions probably would choose to reduce the asymmetry in the maturity structure of assets and liabilities partly by moving into assets that are, by their nature, shorter in term than residential mortgages—such as consumer loans, commercial paper, or commercial loans to housing-related businesses like developers or suppliers of building materials. Thus, it is likely that the thrift industry increasingly would seek to perform a mortgage banking function—originating and servicing residential mortgages that meet the needs of borrowers, while packaging and reselling these loans on secondary markets to institutions that would hold them as investments.

Reductions in the level of mortgage investment at thrift institutions would not affect the overall supply of residential mortgage credit as long as funds could flow freely through financial markets to meet the underlying demands for capital in the economy. In properly functioning markets, a reduction in mortgage supply at thrift institutions would place upward pressure on mortgage yields, and

investors who operate in both mortgage and other capital markets would move more funds into mortgages. After the adjustments, the structure of mortgage supply would be different, but the overall level and cost of mortgage credit should be essentially unchanged.

The efficiency of the secondary mortgage markets has improved in recent years because of widespread use of standardized mortgage documents, growth of private mortgage insurance, development of mortgage pass-through securities, and efforts by securities dealers to develop primary and secondary markets for these instruments. But the greatest improvements have been in the markets for federally underwritten mortgages and pass-through securities, which have been principally the domain of mortgage banking companies rather than thrift institutions. Secondary markets for the trading of conventional residential mortgages—in which thrift institutions specialize—remain relatively underdeveloped compared with other capital markets.

Given the current state of market development, prudence dictates that the provision of expanded operating powers for thrift institutions be accompanied by measures designed to facilitate an orderly transition to a more broadly based and flexible private housing finance system. Public policy should facilitate such an evolution by providing economic incentives for mortgage investment and by removing legal and regulatory impediments to the development of private markets for mortgages and mortgage securities.

The balance of this section of the report develops the specific recommendations needed to strengthen the private housing finance system and to establish the proper role of government credit programs in a revitalized system. Chapter 10 discusses specialized mortgage finance institutions (thrift institutions), and outlines changes that should be made in the legal and regulatory framework governing their operations and activities.

Chapter 11 examines ways to expand private sources of mortgage credit. The discussion considers broad-based tax incentives for mortgage investment; adjustments to laws and regulations limiting the investment choices of specific types of institutions such as pension funds; removal of tax, legal, and regulatory impediments to the development of conventional mortgage-backed securities markets; strengthening of traditional mortgage contracts and development of new types of mortgage forms and instruments that meet the diverse needs of borrowers and lenders; and development of organized options and futures markets that enable mortgage originators and investors to hedge their interest rate risks without shifting these risks to mortgage borrowers.

Chapter 12 deals with government credit programs presently in the housing finance system. With respect to Federal programs, the discussion stresses that greater reliance should be placed on the private sector whenever private institutions can provide needed services at reasonable cost. Concerning State and local governments, the chapter calls for reexamination of the role of tax-exempt revenue bonds for housing, along with all other private sector uses of tax-exempt funds, and urges that existing programs be made operable within the limits of current law.

Adoption of the Commission's package of recommendations should help move the nation in an orderly fashion toward a housing finance system that enables mortgage lenders and borrowers to compete more effectively for funds in the money and capital markets. Within that system, channels would be available to move funds efficiently from capital market investors, through mortgage originators, to ultimate mortgage borrowers. Thrift institutions, commercial banks, and mortgage banking companies would probably continue to originate the majority of mortgage loans, but the investor base would be much broader than in the past. Moreover, a wider variety of mortgage forms would be present in the market, tailored to the needs of borrowers who are at different stages of the life cycle and who have different abilities and inclinations to absorb interest rate risk. This range of mortgages, in turn, would be held by a variety of investors—directly or indirectly through mortgage-backed securities—with suitable liability structures and capacities to handle differing risk.

Development of a more broadly based and resilient private housing finance system, in an environment marked by fiscal responsibility and monetary stability, would reduce the need for government programs that involve intervention in the nation's credit markets. Scaling down the government presence in credit markets—in housing as well as other sectors—would relieve pressure on market interest rates in general, with attendant benefits for housing.

CHAPTER 10

TRADITIONAL SOURCES OF MORTGAGE CREDIT

Savings and loan associations and mutual savings banks—commonly referred to as thrift institutions—have served the housing market for many years by originating, servicing, and holding residential mortgage loans. The activities of these institutions traditionally have been circumscribed by government regulation and heavily influenced by Federal tax policies. Such constraints on the scope of thrift operations, combined with recent dramatic changes in the nation's economic and financial market environment, have reduced the ability of these institutions to supply mortgage credit. The Commission believes that the thrift industry can and will continue to be an important part of the housing finance system, but the developments of the past few years clearly indicate that new policy approaches and a process of adaptation are needed.

To be an effective competitor for funds and a viable force in the housing finance system of the 1980s and beyond, the thrift industry must undergo certain structural changes. The thrifts must also navigate a difficult transition period. Public policy toward thrifts should recognize both the immediate problems faced by this industry and the ongoing changes in the financial environment that have made past policies obsolete.

The structure and performance of thrift institutions and their roles in housing finance are described in this chapter. Recommendations are presented in three major areas. Two deal with basic structural changes needed to increase the strength and resiliency of the thrift industry over the long term: the balance sheet composition of individual firms; and the structure of the industry regarding types of charters, forms of ownership, and numbers and sizes of firms. Recommendations are also presented to help the thrift industry successfully traverse the current transition period to a stronger, more flexible structure.

Balance Sheet Composition

The balance sheets of thrift institutions are composed of liabilities and assets. The liabilities consist primarily of "borrowings" in the form of deposits of individuals, and the assets are composed primarily of mortgage loans made to individuals with the funds received from depositors. In taking deposits and making mortgage loans, thrift institutions traditionally have performed the function of "maturity intermediation," because the maturity of deposits preferred by most savers has been much shorter than the maturity of the mortgage loans needed by most borrowers.

A balance sheet composed of short-term liabilities and long-term, fixed-rate assets need not cause problems for a thrift institution, if a number of conditions are fulfilled. As long as yields on long-term assets exceed the average of short-term interest rates prevailing during the lives of these assets, the institution will generate profits, on average. Under this condition, proper management of reserve accounts can enable the institution to compete effectively for funds at all stages of the interest rate cycle, assuming that rate ceilings do not prevent the payment of competitive rates on liabilities. For this strategy to work, however, another condition must hold: long-term interest rates prevailing in the market at any given time must embody expectations of future levels of short-term rates that are reasonably accurate. Also, prepayment penalties must be sufficient to compensate mortgage holders for the loss of income associated with refinancing by borrowers in periods of relatively low interest rates, and mortgage holders must be able to enforce due-on-sale clauses (where they exist) in periods of relatively high market rates.

The risks of borrowing short and lending long have increased greatly in recent years because pre-

dicting the course of market interest rates has become more difficult. Moreover, State efforts to prevent the enforcement of due-on-sale clauses in outstanding mortgage contracts have exacerbated the situation. These factors alone might have been tolerable if they had not coincided with the demand by savers for short-term, market-rate deposits. The convergence of events has led to a sharp deterioration in net earnings at thrifts, threatening the viability of the industry and its continued ability to serve the mortgage credit needs of the country. During the second half of 1981, for example, the average rate of return on assets held by savings and loan associations was 10.02 percent, while the average cost of funds was 11.53 percent.

The following discussion reviews the evolution of the liability side of thrift balance sheets and makes recommendations to help these institutions compete more effectively for deposit funds. The structure of thrift assets then is reviewed, and sweeping recommendations for change are made. The recommendations on asset powers are designed partly to permit thrift institutions to achieve a closer matching of asset and liability maturities, if they so desire, in order to reduce their exposure to interest rate risk.

Liability Structure and Powers

The liability powers of savings and loan associations and mutual savings banks should be expanded to permit these institutions to compete more vigorously for individuals' savings and to serve the demand deposit needs of all sectors of the economy.

Until recently, regulatory authorities were able to lengthen the average maturity of thrift liabilities during periods of rising market interest rates and to limit increases in the cost of funds to these institutions. In the past few years, however, the maturity structure of thrift liabilities has shortened considerably, and a major share of liabilities now bears competitive market yields. With the recent large increases in market interest rates, the cost of funds to thrift institutions has greatly increased.

Table 10.1
Percent Distribution of Interest-Bearing Liabilities at Savings and Loan Associations, 1966–81

	Dec. 1966	Dec. 1969	Dec. 1973	Dec. 1974	Dec. 1978	Dec. 1980	Dec. 1981
NOW Accounts	—	—	—	—	0.1%	0.2%	1.4%
Passbook Savings	83.1%	64.1%	43.5%	40.1%	29.3	18.4	15.2
Fixed-Ceiling Time	10.9	29.7	48.7	49.4	50.6	20.8	11.1
Total Subject to Fixed Ceilings	94.0	93.8	92.2	89.5	80.0	39.4	27.7
Money Market Certificates	—	—	—	—	8.4	32.6	30.5
Small Savers Certificates	—	—	—	—	—	9.6	16.0
All Savers Certificates	—	—	—	—	—	—	3.3
Total Subject to Market-Determined Ceilings	—	—	—	—	8.4	42.2	49.8
Large-Denomination Time Deposits	—	—	1.2	1.7	3.1	7.1	7.9
Other Borrowings (Except FHLB[a] Advances)	0.4	0.3	0.8	1.2	2.2	3.0	3.1
FHLB Advances	5.6	5.9	5.8	7.6	6.3	8.3	10.4
Retail Repurchase Agreements	—	—	—	—	—	—	1.1
Total Not Subject to Rate Ceilings	6.0	6.2	7.8	10.5	11.6	18.4	22.5

[a]Federal Home Loan Bank.

Source: Data compiled by staff from information supplied by the Federal Home Loan Bank Board.

Changes in the structure of thrift liabilities since the mid-1960s have been heavily influenced by the management of deposit rate ceilings by regulatory authorities. To enhance the competitive position of deposits vis-a-vis market instruments, adjustments to the structure of rate ceilings have been made during each cyclical upswing in market interest rates since 1966. In the mid-1970s, regulators authorized certificates with higher ceiling rates but longer maturities, allowing thrift institutions to retain some rate-sensitive deposits without raising rates paid to those depositors who left funds in existing savings accounts. The introduction of higher-rate certificate accounts thus accomplished a significant lengthening of the average maturity of thrift liabilities, and stiff early withdrawal penalties further helped to protect the thrifts against instability in the volume and cost of deposits.

The ability of the regulators to pursue this policy successfully was fully dissipated in the closing years of the 1970s. Money market mutual funds (MMMFs) and other market instruments became major competitors with deposit accounts for household savings. In response to this competition, in June 1978 the regulators authorized the six-month money market certificate with a rate ceiling tied to six-month Treasury bill rates and a minimum denomination of $10,000. In January 1980, the "small savers" certificate, with a minimum maturity of 30 months and a variable ceiling rate related to yields on comparable maturity Treasury securities, was introduced partly to help counteract the shortening of deposit liabilities that resulted from the popularity of the money market certificate.[1]

The effect of the changing deposit rate structure on the composition of thrift liabilities has been striking (Tables 10.1 and 10.2). At the end of 1966, 94 percent of the total interest-bearing liabilities of

[1] The small savers certificate was first introduced in June 1979 as a four-year certificate with no minimum denomination but with a ceiling rate set considerably below comparable maturity Treasury yields.

Table 10.2
Percent Distribution of Interest-Bearing Liabilities at Mutual Savings Banks, 1966–81

	Dec. 1966	Dec. 1969	Dec. 1973	Dec. 1974	Dec. 1978	Dec. 1980	Dec. 1981
NOW Accounts	—	—	0.1%	0.2%	0.7%	1.1%	1.3%
Passbook Savings	94.5%	91.7%	67.6	64.9	50.2	33.6	29.4
Fixed-Ceiling Time	4.9	7.7	31.3	33.4	38.5	20.4	10.9
Total Subject to Fixed Ceilings	99.4	99.4	99.0	98.5	89.4	55.1	41.6
Money Market Certificates	—	—	—	—	8.3	31.7	33.4
Small Savers Certificates	—	—	—	—	—	7.6	13.5
All Savers Certificates	—	—	—	—	—	—	3.1
Total Subject to Market-Determined Ceilings	—	—	—	—	8.3	39.3	50.0
Large-Denomination Time Deposits	—	—	0.5	0.8	1.2	2.9	3.4
Other Borrowings	0.6	0.6	0.5	0.7	1.1	2.9	4.2
Retail Repurchase Agreements	—	—	—	—	—	—	0.9
Total Not Subject to Rate Ceilings	0.6	0.6	1.0	1.5	2.3	5.8	8.5

Source: Data compiled by staff from information supplied by the National Association of Mutual Savings Banks and the Board of Governors of the Federal Reserve System.

savings and loan associations were subject to fixed ceilings, and the bulk of these funds was in passbook accounts. The introduction of longer-term time deposits with higher rate ceilings resulted in a marked shift from passbook savings to small time deposits until mid-1978, when money market certificates were introduced and market yields rose above rates payable on all fixed-ceiling accounts. By December 1981, only 28 percent of savings and loan liabilities were in deposits with fixed-rate ceilings, while 50 percent of liabilities were in accounts with ceilings tied to Treasury securities rates.[2] In addition, 22 percent of savings and loan liabilities were in forms not subject to any type of rate ceiling.

The growth of money market certificates, small savers certificates, large-denomination time deposits, and market borrowings has largely freed thrift institutions from the constraints of deposit rate ceilings, and has resulted in a sharp rise in the average cost of funds to these institutions. The one-year, tax-exempt "all savers" certificates, authorized on a temporary basis by the Economic Recovery Tax Act of 1981, also have market-determined ceilings, but the thrifts have to pay only 70 percent of the one-year Treasury bill yield for these funds. Experience with the all savers certificates, however, indicates that significant portions of the funds flowing into these accounts have represented transfers from fixed-ceiling accounts with lower interest rates.

Title II of the Depository Institutions Deregulation and Monetary Control (DIDMC) Act of 1980 mandated the phased removal of all deposit rate ceilings. To implement Title II, the Depository Institutions Deregulation Committee (DIDC) was established. The DIDC's voting members are the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Board of Directors of the Federal Deposit Insurance Corporation, the Chairman of the Federal Home Loan Bank Board, and the Chairman of the National Credit Union Administration, with the Comptroller of the Currency serving as a nonvoting member.

The Deregulation Committee has been directed by Congress to increase to market rates, as soon as feasible, all limitations on the maximum rates of interest and dividends that may be paid on deposits. As of March 31, 1986, the authority of Federal financial regulatory agencies to impose interest rate ceilings on deposits will be revoked; all authority previously transferred to the DIDC will become ineffective; and the committee shall cease to exist.

Congress gave the DIDC little guidance as to how to proceed with deregulation. In fact, the basic thrust of Title II has been subject to different interpretations. Some have viewed the legislation as a clear mandate to eliminate rate ceilings while others have considered the act as a six-year extension of Regulation Q (which governs rate ceilings on deposits) and the rate differential in favor of thrifts. The DIDC has attempted major forms of deregulation of deposit rates on two occasions, but the committee was challenged in the courts in both cases. If the shift in deposit mix toward rate-sensitive instruments continues, of course, fixed ceilings may apply to only a small proportion of thrift liabilities by 1986.[3]

Competitive Savings Deposits. Depository institutions must be permitted to compete more effectively with less-regulated financial entities—particularly money market mutual funds—for the savings deposits of households. Several methods have been proposed to accomplish this objective: apply deposit rate ceilings to money market mutual funds; treat the funds as transactions accounts subject to reserve requirements; compel the funds to invest a portion of their assets in Treasury securities; direct some investments of MMMFs into mortgage-lending institutions; and make accounts at depository institutions more attractive to rate-sensitive investors.

It is preferable to improve the competitiveness of deposit accounts of banks and thrifts, rather than to impose new regulations on MMMFs or other institutions, unless such regulations are required to maintain the safety and soundness of the financial system. Depository institutions should be permitted to offer a federally insured, daily-access, market-rate account that would appeal to individuals holding MMMF accounts. This account would be available at depository institutions nationwide, and the security provided by Federal deposit insurance would permit the new account to carry an interest rate below yields on money funds and still compete effectively for savings.

The new account should be designed with care to prevent an unmanageable increase in the cost of funds to depository institutions. The rate ceiling should be set somewhat below that on the money market certificates, changing weekly to reflect Treasury bill auction results. The account should have a relatively high minimum denomination (e.g., $3,000) to minimize shifts from passbook

[2] As shown in Table 10.2, half of the interest-bearing liabilities of mutual savings banks also were in accounts with market-determined ceilings at the end of 1981.

[3] At the March 1982 meeting of the DIDC, a schedule for removal of all deposit rate ceilings was approved. The schedule provides for deregulation beginning with long-term certificates of deposit. By 1986, ceilings are to be removed from all types of accounts.

accounts. No minimum term should be stipulated, but interest should revert to the passbook rate if the balance falls below the minimum denomination. Third-party payment and automatic transfer system capabilities should be restricted to prevent use of the account as a transaction device.[4]

Demand Deposits. As a result of the DIDMC Act of 1980, federally chartered savings and loan associations may now accept transactions accounts (negotiable orders of withdrawal) from individuals and certain nonprofit entities, and Federal mutual savings banks may offer demand deposits to business loan customers. Savings and loan associations and mutual savings banks should have authority to accept demand deposits from all types of customers. Because of the thrifts' historical link to housing, the corporate demand deposit authority would allow thrift institutions to better serve and attract housing-related businesses such as contractors, developers, and suppliers of building materials. Addition of this authority would help to make thrifts full-service financial institutions for the housing industry.

Asset Structure and Powers

Savings and loan associations and mutual savings banks should be granted new and expanded asset powers sufficient to serve the credit needs of all sectors of the economy and to maintain their viability as financial institutions in a deregulated environment.

The earnings problems encountered by thrifts, coupled with the fact that short-term market yields have been close to or above long-term yields, have encouraged the institutions to move unusually large amounts of funds into short-term nonmortgage assets during the past two years to maximize short-run returns and to minimize interest rate risk. However, mortgage assets (including mortgage pass-through securities) still account for about three-fourths of the total assets of savings and loan associations and 55 percent of the assets of mutual savings banks (Figure 10.1).[5]

Thrift mortgage assets remain largely concentrated in long-term, fixed-rate forms, many of which were acquired when interest rates were much lower. At the end of 1980, in fact, long-term mortgages bearing interest rates below 10 percent accounted for two-thirds of all mortgages held by savings and loan associations; the proportion was even larger for mutual savings banks. The concentration of low-rate mortgages is greatest in areas where housing stock turnover has been relatively slow or where State ceilings on mortgage interest rates had been relatively low. The problem is most severe in the northeastern part of the country, particularly New York (Tables 10.3 and 10.4).

Prepayment of mortgage principal at par has slackened because of declining sales of existing homes and widespread assumptions of outstanding low-rate loans. These factors have driven the mortgage turnover rate at savings and loan associations to a historically low level. Moreover, associations have not been able to dispose economically of the seasoned low-rate mortgages held in their portfolios because sales during periods of high market rates traditionally have required the booking of capital losses, in the year of the sale, against current operating income and net worth.[6] Largely because of this factor, net sales (sales less purchases) of mortgage assets (including pass-through securities) by the savings and loan industry have been small or negative in recent years.

The asset powers of federally chartered thrift institutions have been expanded significantly during the past two years. The DIDMC Act of 1980 authorized federally chartered savings and loans to invest up to 20 percent of assets in a combination of consumer loans, commercial paper, and corporate debt securities; to offer credit card services; and to exercise trust and fiduciary powers. Federal associations also were authorized to make second mortgage loans, to originate residential mortgage loans without geographic restrictions, and to invest in open-end investment companies where portfolios are restricted to eligible investments. Federal mutual savings banks, in addition, were permitted to invest 5 percent of their assets in commercial, corporate, and business loans made within their States or within a 75-mile radius of their home offices.

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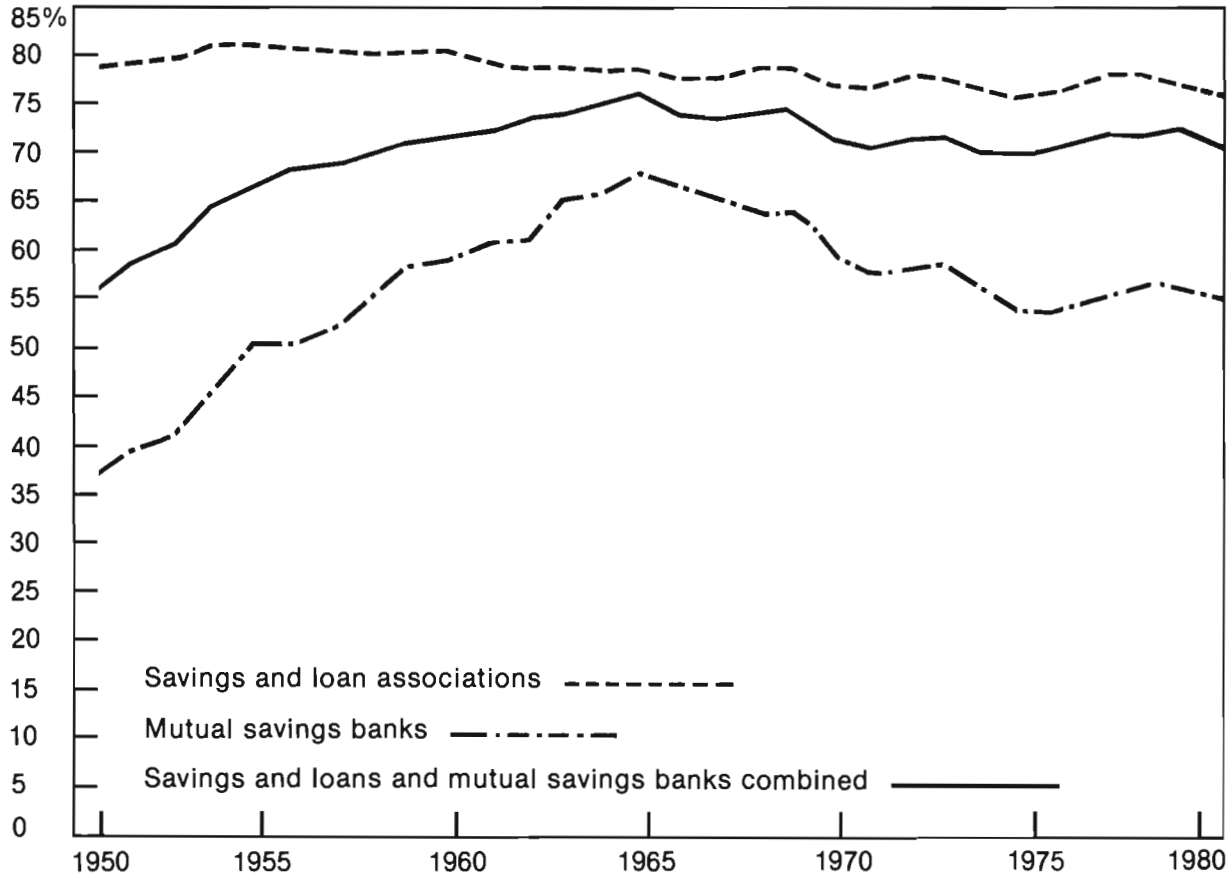
[4] The Commission recommended establishment of such an account prior to approval by the DIDC on March 22, 1982 of a new certificate of deposit. This certificate has a minimum denomination of $7,500, a yield tied to three-month Treasury bills, a 0.25 percent rate differential in favor of thrift institutions, and a minimum term of three months. While this account improves the ability of insured depository institutions to compete with money market mutual funds, the minimum denomination and term are above those recommended by the Commission and may limit the ability of the certificate to compete with MMMFs.

[5] The decline in the importance of residential mortgages in the portfolios of mutual savings banks since the mid-1960s reflects, in part, relatively weak demands for mortgage credit in the local markets served by these institutions. Moreover, until 1980, State-imposed mortgage rate ceilings were relatively low in the primary mortgage markets served by many mutual savings banks, and State restrictions often limited their purchases of mortgages originated in other areas.

[6] The Federal Home Loan Bank Board recently changed its regulatory accounting procedures to permit savings and loans to amortize the loss on sales of mortgages over the expected lives of the mortgages. Under current generally accepted accounting principles, however, this procedure may not be available to stockholder-owned institutions.

Figure 10.1
Residential Mortgages as a Percent of Total Assets at Thrift Institutions



Note: Federally related pass-through securities are included in both residential mortgages at thrift institutions and total mortgages outstanding.

Sources: Federal Home Loan Bank Board; National Association of Mutual Savings Banks; and Board of Governors of the Federal Reserve System, Flow of Funds Accounts.

A series of regulatory changes, made largely in response to the marked shortening of thrift liabilities, has permitted Federal thrift institutions to offer a variety of adjustable-rate home mortgages (ARMs), and the Federal preemption of State mortgage rate ceilings—authorized by the DIDMC Act of 1980—removed an important practical impediment to ARM expansion. In April 1981, revised

Table 10.3
Low-Rate Residential Mortgages as Percent of All Residential Mortgages Held by Savings and Loan Associations, by Federal Home Loan Bank District, 1980

Federal Home Loan Bank District	Less than 6%	Less than 7%	Less than 8%	Less than 9%	Less than 10%
Boston	4.7%	9.0%	19.5%	47.4%	71.8%
New York	4.2	10.0	27.5	64.2	86.2
Pittsburgh	1.5	5.1	16.5	45.9	75.5
Atlanta	1.0	3.8	13.9	43.9	71.4
Cincinnati	1.0	4.7	13.9	41.2	68.2
Indianapolis	1.6	4.7	14.0	39.4	67.0
Chicago	1.3	4.8	13.7	34.8	61.5
Des Moines	1.8	5.4	15.8	41.4	74.9
Topeka	1.2	4.0	11.8	30.9	62.3
Little Rock	1.2	3.7	11.9	33.1	79.3
San Francisco	0.3	3.8	11.7	23.1	52.7
Seattle	0.6	3.1	10.0	24.4	56.2
All Savings and Loan Associations	1.3%	4.6%	14.1%	37.0%	66.7%

Source: Data compiled by staff from information supplied by the U.S. League of Savings Associations.

Table 10.4
Low-Rate Residential Mortgages as Percent of All Residential Mortgages Held by Mutual Savings Banks, by State, 1979[a]

State	Less than 7%	Less than 8%	Less than 9%
New York	23.2%	44.7%	79.7%
City	26.1	49.0	78.9
Upstate	15.3	33.0	81.9
Massachusetts	12.1	27.5	62.2
Boston	22.3	39.4	72.0
Other	9.9	24.9	60.0
Connecticut	7.7	21.2	58.3
Pennsylvania	21.0	38.8	67.3
New Jersey	8.1	22.2	62.8
Washington	7.6	20.9	35.5
New Hampshire	8.1	18.4	44.2
Maine	6.8	18.2	47.5
Rhode Island	10.4	24.3	60.3
Maryland	14.2	31.7	59.5
Vermont	6.1	22.4	52.0
All Savings Banks	17.4%	35.5%	69.2%

[a]At the end of 1981, residential mortgages with interest rates of less than 9 percent accounted for 55.9 percent, and mortgages with rates below 10 percent accounted for 77.2 percent, of all residential mortgages held by mutual savings banks.

Source: Data compiled by staff from information supplied by the National Association of Mutual Savings Banks.

ARM regulations were issued for federally chartered savings and loan associations and Federal mutual savings banks. These regulations override State laws or regulations on the subject and permit substantial interest rate adjustments as well as a good deal of latitude for negotiation of terms between borrowers and lenders.[7] Because of record-high interest rates, the financial plight of thrift institutions, and some confusion among potential borrowers faced with a wide variety of mortgage instruments, however, issuance of ARMs under the new regulations has been modest. By the end of 1981, adjustable-rate mortgages of all types accounted for only about 6.5 percent of total mortgages held by the savings and loan industry, and many of these loans were contracts with limited rate flexibility that had been acquired by State-chartered institutions (particularly in California) during the latter years of the 1970s.

The Commission recognizes that the thrift industry has not yet fully used the expanded asset powers recently provided by legislation and regulation. Two factors have delayed the adjustment: the current economic distress of the industry, and concentration of management expertise in mortgage finance. Over the long term, however, many institutions will need a much broader range of investment opportunities to enable them to pay competitive market rates for funds and to adapt to shifting demand conditions in local, regional, and national markets. Such powers should foster a stronger thrift industry and, consequently, provide a more stable supply of residential mortgage credit.

The Commission recommends that thrift institutions be granted new and expanded asset powers sufficient to serve the credit needs of all sectors of the economy and to maintain their viability as mortgage lending institutions in a deregulated environment. It is expected that these powers will be phased in and utilized during a period of transition.

Consumer Lending. Thrift institutions should have expanded authority to invest in secured and unsecured consumer loans, and should be permitted to provide inventory and floor planning loans to dealers of consumer durables. Without the latter authority, the attractiveness of consumer loans could be diminished. Many of the more profitable consumer loans are originated by dealers and sold to ultimate investors, and dealers generally place their consumer loans with the same institutions that finance inventories and floor plans.

Business Loans and Corporate Securities. Federal savings and loan associations may not invest in loans to businesses, and the business loan powers of Federal mutual savings banks are quite limited. All thrift institutions should be permitted to invest in secured and unsecured commercial and agricultural loans, and their authority to invest in commercial paper and other corporate debt instruments should be expanded. Some of these instruments have relatively short maturities, and thus would provide a partial remedy for the asset–liability mismatch that has developed at most thrifts. These powers also could help attract housing-related businesses as new customers, thereby expanding the demand deposit base.

Municipal Bonds. At present, federally chartered thrift institutions may invest in State and local securities if they are general obligations or certain housing-related instruments. All thrift institutions should be permitted to invest in securities issued by States and municipalities, including both revenue bonds and general obligation instruments. Expanded authority to invest in mortgage revenue bonds could enable thrifts to better serve the housing credit needs of their communities.

Real Property Loans. Although thrift institutions traditionally have been able to invest up to 100 percent of their assets in residential real property loans, current law specifies different loan-to-value ratio limitations, depending on the nature of the secured property, and requires mortgage insurance on loans with loan-to-value ratios over 90 percent. The power to invest in nonresidential real property loans is limited to 20 percent of assets, and such loans must be secured by first liens.

Thrift institutions should have expanded authority to invest in real estate loans, so that they may invest in both residential and nonresidential mortgages, whether first or subsequent liens, without loan-to-value restrictions or mortgage insurance requirements. Nonresidential mortgages have different cash flow characteristics than residential mortgages, and can help to diversify the portfolio. They may also provide for equity participation by the lender, possibly enhancing the rate of return on assets.

Service Corporations. The DIDMC Act of 1980 permitted Federal savings and loan associations to devote up to 3 percent of assets to investment in service corporations. While remaining subject to a percent-of-asset limitation and regulatory supervision, the permitted levels of investment in service corporation affiliates should be increased for savings and loan associations and made available to mutual savings banks.

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[7] See Chapter 11 for more information on this topic.

Real Property Investment. Thrift institutions should be permitted to invest in real estate of various types (including joint ventures with developers) only through service corporations or holding companies. The separation of real estate activities from the deposit-taking entity is necessary for the protection of insured deposits at these institutions.

Other Powers

Savings and loan associations and mutual savings banks should be granted such additional operating powers and authorities as may be necessary to provide financial services to all sectors of the economy.

Sales of Investments. Under current SEC interpretations of securities law, public over-the-counter sales (without registration) of mortgage securities by thrift institutions are prohibited. Furthermore, current FHLBB regulations generally prohibit FSLIC-insured institutions from selling mortgages or mortgage securities with recourse (i.e., with a guarantee to repurchase loans in default). These interpretations and regulations have both constrained sales of mortgage assets by thrift institutions and limited the development of markets for conventional mortgage-backed securities. Thrift institutions should have the authority to make over-the-counter sales of mortgage-backed securities, with or without recourse, subject only to appropriate regulations of their respective supervisors and the Federal deposit insurance agencies.

Leasing. Under current statutes, thrift institutions may not invest in many of the types of assets that are common to the equipment leasing market. Subject to percent-of-asset limitations and regulatory supervision, the powers of thrift institutions should be expanded to permit investment in tangible property for the purpose of engaging in equipment leasing. This power would enable thrift institutions to engage in an activity that has been profitable for the commercial banking industry.

Incidental Activities. Thrift institutions should be provided, where necessary, with the power to engage in activities and ventures incidental to the exercise of authority conferred by law to permit them to carry out their expressed authority more efficiently. For example, there should be no doubt as to the ability of a thrift to engage in correspondent activities, in business relationships that facilitate the sale of low-yielding mortgages, and in the issuance of money orders or cashier's checks.

Industry Structure and Institutional Form

Thrift institutions should be permitted to select their institutional form, with the right to convert from State to Federal charters (and vice versa), from mutual to stock form, and from savings and loan associations to savings banks (and vice versa).

The Federal Home Loan Bank Board should be given power to grant *de novo* Federal stock charters to savings and loan associations and savings banks.

Regulators of financial institutions should permit, where appropriate, interstate and interindustry mergers sought by the private sector.

Growing competition from unregulated elements of the financial system has made it clear that the regulated elements, particularly depository institutions, should have the flexibility to choose the ownership forms and organizational structures that permit the maintenance of their important roles in the financial system—roles that are critical to the growth and stability of the U.S. housing markets and other sectors of the economy. The following discussion presents the Commission's views concerning the proper evolution of the thrift industry over the long term with respect to forms of charters and types of ownership of individual firms, as well as mergers and acquisitions of firms within and across industry and geographic boundaries. The appropriate roles of regulatory authorities in arranging mergers and acquisitions of financially troubled institutions during the current transition period are considered in the next part of this chapter.

Forms of Charters

Nearly half of the savings and loan associations in the country, holding about 55 percent of the assets of the savings and loan industry, have Federal charters and are regulated by the Federal Home Loan Bank Board; the balance are chartered by the States in which they operate and are regulated by State government agencies. All Federal associations, and most State-chartered associations, have deposits insured by the Federal Savings and Loan Insurance Corporation (FSLIC).[8]

Mutual savings banks, which operate in 17 States concentrated in the Mid-Atlantic and New England regions, generally have State charters. In fact, Federal law did not permit savings banks to convert to Federal charters until 1978. Mutual savings banks generally are regulated by the States

[8] Some institutions in five States (Maryland, Massachusetts, North Carolina, Ohio, and Pennsylvania) are insured by corporations chartered by State governments.

where they are chartered and by the Federal Deposit Insurance Corporation (FDIC), which insures deposits at most of these institutions.[9]

Current law does not permit State stock savings and loan associations to obtain Federal charters unless they existed as stock entities before 1976. The Commission recommends that all State-chartered thrift institutions be permitted to convert to Federal charters, and vice versa. Conversion to Federal charters, of course, would permit institutions to convert from mutual to stock forms under Federal law, if they so desired. With respect to the type of thrift institution, all federally chartered savings and loan associations should have the opportunity to convert to Federal savings banks, and vice versa.

Stock Conversions

Thrift institutions traditionally have been mutual organizations with depositors as owners. In today's financial environment, however, the appeal of stock ownership has increased. Stock institutions have the ability to raise capital beyond that provided by retained earnings (and capital certificates). Greater ability to build capital, in turn, can give an institution greater flexibility in managing its operations. A more heavily capitalized firm, for example, is in a better position to absorb the interest rate risks that are associated with accepting short-term savings and extending long-term mortgage credit.

Despite the advantages of the stock form of ownership, many thrift institutions currently do not have the option to become stockholder-owned institutions. In about two-thirds of the States, State stock savings and loan associations may be formed *de novo* and State mutual associations may convert to State stock associations. *De novo* State stock savings banks are permitted in only one State, and State mutual savings banks are permitted to convert to State stock savings banks only in that State. The Federal Home Loan Bank Board does not have the authority to grant *de novo* Federal stock charters, and existing Federal associations may convert from mutual to stock status only in States that allow chartering of stock associations. Federal stock savings banks are not permitted in any State.

The Commission believes that all thrift institutions should have the option to convert from mutual to stock form of ownership. Furthermore, the Federal Home Loan Bank Board should have the authority to grant *de novo* Federal stock charters to both savings and loan associations and savings banks. A broader base of stockholder-owned institutions not only would mean more flexible institutions, but also would establish the potential for a greater number of mergers and acquisitions.

Mergers and Acquisitions

Mergers or acquisitions of financial institutions within and across State or industry boundaries can have beneficial effects on the cost of housing credit over the long term, provided that the regulatory authorities give adequate consideration to competitive impacts and to the adequacy of the capital positions of newly organized institutions. Indeed, to the extent that mergers and acquisitions result in economies of scale and a more efficient financial system, the average level of costs for all users of financial services would be lower.

Thus, interstate and interindustry mergers sought by the private sector should be permitted, where appropriate, in the evolution toward a financial system that provides financial services at the lowest possible cost to mortgage borrowers and other participants in the financial markets and that leads to a more stable flow of housing credit.

The Thrift Industry in Transition

The Commission's recommendations on balance sheet powers, as well as on industry structure and form, should facilitate the long-term evolution of a strong and resilient thrift industry that will remain an essential element of our housing finance system in the future. Nevertheless, many mortgage-lending institutions must weather a difficult transition period as they move toward the revitalized system. The following discussion considers the immediate problems faced by the thrift industry and presents a number of recommendations designed to help these institutions through the transition.

For many years, maturity intermediation was a profitable function for depository institutions because long-term interest rates generally exceeded short-term yields—the "normal" shape of the yield curve—and market expectations of future rate movements were reasonably accurate. During the past decade, however, long periods of flat or inverted yield curves have been encountered and the market has systematically underestimated future levels of short-term interest rates. Under these conditions, balance sheets composed of short-term liabilities and long-term assets inevitably generate losses over a protracted period of time.

This unbalanced relationship between return and cost has led to a large decline in net earnings at savings and loan associations and mutual savings banks (Table 10.5). From historically high levels in 1978, earnings for these institutions have turned

[9] Some savings banks in Massachusetts have deposits insured by the Mutual Savings Central Fund, Inc. Deposits at the few savings banks with Federal charters are insured by the Federal Savings and Loan Insurance Corporation.

Table 10.5
Profitability of Thrift Institutions, 1961–81
(Retained Earnings as Percent of Average Total Assets)

Period	FSLIC-Insured Savings and Loan Associations	All Mutual Savings Banks
1961–65	0.80%	0.45%
1966–70	0.56	0.30
1971–75	0.65	0.47
1976	0.63	0.45
1977	0.77	0.55
1978	0.82	0.58
1979	0.67	0.46
1980	0.14	−0.12
1981	−0.73	−0.81

Source: Data supplied by the National Association of Mutual Savings Banks and the Federal Home Loan Bank Board.

negative, a development that inevitably has led to a reduction in capital positions (Table 10.6). As discussed above, the loss of profitability has been associated not only with market interest rate developments, but also with erosion of the ability of regulators to manage the structure of deposit rate ceilings both to limit deposit outflows and to hold down the average cost of deposits at thrifts.

Although net earnings have turned negative and net worth has been declining, most thrift institutions have been able to maintain their operations. The thrift industry has high-quality assets that generate large and predictable cash flows that have been generally more than adequate to meet current payment obligations. Moreover, most of the institutions have substantial liquid asset balances and have continued to add to their mortgage portfolios. These liquid assets, along with recently acquired mortgages and pass-through securities, serve as additional sources of funds that can be tapped, if needed, without recording capital losses. Thus a widespread liquidity crisis has not emerged at thrift institutions. It is essential, of course, that public confidence in the ability of the supervisory authorities to protect the interests of insured depositors and other creditors against default be maintained; otherwise, widespread withdrawals of funds from the institutions could create severe liquidity problems.

Maintaining Public Confidence in Depository Institutions

The Federal government should clearly and explicitly reaffirm its responsibility to maintain the viability of the financial system, including a commitment to use whatever resources are necessary to assure the safety of deposits insured by FDIC or FSLIC.

Table 10.6
Capital Position of Thrift Institutions, 1960–81
(Net Worth as a Percent of Assets)

End of Year	FSLIC-Insured Savings and Loan Associations	All Mutual Savings Banks
1960	7.02%	8.75%
1965	6.83	8.01
1970	6.98	7.25
1971	6.55	7.07
1972	6.22	6.91
1973	6.23	7.12
1974	6.20	7.27
1975	5.81	6.96
1976	5.58	6.71
1977	5.45	6.77
1978	5.51	6.90
1979	5.59	7.05
1980	5.24	6.63
1981	4.23	5.68

Source: Data supplied by the National Association of Mutual Savings Banks and the Federal Home Loan Bank Board.

Maintaining public confidence in the safety of insured deposits is essential. Despite record operating losses among specialized mortgage lenders and substantial publicity about the problems of thrifts and small banks, public confidence in the system of depository institutions has remained high. This positive outlook is largely due to strict regulatory standards, a past record of strength, and Federal deposit insurance. Indeed, the nation's financial system remains strong and fundamentally sound, and federally insured deposits at all institutions are completely safe.

The principal and interest on savings, certificates, and transactions accounts at most depository institutions are insured up to $100,000 by the FSLIC or FDIC. Furthermore, the claims of other account holders and creditors, including those holding retail repurchase agreements, are subordinate to those of the insured depositors. Nevertheless, doubts have arisen about the ability of the FSLIC and FDIC to meet their obligations. Deposit flows at thrift institutions already have been adversely affected.

Enhancing the financial resources of the FSLIC and FDIC would both reassure depositors and give the agencies greater flexibility to deal with problem depository institutions. The agencies could better evaluate the alternatives of assistance, merger, or liquidation according to long-run social benefits rather than short-run financial constraints. In this regard, the needs of borrowers could be served as well as those of insured depositors and other creditors.

The Commission therefore recommends that the Federal government make clear and explicit its responsibility to maintain the viability of the financial system, including a commitment to use whatever resources are necessary to assure the safety of deposits insured by FSLIC or FDIC. The integrity of deposit insurance could be guaranteed by the full faith and credit of the Federal government.[10] Alternatively, the insurance agencies could be given additional borrowing authority from the U.S. Treasury and/or access to the Federal Reserve System.[11]

Regulatory Agency Activity

Regulatory authorities should continue to have, and to use, the power to arrange, in lieu of liquidation, interstate and interindustry mergers and acquisitions.

When determining whether to assist insured thrift institutions, regulatory agencies should be guided by the reasonably anticipated profitability of an institution rather than being bound by tests concerning the essentiality of an institution to a community or arbitrary accounting procedures relating to book value of net worth.

The Federal agencies that regulate thrift institutions and insure their deposits use a variety of means to assist troubled firms. Measures can include operating assistance for an ongoing institution, assistance to the acquiring firm in the event of a merger or acquisition, or liquidation of an institution—necessitating a payoff of the insured depositors. Liquidation has rarely been required, and the Commission favors the use of supervisory mergers and acquisitions or agency assistance during the transition period.

Supervisory Mergers and Acquisitions. The thrift industry has been undergoing some consolidation because of the financial difficulties faced by a number of firms. At the end of 1980, there were 4,613 savings and loan associations with total assets of $630 billion; by the end of 1981, the number of associations had fallen to 4,380 as industry assets increased to $662 billion. The number of mutual savings banks decreased from 462 with $172 billion in assets in December 1980, to 448 with $176 billion in assets at the end of 1981.[12]

Mergers and acquisitions arranged by regulatory authorities should be permitted to cover a broad range of situations. These include the merger of any insured thrift institution with any other insured thrift or bank, or with any savings and loan or bank holding company, regardless of the locations of the institutions. Interstate and interindustry mergers and acquisitions can open the bidding for troubled institutions to more participants, and potential acquirors often are willing to assume short-run losses to gain access to new markets. Thus, such mergers and acquisitions often can be arranged with relatively little drain on the resources of the insurance agencies.

Agency Assistance. As an alternative to supervisory mergers or acquisitions, regulatory agencies may consider providing a limited operating subsidy to an institution in financial difficulty. Interpretations of law, however, may limit the flexibility of the FDIC in providing ongoing assistance to troubled mutual savings banks. Before short-term assistance can be given to a troubled institution the FDIC must determine that the institution is "essential" to the community for adequate banking service.[13] The FDIC has used the essentiality test to assist commercial banks only five times and has never invoked this provision to assist a mutual savings bank. In the latter instance, it might be difficult for FDIC to determine that a troubled institution is essential; therefore FDIC might be required to merge or liquidate the institution, even when a short-term subsidy would be less costly. Changes to the Federal Deposit Insurance Act should be enacted to provide FDIC with an alternative to the essentiality test in order to allow use of short-term assistance techniques for mutual savings banks.

The FSLIC may be required to take action against a troubled savings and loan association on the basis of arbitrary accounting criteria relating to the book value of net worth, even when the outlook for the institution is favorable and there is no imminent threat to the safety of insured deposits. Similarly, regulations prohibit the Federal Home Loan

[10] In March 1982, Congress passed a nonbinding resolution reaffirming that the full faith and credit of the Federal government stands behind the obligation of the insurance agencies to insured depositors.

[11] Although the Board of Governors of the Federal Reserve System could elect to lend to the insurance agencies, the FSLIC and FDIC are currently prohibited by charter from borrowing from any source other than the Treasury.

[12] Data supplied by the Federal Home Loan Bank Board and the National Association of Mutual Savings Banks.

[13] Section 13(c) of the Federal Deposit Insurance Act.

Bank System from making loans or "advances" to a savings and loan association when the net worth of the association falls below a specific level.

Such arbitrary criteria may not describe the fundamental health of an institution and in many cases are poor predictors of its viability. Low book value of net worth does not necessarily reflect the quality of an institution's assets nor indicate an institution's inability to generate cash flow to sustain normal operations. The use of such indicators shifts the burden of assistance to the FSLIC as the only avenue of relief for a troubled savings and loan association. The Commission therefore recommends that the FSLIC and the FHLBB be guided by the reasonably anticipated profitability of an institution, rather than by arbitrary procedures relating to the book value of net worth.

The FSLIC currently is using a variety of short-term assistance measures to help savings and loan associations through the current difficult period. For example, the FSLIC has bolstered the capital positions of some savings and loan associations by purchasing Income Capital Certificates (ICCs) from associations that are approaching the arbitrary book net worth limits. Under this program, the FSLIC purchases ICCs with promissory notes that qualify as capital for regulatory accounting purposes and bear interest similar to Treasury notes. Thus, the capital base of the association is enhanced, and income from the promissory notes helps to support the earnings position of the association. The ICCs are to be redeemed when the association returns to a profitable position.

Sustaining the Deposit Base at Thrift Institutions

The Depository Institutions Deregulation Committee should take action to forestall the disintermediation of funds upon the maturity of "all savers" certificates.

To permit depository institutions to offer the expanded retirement accounts authorized by law, deposit insurance on IRA and Keogh accounts should be increased to $250,000 per account.

One approach to resolving the problems of depository institutions with low-yielding asset portfolios was the tax-exempt "all savers" certificate. This program is scheduled to expire at the end of 1982, although certificates will begin to mature in the fourth quarter of the year. Because the institutions currently cannot offer taxable accounts that are close substitutes for all savers certificates, there is a possibility of massive withdrawals upon expiration of the all savers program. The Commission therefore recommends that the DIDC take action to limit the possibility of disintermediation upon the maturity of all savers certificates. For example, the DIDC could authorize a new certificate that would allow middle-income depositors to reinvest all savers funds in a taxable account with comparable after-tax yield, denomination, and maturity.

The Economic Recovery Tax Act of 1981 made individual retirement accounts (IRA) available to many more individuals and increased the limits on contributions to Keogh accounts by self-employed persons. The latter action, in particular, means that many account holders will soon have account balances in excess of the $100,000 limit for deposit insurance. To encourage the holders of these relatively inflexible accounts to keep their funds in insured depository institutions, the Commission suggests raising the insurance limit to $250,000 for these accounts only. The current insurance limit for other accounts ($100,000) was raised from $40,000 in 1980 and does not require an increase at this time. However, in the event that the current level of inflation continues, insurance limits on all types of accounts should be reviewed periodically.

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The Commission considers a strong thrift industry essential to the housing finance system of the future. To achieve that goal, it would be appropriate for the Federal government to establish a coordinated program of policies designed to facilitate the transition of thrifts through the intermediate term. The following measures recommended by the Commission provide the base for such a program:

- Reaffirm the Federal responsibility to maintain the viability of the financial system, including a commitment to use whatever resources are necessary to assure the safety of deposits insured by the FSLIC and the FDIC.
- Use assisted and unassisted mergers and other measures (such as Income Capital Certificates) to handle the problems of troubled institutions.
- Broaden the asset and liability powers of thrift institutions in order to forestall disintermediation, to attract new funds, and to increase earnings flexibility.
- Revise regulations to facilitate the sale of mortgage assets by thrift institutions, with or without recourse.

The use of such a program would promote public confidence in the financial system and allow thrifts the flexibility to navigate the current difficult transition period with modest cost to the government.

CHAPTER 11

BROADENING PRIVATE SOURCES OF MORTGAGE CREDIT

Greater participation in mortgage investment by private financial institutions with diversified asset portfolios is essential for the broad-based and resilient system of housing finance needed to meet the demands for mortgage credit in the economic environment of the 1980s. Public and private pension funds, commercial banks, life insurance companies, finance companies, and other major sources of capital should play more important roles in the housing finance markets of the future, particularly if the assets of thrift institutions are less concentrated in mortgages and mortgage securities. Mortgage assets can be integral elements of profitable portfolios of many types of institutions, as long as tax, legal, and regulatory factors do not make mortgage instruments unattractive relative to other types of investments available in the market.

As mentioned in Chapter 9, Federal tax policy has been largely responsible for the dominant position of thrift institutions in the private mortgage finance system. Moreover, a variety of legal and regulatory barriers traditionally have interfered with the free flow of funds to the housing markets from many other types of private institutions. In some cases, laws or regulations have limited the investment choices available to specific types of institutions. In addition, legal or regulatory factors have disadvantaged mortgage instruments relative to alternative investments available in the market, thereby deterring all types of private financial institutions with diversified asset portfolios from acquiring mortgage-related securities. Finally, inflation and interest rate volatility have discouraged investors with relatively short-term liability structures from acquiring the long-term, fixed-rate mortgage instruments that have served as the standard form of residential finance for decades.

Various steps toward broadening private sources of mortgage credit are examined in this chapter. The first part describes tax incentives for mortgage investment that currently are available only to thrift institutions and considers extension of mortgage investment incentives to a broad range of private institutions. The second part examines the legal and regulatory barriers that specifically apply to the mortgage investment activities of institutions such as pension funds, commercial banks, and consumer finance companies. The third part identifies changes in existing laws and regulations that are required to create equality between mortgage-related securities and more traditional investment vehicles traded in the nation's financial markets. The fourth part reviews mortgage forms and instruments, giving particular attention to the shortcomings of mortgage forms currently dominant in the market and the need for new instruments that appeal to investors while serving the special needs of borrowers in periods of inflation. The final part considers the role of organized options and futures markets in mortgage securities as ways for mortgage originators and investors to manage interest rate risk without transferring those risks to borrowers.

TAX INCENTIVES FOR MORTGAGE INVESTMENT

The Federal tax code can be used to influence the investment patterns of individuals and institutions and to alter the allocation of capital in the economy.

The existing tax law provides a strong incentive for thrift institutions to concentrate their assets in residential mortgage instruments. Some relaxation of these provisions should be part of a coherent public policy to broaden the operations of the thrifts. At the same time, tax incentives for mortgage investment should be provided to a broad range of investors to help ensure an orderly transition to a more broadly based housing finance system. The following discussion examines the special bad debt reserve provisions currently available to thrift institutions and develops recommendations concerning a mortgage interest tax credit for all taxable and tax-exempt institutions.

Special Tax Incentives for Thrifts

Current Federal tax law encourages thrift institutions to invest heavily in residential mortgages.[1] The investment incentive is provided through a special bad debt reserve deduction available only to thrifts. Specifically, Section 593 of the Internal Revenue Code stipulates that a thrift institution may deduct as much as 40 percent of its total taxable income as a noncash addition to its bad debt reserve if a specified percentage of its assets is held in mortgages or other qualifying assets.[2]

To qualify for the maximum 40-percent bad debt deduction, a savings and loan association must hold 82 percent of its total assets in qualifying forms; for mutual savings banks, 72 percent of assets must be in qualifying forms. As the percentage of qualifying assets held by a thrift institution falls, the 40-percent rate is reduced incrementally. For savings and loans, the 40-percent rate is reduced by three-quarters of one percentage point for each percentage point that the ratio of qualifying assets to total assets falls below 82 percent; the special deduction cuts off completely at a 60-percent investment level. For mutual savings banks, the 40-percent rate is reduced one and a half percentage points for each percentage point below 72 percent, cutting off completely at a 50-percent investment level.

The special bad debt reserve provision can place a significant barrier to asset diversification at thrift institutions. To cover the additional taxes incurred through diversification, nonqualifying investments would have to provide net pre-tax yields substantially higher than those available on qualifying assets.[3] As long as financial markets are reasonably efficient, it is difficult, if not impossible, for an investor to find one type of instrument that has an expected net yield consistently higher than another, after taking into account differences in lending and servicing costs, as well as nonrate attributes such as maturity, call or prepayment options, default risk, and liquidity or marketability.

In view of the maturity structure of thrift liabilities and the increased interest rate variability evident in recent years, these institutions might be willing to sacrifice some after-tax yield to reduce interest rate risk, and some cross-selling benefits may be derived from moving into areas such as consumer lending. Asset diversification by thrifts might be quite limited, however, unless they are permitted to qualify for tax advantages at lower levels of mortgage investment.[4] Indeed, the Interagency Task Force on Thrift Institutions noted that retention of the special bad debt provision in its current form could discourage thrifts from using roughly half of the rather modest expansion of asset powers provided by the Depository Institutions Deregulation and Monetary Control Act of 1980.[5]

Aside from constraining the portfolio choices of thrift institutions, the present bad debt deduction has a number of deficiencies as a policy tool. First, the provision clearly provides no incentives for other types of institutions to invest in mortgages or pass-through securities. Second, the benefits afforded by this tax break accrue to thrift institutions and have little or no impact on mortgage rates paid by borrowers; unless the thrifts are able to meet the entire demand for mortgage credit by households (which has not been possible), before-tax mortgage rates are determined in the market by the actions of diversified institutions that operate in both mortgage and bond markets and do not have tax benefits tied to mortgages. Because of the various problems associated with the bad debt provision, alternative tax measures should be considered to permit thrift institutions to diversify their portfolios, to provide

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[1] Other types of financial institutions receive tax benefits, but the thrifts are the only institutions whose benefits are tied to mortgages.

[2] Qualifying assets are defined in the Internal Revenue Code as: residential real property loans; cash; Federal government obligations; loans secured by members' deposits; loans secured by church, school, health, and welfare facilities, or commercial property located in an urban renewal or model cities area; student loans; and property used in the conduct of the institution's business.

[3] The Interagency Task Force on Thrift Institutions, in *Report of the Interagency Task Force on Thrift Institutions* (Washington, D.C.: U.S. Government Printing Office, June 30, 1980), pp. 109–112, estimated that nonqualifying assets would have to provide a net pre-tax yield 52 percent higher than available on qualifying assets for a savings and loan association to be indifferent to a shift in its qualifying-to-total assets ratio from 82 to 81 percent; nonqualifying assets would have to provide even greater yields, relative to qualifying assets, for an institution to further reduce its ratio.

[4] Some mutual savings banks have given up portions of their tax advantages to diversify their assets. However, many of these savings banks are located in areas where extremely low mortgage rate ceilings and restrictions on purchases of mortgages originated in other States rendered mortgage assets relatively unprofitable, even before interest rates rose to recent high levels.

[5] *Ibid.*

mortgage investment incentives to a broad range of institutions, and to channel tax-financed benefits to mortgage borrowers as well as institutions.

Tax Incentives for All Mortgage Investors

To encourage greater residential mortgage activity by a broad range of institutions, the same tax incentives should be provided to all types of investors through a mortgage interest tax credit (MITC) on income from mortgages or mortgage pass-through securities. Over time, the special bad debt reserve provision for thrifts should be eliminated. The MITC should be considered a transition device, and should be reconsidered in a thorough review of sectoral subsidies in the entire tax system.

As an alternative to special bad debt provisions for thrift institutions, all investors in mortgages or pass-through securities could be permitted to take, as a credit against their tax bills, a specified proportion of interest income from mortgage assets.[6] Eligibility for the MITC and the rate of tax credit could be based on specified criteria concerning mortgage holdings or mortgage acquisitions by investors.

A mortgage interest tax credit is not a new idea. The Commission on Financial Structure and Regulation (Hunt Commission) recommended in 1970 that an MITC equal to a percentage of the interest income earned on residential mortgages be granted to all investors in such loans. This provision was intended as a direct incentive to ensure the flow of capital into housing finance; it was meant to replace the indirect incentive provided through the special provisions for loan losses at thrift institutions; and it was viewed as a way to compensate thrift institutions for the loss of tax benefits arising from elimination of the special bad debt reserve deduction.

The Hunt Commission recommended a multilevel MITC that would provide higher rates of tax credit for institutions with higher percentages of residential mortgages in their asset portfolios, but the commission did not attempt to establish specific rates and investment levels. The Financial Institutions Act of 1975, passed by the Senate but not by the House, would have eliminated the special bad debt allowance for thrifts and made a progressive MITC available to a broad range of investors. The Senate formulation of the MITC, however, had a number of drawbacks. Because of the progressive design, thrift institutions actually would have been discouraged from using the expanded asset powers contained in the act. Moreover, the provision would have provided substantial windfall gains to other types of taxable institutions, such as commercial banks, and little or no mortgage investment incentive for institutions with low- or zero-marginal tax rates, such as life insurance companies and pension funds. Finally, the Senate MITC formula would have rewarded all investment in residential mortgages, not just mortgage credit used to finance investment in housing.

The Commission believes that a broadly based mortgage interest tax credit can be an important device to facilitate the transition to a more resilient and effective housing finance system. Such a tax credit should be designed to include the following general features:

- Encourage investors to acquire mortgage assets (loans or pass-through securities) related to investment in housing.
- Encourage additional mortgage investment, rather than reward previous mortgage investments.
- Permit thrift institutions to diversify their portfolios to a certain extent.
- Provide equivalent mortgage investment incentives for all types of investors, including tax-exempt institutions.

It is not known, at this time, what specific level of MITC would be needed to achieve the desired results. The need, of course, would depend on the degree of asset diversification by thrift institutions and the sensitivity of diversified investors to changes in the relationship between mortgage yields and yields on other capital market instruments.

Eligible Mortgage Assets

Residential mortgage loans, by definition, are secured or collateralized by residential real estate. Mortgage credit, however, need not be used for investment in real estate. Indeed, during the past decade, the volume of mortgage borrowing associated with nonhousing expenditures has expanded as inflation in home prices has greatly increased the market value of the existing housing stock. In this

[6] If an otherwise profitable institution can minimize its taxable income through the use of tax avoidance devices, the effect of special tax deductions or credits on investment decisions obviously would be lessened. An increase in the authority of thrift institutions to engage in equipment leasing, in conjunction with the leasing provisions of the Economic Recovery Tax Act of 1981, possibly could change the tax status of thrift institutions and alter the effects of the special bad debt reserve provisions on their investment policies. It would be premature, of course, to draw conclusions at this time about the impact of leasing activities on thrift operations over the long run. For instance, competition among lessors (including thrift institutions) could cause a major portion of the tax benefits to accrue to the lessees. Lease payments, for example, could be insufficient to service the debt incurred to purchase capital equipment, requiring the lessor to expend part of the cash flow generated by tax savings to cover the debt payments.

environment, households increasingly have borrowed against equity in the stock of existing homes to finance the purchase of consumer durables, the education of children, and other consumer expenditures. Homeowners have resorted to junior mortgages ("home equity" loans) or have increased the size of outstanding first mortgages through refinancing. Households engaged in the sale and purchase of homes often have "monetized" accumulated equity in homes sold by taking larger mortgages than required on homes purchased.

An MITC should encourage investors to acquire mortgage assets that are associated with investment in housing by the ultimate borrowers. One possibility would be to restrict eligibility to first liens, thus preventing the subsidization of junior mortgages used by homeowners to finance consumption expenditures. This restriction, however, also would exclude junior mortgage borrowing for additions and alterations to existing homes. Moreover, limiting eligibility to first mortgages would not exclude mortgage credit raised through first-mortgage refinancing, or the "excess" first-mortgage credit raised by households engaged in home sales and purchases.

New Mortgage Investment

A mortgage interest tax credit should not be keyed to stocks of mortgages held but should encourage additional acquisitions of mortgage assets. Eligibility for the tax credit could be based on gross mortgage acquisitions—originations plus purchases of mortgage assets (loans or pass-through securities). This approach, however, would encourage widespread refinancing of outstanding mortgages and could entail large costs to the Treasury in exchange for little net new mortgage investment.

A preferable approach would condition tax credit eligibility on the net change in mortgage assets held by an investor. For example, credit eligibility could be contingent on achievement of a specified threshold value for a ratio, defined as the change in mortgage assets relative to the change in total assets during a specified period. This approach also would involve some complications. For example, an institution could buy mortgages from another institution unable to avail itself of the credit; such asset swaps could produce revenue losses for the Treasury without an increase in total mortgage investment. Mergers also could present a problem to the extent that surviving firms would qualify for the credit simply because they acquired the mortgages of other firms. Despite such problems, a requirement based on net changes in mortgage holdings would be preferable to criteria based on the level of holdings or gross acquisitions of mortgage assets.

Threshold Levels and Tax-Credit Rates

In designing a tax credit plan, some minimum or "threshold" value for the net change ratio would have to be established to determine eligibility by individual institutions. In addition, tax-credit rates would have to be set to establish the strength of the investment incentives provided by the program. A flat rate of tax credit could be provided for all institutions above a minimum threshold ratio, or higher rates of tax credit could be attached to higher net change ratios.

For the tax credit to provide an effective broad-based investment incentive, the threshold would have to be set low enough to affect the behavior of large numbers of institutions. On the other hand, a low threshold might encourage thrift institutions to reduce substantially and abruptly their mortgage investment activity.

Data from the Federal Home Loan Bank Board (FHLBB) and the Federal Deposit Insurance Corporation (FDIC) provide some basis for evaluating the likely effects of different thresholds. These data indicate the residential mortgage investment activity of commercial banks, mutual savings banks, and savings and loan associations, and measure the change in mortgage holdings as a percentage of the change in total assets.[7]

Annual data for savings and loan associations are displayed in Table 11.1 for the 1976–80 period. The ratio of net mortgage investment to the change in total assets clearly varies with housing and financial market conditions. In 1980—a relatively bad year for housing—little more than half of all savings and loans devoted more than 60 percent of net asset

[7] The data on mortgage investment do not include mortgage pass-through securities.

Table 11.1
Percent of Savings and Loan Associations with Various Mortgage Acquisition Rates, 1976–80 (Change in Residential Mortgage Assets/ Change in Total Assets)

Year	Mortgage Acquisition Rates			
	> 60%	> 50%	> 40%	> 30%
1976	91.3%	94.3%	96.2%	97.4%
1977	94.8	97.1	98.4	99.0
1978	91.9	95.1	97.0	97.7
1979	71.6	78.4	83.1	86.6
1980	54.9	63.4	71.3	77.9

Source: Data compiled by staff from information supplied by the Office of Policy and Economic Research, Federal Home Loan Bank Board.

flows to mortgage lending. In 1977—a year of strong housing activity—nearly 95 percent of all savings and loan associations exceeded that figure. It appears that, for the most part, a threshold ratio set between 30 and 60 percent would cover the vast majority of associations under varying conditions.

For mutual savings banks and commercial banks, the figures are quite different. A high threshold would eliminate a large number of banks. For 1980, 50 percent of all commercial banks devoted less than 10 percent of their net asset flows to residential mortgages, and 50 percent of all mutual savings banks devoted less than 30 percent of their flows to mortgages.[8] Although the ratios for earlier years are higher (thus displaying a pattern similar to savings and loans), in no case do they approach the levels of savings and loan associations. This suggests that a relatively low ceiling would be appropriate for banks.

The data examined suggest two primary options for an eligibility threshold ratio. First, a net investment ratio somewhere in the range of 30 to 50 percent might be established. This approach would affect a large number of small commercial banks that currently devote significant portions of their portfolios to mortgages. Second, a low minimum threshold ratio could be established, with a low rate of tax credit at the minimum level and higher rates at higher ratio levels. Under such a system, however, progression of the tax credit rate should stop below the minimum asset ratios currently prevailing under the bad debt provision for thrift institutions to avoid discouraging portfolio diversification at the thrifts.

The rate of tax credit, under either a flat- or progressive-rate system, initially should be set so as to neutralize the impact of eliminating the special bad debt provision on the net earnings of thrift institutions. To assure that individual thrift institutions do not incur larger tax bills as a result of the switch from the bad debt reserve provision to the mortgage interest tax credit, thrifts should be given the option—for several years—to use either the MITC or the current version of the bad debt provision.

Tax-Exempt Institutions

If a mortgage interest tax credit were made available to all taxable investors, activity by these investors in the markets presumably would lower pre-tax mortgage rates relative to pre-tax yields on other capital market instruments, because taxable institutions, as a group, would be able to meet the total demand for mortgage credit. This result, however, would discourage institutions with low or zero tax rates—such as life insurance companies and pension funds—from moving into mortgage instruments. Thus, to broaden the base of mortgage supply to include tax-exempt institutions, it would be necessary to make the benefits of the MITC available to them.

Tax incentives for mortgage investment could be extended to tax-exempt institutions in several ways. A refundable credit is the most direct method; a pension fund that engages in a sufficient amount of mortgage investment to meet the threshold requirements of the tax credit provision would receive a payment from the Treasury equal to the credit that could have been claimed by a taxpaying institution. A second option would structure the mortgage instrument so that a pension fund that bought the instrument from a taxable mortgage originator would be able to capture some or all of the benefit. In effect, the originator would sell the mortgage instrument at a discount and retain the rights to the tax credit.

Review of Tax Incentives and the Tax System

Special sectoral tax incentives—whether for housing or other industries—are unnecessary when markets work efficiently to allocate resources. During the next several years, however, the housing finance system undoubtedly will change in dramatic and unpredictable ways, and the traditional strong reliance on specialized mortgage finance institutions probably will decline.

The tax incentives for mortgage investment recommended above are designed to help the nation navigate this difficult transition period without shortfalls in the supply of mortgage funds; thus, these incentives should be considered temporary and should be reconsidered when a thorough review of sectoral subsidies in the entire tax system is conducted. Eventually, it may be possible to eliminate all special investment incentives as the efficiency of private financial markets improves. The recommendations presented in the remainder of this chapter have been designed to help move the nation toward that goal.

INSTITUTIONAL SOURCES

The broad-based tax incentives discussed above are intended to attract a wide range of diversified private institutions into residential mortgage investments. The investment policies of some major types of institutions, however, are circumscribed by laws or regulations established at the Federal or State level. The following discussion focuses on legal or regulatory constraints on housing investments by private and public pension funds (including those at life

[8] Data supplied by the Federal Deposit Insurance Corporation.

insurance companies), commercial banks, and finance companies.

Pension Funds

Pension funds constitute a major potential source of funds for housing. Private pension plans held more than $500 billion in assets at the end of 1981; three-fifths of this amount was held by noninsured plans, and the balance was accounted for by plans with life insurance companies. In addition, over $200 billion in assets were held in retirement plans for employees of State and local governments.[9]

Some public pension funds have acquired substantial amounts of residential mortgages or mortgage pass-through securities, but investment in mortgage assets by private pension funds generally has been quite small. Residential mortgages held by private, noninsured plans apparently account for less than 2 percent of the total assets of these funds, and mortgages constitute only a minor share of the investments of insured pension funds that use separate investment accounts.[10] Of course, private pension plans with life insurance companies commonly do not involve separate accounts, and thus information on the types of investments that make up the reserves for these plans is not available. Overall, life insurance companies, which had been a major source of residential mortgage credit in the 1950s and early 1960s, have shifted away from housing loans toward nonresidential mortgages and other types of assets.

Because pension and retirement funds have long-term liabilities, these institutions should view long-term residential mortgages as potentially attractive investments. In this respect, pension funds are more favorably situated for mortgage investment than thrift institutions, which traditionally have relied on short- and intermediate-term deposits for funds. Pension funds in many cases also have indexed benefit liabilities—those that are tied to an index that reflects the general rate of inflation in the economy. For such funds, investment in alternative mortgage instruments that are also indexed can provide an attractive matching of assets and liabilities not available from other nonhousing investments, including corporate equities.

Private Pension Funds and ERISA[11]

Current provisions of Employee Retirement Income Security Act regulations that limit the housing investments of private pension funds should be eliminated.

Implementation of the Employee Retirement Income Security Act of 1974 (ERISA) has imposed constraints on mortgage investment by private pension funds—both noninsured funds and insured funds that use separate investment accounts. ERISA does not specify a list of investments that a pension plan may or may not make. However, it does establish definitions that dictate the types of transactions prohibited, as well as investment standards that managers of pension funds must follow.

The main difficulties associated with ERISA stem from broad Department of Labor regulatory definitions of the circumstances and conditions under which pension plan investments can and cannot be made. Although the regulations were designed to ensure that investment managers do not enter into conflict-of-interest transactions and unwise investments, in the process the regulators have failed to recognize the realities of the housing finance marketplace and have unduly limited pension plan investment in mortgages and mortgage-related securities. Moreover, adjustments to ERISA regulations generally have evolved slowly, and those modifications that have been implemented are not entirely adequate to meet the needs of the marketplace.

The Commission stressed in its *Interim Report* that transactions involving possible conflicts of interest and unwise investments should not be made to the detriment of pension plan beneficiaries. But the Commission also noted that it is not reasonable to prohibit the development of relationships that arise in the normal course of business between pension plans and such parties as loan originators, sellers, servicers, and mortgagors. In this regard, the Commission recommends that the Department of Labor take several steps at the regulatory level.

Plan Assets. Under current interpretations of Section 401 of ERISA, a security representing an interest in a mortgage investment pool does not constitute an asset of the plan; rather, the underlying mortgages are deemed to constitute the "plan assets." Thus, the pension plan fiduciary must meet all the requirements imposed under ERISA for each and every mortgage in the pool.

The Department of Labor has proposed (but not issued) a plan asset regulation that would exempt investments in certain mortgage-backed securities (MBS) and other nonhousing related securities from the "look through" requirements of ERISA. Although questions have been raised re-

[9] Data obtained from the Board of Governors of the Federal Reserve System, *Flow of Funds Accounts* (Washington, D.C.: Federal Reserve, 1981).

[10] Reliable data are not available on holdings of mortgage pass-through securities by noninsured or insured funds.

[11] The recommendations contained in this section of the report were also part of the Commission's *Interim Report*, issued in October 1981. The Department of Labor has begun to act on some of these recommendations.

garding the nonhousing portion of the proposed regulation, there has been general agreement on that part of the regulation addressing investments in MBSs. Therefore, the Department of Labor should promptly issue the housing portion of its proposed "plan asset" regulations in order to exclude from ERISA regulations mortgages in pools that are associated with pass-through securities issued or guaranteed by the United States or an agency or instrumentality thereof, including the Government National Mortgage Association (GNMA), the Federal Home Loan Mortgage Corporation (FHLMC), and the Federal National Mortgage Association (FNMA).

Conventional Mortgage-Backed Securities. In January 1981, the Department of Labor issued an ERISA class exemption for investments in MBSs that are not issued or guaranteed by a Federal or federally related agency. However, the exemption did not apply to MBSs issued against pools of second liens and did not cover in detail the treatment of forward-placement commitments. The Department of Labor should expand its recently issued class exemption for mortgage-backed securities to cover pools of second mortgages and to clarify the treatment of forward-purchase commitments that are commonplace in mortgage market transactions.

Whole Mortgages and Mortgage Participations. In the case of whole mortgages or mortgage participations, the Department of Labor should issue a class exemption to permit normal business transactions.

On December 3, 1981, in response to the Commission's *Interim Report*, President Reagan announced that the Department of Labor had issued a proposed exemption applicable to pension plan investment in whole mortgages. Although this response is important, the proposed exemption should be revised before it is issued in final form to achieve the goals intended by the Commission. Specific changes are needed to make the exemption more workable, including applicability to participation interests as well as whole loans, and removal of limitations restricting the exemption to those mortgages provided through a federally chartered or regulated financial institution that "commonly makes mortgage loans on similar terms and conditions from its own funds." The exemption should be broadened to include institutions such as State housing finance agencies, mortgage banking companies, real estate subsidiaries of major national corporations, State-chartered and -regulated depository institutions, and other entities that normally engage in mortgage lending or mortgage investment activities. Such an expansion of the exemption would foster a broader base of housing investment activity by private pension funds, as well as permit alternative forms of mortgage instruments to be acquired by pension plans.

Several technical details of the exemption also require change. The exemption, as proposed, would be limited to new single-family housing; this requirement should be revised to include both new and existing one- to four-unit properties, as well as multifamily housing. The exemption also should apply explicitly to over-the-counter purchases and forward commitments, and eligible financial institutions should be given the ability to develop mechanisms for delayed delivery of mortgages and to pool funds for mortgage investment from more than one pension plan.

Future Exemptions and Rulings. The Commission also noted that the mechanisms for evaluating applications to the Department of Labor for mortgage-related exemptions should be streamlined and improved. To accomplish this goal, the Department of Labor should rely on the mortgage and housing expertise that already exists at the Federal Home Loan Bank Board and at the Department of Housing and Urban Development.

Public Pension Funds and State Laws

States should be encouraged to develop program strategies and regulations that facilitate housing investment by public pension funds.

Public pension plans operated for the benefit of State and local government employees are exempt from the ERISA and Department of Labor regulations that apply to private pension plans. Rather, they are subject to State and local laws and regulations that govern their investment practices. Unlike the ERISA regulations for private pension plans, the State and local laws that apply to public pension plans often permit and encourage investment activities that benefit the economies of State or local communities. Some pension plans are directed to seek out local investments and, in a number of instances, residential mortgage investments have received favorable attention in pursuit of that goal.

The enabling statutes for most State and local pension funds specify that investments must be prudent (e.g., involve adequate risk diversification) and accrue to the benefit of plan participants. Many statutes specifically list housing finance as one investment that is permitted if it meets these tests. In fact, some State plans recently have developed investment programs or strategies involving mortgages and mortgage-backed securities secured by residential properties located in the respective States. The majority of these programs do not involve the acquisition of mortgage assets with below-market yields. They simply recognize the investment advantages of long-term or indexed-yield as-

sets and the added benefit of economic returns to the communities of the plan participants.

The Commission views the housing-related investment programs or strategies of public pension plans as positive developments that make additional capital resources available for housing finance. The Commission encourages the continuation of this trend and supports actions at the State and local level to develop the legal and regulatory framework to facilitate public pension plan investment in housing. To assist this effort, the National Conference of Commissioners on Uniform State Laws should recommend changes to State legal investment statutes to provide authority for regulated fiduciaries to invest in conventional mortgage-backed securities meeting a common set of reasonable investment criteria.

Commercial Banks

The powers of commercial banks to invest in residential mortgages and real estate should be clarified and expanded.

Commercial banks have been important participants in the housing market for decades. In addition to their important roles as originators and holders of residential mortgages, banks supply significant amounts of nonmortgage funds for the construction of residential properties. They also acquire mobile home and home improvement loans, make mortgage warehousing loans to other mortgage lenders (such as mortgage banking companies), and invest significant amounts of funds in debt or pass-through securities issued or guaranteed by housing-related agencies, such as GNMA, FNMA, FHLMC, the Farmers Home Administration (FmHA), and the Federal Home Loan Bank (FHLB) System.

Bank investment in residential mortgages and mortgage-related securities generally has not resulted in the type of profit problem that has emerged at thrift institutions, because most banks have used their broader investment powers to avoid excessive interest rate risk. But some commercial banks, particularly smaller urban and rural institutions, have relied heavily on household deposits as a source of funds and have chosen to specialize in residential mortgage lending. Some of these commercial banks now face the same types of difficulties as thrift institutions.[12]

Despite the prominent position of commercial banks in housing finance, these institutions do not have real estate lending, investment, and operating powers equivalent to those recommended for thrift institutions in Chapter 10. Accordingly, the Commission recommends the expansion of bank powers in these areas.

Mortgage Investment Powers

The Commission recommends that the residential real estate and mortgage-lending powers of commercial banks be clarified and expanded to promote continued and increased bank participation in the housing finance market of the future. The statutory framework governing the real estate lending power of banks should be reviewed and updated to reflect current market realities and needs. Percent-of-asset limitations, loan-to-value ratios, and other lending restraints should not be established by statute but should become part of a regulatory framework that provides a more responsive review process, thus giving regulatory agencies the flexibility needed to meet changing market conditions.

Service Corporations

Commercial banks should be permitted to establish service corporations similar to those successfully employed in the savings and loan industry. Corporations that provide market services to a number of institutions could facilitate ongoing real estate investment, secondary market operations, and other mortgage finance-related activities for small community-oriented banks. As a group, these institutions could account for a significant amount of real estate activity; individually, however, they are not able to participate in the market on the same basis as larger institutions.

Real Estate Investment

Commercial banks should be permitted to invest in real estate (including joint ventures with developers) through holding company subsidiaries and to engage in other investment practices permitted savings and loan associations through service corporations. By channeling these investment activities through either holding company subsidiaries or bank service corporations, banks could provide these services and compete with nonregulated institutions without subjecting the deposit insurance agencies to increased risks.

Additional Authority

Commercial banks should be provided, where necessary, with adequate authority to engage in activities incidental to the exercise of authority conferred by law. Furthermore, they should be permitted to make over-the-counter sales of certificates backed by mortgages, with or without recourse,

[12] The American Bankers Association estimates that 1,157 banks have sufficient mortgage holdings to qualify for the thrifts' Section 593 bad debt allowances as presently structured, and 6,153 banks would qualify with only minimum modifications in the eligible asset tests if the bad debt allowances were made available to banks.

subject only to the regulations of their respective regulatory supervisors and deposit insurers.

Consumer Finance Companies

Participation by consumer finance companies in the nation's housing finance system could provide another important source of funds for housing. Entry into the housing finance market by these institutions would increase competition, and the demonstrated access to national capital markets by consumer finance companies would provide a major and flexible source of housing credit.

Finance companies already have shifted to some degree from traditional small, secured and unsecured consumer loans to larger real estate-secured loans. It is estimated that more than 50 percent of total secured loans held by consumer finance companies at the end of 1980 were collateralized by real estate—compared with 38 percent in 1979 and 26 percent in 1978.[13] 3 In many areas, however, the State laws under which finance companies operate are either restrictive or ambiguous concerning the authority of the companies to acquire mortgage loans. Because many of the largest consumer finance companies operate nationwide or have regional branch structures, ambiguities or restrictions at the State level should be removed.

The Commission supports changes in State laws and regulations to facilitate the entry of consumer finance companies into the housing finance system. States should review regulations or statutory prohibitions against dual business and licensing restrictions that impede entry, and should remove restrictions on investment activities that limit acquisitions of residential mortgage assets by consumer finance companies. Currently, limitations on loan size and maturity inhibit consumer finance company investment in first mortgages in many States.

CONVENTIONAL MORTGAGE-BACKED SECURITIES

Mortgage-related securities issued for sale in the secondary market currently are disadvantaged from a legal, regulatory, and tax standpoint in their competition with corporate debt obligations, unless the securities are covered by the guarantee of a Federal or federally related agency. These disadvantages could become increasingly important impediments to the free flow of mortgage credit through the nation's capital markets, particularly if thrift institutions become less important as mortgage investors and Federal participation in the nation's credit markets is reduced as a matter of public policy.

The disadvantages faced by private mortgage-backed securities appear to be largely inadvertent consequences of past policy decisions. Legal and tax problems have arisen partly because mortgage-related securities did not exist or were not contemplated when laws governing investments and investment vehicles were written. In some cases where statutory impediments to trading mortgage securities were not codified, regulatory barriers have been imposed—again, partly because of ignorance of the true nature of these securities or failure to recognize certain realities of the mortgage finance marketplace. As a matter of public policy, legal, regulatory, and tax impediments to the development of broad and active markets for conventional mortgage-backed securities should be eliminated.

There is a consensus in the investment community that an active CMBS market cannot develop until a proper tax, regulatory, and market climate is established. Recommendations made earlier in this chapter concerning ERISA and related Department of Labor regulations, as well as the recommendations concerning extension of tax incentives for mortgage investment to taxable and tax-exempt institutions, could spur the development of CMBS markets.

The following discussion identifies additional adjustments that should be made to laws and regulations to foster development of the CMBS market: revisions to the Federal tax code, modifications to Federal regulations concerning the registration of securities and issuers, changes in Federal Reserve regulations governing the purchase of securities on margin, changes in the Federal bankruptcy code, and modifications to State legal investment statutes and blue-sky laws. The discussion also considers ways to promote standardization of CMBSs, including more widespread use of State housing finance agencies as CMBS issuers and Federal creation of CMBS vehicles with minimum reserve standards to cover credit risk and issuer performance.

Revisions to the Tax Code

The Internal Revenue Code should be amended to provide an exemption for conventional mortgage-backed securities from taxation at the pool/issuer level, provided the CMBSs meet minimum criteria. The Internal Revenue Code should also be amended to treat the recovery of market discounts on CMBSs on the same basis as such discounts are treated on corporate securities.

Section 851 of the Internal Revenue Code (IRC) provides that the income of a regulated investment company (mutual fund) is subject to taxation only at the shareholder level, because it re-

[13] Data supplied by the National Consumer Finance Association.

ceives a deduction for dividends paid to shareholders. In contrast, a CMBS could be taxed at both the pool- and certificate-holder levels, even though all net income is passed through to the certificate holder. Unless CMBS pools are fixed at the outset, are self-liquidating, and have no active management, there is a significant danger that a Federal income tax liability would be incurred at the issuer or pool level.

This constraint has resulted in almost universal use of the "grantor trust" device in the administration of CMBS pools. The grantor trust format is an inflexible tool that produces mortgage-investment instruments with certain limitations. Active management, including the ability to substitute loans, to reinvest principal payments (either in new mortgage assets or under an investment contract), or to alter the pool after formation, generally is impossible. Combined with the monthly payment schedules and prepayment uncertainties inherent in mortgages within the pools, the requirement of passive management results in an unattractive instrument for many investors. Return of principal in small or unpredictable amounts creates reinvestment concerns about timing, investment options, and yield.

The CMBS market clearly needs greater flexibility in pool management to reach a broader range of investors without the danger of taxation at the pool/issuer level. Fears of taxation at the pool level have inhibited use of innovative securities tailored to the particular needs of investors. Issuers should be able to offer various types of instruments, such as those that apply early principal repayments and prepayments to purchases of additional mortgages, and so-called "fast pay–slow pay" pools, in which one group of certificate holders receives all payments of principal until its certificates are retired, thereby insulating the second group from early retirement of its investments.

The tax code treatment of gains and losses of principal also is unfavorable to CMBSs. The IRC stipulates that investors in corporate obligations may treat the recovery of discounts (other than original-issue discounts) on sale or retirement as capital gains, rather than as ordinary income. CMBSs, however, are considered by the Internal Revenue Service to represent the obligations of individual mortgagors, and thus the securities are not entitled to the favorable treatment available to corporate obligations under the IRC; in effect, CMBS holders are required to treat the recovery of all discounts through principal payments as ordinary income. This restriction places deeply discounted low-coupon mortgage securities at a particularly competitive disadvantage in the general capital markets, even though certain investors would otherwise seek to acquire such securities.

Registration of Securities and Issuers

The Securities and Exchange Commission should promulgate regulations to provide specific and streamlined shelf-registration procedures designed for conventional mortgage-backed security issues.

CMBS issuers should be permitted, but not required, to register as regulated investment companies.

Some private issuers of CMBSs have taken advantage of the general shelf-registration procedures of the Securities and Exchange Commission (SEC). Shelf registration is useful to an issuer where disclosure materials remain unchanged from one pool to the next. Unlike corporate entities, CMBS issuers that continually originate and pool mortgages generally produce a series of similar issues over a relatively short period of time. However, if certain pool characteristics change, regardless of how minor the change may be, new registration may be required. This re-registration process is costly and creates undue delays when rapid opinions and responses may be necessary to take advantage of changing market conditions. Therefore, the SEC should develop a streamlined shelf-registration procedure that provides issuers with prompt clearances for both initial and subsequent issues of CMBSs.

Private CMBS issuers might find it desirable to register as regulated investment companies under the Investment Company Act of 1940. By such registration, CMBS issuers would not have to register individual issues and would be permitted greater flexibility in pool management. The act is not applicable to mortgage investment vehicles, however, and the SEC has refused Investment Company Act filings for issuers of mortgage-backed securities. To achieve parity, CMBS issuers should, by amendment to the Investment Company Act of 1940, be permitted—but not required—to register as regulated investment companies.

Purchase of Securities on Margin

The Federal Reserve Board should amend Regulation T to allow for the purchase of privately issued conventional mortgage-backed securities on margin.

Regulation T of the Federal Reserve Board permits a securities broker or dealer to extend credit on the collateral of corporate securities, and Regulation U of the Federal Reserve Board applies to similar extensions of credit by commercial banks. The process of extending credit on the collateral of securities is termed "lending on margin" and the regulations issued by the Federal Reserve Board

specify the characteristics of securities that are "marginable." Under current Regulation U, commercial banks may advance funds on the collateral of a wide range of corporate securities and mortgage-backed securities, whether the securities are issued by a federally related entity or a private entity. CMBSs issued by federally related entities are marginable under Regulation T; however, this regulation prohibits securities brokers and dealers from extending credit on mortgage-backed securities issued by private entities.

The Federal Reserve Board should permit securities brokers and dealers to lend on the collateral of CMBSs that are of a quality (as evidenced by investment ratings) equivalent to corporate securities that are marginable. The availability of margin credit for CMBS instruments would increase the attractiveness of these securities to a more diversified base of investors with both short- and long-term portfolio objectives.

Modification of the Bankruptcy Code

Congress should extend the current provisions of the Federal Bankruptcy Code to all entities that sell mortgage loans, mortgage participations, or conventional mortgage-backed securities.

When selling mortgage loans, mortgage participations, or CMBSs in the secondary market, originating lenders frequently retain the original mortgage documents and continue to service the loans on behalf of the purchasers. To reduce transaction costs, the mortgage notes sometimes are not endorsed, and the purchaser does not always record the transaction evidencing the transfer of ownership of the mortgages. When the seller is an entity that could become a debtor under the Federal Bankruptcy Code, it is clear that the purchaser has title to the mortgages, and thus the mortgages are protected from challenges by the bankruptcy trustees.

There are significant numbers of mortgage lenders—such as FDIC-insured banks, FSLIC-insured savings and loan associations, insurance companies, FNMA, and FHLMC—that may not be covered by the Federal Bankruptcy Code. Thus, when selling mortgages in the secondary market, such lenders incur additional transaction costs to provide the same protection afforded by the Bankruptcy Code. Because it is critical that secondary market purchasers be assured of ownership of the mortgages acquired through a secondary market transaction, Congress should enact a statute clarifying that, in the event of insolvency of a mortgage seller or CMBS issuer, a receiver or bankruptcy trustee cannot disregard or challenge the sale or take the position that the mortgage loans are part of the insolvent's estate and not the property of the purchaser.

State Laws and Agencies

The National Conference of Commissioners on Uniform State Laws should recommend amendments to relevant State blue-sky laws to exempt qualified conventional mortgage-backed security issuers from State registration requirements, and should recommend changes to State legal investment statutes to provide authority for investment by State-regulated fiduciaries in CMBSs meeting a common set of reasonable investment quality criteria.

States should be encouraged to create public conduit CMBS issuers that draw on the capacity and experience of their existing State housing finance agencies.

State blue-sky laws generally exempt from State registration those securities that are superior to, or of substantially equal rank with, securities of the same issuer that are listed on national or specified regional exchanges. However, State securities regulators frequently take the view that even if the issuer of a CMBS is a listed company, its CMBS must be subject to blue-sky laws because the issuer is only a servicer and not an obligor on the security. Registration under State blue-sky laws is both time-consuming and expensive, and is duplicative when the securities also are subject to Federal registration or exchange disclosure rules. Therefore, the National Conference of Commissioners on Uniform State Laws should recommend amendments to the relevant State blue-sky laws to exempt qualified CMBS issuers from State registration requirements.

Mortgage-backed securities fare poorly under myriad State statutes that specify legal investments for State-regulated fiduciaries, such as public pension funds, insurance companies, bank fiduciaries, and State-chartered depository institutions. Because of the unique characteristics of CMBSs, they do not fit under the commonly defined categories of legal investments. As a result, CMBSs are subjected to a maze of restrictions intended for other nonconforming securities, which has the practical effect of prohibiting investment in CMBS issues. The National Conference of Commissioners on Uniform State Laws should recommend changes to State legal investment statutes to provide authority for investment by regulated fiduciaries in CMBSs that meet a common set of reasonable investment quality criteria.

State housing finance agencies have established credibility in the capital markets, and they have the capacity and expertise to generate the large volume of standardized mortgage pass-through securities necessary for efficient dealer markets.

These agencies should be encouraged to become more actively involved as conduits for mortgage loans. They can raise funds in taxable bond markets, acquire mortgage loans with market yields, and resell the mortgages through issues of CMBSs with private mortgage insurance coverage, where necessary. The taxable-bond program of the Alaska Housing Finance Agency, the recently created North Carolina Mortgage Investment Corporation, and pending legislation to permit such conduit issuers in other States represent examples of the States' recognition of this potential role. States should continue to create public conduit CMBS issuers that draw on the capacity and experience of their existing housing finance agencies.

Standardization of CMBS

The steps recommended above are designed to help produce the tax, legal, and regulatory environment necessary to the development of broad and active CMBS markets. Even with such adjustments, however, fully private CMBSs could remain at a competitive disadvantage vis-a-vis other types of investments traded on the capital markets, if investors were uncertain about the quality of the CMBSs. Concerns about investment quality could relate to the default risk on the underlying mortgages and to the performance of issuers with respect to the pass-through of principal and interest on a timely basis (in accordance with pool management arrangements).

To date, credit risks on CMBSs generally have been covered by private pool insurance contracts or letters of credit. If a broad and active CMBS market is to develop, more standardized procedures may be needed. Establishing adequate minimum standards to cover both credit risk and issuer performance could reduce the information-gathering costs of investors, result in a larger volume of CMBS issues, and lower interest costs for borrowers. A larger volume of standardized CMBSs, moreover, would result in smaller bid-ask price spreads at dealers that make CMBS markets.

The Federal government could take steps to encourage the standardization of CMBSs; further study on this topic is appropriate. Several Commissioners suggested that laws or regulations could be established setting minimum criteria for mortgage investment trusts that would provide standardization as well as benefit from the various legal and regulatory adjustments discussed above. (Other CMBSs, of course, also would receive these benefits.) The criteria could include maintenance of a specified "reserve" fund, which would be available to make timely payments on the trust security if the cash flow from the pool were insufficient or the issuer failed to pass through payments to holders of the securities. Such a reserve might actually be funded, or it could be satisfied by letters of credit or acceptable private pool insurance.

MORTGAGE INSTRUMENTS

Long-term investments—including the long-term, fixed-rate instruments that have been the standard forms of mortgage finance for many years—have become increasingly unattractive to investors with relatively short-term liability structures as the future course of short-term interest rates has become more difficult to predict. And, as mentioned above, the interest-rate risk associated with investment in long-term mortgages has been exacerbated by State efforts to restrict the enforcement of due-on-sale clauses in such contracts.

Because of the risks associated with investment in long-term, fixed-rate mortgages, investors have begun demanding shorter-term mortgage instruments that shift a portion of the interest rate risk to borrowers, or they have been charging substantial rate premiums on long-term, fixed-rate instruments. Borrowers, on the other hand, have resisted shorter-term mortgage instruments because of the uncertainty of future monthly payments, and most households have not been able to afford the rates charged on the limited supply of long-term, fixed-rate mortgage credit available in the market.

Recent changes in Federal and State regulations have enabled mortgage lenders to offer a variety of alternatives to the standard long-term, fixed-rate mortgage. Indeed, alternative forms of mortgage instruments have proliferated, causing a good deal of confusion among borrowers, who generally are not able to properly consider all the available variations.

The following discussion identifies the problems caused for borrowers and investors by the traditional mortgage instrument, and recommends action to reduce the problems faced by investors. Second, several types of alternative mortgage instruments that might better meet the needs of both investors and borrowers are discussed. Finally, problems of insurability and marketability of new mortgage forms are addressed.

Standard Mortgage Forms

Before the Depression of the 1930s, the typical home loan had only 5- to 10-year maturity and did not fully amortize the principal. Widespread defaults during the 1930s stimulated major innovations in the form of the mortgage instrument. As a result of government action, an instrument was devised to permit individuals to buy homes with small down-payments and to pay off their loans over a long

period of time—the long-term, fixed-rate, level-payment, fully amortizing mortgage. For more than four decades, virtually all residential mortgage lending has involved this type of instrument. But recent economic events, as well as court and legislative actions at the State level, have made the traditional mortgage instrument unattractive to investors and inappropriate for many borrowers.

Problems Caused by Inflation and Interest Rate Volatility

Inflation and interest rate volatility have deterred both borrowers and lenders from using the standard fixed-rate, level-payment mortgage instrument, but for different reasons. If inflation and future movements in short-term market rates are properly anticipated, interest rates charged on new long-term mortgage loans should reflect these expectations, and investors in the loans should realize profits over the lives of these assets. When anticipated inflation rates are high, however, this process requires borrowers who use the standard mortgage instrument to allocate unusually high proportions of their income to mortgage payments during the early years of the contract, posing a severe cash-flow constraint to home purchase. As borrowers' incomes rise during inflation, the ratio of mortgage payments to income declines over time—a phenomenon commonly referred to as the payment "tilt."

To the extent that future rates of inflation are underestimated, an insufficient inflation premium will be incorporated in long-term mortgage interest rates. In this event, lenders realize capital losses if they sell the loans prior to maturity, or they suffer a reduction in net earnings on loans held as their cost of funds rises above the levels that had been expected. Underestimation of inflation and interest rate increases, in fact, created the severe earnings problems currently encountered by thrift institutions, which traditionally have financed long-term mortgage assets with short-term deposit liabilities. The experience of the thrifts, and the extreme volatility of interest rates in recent years, have made investors less willing to accept the interest rate risks associated with acquisitions of standard long-term, fixed-rate mortgage instruments.

Problems with Due-on-Sale Clauses

Action should be taken at the Federal level to prevent or to discourage State legislative or judicial actions that restrict the enforcement of due-on-sale clauses in outstanding home mortgage contracts.

Federal regulations should be changed to permit the inclusion of due-on-sale clauses in newly originated FHA-insured and VA-guaranteed home mortgages.

As mortgage interest rates have soared at institutional sources, various forms of "creative" seller financing have become common. According to surveys conducted by the National Association of Realtors, about half of all resale transactions in 1980 and 1981 involved some form of financing technique other than a new first mortgage loan from a financial institution. The most prevalent techniques involve the transfer of outstanding low-rate first mortgages from home sellers to homebuyers, often in combination with second mortgages provided by home sellers or third-party investors. Another common practice involves the creation of wraparound mortgages by third-party lenders; these loans encompass outstanding low-rate first mortgages of home sellers and the amount of additional financing required by homebuyers.

The increased incidence of loan assumptions and wraparounds has contributed to the slowdown in the rate of turnover of outstanding home mortgages at institutional lenders, thus reducing the supply of loanable funds available at these institutions and holding down their earnings. As a consequence, many lenders have attempted to invoke due-on-sale clauses that give them the option to declare existing loans payable in full on sale of the mortgaged property; such clauses are incorporated in most outstanding conventional mortgage contracts, but not in loans insured by the Federal Housing Administration or guaranteed by the Veterans Administration. Efforts by lenders to enforce due-on-sale clauses, in turn, have provoked litigation on behalf of home sellers in a number of States. Currently, 17 States significantly restrict the full exercise of due-on-sale clauses in outstanding home mortgage contracts—even though these clauses had been agreed to by both borrowers and lenders.

Restrictions on the exercise of due-on-sale clauses in mortgage contracts clearly benefit home sellers at the expense of mortgage contract holders. Homebuyers, however, may actually accrue little, if any, net benefit; indeed, in highly competitive markets, selling prices should rise by just enough to eliminate any advantage for buyers.[14] In fact, the use of creative financing can create serious financial problems for homebuyers. The National Association of Realtors reports that most second mortgages made in conjunction with assumptions of first mortgages have terms of only three to five years, have monthly payments covering interest only, and require a balloon payment of the entire principal amount on maturity. Many borrowers apparently view these loans as a way to "buy time" until

[14] This conclusion was reached in a report to Congress: Department of Housing and Urban Development, *An Economic Analysis of Due-on-Sale Clauses* (Washington, D.C.: U.S. Government Printing Office, April 1981).

conditions in institutional mortgage markets improve. It also appears that many home sellers take back second mortgages at below-market rates to obtain higher prices for their homes, adding an additional artificial element to home prices. If market interest rates do not decline substantially, many homeowners may have difficulty arranging full refinancing of their second mortgage debts at an affordable cost.

Even though buyers may not truly gain through creative financing, total home sales might be larger if buyers perceive benefits from this type of financing and if sellers would not place their homes on the market at prices that do not incorporate the value of the assumable loan. The total flow of funds to the mortgage markets might also be augmented by creative financing, despite the drain on loanable funds at the institutional holders of outstanding mortgages, as long as individuals increase their investment in mortgages. These possibilities, however, are not sufficient grounds to justify State actions to restrict enforcement of due-on-sale clauses in existing contracts. Indeed, such State actions create uncertainties concerning the enforceability of such clauses and thus have interfered with the operation of the national secondary markets for conventional loans and conventional pass-through securities, because investors find it more difficult to determine the appropriate prices for these instruments. Furthermore, a situation in which some institutions can enforce due-on-sale clauses but others cannot—a dichotomy that currently exists—easily can discourage new sources of capital from entering the housing markets.

The Commission has determined that the ability of investors to enforce due-on-sale clauses in existing mortgage contracts is essential to prevent windfall wealth transfers among mortgage market participants, to attract new investment sources, and to ensure proper operation of the secondary mortgage markets. Therefore, the Commission recommends that actions should be taken at the Federal level to prevent or to discourage State legislative or judicial actions that restrict the enforcement of due-on-sale clauses in outstanding home mortgage contracts.

Two policy options are recommended. First, State legislative or judicial efforts to restrict the enforcement of due-on-sale clauses should be preempted by Federal action. Ideally, the preemption should be extended to all "federally related mortgages," as defined in the regulation implementing the Federal preemption of State ceilings on mortgage interest rates contained in the Depository Institutions Deregulation and Monetary Control Act of 1980. Such federally related mortgages are defined as all loans made by federally insured or regulated institutions, or by mortgagees approved by the Department of Housing and Urban Development (HUD); loans that are guaranteed, insured, or assisted by HUD; loans eligible for purchase by GNMA, FNMA, or FHLMC; and loans made by lenders that regularly extend credit payable in more than four installments, where there is a finance charge, and where the lender makes more than $1 million in residential real estate loans per year.

Under the second policy option, incentives should be provided to encourage the States to relax their restrictions. Several approaches are possible, including (a) raising premiums charged for Federal insurance of deposits to account for the greater risks placed on Federal deposit insurance agencies; and (b) denying Federal deposit insurance to depository institutions located in States that prohibit enforcement of due-on-sale clauses. This latter policy would require States that place a high priority on assumability to organize their own insurance funds.

The Commission also believes that lenders and borrowers should be free to negotiate the inclusion and the price of due-on-sale clauses in all future mortgages. Thus, Federal regulations should be changed to permit the inclusion of due-on-sale clauses in newly originated FHA-insured or VA-guaranteed home mortgages.

Federal action to prevent, or to discourage, State restrictions on the enforcement of due-on-sale clauses in outstanding mortgage contracts would not, of course, require lenders to enforce such clauses. Nor would Federal action be intended to permit lenders to enforce due-on-sale clauses while collecting prepayment penalties in connection with early retirement of loans. Finally, there would be no intention to encourage retroactive enforcement of due-on-sale clauses in mortgages on properties that were purchased during prior periods when State restrictions on the enforcement of due-on-sale clauses were in effect.

The Commission recognizes that Federal preemption of State efforts to prohibit enforcement of due-on-sale clauses in outstanding mortgage contracts raises the broader questions of federalism and States' rights. However, the Commission believes that ensuring the integrity of mortgage contracts is sufficiently important to national and individual interests to justify Federal intervention with respect to due-on-sale clauses.

Alternative Mortgage Forms

Private Sector Development of Innovative Instruments

The private sector should be encouraged to develop new mortgage loan instruments that reduce initial payment levels to borrowers, provide

some protection to lenders against future market interest rate increases, have relatively predictable payment schedules, and avoid excessive negative amortization.

The long-term, fixed-rate mortgage that has been the standard mortgage instrument in the past undoubtedly will continue to be an important part of the mortgage finance system in the future. However, a number of alternative mortgage instruments have been developed to meet the varied needs of both borrowers and lenders in an environment of inflation and interest rate volatility. These instruments modify, in one way or another, the basic characteristics of the standard fixed-rate, level-payment mortgage. Although the impetus for alternative mortgage instruments has come primarily from lenders seeking to reduce their interest rate risks, several new instruments also accommodate the needs of homebuyers.

Variable- or adjustable-rate mortgages (ARMs)—in which the interest rates and payment levels change periodically according to movements in market rate indexes—provide lenders protection against future increases in market interest rates but subject borrowers to uncertainty about future payment levels. Graduated-payment mortgages (GPMs) reduce payments of borrowers at the beginning of the mortgage term, provide for scheduled increases in payments until a specified point in the loan term, and hold payments constant thereafter. However, standard GPM contracts are fixed-rate loans and thus do not provide lenders protection against unexpected increases in interest rates.

Many variations of adjustable-rate and graduated-payment mortgages, as well as other types of instruments, have been introduced into the market; indeed, nearly a hundred different types have been offered by mortgage originators to FNMA under the purchase programs operated by that agency. Experimentation with a range of alternative mortgage instruments should continue. However, it is inefficient for the market to experiment with an unlimited number of instruments for an extended period. Attention and emphasis should be focused on a limited number of instruments.

Many instruments that incorporate features attractive to both borrowers and lenders have emerged. The Commission believes that the following types are worthy of particular attention:

- Graduated-payment, adjustable-rate mortgages;
- Dual-rate mortgages; and
- Growing-equity mortgages.

Graduated-Payment, Adjustable-Rate Mortgage. This instrument combines features of GPMs and ARMs, giving borrowers a measure of payment certainty while providing lenders rates of return at or near market levels. During the early years of the loan term, a GPM schedule is used to determine borrower payment levels. An adjustment to the mortgage rate occurs at the end of the graduated-payment period; at this point, the mortgage is converted to an ARM with periodic adjustments to both the interest rate and the monthly payments over the remaining term of the mortgage.

The GPM feature of the loan permits lower initial borrower payments. Moreover, the pattern of mortgage payments and the amount of negative amortization are known—at least for a set period of time—when the contract is signed. During periods of negative amortization, of course, cash flows to lenders are below those that would be realized on fully amortizing contracts, and default risks may be increased. The amount of negative amortization built up in the early years of the graduated-payment period, however, can be eliminated by the increased payments scheduled during the later years of that period. Thus, the effects of negative amortization could be present only during the first few years of the loan.

Dual-Rate Mortgage. With this instrument, initial payment levels on a long-term mortgage are based on the projected average of short-term interest rates over the intermediate term (say three to five years) and remain constant over that period. At the end of this constant-payment period, the mortgage is recast with a new payment schedule that fully amortizes the loan over the remaining term at a rate adjusted to reflect the projected average of short-term rates over the next intermediate-term period. During the entire term of the loan, the mortgage balance is adjusted to reflect the difference between the projected and actual short-term interest rates. If actual rates rise above the projected average rate, the amount of payment shortfall is added to the mortgage balance (negative amortization); if actual rates fall below the projected average rate, the amount of payment overage is deducted from the unpaid principal balance (accelerated amortization).

This type of instrument provides borrowers certainty about payment levels over the intermediate term and permits initial payment levels lower than those on long-term, fixed-rate mortgages whenever the projected average of short-term yields over the initial fixed-payment period are below long-term rates prevailing in the market. Negative amortization that occurs when market rates increase above the projected average rate, of course, can increase the default risk on this type of mortgage; moreover, the lender's cash flow would fall below that of other market-yield instruments, and the non-

cash addition to principal would not be realized until later in the loan term or at prepayment. On the other hand, if market rates fall below the projected average rate, lender cash flows would exceed those on other market-yield investments.

Growing-Equity Mortgage. The interest rate on this mortgage is fixed for its entire term, and monthly payments begin at a level that would fully amortize the loan over the term of the contract. Payments are adjusted periodically to reflect changes in an index of inflation or wage rates, and the amount of payment change is applied fully to principal. During inflation, therefore, borrowers achieve rapid amortization of their mortgages and lenders realize an accelerated return of principal, allowing reinvestment at market rates. The mortgage, in effect, is converted from a long-term instrument to an intermediate-term instrument; in an era of inflation rates in the range of 8 to 10 percent per year, the term of a 30-year loan would be roughly cut in half.

The initial monthly payments on a growing-equity mortgage should be lower than with fixed-rate, level-payment loans whenever intermediate-term yields are below long-term rates prevailing in the market. If payments are adjusted by an index, of course, future payment levels involve some uncertainty. Certainty of payment levels could be achieved if payments were increased at a fixed graduation rate (say 3 to 5 percent per year).

Role of Government

Federal and State governments should make changes in laws and regulations necessary to permit institutions to originate, purchase, and hold new types of mortgage loans.

To facilitate introduction of new instruments, the Federal government should provide mortgage insurance and guarantees on an experimental basis through the Federal Housing Administration and the Veterans Administration, should provide secondary market support through the mortgage-backed securities program of the Government National Mortgage Association, and should encourage the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation to help develop markets for innovative types of mortgage instruments.

During 1981, both the Federal Home Loan Bank Board (FHLBB) and the Office of the Comptroller of the Currency (OCC) implemented regulations that permit Federally chartered lenders to originate, purchase, and hold adjustable-rate mortgage contracts. Although there are differences in the characteristics of the mortgage contracts that may be offered by national banks and federally chartered savings and loan associations and mutual savings banks, both regulations permit relatively liberal interest rate adjustments as well as latitude for negotiation of loan terms between borrowers and lenders (Table 11.2). However, the regulations are directed only at ARM contracts and do not address other types of instruments currently available in the market or those that may be developed in the future. Therefore, the FHLBB and the OCC should revise their regulations, where necessary, to permit federally chartered institutions to originate, purchase, and hold new types of mortgage loans, including those mortgage instruments discussed above.

Many mortgage lenders are subject to State laws or regulations that currently prohibit these institutions from originating, purchasing, or holding some types of alternative mortgage instruments. Restrictions often are placed on adjustable-rate provisions, and State laws prohibiting the payment of interest on interest inhibit the use of contracts that involve negative amortization. If new instruments are to be used on a widespread basis, such restrictions need to be eliminated.

The uncertain risk and cash-flow characteristics of many new types of mortgage instruments have created questions of insurability and marketability, especially under current economic conditions. To determine the risk characteristics of these loans, and to gain market acceptance, the Federal government should provide mortgage insurance and guarantees through FHA and VA on an experimental basis.

FHA-insured GPMs currently are eligible for pooling under the GNMA-guaranteed, mortgage-backed securities program; the GNMA program also should be made available for the marketing of other types of experimental, federally underwritten mortgage forms. Both FHLMC and FNMA have implemented programs for the purchase of ARM mortgages. FHLMC operates two ARM purchase programs, using one interest-rate index, and does not permit negative amortization. FNMA has developed eight ARM purchase programs, using five different interest rate indexes, and permits negative amortization under several plans. FNMA also has announced that it will permit graduated-payment features to be incorporated in the ARMs it purchases under several of its programs. In addition, FNMA purchases alternative mortgage instruments under negotiated purchase arrangements with individual lenders.[15]

[15] By mid-April 1982, FNMA had been offered 90 different alternative mortgage instruments and had agreed to purchase more than 70 of those offered.

Table 11.2
Major Characteristics of Recent Federal Regulations Governing Adjustable-Rate Home Mortgage Lending[a]

Major Characteristics	Federal Savings and Loans and Federal Mutual Savings Banks	National Banks
Requirements to offer fixed-rate mortgage instrument to borrower	None	None
Limit to amount of adjustable-rate mortgages that may be held	None	None
Indexes governing mortgage rate adjustments	Any interest rate index that is readily verifiable by the borrower and not under the control of the lender, including national or regional cost-of-funds indexes for savings and loan associations.	One of three national rate indexes—a long-term mortgage rate, a Teasury bill rate, or a three-year Treasury bond rate.
Limit on frequency of rate adjustments	None	Not more than every six months.
Limit on size of periodic rate adjustments	None	One percentage point for each six-month period between rate adjustments, and no single rate adjustment may exceed 5 percentage points.
Limit on size of total rate adjustment over life of mortgage	None	None
Allowable methods of adjustment to rate changes	Any combination of changes in monthly payment, loan terms, or principal balance.	Changes in monthly payment or rate of amortization.
Limit on amount of negative amortization	No limit, but monthly payments must be adjusted periodically to amortize fully the loan over the remaining term.	Limits are set, and monthly payments must be adjusted periodically to amortize fully the loan over the remaining term.
Advance notice of rate adjustments	30 to 45 days prior to scheduled adjustment.	30 to 45 days prior to scheduled adjustments.
Prepayment restrictions or charges	None	Prepayment without penalty permitted after notification of first scheduled rate adjustment.
Disclosure requirements	Full disclosure of adjustable-rate mortgage characteristics no later than time of loan application.	Full disclosure of adjustable-rate mortgage characterisitics no later than time of loan application.

[a]The regulations for national banks were issued by the Office of the Comptroller of the Currency on March 27, 1981. The regulations for Federal savings and loan associations and Federal mutual savings banks were issued by the Federal Home Loan Bank Board on April 30, 1981.

FNMA and FHLMC could help develop forms that would facilitate the development of national secondary markets for alternative mortgage instruments. The wide variety of State and local lien laws creates some barriers to nationwide use of standard mortgage forms for alternative mortgage instruments since individual State riders must be developed. The Commission encourages FNMA and FHLMC to undertake efforts to standardize State riders, as they did in the early 1970s for conventional fixed-rate mortgage instruments.

The government may be able to play a useful role in educating consumers about new alternative mortgage instruments. HUD, FHLBB, OCC, and other Federal agencies should prepare educational materials on new instruments, for a broad consumer education effort, indicating the applicability of various instruments to different consumer borrowing needs and concerns.

FORWARD, FUTURES, AND OPTIONS MARKETS

The increased volatility of market interest rates in recent years has had profound effects on mortgage market institutions and practices in this country. Because of the time-consuming nature of the mortgage lending process and the need for long-term contracts to finance the purchase of real estate with long service lives, some parties engaged in mortgage market transactions inevitably have been subject to substantial interest rate risk.

The risk-management techniques traditionally used in mortgage markets have deteriorated under the strain of unprecedented changes in interest rates. But at the same time, new and more flexible techniques have been emerging in the financial markets. These techniques provide the opportunity for a broad range of institutions to engage in mortgage lending and investment while hedging interest-rate risks in ways that do not shift these risks to mortgage borrowers.

Mortgage Interest Rate Risks

A long period of time may elapse between the date when a builder or purchaser of real estate needs to arrange long-term mortgage financing and the date when the mortgage is acquired by a final investor. Due to the relatively long time periods involved in the mortgage origination and secondary marketing process, some parties to these transactions—mortgage borrowers, primary market originators, or secondary market purchasers—ordinarily have been exposed to risks associated with changes in market interest rates. The existence of these risks prompted the evolution of an informal system of mandatory- and optional-delivery forward commitments among mortgage market participants. Thus, the risks associated with the origination and marketing of mortgages traditionally have been termed "commitment-period" risks.

Investors who hold long-term mortgage assets in their portfolios are subject to a different type of interest rate risk, often dubbed "portfolio" risk. Investors holding such assets may have to book large capital losses in the event that they are obliged to sell these assets for liquidity purposes prior to maturity, even if their expectations of interest rate movements were accurate when the assets were acquired. And as discussed above, investors who finance acquisitions of long-term mortgage assets with shorter-term liabilities run the risk that future levels of short-term interest rates will be higher than they had expected when acquiring the assets. Absorption of this type of interest rate risk by thrift institutions, of course, has resulted in their severe earnings difficulties.

Both commitment-period and portfolio risks have increased in recent years as market interest rates have become more volatile and more difficult to predict. Reactions by institutions operating on the supply side of mortgage markets (loan originators, secondary market purchasers, and final investors) generally have involved efforts to transfer interest rate risk from themselves—where it traditionally has rested—to mortgage borrowers—who may be least able to bear such risks. As mentioned in Chapter 9, mortgage originators have sought to shift commitment-period risk to prospective borrowers, partly because secondary market institutions that purchase loans from originators have become more reluctant to issue fixed-rate, forward-purchase commitments. And as discussed earlier in this chapter, investors have been seeking to minimize their portfolio risks by refusing to acquire long-term, fixed-rate loans that do not contain enforceable due-on-sale clauses (or by charging substantial rate premiums on such contracts), and by incorporating adjustable-rate provisions in mortgage contracts offered to borrowers.

Institutions on the supply side of mortgage markets can reduce their interest rate risks in ways other than those that involve shifting risk to borrowers. In fact, increasing interest rate volatility has spurred the development of markets designed to permit institutions to hedge interest rate risks and to transfer those risks to parties who operate outside mortgage markets and who seek to gain by bearing such risks. Futures and options markets relating to long-term, interest-bearing securities, operated on organized exchanges, can provide near ideal risk-transfer mechanisms for mortgage market participants. Indeed, such markets have been estab-

lished—or have been proposed—for both GNMA-guaranteed, mortgage-backed securities and for Treasury bonds.

Exchange-Traded Options

As the volatility of market interest rates has increased, optional-delivery purchase contracts have become more important to mortgage originators, who traditionally have issued optional-delivery (or optional "takedown") mortgage loan commitments to borrowers and have sold the loans they make in secondary mortgage markets. At the same time, however, secondary market institutions that traditionally have issued optional-delivery or "standby" purchase commitments to mortgage originators have been increasingly reluctant to accept the higher risks associated with standbys because of sharply reduced earnings and growing uncertainties about the proper pricing of standby commitments.

Both thrift institutions and FNMA have cut back their supplies of purchase commitments. At FNMA, in fact, writing of long-term (12-month) standbys has been terminated, and fees charged for 4-month, optional-delivery commitments have increased sharply since early 1981. In addition, the standby forward commitment market maintained by the GNMA securities dealers has largely dried up during the past year or so because of unwillingness by dealers to act as intermediaries between the buyers (mortgage originators who issue GNMAs) and writers (private investors in GNMAs) of this type of option. In this environment, the need for exchange-formed or "traded" offset options relating to mortgage instruments has become more acute.[16]

Exchange-traded options relating to GNMAs or other mortgage-backed securities would offer major advantages over informal standby commitment markets. The options contracts would be backed both by the "margin" security deposits demanded of all writers of options,[17] and by the guarantees of the clearinghouse associated with the exchange. This would obviate the risk of nonperformance that often has occurred in the past in the dealer standby market for GNMAs.[18] The costs of hedging by use of exchange-traded options in GNMAs or other long-term, interest-bearing securities would depend on the amount of premiums charged for writing the contracts; these premiums would be determined in actual trading.

In February 1981, the Securities and Exchange Commission (SEC) authorized the Chicago Board Options Exchange (CBOE) to establish a market for standardized options on GNMA-guaranteed, pass-through securities. Commencement of the CBOE's market in GNMA options was delayed, however, because of a suit brought by the Chicago Board of Trade (CBOT) against the SEC. The suit contended that GNMA options are in the domain of the Commodity Futures Trading Commission (CFTC) rather than the SEC.

On March 24, 1982, the U.S. Court of Appeals in Chicago decided in favor of the CBOT. The court noted that the existence of a futures market for GNMAs renders the certificates "commodities" under the Commodities Exchange Act; the court further ruled that exchange-traded offset options are not securities.[19] On the basis of this ruling, the CFTC clearly has jurisdiction and the SEC cannot permit trading in GNMA options.

The jurisdictional dispute between the SEC and the CFTC has substantially delayed the development of options markets needed by mortgage market participants. The CBOT, which is under the jurisdiction of the CFTC, conceivably could develop such an options market, but so far has been prevented from doing so by disinclination of the CFTC to authorize straightforward direct-settlement, exchange-traded offset options.[20] Under these circumstances, it would be advisable for Congress to take whatever action is necessary to facilitate development of options markets related to GNMAs or to other interest-bearing securities with price movements similar to those of GNMAs.

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[16] The options dealt in on organized exchanges are termed "offset" options because they are usually settled without exercise of the option right by the holder, even when the holder is "in the money." Settlement is effected through the exchange's clearinghouse, by taking a second option position that cancels out, or offsets, the original position. Price differences between the two offsetting positions are paid through, and received from, the clearinghouse. There is no literal secondary market trading of such "offset" option rights.

[17] Margin requirements in options markets are applied only to the writers of the options, since the purchaser of the option has no risk exposure. The Federal Reserve Board recently issued regulations governing margin requirements for all options markets in fixed-income securities, although its authority to do so has been questioned within the futures industry on the grounds that offset optionns are not securities—as was held by the U.S. Court of Appeals in the *CBOT* v. *SEC* case discussed below.

[18] Some investors in GNMAs who wrote options and collected standby commitment fees from dealers gambled that open-market prices would rise, and they were unprepared to take delivery of the securities when, instead, market prices fell; in these cases, dealers were obliged to take the securities into their own portfolios.

[19] The court perceived that offset options, like futures, are formed and discharged by parties who never need hold or sell the underlying securities.

[20] The CFTC would prefer to authorize dealings in a form of offset options which, in the settlement process, involves the formation and discharge of a conventional futures contract—a so-called "option on a futures contract."

Financial Futures Markets

Financial futures have been recognized for some time as a way for mortgage originators to hedge interest rate risk incurred during the mortgage origination and marketing process;[21] indeed, the need of mortgage originators for better risk-management tools led to the creation of the GNMA futures market in 1975. But futures could prove to be even more important as a way for mortgage investors (such as thrift institutions and commercial banks) to hedge effectively against interest rate risk associated with a portfolio of long-term assets and short-term liabilities—that is, to hedge asset and liability "mismatches." Techniques have been developed that allow institutions to employ futures markets to control net portfolio yields by establishing hedge positions that can be understood either as effectively increasing the term to maturity of current liabilities, or as altering the sensitivity of fixed-rate assets to interest rate shifts.[22] The latter approach is viewed as effectively converting a long-term asset into a short-term "synthetic" security with the yield characteristics of a shorter-term investment.

Federal agencies responsible for the supervision of commercial banks and thrift institutions recently have recognized the usefulness of futures as an effective means of reducing interest rate risk associated with the management of assets and liabilities. Uniform guidelines for commercial banks and mutual savings banks were issued jointly in November 1979 (revised March 1980) by the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Federal Reserve Board. In July 1981, the Federal Home Loan Bank Board endorsed the expanded use of futures markets by savings and loans so that these institutions might protect themselves more effectively against interest rate risk. The guidelines established at the regulatory level apparently are adequate to permit the regulated institutions to make effective use of futures markets, particularly for institutions under the jurisdiction of the FHLBB.

The remaining obstacles to the use of futures hedging by mortgage investors apparently stem from a lack of understanding of either the potential benefits or the mechanics of futures trading, and from the absence of generally accepted accounting principles (GAAP) for futures transactions. The American Institute of Certified Public Accountants has published an issues paper dealing with the problems of accounting for futures.[23] It would be appropriate for the Financial Accounting Standards Board to act on these recommendations and adopt guidelines in the near future.

In the area of education, Federal regulatory agencies should take a more aggressive role in providing accurate information concerning the uses and mechanics of futures trading. One possibility would be to employ the Federal Financial Institutions Examination Council, with an augmented staff experienced in the workings of financial futures markets, to guide regulated financial institutions in the use of these markets.

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[21] Futures hedging can offset losses and gains from price shifts on positions taken in the so-called cash market—the market where the securities actually are traded. Options also protect against adverse movements in price but hold open the opportunity for gain in the event of favorable price movements—in exchange for a sizable and nonrecoverable premium.

[22] For example, see Kidder, Peabody and Company Incorporated, "Bank Use of Financial Futures" (New York City: 1981).

[23] American Institute of Certified Public Accountants, "Accounting for Forward Placement and Standby Commitments and Interest Rate Futures Contracts" (New York City: 1981).

CHAPTER 12

GOVERNMENT FINANCING PROGRAMS

Agencies at Federal, State, and local levels are involved, in various ways, in the residential mortgage markets. The appropriate roles of government housing financing programs, of all types, need to be reviewed in light of changing economic and market processes and the national commitment to reducing the presence of government in the economy. This chapter examines two major areas—Federal housing credit programs, and State and local government programs that involve use of tax-exempt mortgage revenue bonds.

The recommendations on housing finance presented in the previous chapters of this section are designed to strengthen the ability of the private financial system to meet the demand for housing credit that is expected during the years ahead. As the private sector's capacity to meet this demand expands, the need for government programs designed to stabilize or increase the volume of residential mortgage credit should decline.

The Federal government clearly has a responsibility to ensure that the process of change in the housing finance system is directed to meet the needs of housing consumers without disruption. In this regard, the government should create the economic and market environment necessary for a shift of certain government housing credit programs to the private sector and should carefully manage and monitor the changeover. The Federal government also has important and continuing roles to play in the housing credit markets, in areas where the private sector cannot provide needed services at reasonable cost.

The Commission has stressed, as matters of principle, the importance of free and deregulated markets and of reliance on the private sector in fashioning a mortgage credit system to meet the nation's housing needs. The Commission also believes that this principle should apply, to the extent possible, in other sectors of the economy. The prominent position of the government in the nation's credit markets today clearly is inconsistent with this focus. Borrowing under Federal auspices—the sum of funds raised by the Federal government and government-sponsored enterprises, together with federally insured or guaranteed borrowing by the private sector—accounted for more than a third of all funds raised in the nation's credit markets during the past two years (Table 12.1). When tax-exempt borrowing by State and local governments is included, the government participation rate rose above 40 percent in 1980–81. Tax-exempt borrowing by municipalities may be considered federally assisted borrowing because of the Federal tax exemption for the interest income on the issues of State and local governments.

An important factor in the growth of borrowing under Federal auspices has been insured or guaranteed credit. The effects of Federal loan insurance and guarantees on the economy clearly are less dramatic, dollar for dollar, than are the effects of direct Federal borrowing. The credit market effects are a function only of net additions to private borrowing as a result of the insurance and guarantee programs, and these net additions are likely to be much smaller than the gross volume of federally underwritten credit. However, federally underwritten borrowing can have important economic consequences and, if not restricted, can pose a significant threat to the ability of the private market to allocate credit efficiently.

Federal insurance and loan guarantee programs can provide a net benefit to assisted borrowers in the form of lower credit costs and thus can stimulate the volume of federally underwritten credit, even when the programs are run on a self-sup-

Table 12.1
Government Participation in Domestic Credit Markets
(Dollars in billions)

	Fiscal Years										
	1972	1973	1974	1975	1976	TQ[a]	1977	1978	1979	1980	1981
Total funds raised in U.S. credit markets[b]	$151.9	$198.5	$186.7	$174.4	$241.5	$65.0	$310.8	$378.9	$412.9	$342.5	$407.8
Raised under Federal auspices	39.1	46.5	24.2	64.8	98.1	19.3	79.0	93.9	80.7	123.5	142.1
Federal borrowing from public	19.4	19.3	3.0	50.9	82.9	18.0	53.5	59.1	33.6	70.5	79.3
Borrowing for guaranteed loans	18.9	16.6	10.3	8.6	11.1	−0.1	13.5	13.4	25.2	31.6	28.0
Government-sponsored enterprise borrowing	0.7	10.6	10.9	5.3	4.1	1.4	12.0	21.4	21.9	21.4	34.8
Federal participation rate (percent)	25.7%	23.4%	13.0%	37.2%	40.6%	29.7%	25.4	24.8%	19.5%	36.1%	34.8%
Tax-exempt credit	$13.7	$12.2	$16.5	$11.4	$20.9	$3.8	$20.5	$23.5	$20.5	$20.4	$24.5
Government participation rate, including tax-exempt (percent)	34.7%	29.6%	21.8%	43.7	49.2%	35.6%	32.0%	31.0%	24.5%	42.0%	40.8%

[a] Transition quarter.
[b] Nonfinancial sectors, excluding equities.
Source: Executive Office of the President, Office of Management and Budget, *The Budget of the United States Government, FY 1983; Special Analysis F, Federal Credit Programs* (Washington, D.C.: U.S. Government Printing Office, 1982).

porting basis (premiums and fees equal default losses and other costs). This result occurs when the value placed by investors on the Federal guarantee of payment, and on attendant improvements in the liquidity or marketability of the federally underwritten instrument, exceeds the cost of the guarantee charged to borrowers. The net benefit to borrowers is funded, indirectly, by nonguaranteed private borrowers who pay relatively higher rates for the limited funds available in the capital markets.

The upward pressure placed on market interest rates by credit raised under government auspices—especially direct borrowing—has an adverse effect on housing, because the demands for housing credit are particularly sensitive to interest rate levels. Moreover, an expanding government presence can inhibit the development of the capital market environment necessary to a healthy housing industry. Accordingly, it is in the long-term interests of the housing sector to redirect Federal efforts toward development of efficient private markets. The recommendations presented in this chapter deal exclusively with government housing credit and financing programs. However, a reexamination of government credit programs in other sectors of the economy also is appropriate.

The remainder of this chapter is divided into two major parts. The first part considers programs that involve agencies or instrumentalities of the Federal government. It presents an overview of the role of Federal credit programs in the mortgage markets, identifying those that are dominant in size, as well as those where a shift of functions to the private sector appears most feasible. Based on that overview, recommendations are developed on Federal Housing Administration (FHA) mortgage insurance for single-family homes and multifamily dwellings, Government National Mortgage Association (GNMA)-guaranteed, mortgage-backed securities, federally related credit agencies—the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC)—and the role of the Farmers Home Administration (FmHA) in rural housing credit markets.

The second part of this chapter deals with housing finance programs of State and local governments that involve borrowing in tax-exempt markets. The discussion considers the advantages and disadvantages of tax-exempt mortgage revenue bonds as a way to stimulate homeownership and rental housing opportunities for low- and moderate-income households, and examines technical problems in current laws and regulations that have severely constrained issuance of mortgage revenue bonds since 1980.

FEDERAL HOUSING CREDIT PROGRAMS

The various Federal programs involved in the residential mortgage markets are summarized in Table 12.2. The programs are divided into two major types: those that involve the acquisition and holding of mortgage assets by Federal or federally related agencies, and those that enhance the quality of mortgage assets by providing insurance or guarantees on mortgage loans or mortgage pass-through securities. The table also shows the overlap of Federal programs that occurs when agencies hold federally underwritten mortgage credit.

Federal and federally related agency holdings of residential mortgage assets have grown rapidly since the late 1960s, from $19.9 billion in 1969 to $101.0 billion in 1981 (Table 12.2, line 11). However, the agency share of total residential mortgages outstanding has increased only slightly (from 6.0 percent in 1969 to 8.7 percent in 1981), even when FmHA-guaranteed pass-through securities held by the Federal Financing Bank (FFB) are included in agency mortgage assets (line 12). On balance, mortgage holdings by most agencies have changed quite modestly, and at the end of 1981, FNMA (line 8) and the FFB (line 6) accounted for more than four-fifths of total mortgage holdings by Federal and federally related agencies.

Federally guaranteed mortgage pass-through securities outstanding have grown from a negligible amount in the late 1960s to nearly $150 billion at the end of 1981 (Table 12.2, line 16). Not all of this increase represents additional mortgage credit underwritten by the Federal government, because GNMA-guaranteed securities represent shares in pools of federally insured or guaranteed mortgages. After correction for this overlap, the volume of federally underwritten mortgage credit has declined as a percentage of total residential mortgages outstanding during the past decade (line 21). The relative decline primarily reflects diminished importance of FHA home mortgage insurance in conjunction with development of the private mortgage insurance industry, as well as the existence of FHA loan limits during a period of rapid inflation in house prices.

The proportion of federally underwritten mortgage assets held by the Federal and federally related credit agencies has increased somewhat—from 15.6 percent in 1969 to 23.1 percent in 1981 (Table 12.2, line 24). Due to this overlap of Federal support, together with the decline of the position of federally underwritten credit in the mortgage market, privately held government-underwritten mortgage assets have fallen as a proportion of total residential

Table 12.2
Federal Role in Residential Mortgage Markets
(Amounts outstanding at end of period, in billions of dollars)

Type of Involvement	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
Mortgage Assets Held													
1. Total Federal agencies	$8.9	$9.3	$9.1	$8.8	$8.3	$9.8	$15.8	$14.9	$17.6	$21.0	$24.1	$28.4	$31.5
2. GNMA	4.9	5.2	5.3	5.1	4.0	4.8	7.4	4.2	3.7	3.5	3.9	4.6	4.8
3. FHA	0.7	0.8	1.0	1.3	1.7	2.2	3.1	3.6	3.7	3.8	3.8	3.9	4.3
4. VA	2.7	2.7	2.4	2.1	1.8	1.9	1.9	1.6	1.5	1.5	1.7	1.7	1.9
5. FmHA	0.6	0.6	0.4	0.3	0.8	0.9	0.4	0.7	0.9	0.6	0.5	1.5	2.2
6. FFB[a]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	3.0	4.8	7.8	11.6	14.2	16.6	19.3
7. Total federally related agencies	11.0	15.9	18.8	21.6	26.9	34.6	37.4	37.8	38.3	47.3	56.7	64.5	69.5
8. FNMA	11.0	15.5	17.8	19.8	24.2	29.6	31.8	32.9	34.4	43.3	51.1	57.3	61.4
9. FHLMC	n.a.	0.4	1.0	1.8	2.6	4.6	5.0	4.3	3.3	3.1	4.0	5.1	5.3
10. Federal Land Banks	n.a.	n.a.	n.a.	n.a.	0.1	0.4	0.6	0.6	0.7	0.9	1.6	2.1	2.8
11. Total agency holdings	19.9	25.2	27.9	30.4	35.2	44.4	53.2	52.7	55.9	68.4	74.0	92.9	101.0
12. Percent of total mortgages outstanding	6.0%	7.0%	7.0%	6.7%	6.9	8.1%	9.0%	7.2%	7.3%	7.7%	7.3%	8.5%	8.7%
Insurance and Guarantees													
13. Total Mortgage loans[b]	$100.2	$109.2	$120.7	$131.1	$135.0	$140.2	$147.0	$154.1	$161.8	$176.4	$199.1	$225.1	$239.5
14. FHA	64.5	71.9	31.2	86.4	85.0	84.0	85.4	87.1	88.2	94.4	107.1	123.5	133.3
15. VA	35.7	37.3	39.5	44.7	50.0	56.2	61.6	67.0	73.6	82.0	92.0	101.6	106.2
16. Total mortgage pass-through securities	1.4	2.6	6.8	11.1	14.3	19.4	29.4	44.1	63.7	80.7	108.7	130.0	147.4
17. GNMA	n.a.	0.3	3.1	5.5	7.9	11.8	18.3	30.6	44.9	54.3	76.4	93.9	105.8
18. FHLMC	n.a.	n.a.	0.1	0.4	0.8	0.8	1.6	2.7	6.6	11.9	15.2	16.9	19.8
19. FmHA[c]	1.4	2.2	3.7	5.1	5.6	6.9	9.5	10.8	12.2	14.5	17.1	19.3	21.8
20. Total credit underwritten[d]	101.6	111.4	124.5	136.6	141.4	147.9	158.1	167.6	180.6	202.8	231.4	261.3	281.1
21. Percent of total mortgages outstanding	30.3%	31.1%	31.3%	30.0%	27.8%	26.9%	26.8%	25.4%	23.5	22.9%	23.0%	23.8%	24.1%

Table 12.2 (Continued)
Federal Role in Residential Mortgage Markets
(Amounts outstanding at end of period, in billions of dollars)

	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
Underwritten Credit Held by Agencies[e]													
22. Total amount held	$15.8	$21.0	$23.9	$26.3	$29.1	$34.2	$39.5	$38.2	$40.5	$48.1	$54.1	$61.2	$65.0
23. Percent of agency mortgage holdings	79.4%	83.3%	85.7%	86.5%	82.7%	77.0%	74.2%	72.5%	72.5%	70.4%	73.1%	65.9%	64.4%
24. Percent of total credit underwritten	15.6%	18.9%	19.2%	19.2%	20.6%	23.1%	25.0%	22.8%	22.4%	23.7%	23.4%	23.4%	23.1%

[a] Federal Financing Bank (FFB) holdings of Certificates of Beneficial Ownership issued by the FmHA.
[b] The VA includes the total amount of guaranteed loans outstanding, not just the guaranteed portion. Home loans made by private institutions and guaranteed by the FmHA are not shown, because the amounts are negligible; only about $10 million of such loans were outstanding at the end of 1979. Residential mortgages made by FmHA from the Rural Housing Insurance Fund and held by FmHA are also excluded; when sold, these loans appear under the mortgage pass-through securities category.
[c] Includes FmHA-insured notes sold individually or in blocks through syndicates of securities dealers and Certificates of Beneficial Ownership sold to private investors or to the Federal Financing Bank.
[d] FHA and VA mortgage loans, plus mortgage pass-through securities guaranteed by FHLMC and FmHA. GNMA-guaranteed pass-through securities represent shares in pools of FHA and VA mortgage loans. The total on line 20 adjusts for the overlap.
[e] Loans in default and assigned to FHA and VA are classified as conventional mortgages.
n.a.—Not applicable, because programs are not in operation.

Source: Data compiled by staff from information supplied by the U.S. Department of Housing and Urban Development, the Veterans Administration, the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Farmers Home Administration, the Federal Financing Bank, and the Federal Land Banks.

mortgage assets held by the private sector, despite the development of federally guaranteed pass-through securities.

Among the Federal housing credit programs identified in Table 12.2, the Commission has concentrated its attention on those that are dominant in size and those with a potential for successful transfer to the private sector. To date, private sector competition with Federal programs has been greatest in the area of FHA mortgage insurance, particularly in the single-family area. Although private guarantees of pass-through securities have been quite limited to date, it is expected that the private market will increasingly assume this function, especially if the recommendations made in the previous chapter are adopted. Consequently, the Commission has developed recommendations to phase down the GNMA guarantee program in concert with development of the private market.

The Commission believes that the major federally related agencies that have been operating in the secondary mortgage markets—FNMA and FHLMC—eventually should be converted to fully private corporations that do not have significant competitive advantages over other private entities. It is anticipated that these agencies will play an increasingly important role in development of the private conventional pass-through securities markets. On the other hand, as the mortgage supply base in the private sector is broadened in the years ahead, the need should decline for programs that channel funds from agency securities markets into mortgages. Furthermore, as organized options markets in mortgage-related securities are developed, the need of mortgage originators for optional-delivery purchase commitments written by government agencies should contract.

The rural housing credit programs operated by FmHA also deserve careful review. Because FmHA programs ordinarily involve the provision of Federal subsidies to lower-income homeowners and renters, these programs already have been considered in Chapter 2. Recommendations relating to the financial market aspects of FmHA programs, however, are presented in this chapter.

Recommendations have not been developed by the Commission concerning VA loan guarantees. The VA-guarantee program is specially designed as a veterans' benefit or entitlement earned for service to the country. Moreover, transfer of the program to the private sector currently is not feasible since there are no guarantee fees on VA loans.

FHA Single-Family Mortgage Insurance

In view of development of the private mortgage insurance industry, the Federal Housing Administration should increasingly complement, rather than compete with, the private market. FHA should provide mortgage insurance where the private market is unable or unwilling to do so, and there should be a continuing demonstration role for FHA in developing and underwriting innovative forms of mortgage instruments.

All FHA home mortgage insurance programs should be streamlined to operate more efficiently and at the lowest possible cost in meeting program objectives.

FHA has performed a number of important functions since it was established in the 1930s. First, FHA helped revive a collapsed housing industry when the Great Depression reduced the country's financial system and housing sector to chaos. Second, FHA has performed an important role as an innovator over the years, successfully gaining market acceptance for new types of home mortgage instruments. FHA demonstrated the feasibility of long-term, high loan-to-value, fully amortizing mortgages and currently is performing another demonstration role through its Section 245 negative-amortization, graduated-payment loan programs. Third, FHA has contributed to the standardization of home mortgage instruments, assisting in the development of national secondary mortgage markets. Finally, FHA at times (particularly during the late 1960s and early 1970s) has operated programs intended to provide implicit subsidies to achieve social goals. Special high-risk insurance programs have been used to promote homeownership for lower-income or inner-city families as well as to alleviate patterns of discrimination in the provision of mortgage credit to such families.

Development of Private Mortgage Insurance

Private mortgage insurance companies established since the late 1950s have taken advantage of the experience and market acceptance generated by the unsubsidized FHA home mortgage program, becoming an important factor in the market for long-term, fully amortized mortgages. By offering mortgage insurance with less than 100 percent coverage, by charging lower premium rates than FHA, and by requiring less paperwork and shorter processing delays, the private insurance companies have been able to compete with FHA, drawing away many lower-risk homeowners that might otherwise have been served by the unsubsidized single-premium FHA insurance program; indeed, the cross-subsidization of risk inherent in FHA's single-premium structure has made this substitution process possible. Private mortgage insurance also was given a substantial boost in the early 1970s when FHLMC and FNMA began to purchase high loan-to-value

ratio conventional loans insured by private companies.

Some 15 firms are active throughout the country in the private mortgage insurance industry. In 1981, the number of privately insured home mortgages originated was greater than the number of mortgages underwritten by FHA and VA combined. The private mortgage insurance industry, in fact, has the capacity to expand greatly its level of activity, because of current insurance reserves and an ability to raise additional capital directly or through holding company arrangements. Nonetheless, according to aggregate statistics, a substantial overlap still exists between the markets served by FHA and the private mortgage insurers—in terms of types of borrowers and loans. Thus, FHA continues to insure mortgages that the private sector could and would insure, partly because of the FHA premium structure and partly because FHA insurance gives lenders access to the markets for GNMA-guaranteed, mortgage-backed securities.

Redirection of FHA

In view of the development of a strong private mortgage insurance industry, FHA should increasingly complement, rather than compete with, the private market. Further reliance on the private sector for home mortgage insurance should be spurred by public policy designed to redirect FHA programs that serve the same market that could be served by private insurers. FHA should, however, continue to provide mortgage insurance for standard home loans (i.e., fixed-rate, level-payment mortgages) where the private market is unable or unwilling to do so. In addition, FHA should continue to perform a demonstration role in developing and underwriting innovative forms of mortgage instruments.

Standard Home Mortgage Insurance Program. While preserving FHA's historic role in assisting low- and moderate-income families to achieve homeownership, the insurance of standard fixed-rate, level-payment, "market-risk" home loans should be shifted from FHA to the private sector via a market-oriented approach that permits private companies to continue to draw this type of business away from FHA.[1] This approach should involve several steps. First, the FHA premium structure should be reshaped to fit actual claims experience more closely. This step would result in higher premiums in the early years of the loan term and a shorter total period of insurance coverage. One possible approach would require a one-time payment of the insurance premium at time of loan closing, with some portion of the up-front premium eligible for inclusion in the loan amount. The up-front premium could be calculated as the present value of premiums that would be paid under the current system over the expected term of the loan; this amount currently would be approximately 3 percent of the loan amount for the Section 203(b) unsubsidized home loan program.

As a second step, FHA maximum loan-size limits should be managed to emphasize FHA's historic focus on low- and moderate-income homebuyers. One possible method would hold mortgage limits constant in nominal-dollar terms. Regionalized mortgage limits should be used because they are more effective and equitable than a single national limitation, as shown by the Department of Housing and Urban Development's (HUD) recent experience with regionalized mortgage limits.

For a third step, a general review of FHA programs should be conducted to assure that FHA does not have significant competitive advantages that would frustrate the shift of market-risk insurance activity to the private sector. For example, the mutuality feature of the current FHA single-family program, which involves premium rebates, should be reconsidered.

The combination of loan limits and pricing would be an efficient way of shifting the insurance of standard types of market-risk home mortgages from FHA to the private sector while avoiding the credit rationing and lack of attention to high-risk classes of borrowers inherent in arbitrary reductions in FHA commitment authority in the Federal credit budget. This market-oriented procedure would simply accelerate the process already under way. Private insurance companies would continue to compete with FHA's standard single-premium program (203(b)) for the lower- or market-risk loans, but the availability of FHA insurance would be maintained for eligible borrowers unable to secure private mortgage insurance. Additionally, such a continuing FHA presence in the market could exert a latent competitive influence to guard against monopolistic pricing and discriminatory practices in the private sector.

As lower-risk business is bid away from FHA because of reshaped premiums and managed loan limits, the level of FHA premiums could be expected to rise to maintain the economic soundness of FHA's standard home mortgage insurance program. But if FHA home mortgage premiums were so increased, higher-risk borrowers otherwise eligible for FHA insurance might be unable to afford such FHA premiums.

To afford access to homeownership for such borrowers, two broad options would be available. First, FHA could operate subsidized insurance pro-

[1] "Market-risk" home loans are those that the private mortgage insurance industry can and will insure.

grams for higher-risk loans—programs not expected to achieve actuarial soundness—with eligibility requirements targeted to the program's intended beneficiaries. For example, insurance could be made available for lower-cost, one-to-four-family dwellings for lower-income families, as under the Section 221(d)(2) program. Second, government policy could establish that FHA insurance funds not be used to provide implicit subsidies to families who cannot afford to purchase insurance under programs that are run on an economically sound basis, but provide subsidies directly to such households (such as through income supplements) to assist them in obtaining access to mortgage insurance and homeownership.

Demonstration Role. Although insurance of standard, market-risk home loans should increasingly be shifted from FHA to the private sector, there should be a continuing demonstration role for FHA in the single-family sector. In particular, FHA should conduct experiments with new mortgage forms that appear to meet the needs of lenders and borrowers in the current environment of inflation and interest rate volatility. Federal experimentation may be justified when one or more of the following conditions are met:

- Private insurance companies are unwilling to insure the risks posed by new instruments, and investors are unwilling to buy these instruments without insurance.
- Private institutions cannot afford to conduct experiments of sufficient size to identify the risk characteristics of some types of loans.
- A private institution that conducts a market experiment is not able to capitalize on information gained, because the information would become available to private competitors.
- Private institutions are constrained by law or regulation from insuring or acquiring new mortgage forms without Federal insurance.
- Inconsistent State laws prevent the insurance or acquisition of uniform mortgage instruments on a nationwide basis.

As in the past, information generated by FHA on risk characteristics of new mortgage forms would be valuable to private insurers, regulators of State-chartered investors, and State insurance commissions.

Some promising candidates for FHA experimentation in the single-family area include graduated-payment, adjustable-rate mortgages; dual-rate mortgages; growing-equity mortgages; and shared-appreciation mortgages.[2] FHA also should expand its Section 245(b) graduated-payment mortgage program—which allows both negative amortization and low initial downpayments—to make existing home loans and all potential buyers eligible for coverage. FHA should include fair housing requirements in all demonstration programs and should have the statutory right to preempt inconsistent State laws with respect to the terms and conditions of its innovative instruments, as it has done with its Section 245 graduated-payment mortgages. Finally, FHA demonstration programs should incorporate sunset provisions, so that they do not become permanent additions to FHA.

Program Efficiency and Cost

All FHA programs should be designed for maximum market efficiency and should be operated at the lowest possible cost in meeting program objectives. The following measures would help accomplish these goals in the single-family programs:

- Rate ceilings on FHA mortgage interest rates should be eliminated, and rates should be determined through negotiation between lenders and loan applicants.
- Due-on-sale clauses should be permitted for all loans, and prepayment penalties should be permitted for long-term, fixed-rate contracts.
- Certain conditions of the FHA Section 234 condominium unit program should be reviewed, including presale and project-approval requirements.
- Subject to appropriate HUD monitoring, processing should be delegated to private institutions, as in recently successful HUD experiments.
- Underwriting criteria should be carefully reviewed and assiduously applied to assure that FHA loans are soundly underwritten.
- Subject to appropriate HUD monitoring, private collection agencies should be used in lieu of HUD/Justice Department collection procedures.

Single-family co-insurance is not recommended at this time because it represents a potential expansion of FHA into markets already adequately served by private mortgage insurance companies.

FHA Multifamily Mortgage Insurance

The Federal Housing Administration should continue to insure standard unsubsidized multifamily mortgages and should perform a demonstration role with respect to innovative forms of multifamily mortgage instruments.

[2] Discussions of alternative home mortgage instruments are contained in Chapters 6 and 11.

Adjustments should be made to permit FHA programs to operate more efficiently and to lower costs to FHA and developers of multifamily projects.

Standard Multifamily Insurance Program

FHA insurance of multifamily mortgages has been limited in recent years primarily to subsidized projects. The low level of insurance for unsubsidized projects can be attributed to the strong emphasis placed on subsidized rental housing construction since the Housing Act of 1968, as well as to FHA program requirements that have deterred use of FHA insurance by lenders and developers of unsubsidized projects. As production subsidies are phased down—as recommended by the Commission—the need for FHA insurance for mortgages on newly constructed unsubsidized projects is likely to increase. Moreover, to facilitate the funding of rehabilitation needed to make units eligible for the program of housing assistance payments recommended in Chapter 2, FHA insurance will be required for mortgages that refinance existing rental projects.

Unlike the home mortgage area, FHA does not compete with the private sector in insuring unsubsidized, long-term, fixed-rate project mortgages. Furthermore, loan insurance is important to gain investor acceptance of multifamily mortgages and to facilitate access to secondary market financing. Thus, the Commission recommends that the Federal government continue to insure unsubsidized multifamily loans and eliminate aspects of the insurance programs that have inhibited participation by both lenders and developers.

Private insurance of multifamily mortgages has been minimal for several reasons. First, State laws generally impose strict limitations on insurance of projects by private companies. Second, the risk on project loans is difficult for private insurers to diversify because of the large size of the liability represented by each loan. Third, the risk on project loans is different from that associated with single-family mortgages since, in effect, insurance of a project loan represents coverage against the risk of failure of a business enterprise.[3] The success of a rental housing project depends on a variety of factors, including the stability of the rent flow, the ability of management to control operating costs, and changes in the neighborhood environment. The threat of outside interference in project management through government regulations relating to rent control and condominium conversions also increases uncertainty over the future value of the project.

Demonstration Role

FHA should perform a demonstration role with respect to new forms of multifamily mortgages that meet the needs of borrowers and investors in an era of inflation and interest rate uncertainty. Experiments should be conducted to determine the risk characteristics of contracts such as adjustable-rate loans; graduated-payment loans with shared-appreciation provisions; and mortgages that provide lenders a proportion of net rental receipts. As with experimental programs in the single-family area, FHA should have the right to preempt State laws that are inconsistent with the provisions of the new mortgage contracts, and all demonstration programs should include sunset provisions.

Program Efficiency and Cost

FHA has been subjected to a substantial degree of adverse risk selection in the multifamily area, because developers have tended to seek insurance for projects with the highest risks of failure. Use of replacement-cost valuation for projects has sometimes invited the insurance of financially unsound projects. Thus, in the future, multifamily mortgages should be insured for no more than 90 percent of the real economic value of the project, based on the lower of capitalized income, market comparables, and replacement-cost methods of appraisal. Use of such an approach should eliminate the need for the current complex cost certification procedures. It is necessary to prohibit inclusion of builder/sponsor profits in the mortgage amount (the so-called builder/sponsor profit and risk allowance) in order to ensure that developers have significant equity in projects financed with FHA-insured loans.

Risk-sharing techniques also should be used with project mortgages to encourage better project design and loan underwriting. The following possibilities should be considered:

- Require the developer to maintain a reserve fund from syndication proceeds or other sources during the early high-risk period of the loan term.
- Require partial recourse loans (with appropriate changes to the Internal Revenue Code's at-risk rules for limited partnerships).
- Require the lender to share the default risk through co-insurance for the early years of the loan.
- Allow for co-insurance by private mortgage insurance companies.

[3] If a project fails, the insurer stands ready to buy it at a price equal to the outstanding principal balance on the loan.

A number of other adjustments should be made to increase the efficiency and to lower the cost of FHA multifamily insurance programs. In particular, interest rate ceilings should be eliminated; FHA restrictions on provisions allowing lenders to call loans prior to full maturity should be liberalized; regulation of developers of FHA projects should be minimized, particularly with respect to the A-95 review, minimum property standards, and environmental impact statements; and unsubsidized projects with FHA-insured loans should not be subject to regulatory control of rents, either by localities or by HUD.

Additional steps should be taken to encourage the use of FHA insurance programs for the rehabilitation of existing rental projects. The FHA Section 223(f) program—which provides for FHA insurance of loans on existing projects—has been used only to a limited extent since its creation in 1975, partly because of program restrictions and administrative complications. HUD should make this program more workable, while preserving its actuarial soundness. To do so, HUD should consider a co-insurance program for Section 223(f) multifamily loans, cash payment of claims (rather than payment in FHA debentures), and higher permissible levels of rehabilitation.

GNMA Mortgage-Backed Securities Program

A major goal of public policy should be to develop private markets for mortgage-backed securities (MBS). The Government National Mortgage Association MBS program should be phased down to encourage the growth of private mortgage-backed securities, but this phasedown should be done in concert with the development of the market for private securities.

During the transition to greater reliance on the private market, GNMA should continue to guarantee securities issued against pools of mortgage instruments insured or guaranteed by the Federal government, including innovative instruments.

The GNMA mortgage-backed securities program was established by Congress to increase liquidity in the secondary mortgage market and to attract new sources of private funds into residential mortgages. Under the MBS program, GNMA guarantees the timely payment of principal and interest on pass-through securities that are issued by private institutions. The securities are based on pools of government-underwritten residential mortgages originated by private lenders.

The first GNMA-guaranteed MBS was issued in 1970, and the volume of GNMAs outstanding has increased more than five-fold since 1975—from $20 billion to $106 billion at the end of 1981.[4] The mortgage pools securing issues of GNMAs consist primarily of standard FHA-insured and VA-guaranteed, long-term, level-payment home mortgage loans (more than 90 percent of the total).[5]

GNMAs and Conventional Securities

The current market for GNMA-guaranteed securities issued against pools of standard long-term, FHA/VA home mortgages has substantial depth and liquidity—a goal that may not be achieved in conventional pass-through markets for several years. Moreover, the GNMA market may well play a supportive role in the development of conventional mortgage-backed securities (CMBS) markets. GNMA securities serve as a benchmark against which new types of mortgage-backed securities can be priced. GNMAs also provide the basis for the prospective exchange-traded options markets and the currently active organized futures markets in GNMAs. These markets allow mortgage originators and investors to hedge their interest rate risks. The futures markets also permit hedging activities that should be helpful to the development of dealer forward markets for CMBS. Forward markets are important to issuers of pass-through securities, and dealers who extend forward-purchase commitments to issuers often use GNMA futures to hedge their positions.

Although the GNMA market can be supportive of the development of private pass-through securities markets, it is also true that an unfettered volume of GNMA issues entering the market could inhibit the development of CMBS markets. Investors naturally place a high value on GNMA's "full faith and credit" Federal guarantee of timely payment, and CMBSs must provide a substantial yield advantage to compete for the limited supply of long-term funds available in the capital markets.

The GNMA securities markets, and the associated options and futures markets, could continue to function in the face of a reduced volume of new issues, as long as the stock of outstanding securities was sufficient to sustain trading volume.[6] The outstanding stock currently exceeds $100 billion, and the long-term nature of the instruments ensures a

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[4] Data supplied by the Government National Mortgage Association.

[5] Other loans that have been pooled in limited amounts include: FHA-insured, multifamily construction loans; FHA-insured, long-term multifamily mortgages; FHA-insured and VA-guaranteed, mobile home loans; FmHA-guaranteed home mortgages; and FHA-insured, graduated-payment home mortgages.

[6] As discussed in Chapter 11, options and futures markets in nonmortgage securities such as Treasury bonds also can provide adequate hedging mechanisms for mortgage market participants.

large stock for years to come. Thus, it is possible to reduce the volume of newly issued GNMAs without eliminating the elements of this market that can support the development of the CMBS markets. Any policy for reducing the volume of GNMA issues, however, still must take cognizance of the condition of the housing market and the state of CMBS market development because of the need for continuing linkages between mortgage markets and the broader capital markets—particularly in view of the prospect for portfolio diversification by thrift institutions.

Phasedown of GNMA Mortgage-Backed Securities Program

A delicate balance clearly must be struck in any effort to limit the GNMA program in concert with growth of the private market. GNMA new-issue volume should be reduced to provide leeway for the private CMBS market to develop, but the GNMA reduction should coincide with the development of the private market. As part of this strategy, it is essential that policymakers send clear and consistent signals to the private market concerning the long-term future of the GNMA program, and that the reduction process be managed with an eye to market conditions.

The reduction need not proceed uniformly for all components of the GNMA program. For example, the GNMA program should continue to guarantee securities issued against pools of innovative types of federally underwritten mortgages. This GNMA activity can help generate information, for use by the private market, on investor acceptance and pricing of new types of pass-through securities.

In the absence of an explicit public policy to alter the GNMA program, the volume of issues of GNMA-guaranteed securities would depend, of course, on the volume of federally underwritten mortgages eligible for GNMA pools. If the basic, unsubsidized, FHA home mortgage insurance programs were reduced through altered pricing or greater targeting (as recommended above), the volume of GNMAs backed by such loans also would decline, even if the GNMA program continued to operate on a demand basis at current fee levels. Although the Commission does not recommend limits on the volume of VA-guaranteed home loans because the VA program is an earned entitlement for veterans, access of VA loans to GNMA pools should be restricted since the GNMA program benefits should not be viewed as an entitlement. As with FHA, VA home mortgages in excess of specified loan-size limits should not be eligible for pooling.

When reduction of the GNMA mortgage-backed securities program is considered appropriate (independent of the volume of government-underwritten loans eligible for pooling), several policy options could be implemented. First, it might be possible to make the GNMA mortgage-backed securities program a private function by selling GNMA's charter to a private entity, which would provide the same services without a Federal guarantee. However, GNMA as an entity probably has little value without the Federal guarantee. GNMA has few assets in infrastructure and equipment, and information on GNMA's contracts, requirements, and performance is available at no cost to the private sector.

As a second option, the GNMA mortgage-backed securities program could be reduced through scheduled cutbacks in the limits on new issues of GNMA commitments to guarantee, as established in the Federal credit budget. Although this process would use an existing mechanism, serious problems of rationing a limited volume of valuable commitments could emerge.

Reduction also could be accomplished through a third option—gradually increasing the commitment and/or guarantee fees charged by GNMA. This process would encourage the private sector to compete with GNMA, just as the private mortgage insurance companies have been competing with FHA. Management of fees clearly would be a more efficient way of allocating guarantees than would restrictions on commitment levels in the Federal credit budget. Of the three options listed, the Commission recommends this procedure.

Federally Related Credit Agencies

The Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation should play important roles in the development of markets for conventional mortgage pass-through securities. Federal policy should encourage the operation of FNMA and FHLMC as private corporations that retain limited benefits arising from Congressionally mandated commitments to housing.

FNMA and FHLMC are the major federally related credit agencies operating in the secondary markets for residential mortgages. Although both agencies buy mortgages from loan originators, FHLMC currently buys only conventional mortgages, while FNMA buys both FHA/VA and conventional loans. Traditionally, FHLMC has sold the loans it acquires, and in recent years sales have been accomplished by issuing pass-through securities that FHLMC guarantees and markets through a syndicate of securities dealers. FNMA traditionally has held most of the loans it acquires; as a result, it has built the largest mortgage portfolio in the country. Recently, however, FNMA has initiated a program whereby it buys conventional loans and resells them by issuing pass-through securities on which it guarantees the timely payment of principal and in-

terest. Because of their prominent market positions and considerable expertise, FNMA and FHLMC should play important roles in the development of markets for conventional pass-through securities.

Long-Term Policy

Federal policy should encourage the operation of FNMA and FHLMC as private corporations that retain limited benefits arising from Congressionally mandated commitments to housing. These institutions have the size, reputation, and ability to serve as guarantors of a volume of securities sufficient to justify the establishment of secondary markets by securities dealers, with reasonable bid-ask price spreads. These corporations, however, should not have such unfair competitive advantages over other private institutions that market inefficiencies develop.

Eventually, both FNMA and FHLMC should become privately owned corporations with common responsibilities and advantages:

- A Congressionally mandated dedication to the secondary markets for residential property loans;
- The right to purchase any type of residential mortgage instrument that can be originated by federally regulated financial institutions or HUD-regulated mortgagees, and to guarantee pass-through securities issued against pools of such mortgages;
- An exemption from the requirements of State blue-sky laws, provided they are subject to reasonable alternative investment disclosure requirements;
- A limited exemption from the bankruptcy code, clarifying the ownership of mortgage pools by holders of their pass-through securities;
- The right to preempt State laws concerning the enforcement of due-on-sale clauses, usury laws, prepayment penalties, foreclosure moratoria, or rent control, and the right to use Uniform Federal Foreclosure procedures available to FHA, if enacted;
- A limited exemption from Federal antitrust laws to assure that FNMA and FHLMC can continue to cooperate in developing common forms and documentation;
- An exemption from State and local income taxation; and
- Subjection to Federal income taxation but eligibility for any broad-based tax credit made available to mortgage investors.

Transition Phase

Currently, the ability of either FNMA or FHLMC to guarantee large amounts of newly issued pass-through securities as private corporations would be limited without a significant Federal connection. FHLMC, as part of the Federal Home Loan Bank System, was provided a modest amount of capital when it was chartered and has been able to add only limited amounts to its capital base through retention of earnings. FNMA's profit problems—stemming from the same type of portfolio maturity imbalance that has plagued thrift institutions—have resulted in a potential diminution of capital. Thus, a transition period is needed.

During this period, adjustments to the powers and Federal connections of the two corporations should be carefully managed to preserve a reasonable competitive balance. FHLMC's status should be altered to permit this corporation to act more flexibly as a mortgage purchaser and as a guarantor of pass-through securities. FHLMC should be given authority to raise capital by issuing stock and convertible debt securities. On an interim basis, FHLMC could have a limited backstop line of credit to the Federal Home Loan Bank System, an exemption from Securities and Exchange Commission registration requirements, and Federal agency status for its obligations (provided that the U.S. Treasury has oversight concerning the volume and timing of securities issued in the public market). At a given date, however, these Federal benefits should be eliminated, and FHLMC should retain only those advantages listed previously.

FNMA clearly faces a difficult transition. Losses resulting from this agency's historic role as a purchaser of long-term, fixed-rate mortgages would put a totally private FNMA at a serious disadvantage vis-a-vis a newly recapitalized FHLMC. Thus, FNMA's beneficial Federal linkages should not be altered until FNMA returns to a positive profit position. In particular, a timetable to phase out FNMA's Treasury backstop borrowing authority and agency status for its obligations should be considered only after FNMA's financial condition clearly has stabilized. Moreover, FNMA should not be discriminated against in its tax treatment. FNMA's tax status should be brought into parity with thrift institutions concerning losses (i.e., the provision for carry back/forward of losses should be changed from 3 years/15 years to 10 years/3 years). In addition, FNMA's charter should be amended immediately to eliminate HUD regulatory authority over FNMA (which seriously limited FNMA's operating flexibility in 1976–78), but to retain a HUD oversight role; to allow FNMA to buy any type of residential mortgage instrument that can be originated by federally regulated depository institutions or HUD-regulated mortgagees; and to broaden the range of obligations that can be issued by FNMA, subject to Treasury oversight concerning the volume and timing of issues sold in the public (agency) market.

Rural Housing Credit Programs

The housing credit programs of the Farmers Home Administration should be conducted without subsidy and in a manner that encourages the development of private housing credit institutions in rural areas.

If the subsidy aspects of FmHA rural housing programs are incorporated into the housing payment and block grant programs, as recommended in Chapter 2, the remaining programs of the FmHA relate to the availability of housing credit in rural areas. Direct lending by FmHA—which ultimately involves channeling funds from the Treasury securities market through the Federal Financing Bank to FmHA—eventually should be eliminated, and lending by private institutions should be encouraged.

Any direct loans made by FmHA in rural areas during the transition period should be made at rates and terms comparable to those prevailing for private credit in similar rural housing areas so as not to frustrate the development of private financing. Furthermore, the FmHA loan guarantee program should be carefully managed to prevent the emergence of another large Federal guarantee program in the nation's credit markets.

The Farmers Home Administration could foster private lending in rural areas by promoting the development of institutions that have the ability and skills necessary to meet the specialized needs of rural lending. FmHA should promote this core of rural home-lending expertise by contracting with private mortgage lenders to originate and service loans, with licensing arrangements that require agents to maintain the standards of the FmHA programs and to apply FmHA rules and regulations to loans. Qualified agents could include commercial banks, savings and loan associations, mortgage banking companies, real estate agencies, lawyers, rural cooperatives, and other individuals or institutions. To facilitate development of an adequate supply of individuals and institutions with rural lending expertise, FmHA should not insist on exclusive use of agent services; agents should be permitted to combine their FmHA activity with outside lending, financial, or other services.

As in other areas of the housing market, the availability of secondary mortgage markets would be essential as the private sector assumes greater responsibility to meet the demands for housing credit. Currently, FmHA-guaranteed mortgages are eligible for pooling under the GNMA-guaranteed securities program. It would be appropriate for FmHA to coordinate plans with State housing finance agencies, as well as FNMA and FHLMC, to promote the development of other mortgage pass-through securities programs to provide access for rural housing loans to the general capital markets.

STATE AND LOCAL GOVERNMENT FINANCING PROGRAMS

The structure of debt financing by State and local governments has changed dramatically during the past decade. There has been a sharp decline in the relative importance of general obligation bonds used to finance public capital expenditures for purposes such as education, public safety, transportation, and utilities. Conversely, there has been a rapid rise in the use of revenue bonds to finance private sector investments such as industrial development, housing, and hospitals. Between 1970 and 1980, the share of total long-term, tax-exempt borrowing accounted for by revenue bonds increased from one-third to more than two-thirds.

General obligation bonds carry a "full faith and credit" security pledge of municipal issuers, and debt service payments are financed from general tax revenues. Debt service on revenue bonds, on the other hand, is paid solely from the earnings generated by the investments financed with bond proceeds. In effect, revenue bond financing enables public sector entities to function, with little public accountability, as financial intermediaries that borrow at tax-exempt rates and relend at below-market rates to finance selected private sector activities.

The first use of tax-exempt financing for housing involved general obligation bonds issued to fund home loans for veterans. The "Cal-Vet" program was begun in California during the 1920s, and similar programs have been used in other States since then. During 1981, veterans' programs were active in California, Oregon, and Wisconsin, and $0.9 billion in such bonds were issued (Table 12.3).

State housing finance agencies (HFAs) traditionally have been the major providers of tax-exempt funds for housing.[7] Forty-six States and the District of Columbia currently have HFAs that raise funds with revenue bonds to originate or purchase residential mortgages, or to finance programs that involve below-market rate lending to private mortgage lending institutions (loan-to-lender programs). State HFAs often have interacted with Federal rental housing programs (such as HUD's Section 8 program) to link tax-exempt financing with Federal subsidies, thereby lowering the cost of rental housing for low- and moderate-income families. Until 1975, in fact, virtually all State HFA activity

[7] The first tax-exempt HFA bonds were issued in 1961 by the New York State agency.

Table 12.3
Tax Exempt Bonds for Housing
(Amounts in billions of dollars)

Period	Total Housing Bonds	Veterans' Housing G.O. Bonds	Single-Family Revenue Bonds			Multifamily Revenue Bonds			Total Housing Bonds as Percent of All Municipal Bond Issues
			Total	State	Local	Total	State	Local	
1975	$1.4	$0.6	—	—	—	$0.9	$0.9	—	5%
1976	2.7	0.6	$0.7	$0.7	—	1.4	1.4	—	8
1977	4.4	0.6	1.0	1.0	—	2.8	2.6	$0.2	9
1978	7.0	1.2	3.4	2.8	$0.6	2.4	1.7	0.7	14
1979	12.1	1.6	7.8	3.3	4.5	2.6	1.9	0.7	28
1980	14.0	1.3	10.5	5.0	5.5	2.2	1.4	0.8	29
1981	5.4	0.9	3.5	1.7	1.8	1.1	0.7	0.4	11

Source: Data compiled by staff from information supplied by the U.S. Department of Housing and Urban Development.

focused on multifamily housing. During the 1975–80 period, however, State agencies issued large amounts of single-family mortgage revenue bonds.

Local use of tax-exempt financing for housing traditionally has been quite limited, consisting primarily of issues by local housing authorities to provide low-rate interim and permanent financing of public housing projects whose debt service payments are provided by HUD. Since 1978, however, local government entities have issued mortgage revenue bonds to provide below-market rate funds for home loans, in some cases for middle-income families in suburban areas. By 1980, local mortgage revenue bond programs were active in more than 20 States, and the volume of single-family issues exceeded $5 billion.

The rapid growth of single-family revenue bond financing at both the State and local levels increased total tax-exempt financing of housing to nearly $14 billion by 1980, accounting for roughly 30 percent of all municipal bonds sold—the largest single use of tax-exempt financing. In response to both mounting costs to the Treasury (in terms of forgone tax revenues) and use by some municipalities of tax-exempt funds to support neighborhoods and borrowers other than those most in need, the Federal government set limits and conditions on the issuance of single-family mortgage revenue bonds at the end of 1980. The Mortgage Subsidy Bond Tax Act of 1980 sets limits on the volume of tax-exempt financing of single-family housing that can occur within any State during the 1981–83 period, and forbids new issues of such bonds after the end of 1983. Moreover, the act imposes home price limits, requires that a portion of bond proceeds be used to finance mortgages in geographically targeted areas, limits eligibility to principal residences of first-time homeowners, restricts the assumability of the low-rate mortgages, sets limits on the differential between bond rates and mortgage rates, limits the portion of bond proceeds that can be set aside in reserve funds, and restricts the amount of profits that can be earned on funds held in reserve. Technical problems of compliance with the provisions of the Mortgage Subsidy Bond Tax Act, and the lack of appropriate authorizing regulations, caused issuance of single-family mortgage revenue bonds to decline sharply in 1981. Indeed, virtually no single-family housing bonds have been issued beyond those in process when the act was signed into law.

The Commission recognizes that the unchecked use of revenue bond financing (housing and nonhousing) by State and local governments to fund private sector investments can have an impact on capital allocation contrary to overriding national interests and can impose excessive costs on the Treasury and taxpayers in general. Thus, an examination of revenue bond financing in housing as well as in other sectors of the economy is in order. Accordingly, the Commission recommends the following:

The Administration should promptly bring to the appropriate cabinet council for thorough review the issue of private sector use of tax-exempt revenue bonds of all kinds and present to Congress an approach covering all categories of tax-exempt funding and/or specific options for more effective substitutes. Pending the outcome of the recommended study, State and local authorities should be allowed to issue mortgage revenue bonds, under the volume limits and targeting provisions of existing law. Moreover, the

technical problems associated with the Mortgage Subsidy Bond Tax Act ought to be addressed by the Administration so that mortgage revenue bond programs can be made operable.

The Commission acknowledges that considerable controversy exists regarding the relative effectiveness of tax-exempt revenue bonds as a way of stimulating the development of low- and moderate-income homeownership and rental housing. Many of the questions that remain to be answered about housing bonds apply as well to the use of tax-exempt revenue bonds for other private purposes. Accordingly, a comprehensive study of all types of revenue bond financing should be conducted.

The following discussion considers the costs and benefits of tax-exempt financing of housing, alternative ways of providing aid to low- and moderate-income homebuyers and renters, and ways to make current mortgage revenue bond programs operable.

Benefits and Costs of Tax-Exempt Financing

The past decade has demonstrated the housing production and finance capability of State and local governments. There is now in existence both a network of marketing channels for tax-exempt housing bonds and a corresponding set of institutional arrangements for using the bond proceeds in the production of multifamily housing for low- and moderate-income households and the financing of single-family homes. It is argued that this capability represents an important resource in the provision of housing, particularly in those local situations where additional housing is needed to facilitate the effective working of the consumer-oriented housing payments program discussed in Chapter 2. State and local governments, with their record of experience, generally are prepared to respond quickly to local problems, while the Federal government may require a longer period to react.

Tax-exempt financing of housing can provide a number of benefits. The primary benefit is a reduction in mortgage costs for homebuyers and developers of rental housing; a program targeted to marginal borrowers and neighborhoods can be a relatively effective way to provide decent housing for needy families. When tax-exempt yields are sufficiently below taxable yields, this type of financing permits significant reductions in monthly mortgage payments or rent levels necessary to support the debt service.[8] The lower costs, in turn, bring homeownership and new rental housing within the reach of more lower-income households than would otherwise be possible. Tax-exempt financing also has administrative advantages for State and local governments. It permits Federal subsidy of additional housing, where it is deemed important by those who know the local situation, without requiring that a Federal program, complete with Federal regulations and Federal review, be created for this purpose.

Tax-exempt bond financing of housing, however, also has a number of problems and costs. Tax-exempt financing is viewed by some as an inefficient and inequitable way to provide Federal subsidies to private market participants. It is argued that the loss in Federal tax revenues inevitably is larger than the reduction in borrowing costs enjoyed by State and local government entities as a result of the tax exemption; thus, a given housing objective could be met, with smaller costs to the Treasury, through direct Federal subsidies. Moreover, the excess cost to the Treasury inevitably represents a windfall gain to bondholders in the highest marginal income tax brackets. On these grounds, it is argued that a program of tax credits or direct subsidies generally is preferable to tax-exempt financing as a way to achieve a given policy objective.

In fact, the exact impact on Treasury receipts of tax-exempt housing bonds is difficult to estimate. Because this estimate depends on the spread between taxable and tax-exempt yields, as well as on the tax brackets and portfolio shifts by investors in tax-exempt bonds, different assumptions lead to different estimates. The Commission examined a wealth of studies and evidence that suggests a wide range of costs to the Treasury, and it is difficult to draw firm conclusions concerning the size of excess Federal expense associated with tax-exempt housing bonds.

Aside from costs imposed on the Treasury, issuance of mortgage revenue bonds places upward pressure on all tax-exempt interest rates, raising the general level of borrowing costs for municipalities. This effect can be substantial when large amounts of housing bonds are brought to the market. Restrictions on the volume of housing bonds, such as those contained in the Mortgage Subsidy Bond Tax Act of 1980, help to limit the impacts on the municipal securities market or other segments of the capital markets.

It is argued that the net impact of single-family mortgage revenue bond programs on mortgage lending and housing activity is much smaller than the volume of tax-exempt borrowing. The incremental impacts of revenue bond programs on the housing market are small when the beneficiaries of

[8] The relationship between tax-exempt and taxable bond yields can vary substantially over time and often is relatively narrow during periods of high market interest rates.

the programs would have purchased houses without the assistance.

Alternatives to Tax-Exempt Financing

The Federal government has a number of ways to lower the cost of housing for low- and moderate-income families. The principle of enlightened federalism adopted by the Commission suggests that lower levels of government should play some role in the management and design of such programs. For example, as an alternative to tax-exempt financing, State or local agencies could raise funds needed for mortgage finance in the taxable securities markets, lend these funds at below-market rates to mortgage borrowers, and use direct Federal subsidies to help meet interest payments to bondholders.[9] Alternatively, borrowers could raise mortgage credit in the private market and receive Federal subsidy payments channeled through the State or local agencies administering the programs. Borrowers qualifying for subsidy payments, of course, might find it difficult to arrange credit in the private market, unless they could obtain Federal mortgage insurance.

The taxable bond concept has several merits. Federal payment of interest rate subsidies to municipalities would provide for greater budgetary control than is possible under tax-exempt bond programs, because the depth of the subsidy can be established by the Federal government and can be changed when market conditions dictate. If there were a desire to stimulate housing production, for example, the subsidy could be set at a level higher than needed to bring the taxable-bond interest cost down to the level of tax-exempt instruments; similarly, a shallower subsidy rate could be established when desired. On the other hand, taxable bonds coupled with direct Federal subsidies may not prove to be a more efficient mechanism for lowering financing costs of low- and moderate-income housing. The appropriation of direct Federal subsidies may remove an element of State and local agency planning control over the timing and amount of bond issuances, and a direct subsidy program may involve higher administrative costs.

Making Programs Operable

Pending the outcome of the recommended study of revenue bond financing generally, State and local authorities should be allowed to issue mortgage revenue bonds under the volume limits and targeting provisions of the Mortgage Subsidy Bond Tax Act of 1980. Since the passage of the act, issuance of mortgage revenue bonds has been well below the volume limits that were established. Technical provisions in the act have been largely responsible for the low levels of activity.

In particular, the limits set on the spread between bond yields and mortgage rates have effectively prevented many potential issuers from operating programs that otherwise would have been financially feasible. The act specifies that the contract rate on mortgages purchased can be only one percentage point above the bond yield, and this margin must cover origination fees, servicing fees, underwriter discounts, and operating costs; the typical margin (arbitrage) prior to the act was 1.5 percentage points, and this margin did not have to cover the fees and costs now required as part of the calculation. Other technical problems include a requirement that mortgage revenue bonds be issued in registered form (unlike other tax-exempt bonds), ambiguities regarding the requirement that 20 percent of the proceeds from a bond issue be used in HUD-designated target areas, and the need for periodic verification of home price eligibility.

Reserve limits also have been a problem. The proportion of bond proceeds that initially can be allocated to reserves has been reduced below previous industry standards, and reserves must be reduced when mortgage prepayments occur. And whereas reserves previously could earn unlimited income, current requirements state that earnings on reserves in excess of coupon rates on mortgages must be paid to the Federal government or be remitted to mortgagors.

Further technical problems are related to cooperative and congregate housing. In the Mortgage Subsidy Bond Tax Act of 1980, shares in cooperative residences are included in the mortgages eligible for financing with single-family tax-exempt bond proceeds, but blanket project mortgages for cooperative residences were ignored. Since cooperatives represent a proven method for increasing homeownership opportunities for low- and moderate-income households, cooperative blanket project mortgages should be included in Treasury regulations for multifamily bonds. In addition, the definition of "congregate housing" needs to be clarified by the Treasury Department in order to qualify these projects for financing under mortgage revenue bonds. The Commission suggests the following definition of "congregate housing" under any mortgage revenue bond program:

- Community-based residential facilities for the elderly and handicapped which provide some supportive services, such as at least one meal for residents each day; eligible

[9] Taxable bonds alone do not offer lower interest rates unless backed by the full faith and credit of the issuing government, which has rarely been the case in housing.

buildings could include "non-self-contained" units, i.e., units without full kitchen or bathroom facilities, provided units can be owned or rented initially on yearly leases.

Delays in the implementation of Treasury regulations for single-family bonds, and the absence of regulations for multifamily bonds, also have impeded the issuance of housing bonds and have hindered evaluation of the effectiveness of the volume and targeting provisions of the act. The various technical problems that have depressed the volume of mortgage revenue bonds should be addressed promptly by regulation or legislation, as appropriate, so that the programs can be made operable.[10]

[10] On March 29, 1982, President Reagan announced the Administration's intention to make regulatory changes to enable State and local governments and agencies to issue a larger volume of mortgage revenue bonds within the volume limits of existing law. The regulatory changes would ease the arbitrage restrictions and broaden the targeting definitions.

Section IV:

GOVERNMENT REGULATION AND THE COST OF HOUSING

CHAPTER 13

INTRODUCTION: THE NEED FOR REGULATORY REFORM

Government regulations can have a substantial impact on the cost and availability of housing—a finding not new to Presidential commissions. More than a decade ago, the President's Committee on Housing (Kaiser Committee) and the National Commission on Urban Problems (Douglas Commission) both reached this conclusion. Despite these warnings and calls for reform, however, governments at all levels have continued to expand their regulatory control of housing.

The Douglas Commission focused on municipal land-use and building regulations, while the Kaiser Committee considered the effects of these regulations on the efficiency of the homebuilding industry and its capacity to provide affordable housing. Both panels accepted continuing land-use and building controls, but they were highly critical of municipal regulations that ignored regional needs, excluded lower-income families, or added unnecessary costs to housing.

A decade later, this Commission was confronted with an even larger array of regulations that directly or indirectly affect housing. State and local governments have increased their use of traditional land-use and building regulations while becoming more involved in other rulemaking that affects housing: environmental regulations and energy standards; State licensing requirements controlling entry into one of the construction trades; municipal use of special fees for on- and off-site development; growth management controls used to limit and channel development; and rent control and condominium conversion regulations.

The Federal regulatory presence—fed by grass-roots consumer, environmental, and energy movements—also increased dramatically during the 1970s. Nonhousing agencies—e.g., the Environmental Protection Agency, the Department of Agriculture, the Department of the Interior, the Consumer Product Safety Commission, the Federal Trade Commission, and the Occupational Safety and Health Administration—all promulgated regulatory policies that directly or indirectly affect housing costs. Regulation of lenders was extended through the Community Reinvestment Act, the Truth-in-Lending Act, and the Home Mortgage Disclosure Act. Congress increased the regulatory authority of the Department of Housing and Urban Development (HUD) through such programs as the Real Estate Settlement Procedures Act, the Manufactured Housing Contruction and Safety Standards Act, and Federal flood insurance (now administered by the Federal Emergency Management Agency).

This Commission reexamined the regulatory content of housing because of its concern about the rapid expansion of housing regulation and its effect on costs and production. In its deliberations, the Commission attempted to weigh three sets of housing-related interests—those of property owners, the community, and prospective residents.

This chapter describes these three regulatory interests and the shifts in balance that have occurred over time. It then reviews the early warnings of previous Presidential commissions and the results of hearings conducted by this Commission. Finally, it summarizes the need for regulatory reform by highlighting the costs of excessive regulation—reduced housing choices, constrained production, increased prices, and lowered productivity.

Regulatory Interests

Those who favor government regulation justify intervention on various grounds. Land-use regulation, for example, is viewed as a logical extension of the doctrine of nuisance developed as part of the English common law and incorporated into American jurisprudence. Obnoxious and incompatible land uses are harmful to the rights of adjoining landowners, and such uses may pose a substantial threat to the health and safety of the community. Regulatory proponents contend that the use of land can be chaotic and that regulation is necessary to bring order and stability. Regulation, it is argued, is also justified as a means of removing the excesses and limitations of the private market. Proponents generally see local regulations as a reflection of community values expressed through the democratic process—local citizens controlling their own environment.

But there are negative aspects to regulation. One of the most indefensible of these is its use in protecting special interests and denying access to others. Tradesmen or owners of homes or apartment buildings may benefit from regulations that are exclusionary in operation. Residents of a community can use regulation to protect their social environment against newcomers who might change its character; such regulation often is designed to exclude lower-income families. This kind of regulation pushes up costs unnecessarily for all and makes housing inaccessible in many locations for a growing number of Americans.

This nation was founded in part on strong beliefs about property rights and the need to protect these rights from excessive infringement by government. Yet each new regulation that shapes land-use and housing decisions limits the owner's use of property. From this perspective, the Commission views with some concern the proliferation of regulatory controls over recent years.

Where does one draw the line, if a line can be drawn, between permissible and impermissible regulation? What is the proper balance between private market activity and regulation? To answer these questions, one must consider three major sets of interests—those of developers and landowners, communities that wish to control development through regulation, and people who want to move into a new community.

Property Interests. Historically, regulatory restraints on private development often were designed to protect larger public interests—the health and safety of the community. In other words, an owner or developer could use his land as he chose so long as development did not create conditions that were unsafe, unsanitary, or obnoxious to his neighbors.

This historical predisposition for respecting individual property rights is found in the Constitution's Fifth Amendment assertion that private property shall not be taken for public use without just compensation and that a person cannot be deprived of property without due process. These protections were made applicable to the States through the Fourteenth Amendment.

Community Interests. During this century, however, government began to regulate land uses for a much wider range of purposes, reflecting a growing view that better community life could be achieved through planned development.

Zoning—introduced in 1916 as a policy for municipal land-use control—is now commonplace. In 1926, the Supreme Court upheld a municipality's right to control its own land use through zoning. Behind this landmark decision (*Euclid* v. *Ambler Realty Co.*, 272 U.S. 365) was the belief that legislatures—not the courts—should bear primary responsibility for settling conflicting land-use claims.

Municipalities have used this power to control the scale of development and to manage the process of growth. Zoning is used to protect residential neighborhoods from other uses, to control density and its impact on public services and neighborhood characteristics, to encourage commercial and industrial development by designating areas for such uses, and to ensure development consistent with long-range capital planning and efficient use of public resources. The *Euclid* decision allowed municipalities to assume much greater regulatory power over land use.

Prospective Residents. Families or individuals who want to move into a municipality also have a stake in how property is regulated. This has been a special concern for less affluent households, but rising housing costs and declining new construction have made it one for middle-income families as well. All citizens have a stake in the opportunity to move in and out of communities without artificial restriction. These interests did not receive prominent attention until the 1970s, when several State courts and legislatures acted to correct municipal regulations that failed to account for a municipality's fair share of the diverse housing needs of the region's population.

The relative influence of these three interests changes over time. Before the turn of the century, property rights and limited regulatory intervention by the community in the areas of health and safety were dominant values. In this century, the emphasis shifted from property rights toward dominance by community interests. Only recently have the rights of prospective residents become important. Proper-

ty interests, however, have not regained their former standing.

The Commission concluded that a reevaluation of the balance of these interests is long overdue, and the recommendations offered in this section of the report are aimed primarily at that objective. The Commission does not believe that the best interests of the community have to be sacrificed in crafting a rational regulatory policy that can serve all legitimate needs. Still, the priority of individual property rights needs to be reestablished, not only because it would surely have a salutary effect on housing production, but also because it would reassert a principle that has too often been abused or overlooked in the pursuit of other interests.

In its deliberations and conclusions, the Commission drew not only upon its own research and extensive hearings on housing regulation, but upon the pioneering work of individuals and groups that preceded this panel.

Early Warnings: The Douglas and Kaiser Panels

A benchmark for considering regulatory reform was 1968, when the Douglas Commission and Kaiser Committee issued their reports. At that time, more than 78 percent of all municipalities with a population greater than 10,000 had some form of land-use regulation. More than half had zoning ordinances, nearly 45 percent had enacted subdivision regulations, and almost half had a building code.[1]

Both panels found that some municipalities abused housing and land-use regulations, principally through overly restrictive zoning, subdivision requirements, and building codes. The most widely recognized abuse—exclusionary zoning—encompassed large-lot size restrictions, exclusion of multiple dwellings, imposition of minimum house-size requirements, and exclusion of mobile homes. By such devices, zoning authorities limited residential development to single-family residences on large-size lots, thereby reducing the total amount of housing available in a given area. The effect of restricted supply was to impose greater costs or locational constraints on the availability of housing.

By the late 1960s, some devices like large-lot zoning were commonly used to assert governmental authority over specific project planning and frequently were used as exclusionary techniques. By requiring rezoning in order to construct apartment units, zoning officials often could exercise tight control over a developer's plans by controlling density. Similarly, increased discretionary zoning authority by some local officials resulted in abuses and a shift in important land-use decisions from the developer to the local official.

Local officials who failed to account for regional concerns in their zoning ordinances were criticized for creating inefficient patterns of metropolitan development. Where such jurisdictions ignored the effects of their zoning practices on neighboring communities by excluding land uses they considered undesirable, the needs of the region as a whole were left unsatisfied. The Douglas Commission warned that continuing failure by local officials to exercise effective leadership in solving development problems inevitably will result in a reduction in the quality of urban environments.

The Douglas Commission and the Kaiser Committee found similar problems with local building codes. Lack of standardization in building codes, coupled with excessively restrictive codes in some communities, seriously affected construction costs and productivity in the housing industry. Local authorities were slow in accepting new products and technologies; the Douglas Commission attributed this problem to insufficient personnel and expertise, lack of uniform costs, and inadequate procedures for revising building codes to keep pace with the building industry.

The Kaiser Committee was more critical. It found that some communities imposed excessively restrictive codes to prevent the construction of low-cost housing, thereby denying local housing opportunities for lower-income groups. Industry and labor groups sought code restrictions to protect the market for their own products and skills. Finally, although building codes sometimes provided for the acceptance of new methods and materials at the discretion of appointed building officials, few officials were adequately trained to use this discretionary power.

In suggesting solutions, the Douglas Commission recommended greater centralization of land-use regulatory authority, reduction in incentives for fiscal and exclusionary zoning, fairer allocation of land-use costs between government and developer, and larger-scale development.

Venturing farther, the Kaiser Committee recommended that the Federal government preempt local zoning and other land-use regulations in controlling Federal construction projects and low-income housing development. It favored State review of local zoning ordinances to ensure that they did not interfere with satisfying the housing needs of metropolitan areas, and State adoption of uniform subdivision regulations that did not unreasonably add to the cost of housing. The Kaiser Committee found that "given the widespread abuses, and the

[1] National Commission on Urban Problems, *Building the American City* (Washington, D.C.: U.S. Government Printing Office, 1968), Part III.

need for low cost housing, local prerogatives should yield somewhat in this instance."[2] But unnecessary regulation has continued to grow since the Douglas and Kaiser panels warnings, giving cause for concern by yet another housing Commission over a decade later.

The Need for Regulatory Reform

In hearings held across the country, the Commission was told repeatedly that unnecessary regulations at all levels of government have seriously hindered the production of housing, increased its cost, and restricted opportunities for mobility. (See Methodology in appendix.) Some testimony, however, expressed support of regulation to achieve social (e.g., environmental) or economic (e.g., energy conservation) benefits. Nevertheless, the Commission believes that unnecessary regulation of land use and buildings has increased so much over the past two decades that Americans have begun to feel the undesirable consequences: fewer housing choices, limited production, high costs, and lower productivity in residential construction. Based on these hearings and other research and consultation, the Commission found that:

- Regulation can hinder the efficient operation of the marketplace by denying consumers a wide range of housing choices and denying owners and developers the freedom to use property efficiently;
- Overregulation has hampered the production of housing, particularly for people of average or lower income;
- Regulation has unnecessarily pushed up costs in some localities by as much as 25 percent of the final sales price; and
- Regulation often limits flexibility in housing construction, both by inhibiting the substitution of available materials, labor, land, and capital in response to changes in relative prices, and by impeding the rate at which new products and building systems can be introduced.

With these findings in mind, the Commission concluded that government should substantially cut back its regulation of housing to give freer play to the marketplace, leaving to government its traditional responsibility to protect public health and safety and other vital and pressing governmental interests. Regulatory reform and a more robust private market should provide greater housing opportunities not only for those living within the community, but for prospective residents as well.

Housing Choices

Government regulations can unnecessarily restrict housing choices by limiting locations where construction can occur, by driving up the cost of housing and thereby placing new housing beyond the financial reach of increasing numbers of people, and by arbitrarily placing absolute limits on the amount and type of housing built. Location limitations may arise from such land-use policies as zoning, growth controls, and farmland preservation policies, which either prohibit housing development in certain areas or direct growth away from some areas and into others. Prohibitions on multifamily housing or mobile homes restrict the choices available to consumers, as do requirements that multifamily housing include units with only a few bedrooms.

Owners are similarly denied the full use of their property as a consequence of these restrictions. While the Commission does not advocate unrestricted use of property in a way that is harmful to others, it is concerned that regulations impose unjustified restrictions on property interests.

Limited Production

Regulations, especially local ones, have inhibited the production of housing. Traditional zoning restrictions on density, lot sizes, and house sizes limit the amount of housing that can be built in response to market demand. Prohibitions on mobile homes and excessive limitations on multifamily housing deny or reduce the opportunity to obtain lower-cost housing.

More recent land-use policies likewise reduce production. Growth controls can limit the total number of new building permits allowed. Similarly, zoning solely for agricultural use excludes land from housing development. Rent control, too, is a municipal regulation that limits production of rental housing by discouraging private investment.

Federal regulations also act to limit production. Environmental regulations may unduly prohibit construction in certain floodplains or wetland areas. Federal farmland policies that restrain the use of Federal programs to convert farmlands to other uses may lead to more extensive agricultural zoning at the local level.

Increased Costs

Housing costs rose dramatically during the 1970s. Over the decade the average cost of a new single-family home rose from $23,400 to $64,600, an increase of 176 percent, while at the same time, the Consumer Price Index (CPI) rose only 112 percent. As shown in Table 13.1, the various components of new home construction all increased at rates faster than the CPI with the greatest increases in the areas

[2] The President's Committee on Urban Housing, *A Decent Home* (Washington, D.C.: U.S. Government Printing Office, 1969), p. 144.

Table 13.1
Approximate Cost Breakdown for New Single-Family Homes

	1970		1980		Percent Change 1970–80
	Cost	Percent	Cost	Percent	
Land	$4,450	19%	$15,500	24%	248.3%
On-site labor	4,500	19	10,350	16	130.0
Materials	8,650	37	22,000	34	154.3
Financing	1,600	7	7,700	12	381.3
Overhead, profit, other	4,200	18	9,050	14	115.5
Total	$23,400	100%	$64,600	100%	176.1%

Source: Merrill Lynch, Pierce, Fenner and Smith, "Housing Industry", a Merrill Lynch Basic Report, January 1982, p. 28.

of land and financing. While this increase was due to many factors, increased regulation played a large role.

Excessive regulation raises housing costs by restricting available land, imposing unnecessary requirements in site development and construction standards, and lengthening the time needed to obtain regulatory permits. Many studies have examined the impact of governmental regulations on the costs of single-family homes, and a number of these will be discussed in later chapters. Although the cumulative effect cannot be precisely determined, all the studies have a common finding: regulations increase costs—as much as 25 percent of the selling price in some cases.[3]

Governmental land-use constraints that limit the availability of land for housing development drive up costs. A 1981 analysis of residential land prices in various metropolitan areas found that the cost of lots was significantly affected by the degree of regulatory restrictions.[4] Other studies reached the same conclusion: Zoning and density restrictions directly affect the per-unit cost of land.[5]

Site-development standards that prescribe how land must be improved (i.e., street widths, curbing, sewers, water mains, street lighting, and sidewalks) are another potentially costly element of housing construction. In a 1976 survey of 2,471 builders and developers, builders estimated that subdivision requirements above and beyond commonly accepted industry standards accounted for more than 5 percent of the average total selling price.[6] The General Accounting Office (GAO) in 1978 surveyed 87 communities and found that changing 17 common site-development standards would not be harmful and would result in an average saving of $1,295 per home (2-3 percent of new-home prices at that time).[7]

Various municipal fees beyond the cost of providing services are sometimes imposed on developers as a way of generating governmental revenues. Fees for permits, inspections, and utility tap-ins can be substantial. In the 87 communities surveyed by GAO in 1978, the median cost of fees was about $930 per home (ranging from a low of $56 to a high of $3,265).[8] In some localities the rise in fees has been dramatic. In one 8-year period, fees and taxes paid by a San Jose, Calif., builder rose from $314 to $1,880 per unit.[9] In the Livermore, Calif.,

[3] Specific studies include: U.S. General Accounting Office, *Why Are New House Prices So High, How Are They Influenced by Government Regulation, and Can Prices Be Reduced* (Washington, D.C.: U.S. Government Printing Office, May 1978) (subdivision regulations add 3 percent and fees add 5 percent); Urban Land Institute and Gruen, Gruen, and Associates, *Effects of Regulation on Housing Costs: Two Case Studies* (Washington, D.C.: Urban Land Institute, 1977) (growth controls add 7 percent); and *Housing Cost Reduction Demonstration* (Washington, D.C.: U.S. Department of Housing and Urban Development, December 1980) (modification of code requirements, density increases, and permit processing time reduces costs by 21–33 percent). For a general review of cost studies, see Gary Hack and Greg Polk, "Housing Cost and Governmental Regulations: Is Regulatory Reform Justified by What We Know?", unpublished preliminary draft (Cambridge, Mass.: Joint Center for Urban Studies and the Lincoln Institute for Land Policy, May 8, 1981).

[4] J. Thomas Black and James E. Hoben, editors, *Urban Land Markets: Price Indexes, Supply Measures and Public Policy Effects* (Washington, D.C.: Urban Land Institute, 1980).

[5] Lynn Sagalyn and George Sternlieb, *Zoning and Housing Costs* (New Brunswick: Center for Urban Policy Research, 1972). Michael Gleason, "The Effect of an Urban Growth Management System on Land Values" (Minneapolis: Hubert Humphrey Institute, University of Minnesota, Working Paper No. 4, Monitoring Growth Management System Project, 1978). George Peterson, *The Influence of Zoning Regulations on Land and Housing Prices* (Washington, D.C.: Urban Institute Working Paper No. 120–124, July 1974).

[6] Stephen Seidel, *Housing Costs and Government Regulations: Confronting the Regulatory Maze* (New Brunswick: Center for Urban Policy Research, 1978).

[7] U.S. General Accounting Office, *op. cit.*

[8] *Ibid.*

[9] Urban Land Institute and Gruen, Gruen, and Associates, *op. cit.*

area, a municipal fee structure in the $300 range in 1972 increased to $4,400 per house by 1979.[10]

Costs generated by excessive building-code standards often can be very high. Though most research indicates savings of 1.5 percent to 3 percent if capital-intensive technologies were introduced and housing could be produced for a national market, one study claimed a potential cost reduction of 8 percent.[11] GAO examined 64 building materials or practices for which there were more cost-effective alternatives. It found a median savings of $1,741; other savings ranged from none in two places to a high of $7,327 in another.[12]

The adage that "time is money" is especially true for developers in times of high interest rates. Substantial carrying costs can accrue from the time a developer secures the land until the developed site is finally sold or occupied. The delay may lead the developer to build the costs of uncertainty into the price of the project.

The number of agencies, levels of government, and officials involved in the permit process has multiplied as citizens concerned about the environment or local taxes have taken a more active role in the regulatory process. GAO estimated the average length of time for residential project approval in its 87 sample communities at 7½ months, with a range from 4 months or less in about one-third of the communities to more than 18 months in a few.[13] The Commission received testimony that in some California cities, permit approvals can take up to three years. Increased regulation requires more approvals and more agencies to visit for approval, a point repeatedly made to the Commission. The resulting delay imposes heavy costs in any era of inflation.

Productivity

Nobody knows the precise numbers,[14] but there is general agreement that construction productivity is low, with residential productivity generally lower than that of industrial or commercial construction. Data suggest that there has been little or no improvement in residential construction productivity in recent years.[15]

While severe swings in housing cycles are a primary cause of productivity problems in residential construction, this problem is exacerbated by the fragmented and counterproductive regulatory structure. Even though precise effects are not easily measurable, there is no doubt that regulations can impede the ability of builders to pursue actions traditionally associated with increased efficiency and productivity. Regulations impede the ability of entrepreneurs to substitute materials, labor, and capital in response to relative changes in factor prices. For example, developers cannot rapidly respond to rising land costs by substituting less land (below the minimum lot size) or using land not zoned for housing development. Similarly, builders faced with high interest rates will seek ways of reducing the construction time in order to save cost. However, if regulatory policies—e.g., prohibition on mobile homes or restrictions on pre-assembled components—deny the use of time-saving technologies, productivity suffers.

The regulatory structure itself—organized around local building codes—often effectively restricts successful innovation to individuals and firms with enough money and tenacity to overcome the regulatory strictures. Because competition often is restricted by the regulatory structure, consumers have fewer new products from which to choose.

Housing cycles cause the industry to organize along subcontracting lines that in turn lead to a regulatory network not conducive to productivity. When an economic downturn forces experienced builders from the market, many do not return. New upturns bring in inexperienced (and thus less efficient) builders, and productivity is further damaged. To protect themselves, builders and others in the residential construction business subcontract the bulk of their work to specialty firms, thereby minimizing the capital investment each must carry. However, during a downturn, builders will preserve work for their own employees by on-site construction rather than by purchase of factory-assembled components.[16] Subcontracting not only denies the building firm much of the efficiency that comes with direct management of the entire production process; it also fosters an industry of relatively small firms.[17] The result is that homebuilders do not

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[10] Bernard J. Frieden, *The Environmental Protection Hustle* (Cambridge, Mass.: Massachusetts Institute of Technology Press, 1979).

[11] Charles G. Field and Steven Rivkin, *The Building Code Burden* (Lexington, Mass.: Lexington Books, 1975).

[12] U.S. General Accounting Office, *op. cit.*

[13] *Ibid.*

[14] See, e.g., *Business Week*, "A Productivity Drop That Nobody Believes" (Feb. 25, 1980), pp. 77–80; Clint Bourdon, "Is Construction Productivity Declining?" (Cambridge, Mass.: Joint Center for Urban Studies Working Paper, 1981).

[15] American Productivity Center, *Productivity Perspectives* (Houston, Texas: 1981), p. 6. John M. Quigley, "Residential Construction and Public Policy: A Progress Report," in Richard Nelson (ed.), *Government and Technical Change* (Elmsford, N.Y.: Pergamon Press, 1982).

[16] For extensive discussion of the impact of housing cycles, See Mark A. Willis, "The Effects of Cyclical Demand on Industry Structure and the Rate of Technological Change: An International Comparison of the Housebuilding Sectors in the U.S., Great Britain, and France" (New Haven, Conn.: Economics Ph.D. Thesis, Yale University, 1979).

[17] See Michael Sumichrast *et al.*, *Profile of the Builder* (Washington, D.C.: National Association of Homebuilders, 1979).

benefit from many economies of scale compared to other manufacturing sectors.

Subcontractors in turn attempt to reduce their own vulnerability through specialization. Plumbers, carpenters, or electricians can divert these skills to other construction work when new home construction slackens. However, changes in technology that alter the distribution of work among subcontractors will be resisted. Not surprisingly, innovations in home construction tend to come within the confines of the separate specialties.

The subcontracting system has spawned a regulatory network of specialty codes and licensing requirements. While these codes and requirements serve health and safety goals, they may also serve the desires of those in the specialty trades to control what work is done and by whom. Local special interests tend to influence the content of local codes and the enforcement process and also to capture the local or State bodies responsible for licensing plumbers, electricians, and other specialized subcontracting specialties. Because of the fragmentation of these regulations and the nature of controlling, narrow interests, comprehensive reform of the regulatory structure will be difficult.

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The record of regulation over the past decade suggests that the dominance of parochial interests has restricted both development and choice and has raised costs. The balance should be shifted; instead of more regulations, we need fewer.

The Commission believes that the marketplace is often a better mechanism than public regulation for determining what housing should be built and where. Like other successful entrepreneurs, builders and developers have to be proficient at their trades. They must build a competitive product that consumers want and can afford. They have to use the land efficiently.

The competitive market seeks to satisfy a wide range of consumer preferences and choices—a role not traditionally assumed by government. They must consider a myriad of consumer preferences about neighborhood location, space needs, proximity to work, school or recreational facilities, and energy efficiency, among many other considerations. Because builders specialize in order to serve particular segments of the market, they can respond to individual consumer needs more ably than government, which is inherently less flexible.

This is not to say that the private marketplace is infallible or that self-interest does not sometimes fail to accommodate the larger interests of the community. Nor does it suggest that government always causes inefficiencies. Government does have a regulatory role when marketplace actions jeopardize vital and pressing governmental interests, both current and future. The Commission's view, however, is that the balance should shift to allow the free operation of the housing market to better serve the common good.

A sweeping revision of the regulatory process will be required to achieve this. The following chapters map the scope of reform needed at each level of government and for every facet of housing affected by regulation.

Because Federal housing regulation has grown so rapidly during recent times, its effects on the production and availability of housing are not fully known. The Commission is convinced, however, that much regulation is redundant because of State, local and private-sector efforts. Moreover, there is little coordination or concern (in cases of housing-related regulations) for the impact of Federal regulation on the cost or availability of housing. The reasoning behind these conclusions and recommendations for specific reform of the Federal regulating process are discussed in Chapter 14.

Obviously, government entities closest to the community are best able to tailor regulatory policies to meet their housing needs. State and local regulation has grown beyond its appropriate role.

The Commission recommends that State and local governments limit their regulatory involvement in zoning decisions to actions that are justified by a vital and pressing governmental interest, a more restrictive standard than the one now used by the courts. Whether that standard should be changed by judicial decision is discussed in Chapter 15.

As discussed in Chapter 16, the marketplace and private standards groups are increasingly providing effective substitutes for Federal government-generated standards. Building codes and other regulations at the State and local level continue to impose unnecessary housing costs, primarily because of significant variations from locality to locality and the need for further improvement in the professionalism of code officials. Therefore the Commission recommends that governments at all levels rely on appropriate private-sector standards and model codes and ensure that all government building regulations are current, professionally administered, and uniformly applied across jurisdictional lines.

Needed deregulation will not occur unless a concerted effort takes place at all governmental levels. Chapter 17 explores the various barriers to the implementation of deregulation and sets forth a number of steps designed to create and maintain momentum for change. It also identifies promising public and private initiatives already under way.

CHAPTER 14

FEDERAL HOUSING REGULATION

Federal regulation of homebuilding has proliferated during the past two decades with little regard for the effects of regulation on the cost and availability of housing. As a result, housing availability has decreased and costs have escalated dramatically.

The need for fewer regulations seems clear. Federal agencies should impose only those regulations that implement a statutory mandate or protect vital public interests like health and safety. Of course, some regulations are required to meet legitimate Federal obligations and to keep pace with the growing complexity and interdependence of the economy and governmental institutions. Too many Federal regulations, however, are vague and evasive, reflecting compromises designed to accommodate all housing-related interests but satisfying none. New, more reasonable Federal guidelines are needed in place of these.

This chapter examines four broad areas of Federal regulation: environmental programs, real estate and mortgage disclosure, other housing-related regulations, and general regulatory reform. Although an exhaustive study of any one of these issues was beyond the resources of the Commission, the scope of the regulatory problem and the need for reform are stressed in each instance.

ENVIRONMENTAL RULES

The mid-1960s marked the beginning of a strong environmental movement sparked by public concern about the long-term effects of public and private actions on the country's limited natural resources. Elected officials were responsive, and the Federal government's lead in enacting and supporting environmental protection legislation was soon echoed by State and local governments.

Not all these laws were defensible on their own terms, and those that were often had unfortunate—if unwitting—effects on the economy in general and the housing construction industry in particular. Housing production and environmental protection are both inarguably important national objectives. Yet, the former is too often unnecessarily constrained by the latter. Government must construct a new balance to ensure a legitimate role for housing development. In particular, land-use regulations promoting environmental objectives should not be allowed if they limit housing production, except where they are necessary to achieve a vital public interest.

Environmental regulations affect the cost of housing in several ways. In some cases, land is removed from development, thereby driving up the cost of remaining developable land. A further consequence can be the effective exclusion of lower-income groups. In other cases, the manner in which land is developed is heavily regulated in terms of development density and infrastructure requirements, such as street and water supply. Finally, the process whereby proposed development is reviewed for conformance with environmental statutes and regulations is often protracted, resulting in project changes or time delays that add major costs, especially during periods of high interest rates.

Thus, legislative controls and restrictions of residential housing development—in the interest of environmental quality, coastal protection, or reduced density in areas deemed to be sensitive—often inflate real estate and housing costs and exclude lower-income groups.[1]

Recommendations are made in the following major areas of environmental regulation affecting housing construction: duplicative general requirements, wetlands, environmental impact statements,

[1] See Tom Bethell, "No Growth-No Vacancies," *Regulation* (July/August 1981), pp. 13, 15.

local area certification, floodplain regulation, coastal barriers, and flood insurance.

Duplicative Environmental Requirements

The Administration should eliminate overlapping Federal and State environmental permit and compliance requirements, develop procedures for permit coordination, and eliminate the necessity for complying with both the National Environmental Policy Act and comparable State environmental policy acts.

Among the more important laws or executive orders affecting housing development are the National Environmental Policy Act; Flood Disaster Protection Act of 1973; Executive Order 11988, Flood Plain Management; Executive Order 11990, Protection of Wetlands; the Coastal Zone Management Act of 1972; the National Historic Preservation Act of 1966; the Endangered Species Act of 1973; the Clean Water Act; and the Clean Air Act. The Commission urges the Administration to coordinate procedures to limit processing delays and unnecessary data collection in enforcing such Federal environmental requirements.

Some States and localities have taken steps to shorten their environmental permit process, to insert more predictability into decisionmaking procedures, and to eliminate unnecessary data collection or duplication. Methods used include bringing developers together with agency representatives at the start of the process, identifying common data requirements, and highlighting difficult issues. Centralized processing of multiple Federal permit requirements is likewise appropriate.

With the passage of the National Environmental Policy Act (NEPA) in 1969, a formal regulatory process was established to review the environmental effects of Federal actions. Following the Federal lead, State environmental protection acts (SEPAs) also establish regulations that affect housing. As a result, developers must comply with both NEPA and SEPA regulations, which may be essentially the same. When developers assume off-site infrastructure responsibilities (roads or wastewater treatment, for example), multiple Federal and State requirements must be met. Complying separately with each process can result in costly delays due to internal agency review periods and public hearings. Only one procedure should apply when a project must comply with both NEPA and substantially similar State rules.

Wetlands

Congress should amend Section 404 of the Clean Water Act and limit its application in the case of housing development to Phase I and II waters, as defined in 1975 by the U.S. Army Corps of Engineers. Furthermore, the Federal government should ensure the same interim result administratively by issuing a general permit by the Corps of Engineers. As a related matter, the government should accelerate its mapping and inventorying of related wetlands and place greater reliance on State and local permitting.

The nation's wetlands are protected as an important environmental resource under Section 404 of the Clean Water Act. The U.S. Army Corps of Engineers' regulatory program, which controls the dredging and filling of wetlands, has resulted in constraints on land available for housing, as well as serious delays in the development of new housing in many areas. Program reforms are necessary to reduce the overly expensive coverage—and resulting cost burdens—that Section 404 compliance now imposes on housing development.

Some 19,000 permit requests were received in fiscal year 1981 by the Corps of Engineers (no separate housing tally was made). About 69 percent of these were noncontroversial and were processed within 70 days; the others took an average of 252 days. Applications requiring environmental impact statements (EIS) took an average of two and a half years.

The Clean Water Act defines wetlands in terms of "Navigable Waters" that have been defined to include streams three feet wide by two feet deep. In arid western areas, some 10,000 natural depressions known as "playa" lakes fill with water only after a rainfall, yet are now subject to the Section 404 process; many of these "navigable waters" have no outlet, are privately owned, and are used for agricultural purposes.

In the case of proposed housing development, the jurisdiction of Section 404 regulations should be restricted to (1) Phase I waters—navigable waters of the United States plus adjacent wetlands, and (2) Phase II waters—primary tributaries and adjacent wetlands and natural lakes of more than five acres.[2] The Commission's recommendation would remove Phase III waters—all other waters, including mudflats, sandflats, sloughs, prairie potholes, wet meadows, playa lakes, or uncovered natural ponds—from Section 404 authority, thus focusing Section 404 regulations on bodies of water and wetlands that are of more legitimate concern to water quality.

[2] For purposes of the Clean Water Act, the definition of "navigable waters" is "waters of the United States," which is defined in the code at 40 CFR Section 122.3. Phase I, II and III waters are defined at 33 CFR 209.120(e)(2)(i)(a.), (b.), (c.), July 25, 1975.

As an interim step, the Commission urges the Corps of Engineers to issue a general permit as quickly as possible for housing developments located in areas defined to be in Phase III waters. This action would allow development in these areas without securing an individual permit for each proposed development, but would obligate a developer to meet the requirements specified in the general permit.

The Commission also urges the Environmental Protection Agency (EPA) and the Corps of Engineers to map Section 404-related wetlands, based on the development of a working definition that can be readily understood and applied in the field. EPA also should provide States with program incentives to assume greater responsibility in administering the 404 program. Finally, EPA should develop memoranda of understanding with States to allow them to assume responsibility for the 404 program.

Consistent with all these concerns, the Commission recommends a full review of Executive Order 11990, which establishes wetland development policies.

Environmental Impact Statements

The Department of Housing and Urban Development should raise the threshold for an environmental impact statement to 2,500 dwelling units or lots and use two-stage review processes to limit the necessity for an EIS where an environmental assessment or public response to HUD notice indicates an absence of significant environmental issues.

The National Environmental Policy Act requires an evaluation of the impact of Federal actions on the environment. Depending on their size, housing projects are subject either to an environmental assessment statement or an environmental impact statement. An assessment is a qualitative analysis by HUD of the possible environmental effects; it may result in (1) no action, (2) mitigation to avoid environmental effects, or (3) a full EIS. No public notice and comment are required. The more expensive and time-consuming EIS, by contrast, is a formal analysis conducted by HUD (but carried out by the builder) and subject to public comment.

To limit the number of housing projects requiring EIS, HUD and State governments have increasingly established thresholds based on project size or site characteristics, and two-stage preliminary assessment processes. Thresholds can be implemented through qualitative or quantitative standards, the latter specifying a number of housing units triggering EIS requirements. Although quantitative standards are less flexible than qualitative standards in considering local factors, they are easier to administer and provide more certainty as to whether developers must file an EIS.

In addition to quantitative thresholds, the applicability of environmental impact statements can be further limited through a two-stage qualitative assessment process. This involves a preliminary analysis to determine the significance of the environmental impact, and precludes the necessity for the EIS process when an environmental assessment or public response to a HUD notice indicates an absence of significant environmental issues.

A HUD staff analysis of EISs indicated that housing projects with fewer than 2,500 units generally create marginal environmental impacts and could be adequately addressed by environmental assessment statements. Raising the threshold for full EIS review from 500 to 2,500 dwelling units or lots thus could reduce both costs and time for a developer without sacrificing environmental quality. Use of the 500-unit threshold already has reduced the number of Federal housing projects for which EIS are required. According to an internal HUD study, when quantitative thresholds are combined with a two-stage assessment process, the number of EISs required is reduced dramatically. A review of 40 environmental impact statements prepared between fiscal years 1979 and 1981 showed that a 2,500-unit threshold eliminated the need for 16 EIS, and a first-stage assessment eliminated the remaining 24.

Local Area Certification

HUD should improve and expand its use of the local area certification procedure as an alternative to project-level assessments and/or environmental impact statements.

HUD's NEPA environmental review responsibilities can be assumed by local jurisdictions if they qualify under HUD's local area certification procedures. Thus, the EIS process is not required of a proposed project located in a certified community. Instead, local assessement procedures govern.

To qualify, local procedures must be judged by HUD to be compatible with HUD's procedures. This determination takes into account 35 different criteria, ranging from zoning and subdivision controls to a variety of environmental conditions. By December 1981, 150 communities had been certified.

Expanded use of Local Area Certification would prove beneficial by limiting the number of EISs required for housing projects and shifting responsibilities from the Federal government (principally HUD) to local jurisdictions. Expansion of the certification process may necessitate technical assistance for jurisdictions that are interested in

receiving certification but require help in developing or improving their procedures.

Floodplain Management/Flood Insurance/Coastal Barriers

Developing floodplains and coastal barriers can be very costly. For years, the Federal government's flood policy was directed at building flood-control structures and providing disaster assistance to enable property owners to rebuild and repair their flood-damaged homes. Average flood losses were estimated in 1975 to be more than $2.2 billion, and best current estimates indicate that flooding causes more than $3 billion in property damage per year throughout the United States. Federal disaster assistance for all forms of natural hazards has exceeded $1 billion each year.[3]

In response to flood disasters and subsequent Federal relief payments, Congress enacted a national flood insurance program intended to decrease flood damage by two means: (1) the use of proper construction in flood areas, determined to be the 100-year floodplain, in return for federally subsidized flood insurance; and (2) restrictions on new development in high-risk areas of the 100-year floodplain.

Revising Floodplain Regulation

Existing floodplain management regulations and construction standards should be revised, consistent with the overriding need to protect Federal investments and human safety, to be more sensitive to local variations in flood risk and to economic considerations attendant with compliance.

Congress enacted the National Flood Insurance Act (NFIA) in 1968 to meet the costly Federal burden of providing relief to victims of floods by instituting a subsidized insurance program.[4] NFIA requires participating communities to adopt zoning or building codes to reduce or avoid flood damage through local floodplain management standards for new construction. Participating local governments must require builders to certify that proposed buildings will be anchored to prevent collapse and flotation and will be designed to resist flood damage.

For the purposes of implementing the insurance coverage sections of the act, the 100-year floodplain standard was established, based on then-current knowledge and experience. Under this standard, insurance coverage is limited to those areas that have a 1 percent or greater chance of flooding in a given year.

The Federal Emergency Management Agency (FEMA)—the administering agency—provides formal designations and maps to implement the 100-year floodplain standard. Until FEMA has completed mapping the 100-year floodplain areas, participating communities determine flood-risk elevations.

About 17,000 communities participate in the National Flood Insurance Program. Of these, some 10,000 have not undergone FEMA mapping; although their insurance rates are subsidized, coverage is limited to $35,000 per property. In the remaining 7,000 communities, FEMA maps and designations have been completed and actuarially based insurance rates have been established based on FEMA maps; additional insurance coverage up to $185,000 is permitted for a single-family residence.

It can take up to four years to determine and map 100-year flood elevations within a community. The methodology used in the mapping may underestimate or overestimate the 100-year floodplain elevations; these discrepancies in flood-risk estimates can limit or prohibit housing development in certain areas or require construction to fulfill flood-loss mitigation standards at extra cost.

For these reasons, the 100-year floodplain standard should be reevaluated and revised, where appropriate, to take into account water height, velocity of flow, frequency of flooding, quality of flood water (sediment and debris), historical flood-loss experience, socioeconomic costs (both in terms of damage and of removal of land from development), and maximum average annual damage (expressed as a percentage of property improvements value) that may be expected in a particular area.

New restrictions based on an acceptable level of flood damage to structures would be preferable to the 100-year floodplain standard. Though difficult to formulate, such a risk-based approach would be more sensitive to changes in potential for flooding as a result of land-use changes. This issue should be reviewed by the Vice President's Task Force on Regulatory Relief, with special consideration to the costs and benefits of using alternative standards.

Review of Executive Order 11988

The Vice President's Task Force on Regulatory Relief should designate Executive Order 11988 for review and revision. Revisions should establish a workable definition of "acceptable risk," allow for local variability and take into account the socioeconomic costs and benefits of occupying floodplains.

In 1977, President Carter issued Executive Order 11988 to curtail Federal support of develop-

[3] Data supplied by the Federal Emergency Management Agency.

[4] Title XIII of the Housing and Urban Development Act of 1968, PL 90–448.

ment in the 100-year floodplain. The order directed all Federal agencies "to avoid to the extent possible the long- and short-term adverse impacts associated with the occupancy and modification of floodplains and to avoid direct and indirect support of floodplain development wherever there is a practicable alternative" outside of the floodplain area. HUD has estimated that between 5 percent and 10 percent of its projects are located in flood hazard areas.

HUD's proposed regulations implementing the executive order (24 CFR Part 55) set less stringent requirements than those set forth in the U.S. Water Resources Council Floodplain Management Guidelines and followed by the Council on Environmental Quality and FEMA. Since August 1979, HUD's policy has been not to deny automatically assistance for properties or projects located in flood hazard areas if there are alternative ways of protecting the property within the floodplain area, even though there are practicable alternatives outside the floodplain. Clarification therefore is needed.

The policy of denying development within a floodplain when practicable alternatives exist outside places an overly severe restriction on housing development, when such development can safely proceed within the floodplain. The development of a working definition of "acceptable risk" that considers local variations, as well as socioeconomic costs and benefits of occupying floodplains, is important if the imposition of a rigid national standard is to be avoided. Because acceptable risk will vary under different circumstances, the introduction of flexibility into the working definition would achieve the established national purpose yet demonstrate sensitivity to local conditions.

Coastal Barriers

The definition and delineations of the undeveloped coastal barriers by the Coastal Barriers Task Force of the Department of the Interior should be changed, consistent with the overriding need to protect Federal investments and human safety, to allow for increased sensitivity to uses of coastal property already approved at the local level and to the suitability of the area for development.

The Omnibus Budget Reconciliation Act of 1981 established a new Section 1321 of the National Flood Insurance Act of 1968 that prohibits the sale of Federal flood insurance for new construction or substantial improvements of structures located on "undeveloped coastal barriers" after September 30, 1983. This action was intended, in part, to minimize Federal financial exposure in areas not suited to development and subject to frequent flooding.

The statutory definition of coastal barriers by the Interior Department includes barrier islands, barrier spits, bay barriers, and tombolos. Delineations of coastal barriers are, for the most part, straightforward and noncontroversial, but in some cases even professional geologists disagree over the classification of specific areas.

Opponents of Federal flood insurance for undeveloped coastal barriers point out that coastal barriers are unstable, erosion-prone, vulnerable to devastation by storms and hurricanes, and act as a buffer for adjacent mainland areas. They contend that prohibition of Federal flood insurance will result in significant savings to taxpayers; tax dollars should not be used to develop areas that are difficult to evacuate and continually face heavy losses of lives and property. Indeed, the probability of any 50-mile stretch of the Atlantic or Gulf of Mexico coasts sustaining a direct hit by a hurricane is one year in ten. Opponents would have private industry—not the Federal government—be the appropriate source for insurable risks on coastal barriers.

Proponents of Federal flood insurance for barrier islands claim that the prohibition of insurance will not result in tax savings, that the 1981 act does not reflect variations in the susceptibility of different coastal barriers to flooding or their suitability for development, and that the prohibition is insensitive to communities that already have approved development projects. They argue that the prohibition allows no mechanism by which local communities can appeal designations of undeveloped coastal barriers. For example, appeals would be appropriate for areas developed before October 1, 1983, and for those not subject to unusually high risk due to flooding. Finally, they point out that many environmentally sensitive coastal developments already exist.

In August 1982, the Interior Department is to report to Congress on its designations of areas as undeveloped coastal barriers and to make any recommendations for changes to the coastal barrier provisions. To the extent that the present definitions of "undeveloped coastal barriers" include areas suitable for development in an environmentally sound manner, the Department should seek amendments to alter this result.

In view of the above disagreements, Congress, after receiving the Interior Department report, should evaluate the prohibition's potential impact on coastal developments, weigh the potential risk to the Treasury and to human safety and property, and modify definitions and delineations of undeveloped coastal barriers, as appropriate.

Private-Sector Insurance

The Federal Insurance Administration should continue to develop a program whereby the pri-

vate insurance industry can assume responsibility for servicing and eventually assume the risk of underwriting flood insurance.

The Federal Insurance Administration has been considering alternatives to the Federal flood insurance program. One involves development of a new rating structure for flood insurance that complements and conforms to private industry standards and places flood insurance rates on an actuarially sound basis. To be actuarially sound, a flood insurance program must have a rate structure that places the financial burden equitably according to the level of risk due to the location, type, and construction of the structure insured and the type of flooding likely to occur.

During a public hearing of the Commission, private insurance representatives indicated that the industry would not be interested in providing flood insurance protection on a risk-sharing basis unless an actuarially sound program were established with rates assessed commensurate with the risk of damage and with appropriate flood-management measures to mitigate damage at the local level. They said that the industry's experience under the earlier cooperative public/private insurance program was such that the industry did not want to assume any risk responsibility for flood insurance.

The Federal Insurance Administration also is considering development of a program that allows private insurers to service the Federal flood insurance program until actuarially sound rates and standards are established.

REAL ESTATE/MORTGAGE DISCLOSURE LAWS

The Community Reinvestment Act (CRA), the Home Mortgage Disclosure Act (HMDA), and the Real Estate Settlement Procedures Act (RESPA) were enacted in the mid-1970s during a period of Congressional concern over consumer protection and neighborhood and community vitality. Although these laws have undergone piecemeal revision, enough time has now passed to reexamine the costs and benefits of the laws thoroughly with the view of reducing the regulatory burden while maintaining appropriate benefits.

HMDA and CRA

Upon receipt of the report of the Federal Financial Institutions Examination Council,[5] Congress and the appropriate regulatory agencies should review the approach and structure of the Home Mortgage Disclosure Act and the Community Reinvestment Act and compare the benefits derived from these laws with the burdens they impose on depository institutions.

In the 1970s, concern for the vitality of urban neighborhoods engendered fears that inadequate and discriminatory mortgage lending was responsible for neighborhood decay. That led Congress to pass two laws affecting mortgage lending—the Home Mortgage Disclosure Act of 1975 (HMDA) and the Community Reinvestment Act of 1977 (CRA).

HMDA requires depository institutions to prepare annual summaries, by census tract, of mortgage loans made or purchased. Citizen groups had complained that lending patterns were difficult or impossible to compile from existing sources, yet these patterns were considered essential for evaluating the performance of a lender. The information was said to be especially useful in revealing whether a lender was "redlining"—that is, unfairly discriminating against—the areas where depositors lived.

CRA requires that whenever regulatory agencies examine regulated institutions, or evaluate requests for actions such as new branches or mergers, they must consider the applicant's record of "meeting the credit needs of its entire community, including low- and moderate-income neighborhoods." Depending on the policy of the particular agency, an unfavorable evaluation could result in conditional approval or even denial of the application.

There is no doubt that HMDA achieved the basic Congressional goal. For the first time, learning in which areas a depository mortgage lender has made or purchased mortgages has become a relatively simple process. If redlining were defined as "making no mortgages in an area," HMDA could detect such action by a lender. However, collecting data on loans made by an individual lender may not accurately detect redlining. A lender's records by census tract of mortgages made or purchased do not reveal why few loans were made, if that is the case. Has the lender received many applications and denied most of them, or were few applications received? If the latter, were there few home sales or did the applications go to other lenders? If they went to other lenders, was it because the first lender prescreened or otherwise discriminated, or did other

[5] Section 311(e) of the Home Mortgage Disclosure Act of 1980 requires that:

> To promote efficiency and avoid duplication to the maximum extent feasible, the Federal Financial Institutions Examination Council shall transmit a report to the Congress no later than September 30, 1982, on the feasibility and desirability of establishing a unified system for enforcing fair lending laws and regulations, implementing the Community Reinvestment Act of 1977, and satisfying the public disclosure purposes of the Home Mortgage Disclosure Act of 1975. Such report shall evaluate the status and effectiveness of data collection and analysis systems of such agencies involving fair lending and community reinvestment, and shall outline possible specific timetables for implementing such a unified system.

lenders offer better terms or a preferred type of mortgage?

There is a risk that people will infer discrimination from the HMDA reports without considering why variations exist, especially since data that reveal the sources of variation are hard to obtain. Although it would increase the cost of complying with HMDA, requiring lenders to report applications received in addition to loans approved would improve the usefulness of the data and forestall unfounded inferences of discrimination. Agencies overseeing depository institutions have additional information that allows them to ascertain whether or not inferences reflect actual improprieties.[6]

Another deficiency of HMDA as originally enacted was substantially remedied when the act was extended in 1980 to require all depository institutions to conduct uniform, calendar-year reporting using identical reporting forms. This made it possible to aggregate the reports of all depository lenders to obtain a more complete picture of mortgage lending, thus reducing the risk of groundless accusations of redlining in a neighborhood just because a particular institution is not lending there.

HMDA still does not apply directly to all mortgage lenders—nondepository institutions, for example—and this omission could seriously bias a commmunity's mortgage-lending statistics. As a partial correction, HUD is required to compile data about the location of all FHA-insured lending in a form compatible with the aggregate HMDA statistics.

The first attempt at preparing accurate aggregate tabulations of the HMDA data was not promising. While future efforts may be more successful, only a fraction of the current data is useful for making comparisons or drawing conclusions about the adequacy of lending. The tabulations cannot show the amount of lending desired by tract residents—since that is unknown—and do not sufficiently quantify the number of housing units by type of tract. Consequently, the tables provide little basis for judging how well the mortgage needs of the area are being met. Should the program of aggregation be continued, the system must be revised to be more useful.

CRA is even more difficult to evaluate because its goals and requirements are less specific than HMDA's. For example, the requirement that regulators evaluate how a lender has helped "meet the credit needs of its entire community, including low- and moderate-income areas" suggests that standards exist permitting actual lending to be compared with expected lending. But it is difficult to set such standards because a community's needs depend in complicated ways on its own singular characteristics and those of its neighbors. Nevertheless, there is pressure to calculate such ratios. The California State Department of Savings and Loan tries to identify "mortgage deficient" areas through the use of ratios; fortunately, however, the Federal regulatory agencies have explicitly rejected such mechanical approaches to enforcing CRA.

Once a community's credit needs are identified, it is necessary to decide what proportion an individual lender must meet. Yet, how can it be known whether a lender's effort is great enough? One repeated suggestion during hearings preceding the enactment of HMDA was that mortgage flows should correspond to volume and direction of savings flows. That analysis, however, denies the existence of both capital-importing and capital-exporting areas. Another suggestion was that institutions should share in meeting credit needs in proportion to total assets, which might prompt agencies charged with enforcing CRA to rely on inappropriate ratios to provide unambiguous, legally supportable guidelines.

The primary deficiency of CRA is that it does not resolve the problem it was intended to solve. The important issue is whether a community's credit needs are met, not the specific role of each lender in meeting that need. However, no single agency has the authority to review all lending in a given area.

The Commission reviewed the impact of both HMDA and CRA on the operations of depository institutions and concluded that Congress and the appropriate regulatory agencies should review whether there are more cost-effective ways to achieve the benefits desired. This review should follow the Examination Council's report on HMDA, CRA, and fair lending requirements due September 30, 1982.

Some options for reducing the burdens of HMDA include an increase in the minimum-size exemption and a deletion of nonoccupant owner loans and reporting requirements for mortgages purchased. Requiring HMDA report preparation only on receipt of a specific request also could reduce the burdens. With regard to CRA, the review should include analysis of the likelihood that problems of overly restrictive regulatory enforcement will develop because of the vagueness of the CRA directive.

RESPA Review

Section 8 of the Real Estate Settlement Procedures Act should be revised to permit the de-

[6] The regulatory agencies (FHLBB, Comptroller of the Currency, and FDIC, but not the Federal Reserve Board) have committed themselves to collect systematic fair housing loan information. See, e.g., Comptroller of the Currency, Administrator of National Banks, "Fair Housing Home Loan Data System: Regulation 27" (Washington, D.C.: October 1979).

velopment of alternative settlement services and to require timely, full, and adequate disclosure.

The Real Estate Settlement Procedures Act (RESPA) was intended to address allegations that settlement costs are unnecessarily high. Congress heard testimony that many consumers were taken advantage of by settlement service referrals involving kickbacks (hidden payments). To answer such concerns, the 1974 act, amended in 1975, imposes many requirements on real estate transactions, including use of a uniform settlement transaction form, provision by the lender of a "good faith estimate" of likely settlement service costs, prohibition on requirements by sellers that buyers use particular title insurance firms, and prohibition of excessive escrowing of borrowers' funds. The portion of RESPA of particular concern to the Commission is Section 8, which prohibits payment of referral fees or settlement service fees other than for services actually performed.

The Federal stake in real estate transaction costs is substantial. High transaction costs, especially during times of high interest rates, can seriously impede homebuying. The inability of homeowners to purchase a new home results in longer tenure in their present homes. This, in turn, extends the life of mortgages, with serious consequences for the financial markets and federally insured institutions that must hold lower-rate mortgages.

Under the current HUD interpretation, Section 8 of RESPA prevents the development of efficient combinations of settlement services. Yet, packaged services lower costs because of efficiencies achieved by combining services rather than by providing them separately. The critical issue is whether enough competition exists among settlement service providers to ensure that these savings are passed on to consumers. Staff at the Federal Trade Commission and HUD have concluded that controlled business arrangements and permitted referral fees may result in lower combined prices of the package of services.[7] In addition, with the emergence of new, nontraditional competitors in settlement services, prices are likely to reflect lower costs.

Firms offering a package of services do in fact provide the important settlement service of shopping and quality control. As in department stores, buyers shop for combinations of products with confidence that the products are a suitable mix of price and quality; the department store purchases from among many suppliers to bring customers a select group of choices.

The Commission calls on HUD to promulgate a regulation interpreting Section 8 of RESPA to permit packaging of services while prohibiting fees for referrals if the referrer provides no shopping and quality control or other packaging services. Conditions regarding price and quality should be deemed to have been met if the referrer has provided sufficient disclosure regarding price and quality and given the consumer a reasonable period to seek out other services. Any agency enforcing the provisions of Section 8 of RESPA should be guided by this interpretation. The Commission also urges State agencies to apply this interpretation to their implementation of State laws similar to the prohibitions of Section 8.

Not only HUD interpretations of Section 8, but also RESPA itself can inhibit development of combinations of settlement services that can be provided more cheaply as a package than separately. As a serious governmental intrusion into the marketplace, Section 8 of RESPA deserves examination to see whether less intrusive alternatives are available.

Section 8 of RESPA was included in the legislation after Congress heard testimony that settlement costs were unfairly increased by marketplace abuses, including steering of homebuyers to title companies and other services, which paid generous commissions to brokers and others, often without the homebuyer's knowledge. To prevent recurrence of such abuses, the Commission urges that Section 8 of RESPA be revised to provide that any provisions against referral fees and kickbacks be applicable only to unauthorized and undisclosed payments, and to require full, timely, and effective disclosure to the consumer of relevant information about settlement services.

It is important to assure that consumers receive full information in advance about the services they buy and the prices they pay. When the consumer is required to purchase packaged services, the contents of the package and its total cost must be disclosed. To prevent hidden charges and to ensure the chance to shop, this disclosure must be made before the consumer has committed funds to the transaction or any part of it. HUD should interpret this requirement through regulations that ensure a reasonable shopping period in the various possible transactions.

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[7] House of Representatives, *Real Estate Settlement Procedures Act—Controlled Business, Hearings Before the Subcommittee on Housing and Community Development*, Committee on Banking, Finance and Urban Affairs, September 15 and 16, 1981 (Washington, D.C.: U.S. Government Printing Office, 1981), pp. 68-76; U.S. Department of Housing and Urban Development, *Report to Congress on the Need for Further Legislation in the Area of Real Estate Settlements*, Appendix A (Washington, D.C.: U.S. Government Printing Office, September 1981), p. IV-49. The HUD report also includes valuable recommendations for State and local governments to upgrade the quality of their land title recordation systems. See Chapter V, "Land Title Records."

In the case of recommendations where the consumer is urged by the referrer (but not required) to use a specified provider, the relevant disclosure concerns the existence and nature of the relationship between the referrer and the service provider. Disclosure of a relationship involving referral fees or other financial interest—the original abuse that Section 8 was intended to address—should place the prudent homebuyer on notice that shopping for another service provider may be appropriate. Again, to assure the possibility of shopping, the disclosure must be made before the customer has committed funds to the relevant transaction; HUD should interpret this requirement by regulation to specify an appropriate length of time that allows reasonable shopping. The Commission found that these information disclosures appropriately address the concerns of RESPA, without the drawbacks of Section 8 as presently interpreted and enforced. The Commission also urges States to replace bans on referral fees with information-disclosure requirements.

The Commission views unfavorably HUD's recent proposal to replace Section 8 of RESPA with a requirement that lenders provide a standardized package of settlement services for a price disclosed at the time of loan application. According to HUD, mandatory lender packaging would let consumers continue to shop for a lender without having to shop for other services; the lender, in turn, would have an incentive to improve the efficiency of the settlement services. The lower costs can be translated into lower prices when consumers shop around for the best price. In contrast to optional packaging of services, however, the HUD alternative would force some lenders to offer services they cannot and do not wish to offer.

OTHER REGULATIONS

The Commission received testimony that numerous Federal regulations, not specifically focused on the housing industry, adversely affect housing production and costs. Although the general issue is discussed in Chapter 17, this part addresses three specific areas: Davis-Bacon Act, Federal Farmland Protection Policy Act, and timber harvesting policies.

Davis-Bacon Act

Construction of housing and related infrastructure should be excluded from coverage under the Davis-Bacon Act.

The Davis-Bacon Act (1931) requires payment of local "prevailing" wage rates on all construction projects receiving Federal assistance. The act covers certain categories of housing and public infrastructure.

Regulations of the Department of Labor (DOL) define and set the "prevailing" wage for five classes of construction, for numerous job classifications within each class, and for every county in which a Federal construction project over $2,000 is located. Wage determinations usually are based on DOL surveys and, in the case of residential construction, are supplemented by HUD surveys. The regulations require a survey of all projects of a "similar nature" in the county within which the Federal project is located. However, the actual survey may be so limited that distortions and inaccurately high determinations occur.

The act's coverage includes Section 8 housing (except the Existing Housing program), FHA-insured multifamily housing, public housing, rehabilitation and repair of acquired projects, and some Community Development Block Grant funds. FHA single-family dwellings are not covered; in fact, no projects involving fewer than nine units are covered.

A major housing issue affected by the Davis-Bacon Act is cost increases in construction. Increases in labor costs on Federal construction projects occur because the law requires payment of a prevailing wage, which may be distorted by regulation and by survey policy. Deficiencies in actual estimation and survey techniques compound this exaggeration. Between 1 million and 4 million construction workers—including between 800,000 and 1.2 million housing construction workers—are protected by the Davis-Bacon Act from lower wages that would result from competitive bidding. Estimates of the total impact on HUD-assisted programs range between 1 percent and 4 percent of development costs, including some administrative costs. Added delays, additional costs to contractors, and uneven wage application also result from the act's administrative requirements.[8]

Good estimates of total development costs relating to HUD programs covered by Davis-Bacon are not available. In 1977, an estimated 150,000 units, or $3 billion in development costs, were subject to residential wage determinations. An estimated $3 billion in development costs were covered in 1981.[9] Multistory construction, to which commercial determinations apply, probably constitutes a smaller amount, but no estimates of its value exist.

An interagency agreement, under which HUD conducts the wage surveys and submits the data for DOL determinations, has had mixed results. Since

[8] U.S. Department of Housing and Urban Development, "Housing Under the Davis Bacon Act," unpublished paper prepared for the President's Commission on Housing (Washington, D.C.: November 1981).

[9] *Ibid.*

DOL could not gather complete data because of the variety and multiple business arrangements with subcontractors in most residential projects, the agency has used union determinations on commercial construction for residential construction. A HUD study proposed a new agreement under which DOL would base its determinations, but that agreement has not yet been reached.[10]

Although the Davis-Bacon requirement shields construction workers against lower wages that might occur through a competitive bidding process, it does so at the price of deterring construction or elevating costs for users or purchasers of the structure. The Commission therefore recommends partial repeal of the Davis-Bacon Act to exclude housing construction from its coverage.[11] The Commission also concludes that where significant infrastructure costs are charged to the homebuyer, such infrastructure should be exempted from the provisions of the act for the same reason given above.

Until Davis-Bacon is revised to exclude housing construction, interim regulatory changes could help. Important regulations that could be amended include: (1) the rule that, in effect, the rate determined to be prevailing may actually represent only 30 percent of the construction in a county; and (2) the requirement that HUD surveys covering all county construction activities be acceptable to DOL.

Regulatory reforms have been proposed by DOL, including use of a 50-percent rule (instead of the 30-percent rule) or straight averages; allowing for the inclusion of "helper" classes; use of a sampling technique for surveys; application of more flexible job categories; allowing greater HUD autonomy in making wage determinations; and loosening compliance requirements, especially for small contractors.

Timber Production and Policy

The nation's policy for timber management programs, including harvesting and reforestation, should consider fully all relevant economic and environmental data. The economic inquiry should include the opportunity costs involved in withholding timber from the market, the consequences of policy on the price of timber and the cost of housing, and the long-term supply of timber. While this policy can be implemented under existing laws through the Departments of Agriculture and Interior, Congress should enact appropriate legislation to ensure the permanence of this policy. States, in turn, should reform forest tax policies and forest practices regulations that currently impede efficient private investment in timber and timber production.

The timber industry is important to the U.S. housing industry; wood products account for 15 percent of the cost of an average home. Unlike many other material product industries, the availability and price of timber is greatly influenced by Federal policies, which in the past few decades have restricted the supply of timber from public sources.

In the past, most wood products were supplied by timber produced on private lands. Now, however, the private sector has cut most of its virgin timber stands; although its forest lands have been replanted, the second-growth timber is not yet ready for harvest. Since most of the nation's inventory of mature softwood timber is located on public lands, management policies for these lands need to be sensitive to the market demand.

Part of the concern that led to current public policies in this area was that excessive timber cutting would lead to deforestation. Studies indicate, however, that timber supplies on public lands are so abundant that increases in current annual production levels can be accommodated by their annual growth.[12] To manage public forests efficiently, the U.S. Forest Service (USFS) and the Bureau of Land Management (BLM) should fully consider all the economic and environmental data relevant to timber harvesting programs to determine the effects on the price of timber and wood byproducts.

Another important economic consideration is the opportunity costs (the implicit capital carrying charges) of withholding timber from the timber-related industries. Whereas a forest represents a capital asset, neither the USFS nor the BLM considers the opportunity costs of holding these assets rather than cutting or liquidating them. Thus, in an economic sense, an unnecessarily large inventory of timber is maintained on public lands because capital carrying costs are not charged against them.

The executive branch already has the authority to implement such a policy. Current legislation stipulates that national forests are to be "developed and administered for multiple use and resources of the national forests for multiple use and sustained yield of the several products and services obtained therefrom."[13] Another act requires a comprehensive as-

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[10] *Ibid.*

[11] A less radical alternative would be to amend the statutory size exemption up to 19 units per project. A single means of minimizing the burden on rehabilitation would be to raise the limit set by law from its present level of $2,000 to a more realistic level of about $25,000-$30,000 per unit.

[12] Steve H. Hanke and Barney Dowdle, *Federal Timber Policy and the Housing Industry*, background paper, originally prepared for the President's Commission on Housing, (Washington, D.C.: Heritage Foundation, 1982).

[13] Section 2 of the Multiple-Use, Sustained-Yield Act of 1960.

sessment of present and anticipated future uses of national forests based on "the *economic* and environmental aspects of various systems of renewable resources management, including...timber..." (emphasis added).[14] In 1976, Congress added the statutory requirement of nondeclining, even flow.[15] Together, these provisions require economic analysis as part of the planning process. However, the Federal government has failed to comply with such mandates by not considering all significant economic aspects when making multiple-use determinations.

The executive branch should provide enough funds to implement these policies in a cost-efficient manner. Federal revenues from timber sales could be used to fund the harvesting and reforestation requirements of public lands—an approach used by some State governments.

Both USFS and BLM should include in their analyses the full economic costs of their policies of withholding Federal timber from the market. If these changes cannot be made soon, the statutes governing the management of Federal timber holdings should be amended to state explicitly the requirement of accounting for the opportunity cost of carrying capital assets.

Timber-sales practices of USFS and BLM create speculation and instability in log markets. Timber is sold by the government on a pay-as-cut basis. Very little cash is put up-front for a contract, and the purchasers pay the bid price to the government when they cut the timber. Although these contracts have a fixed term, contract extensions have been granted when the originally negotiated price exceeds the market price that exists near the end of a contract's term.

Since there is little cost in holding a contract and little risk in being forced to forfeit a contract, purchasers tend to engage in speculation and overbid on contracts. As a result, purchasers often cannot afford to cut the timber during the term of their contracts. This creates an artificial disruption in the flow of timber. Several remedies have been suggested. One would require a reasonable percentage of the bid price in cash, in advance. Another remedy would be to refuse contract extensions.

In addition to the policies governing the management and sale of Federal timber, the State tax and regulatory laws that affect private timber production should be modified. At present, many States impose an annual *ad valorem* property tax on both timber land and the maturing timber, which amounts to an inventory tax on the maturing trees. Hence, it creates a disincentive to allow timber to mature and to reforest cut-over lands. Many States require private timber companies to replant homestead timber lands. This often leads to economic waste, since private firms are required to invest capital to reforest marginal or uneconomic timber lands.

If State tax laws were reformed so that annual *ad valorem* property taxes were levied only on timber lands and not on maturing timber, the production efficiency on private lands would improve. For example, some States have substituted an excise tax on timber harvest income for the *ad valorem* tax on timber inventories. Also, regulations governing reforestation (which are partly the result of State tax laws) should be eliminated. This would result in increased efficiency in the private production of timber, since returns from productive properties no longer would be forced to cross-subsidize unproductive properties.

Farmland Preservation Controls

Congress should repeal the Federal Farmland Protection Policy Act of 1981 because it could have a potentially serious and detrimental impact on the cost and availability of land for housing.

As the nation's population has increased, market forces have promoted the conversion of farmland to uses in greater demand, such as housing. However, conflicting estimates exist as to the extent of this conversion. In January 1981, the National Agricultural Lands Study (NALS) estimated 3 million acres per year. These statistics led to claims of a crisis in agricultural land inventory and to passage of the Federal Farmland Protection Policy Act of 1981.

NALS, however, has been charged by some with overestimation of the conversion rate by at least a factor of two. William Fischel asserts that the conversion data used by NALS included land that had been classified as urban in prior studies.[16] He argues that the rate of increase of urban construction did not come close to matching the stated increase in land conversion rates. Construction rates increased only 12 percent to 13 percent during the period in question, while the NALS statistics showed a 100-percent increase in the rate of conversion of agricultural land to other uses. This extensive difference cannot be attributed to an increase in average lot sizes, since that statistic actually showed a decrease during the relevant period.

There is little evidence that conversion of farmland is a crisis in the making. In fact, the

[14] Section 6(8) of the Forest and Rangeland Renewable Resources Planning Act of 1974.

[15] Section 4 of the Multiple Use, Sustained-Yield Act of 1960, as amended.

[16] William A. Fischel, "The Utilization of Agricultural Lands: A Review of the National Agricultural Lands Study," *Land Economics*, Vol. 58 (May 1982).

private market appears to function effectively, a situation that obviates the need for regulations. The imposition of farmland protection regulations may create severe problems for housing at the local level.

The Federal Farmland Protection Policy Act of 1981 requires the Department of Agriculture, in cooperation with other agencies, to issue criteria for identifying the effects of Federal programs on the conversion of farmlands. Federal agencies, in turn, are to use the criteria to evaluate their programs and to consider alternative actions to lessen adverse effects. This involves agency review of current provisions of law, administrative rules and regulations, and policies and procedures. The Agriculture Department is to report to the Congress in 1982.

If not carefully reviewed and implemented, the act's regulations may foster withholding of land needed for housing development. The Federal act could also be used to justify State and local exclusionary zoning actions under the banner of farmland preservation.

The Commission recommends that the act be repealed. However, some Commissioners were reluctant to recommend repeal of a recently passed statute without new data to support such action. Pending the repeal, the Commission suggests that the implementation of the act be reviewed under an appropriate Cabinet Council to assure full consideration of the conflicting claims between housing and agricultural needs.

GENERAL REFORMS

All major housing regulations are subject to the same general rulemaking procedures. Because all specific regulations could not be addressed by the Commission, its attention was focused on general procedures that lend themselves to constructive modification—the Administrative Procedure Act, negotiated rulemaking, and management of the HUD clearance process.

Federal agencies are held to an "informal" rulemaking process under Section 553 of the Administrative Procedure Act (APA). Unless statutorily exempted, an agency must publish any proposed rule or regulation, receive public comments, and provide a concise general statement indicating the basis for the final issued rule. The APA was designed to oversee rules of procedure and substantive rules of general applicability, but not interpretive rules, general statements of policy, or an agency's rules for organization, procedures, or practices. The APA specifically exempts loans, grants, benefits, or contracts from Section 553. However, some agencies—HUD among them—have waived these exemptions. The judicial standard of review is that rules must fall within the scope of the agency's authority and not be arbitrary or capricious.[17]

When the act was first passed in the 1940s, the courts imposed a light burden on an agency to justify its rules. If an agency followed notice-and-comment procedures, the courts were likely to defer to agency decisions. The courts did not set high review standards for data and methodologies used by an agency when promulgating a rule. Only in the absence of a rational explanation would the court nullify a rule. The challenger of the rule carried the burden of proof to show there was no rational basis for the rule. As a result, challengers had difficulty in overturning agency decisions.

The trend over the past decade, however, has been to limit an agency's rulemaking powers. For some programs, Congress has statutorily required that an agency meet a "substantial evidence" test. Unlike the "arbitrary and capricious" test—which was satisfied by any plausible hypothesis (rational basis) from the facts in the record, even if conflicting conclusions could be reached by using other data in the record—the substantial evidence test requires the court to consider the record as a whole. The agency must explain any significant inconsistencies. Congress in some cases also requires oral presentation of comments and cross-examination of witnesses.

The courts themselves have imposed more stringent review standards called "hybrid rulemaking." Instead of accepting an agency's characterization of the facts at face value, some courts review the data and methodologies used in the rulemaking and require cross-examination, detailed agency justifications, responses to significant public comments, or explanations of rules. This form of judicial approval was in effect from the mid-1960s until 1978, when the Supreme Court held that reviewing courts could not impose procedures not found in the APA. According to at least one administrative law expert, however, many court-imposed provisions that had imposed more stringent analytical requirements were left in effect.[18]

Agencies' actions must comply with several other statutory requirements, chiefly the Federal Advisory Committee Act and the Regulatory Flexibility Act. Also Executive Order 12291, the principal management control over Federal rulemaking, requires all agencies to submit proposed and final rules to the Office of Management and Budget for review and comment. Major rules under the execu-

[17] 5 USC § 706.

[18] James V. Delong, "Informal Rulemaking and the Integration of Law and Policy," *Virginia Law Review*, Vol. 62 (1979), p. 260.

tive order require regulatory impact analyses.[19] Finally, HUD itself is subject to Congressional oversight under Section 7(o) of the HUD Act.[20]

The Commission finds that if the process by which Federal rules are developed is modified, the current burdens on the housing industry could be minimized. Three sets of recommendations are made: modification of APA, institution of negotiated rulemaking, and management of HUD clearance process.

Modification of the Administrative Procedure Act

The President should consider modifications to the Administrative Procedure Act as a means of limiting the regulatory authority of agencies concerned with housing.

A number of changes to the APA would ameliorate regulatory effects on housing. However, the Commission recognizes that such changes would affect all Federal regulations. Therefore, the Commission recommends that the President carefully consider the Commission's proposed changes to the APA.

Federal agencies could exercise more restraint by meeting a stricter standard under the APA. One likely standard would be akin to a "vital and pressing" standard, as defined in Chapter 15. Another possibility is an intermediate standard—between the arbitrary and capricious and substantial evidence standards described above. Congress in April 1982 was considering a "substantial support" standard (H.R. 746 in the House of Representatives and S. 1080 in the Senate), but the meaning of this standard was unclear. It would require a greater justification than the arbitrary and capricious test, but less than the substantial evidence standard.

A substantial majority of the Commission believes that fewer and more carefully considered regulations would result from changes to the present judicial rules relating to presumptions and allocations of proof. Statutory actions for Presidential consideration include, first, deletion of any judicial presumptions that an agency's rule is valid and, second, shifting the burden of proof now borne by the plaintiff to the agency.

Several members of the Commission disagreed with the recommendation for changing the presumption and burden of proof rules in judicial review of agency action. To them, the Commission recommendation appears counterproductive. The Commission has sought to reduce the regulatory role of government in everyday life, as well as to make the operation of government more efficient and responsive. In the opinion of these Commissioners, however, the recommended reforms would not reduce the role of government, but would cripple the capacity of the executive branch to govern efficiently. In their view, the Commission's recommendation threatens to subject every controversial administrative decision to second-guessing by a Federal judge. The result would be delays in agency rulemaking and additional burdens on the courts and on all those affected by the uncertainty of a contested rule.

The Commissioners agreed on two other changes in this area. One would require by statute the use of cost-benefit analysis now required by Executive Order 12291. Although agencies now conduct such analysis, this change would make the agency's analysis reviewable in court, which is not the case in the analysis required by the Executive Order. The possibility of court review may itself give the necessary incentive for agencies to consider such analyses seriously.

The other change would limit the use of guidebooks, handbooks, and other policy memoranda in circumventing the APA process. These documents are not subject to APA requirements because they are considered to be for internal agency guidance only. Some agencies, however, have abused this vehicle by placing in these documents requirements to be imposed on those benefited or governed by the regulations. The APA should be clarified to require that documents that substantially affect the obligations of those regulated or benefited should be subject to notice and comment procedures.

Negotiated Rulemaking

Federal agencies concerned with housing should consider instituting negotiated rulemaking as a means of developing fewer and more effective regulations.

Strengthening APA requirements would not ameliorate the troubling adversarial climate that has developed between some agencies and the people and businesses substantially affected by their rules. One observer of the rulemaking process observed that many of the new procedures designed to ensure rationality have been taken in the name of "participation" in the rulemaking process. This has come to mean a formal presentation and an oppor-

[19] A major rule is defined as a regulation likely to have an annual effect on the economy of over $100 million; to cause a major increase in costs or prices for consumers, individual industries, geographic regions; or Federal, State, or local government agencies; or have significant adverse effects on competition, employment, investment, productivity, innovation, or on the ability of the United States-based enterprises to compete with foreign-based enterprises in domestic or export markets (Section 1, Executive Order 12291).

[20] 79 Stat. 667; 42 U.S.C. 3531-3537.

tunity to meet opponents' evidence and policy contentions. It looks very much like informal adjudication, with the agency having to resolve the competing contentions. As this form of participation grew, real participation, in which those affected actually share in the decision itself, decreased. The parties were held at arms length during the decision-making process, and the agency alone would make the decision, albeit based on the record and contentions of the parties. The regulatory process had clearly become adversarial.[21] The adversarial process often ends in litigation and eventual settlement, at which time the substantially affected parties negotiate a compromise under court supervision. But the time to negotiate rules is at the beginning, before costly litigation is initiated.

Negotiated rules are not uncommon.[22] The National Institute of Building Sciences, for example, convened a panel of industry and agency parties to seek jointly a common insulation standard for adoption through the voluntary standards process and ultimate use by Federal agencies. Previously, agencies had used different standards. The panel is working on the technical issues with the expectation that the results will be suitable for adoption by the agencies.

Negotiated rulemaking would improve agency regulations by providing agencies with a more realistic method of reaching a regulatory consensus. Negotiation would involve discussion between the agency and interested parties, who jointly identify and analyze the various issues considered in the rulemaking process. The goal is to bring information before the agency pertinent to the development of practical and cost-effective regulations. Although some rules would benefit from a formal process,[23] negotiations could be held informally between an agency and interested non- Federal parties. The Federal Advisory Committee Act would have to be modified to allow contacts with agencies without notices in the Federal Register, a burdensome requirement.

The advantages of negotiations are numerous. The parties involved focus their research on unanswered questions. There is an incentive for parties to bring relevant data to the table, thereby reducing the need for and cost of acquiring additional data. Managers and technicians should be party to the negotiation to advance the technical aspects of the discussions and the likelihood that pragmatic rules will result. To ensure analysis of all relevant issues, agencies should be prepared to fund independent surveys and analyses when the parties to the negotiations are unable or unwilling to provide the missing information. Such new research might arise at the request of consumer groups when neither they nor industry groups have relevant data.

As in any other successful negotiation that requires use of business-sensitive information, the parties must be able to discuss issues in private. To accomplish this, the Federal Advisory Committee and Freedom of Information acts must be amended. To satisfy the public interest for disclosure, any proposed rule based on negotiation should provide a full explanation, including supporting data, to justify the proposal.

Management of the HUD Clearance Process

The Department of Housing and Urban Development should implement a management system for controlling its clearance process and implement changes to speed up timely resolution of issues. HUD should institute a briefing procedure for new managers to cover the rulemaking process.

HUD has shown a commendable willingness to initiate deregulation, both in reforming its own regulations and in assisting local governments to reform theirs. HUD is continuing to review and revise many housing regulations in public housing, mortgage insurance, technical standards, and manufactured housing. The problem is not HUD's willingness to effect reform, but the management of the clearance process.

HUD has established a formal procedure for clearing rules and regulations. Multiple levels of review ensure that thorough coordination occurs within the agency. However, when not closely managed, the system invites substantial bottlenecks. HUD should consider the use of a regulatory task force to resolve disagreements. Early participation by the Office of General Counsel and the Policy Development and Research Office could help identify potential disagreements before the draft regulation enters formal clearance.

Several former senior HUD officials suggested that they would have benefited from a management workshop on the rulemaking process. They would thus have saved considerable time in issuing rules. HUD should institute such a workshop on a continuing basis.

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[21] Philip J. Harter, "Regulatory Negotiation: A Cure for the Malaise Through Direct Participation in Rulemaking?" (Washington, D.C.: Administrative Conference of the United States, January 1982), pp. 5-14.

[22] One example of a formal process was proposed by Sen. William V. Roth, Jr.'s "Regulation Mediation Act of 1981" (S. 1601).

[23] Christopher C. DeMuth, "Domestic Regulation and International Competitiveness," paper prepared for a Conference on United States Productivity, Brown University (February 27-28, 1981), p. 32.

CHAPTER 15

STATE AND LOCAL HOUSING REGULATIONS

State and local land-use requirements affecting the cost of housing include zoning, growth controls, subdivision requirements, and permit processing. Reforming these regulations in the interest of lower housing costs and greater housing production is the subject of this chapter.

In addressing these issues, the Commission sought to evaluate regulatory costs and benefits and to determine the extent to which government should intervene in private marketplace transactions.

Regulation to protect vital and pressing governmental interests is legitimate, but the Commission found that State and local enactments often go beyond these interests. Some land-use controls—e.g., large-lot zoning or the exclusion of manufactured housing (mobile homes)—may serve aesthetic or exclusionary motives. Growth controls can artificially enhance the financial well-being of the resident community at the expense of newcomers by increasing the cost of producing housing, the amount depending on the nature and severity of the controls. Studies show that growth management, minimum house and lot sizes, regulation of the density and location of multifamily development, and subdivision code requirements can contribute substantially to housing-cost inflation. Excessive processing requirements, for example, can significantly delay construction; with prevailing high interest rates, the additional expenses to developers can be heavy.

The land-use market does not operate haphazardly; in using land, builders and lenders make their decisions on the basis of land prices, competitive conditions, and consumer demand. Removing excessive restraints will make owners and developers more competitive; this in turn should stimulate housing and rental price competition, promote greater variety in product, design, and aesthetics, and otherwise serve the interests of housing consumers.

The Commission is concerned about the plight of millions of Americans of average and lesser income who cannot now afford homes or apartments. Excessive restrictions on housing production have driven up the price of housing generally, damaging the new housing market and the filtering process that makes older units available to families seeking to "move up" to more desirable accommodations.

A program of land-use deregulation based on the Commission's recommendations will augment the production of housing while simultaneously preserving the legitimate interests of government. The police power will then accomplish its intended purpose of securing the public health, safety, and welfare, and at the same time satisfy the rights of property owners and developers to produce housing and of consumers to obtain affordable housing.

As noted, land-use regulations often have been used for exclusionary purposes. Some State courts appear to be increasingly concerned about the regional impact of zoning restrictions that exclude people from areas and otherwise limit housing opportunities, recognizing that housing markets extend across jurisdictional boundaries. As the Supreme Court of Pennsylvania stated when invalidating large-lot (two- and three-acre) zoning:

- It is not for any given township to say who may or may not live within its confines, while disregarding the interest of the entire area.[1]

and again:

- The question posed is whether the township can stand in the way of the natural forces which send our growing population into hitherto undeveloped areas in search of a comfortable place to live. We have con-

[1] *In re Appeal of Kit-Mar Builders, Inc.*, 439 Pa. 466, 268 A.2d 765, 768-769 (1970).

cluded not. A zoning ordinance whose primary purpose is to prevent the entrance of newcomers in order to avoid future burdens, economic and otherwise, upon the administration of public services and facilities cannot be held valid.[2]

Courts in New Jersey and New York have shown similar concern by establishing a judicial policy against exclusionary zoning.[3] Illinois and Michigan courts have struck down bans on mobile homes. The supreme courts of Pennsylvania and New Jersey have shifted the presumption of validity and burden of proof from the property owner to the municipality in exclusionary zoning cases.

The Commission also noted recent executive and legislative trends in some States to curtail this kind of zoning. Perhaps the most notable of these actions was a 1980 California statute limiting the enactment of growth control ordinances. Massachusetts now follows a policy of withholding State development assistance to communities whose land-use regulations do not provide for their fair share of all housing growth. During public hearings, low-income housing advocates urged the Commission to speak out against zoning and other regulations that discriminate against low- and moderate-income people and minorities seeking affordable housing.[4] Indeed, the changes proposed by the Commission would limit the ability of government bodies to use zoning restrictions for discriminatory purposes.

Excessive regulations are detrimental to other national interests. Regulations that mandate large-lot zoning and impose other severe density restrictions or prevent housing construction in developed areas force new construction into more remote areas, thereby reducing the amount of land otherwise available for farming, grazing, mining, drilling, open space, and other uses. The resulting low-density sprawl requires the use of more resources for transportation and utilities. Thus, land-use controls intended to enhance the natural environment also can adversely affect housing availability and costs.

The Commission's findings and conclusions regarding these State and local regulatory issues and their effects on the costs and availability of housing are discussed below. They are discussed in four major sections: zoning (general and specific), development regulations, and local permit processing.

General Zoning Regulations

General Standard

To protect property rights and to increase the production of housing and lower its cost, all State and local legislatures should enact legislation providing that no zoning regulations denying or limiting the development of housing should be deemed valid unless their existence or adoption is necessary to achieve a vital and pressing governmental interest. In litigation, the governmental body seeking to maintain or impose the regulation should bear the burden for proving it complies with the foregoing standard.

Under the Federal system, States have primary responsibility for zoning regulation. Virtually all States, however, have chosen to delegate this authority to local governments, and many municipalities have used this power in ways that unnecessarily restrict the production of housing and increase its costs.

To correct improper use of this power, States should adopt constitutional or legislative enabling provisions that prohibit restrictive local zoning—except where land-use regulation is necessary to satisfy a "vital and pressing" governmental interest. Where States fail to act, localities should enact their own ordinances to correct improper zoning.

Generally, a vital and pressing governmental interest will involve protecting health and safety, remedying unique environmental problems, preserving historic resources, or protecting investments in existing public infrastructure resources.[5] This new standard for zoning is intended to limit substantially the imposition of exclusionary land-use policies, since exclusion is clearly not an acceptable governmental interest.

In enacting the proposed new standard, the States should give this standard specific content to assure it is not abused. State statutes (or local ordinances, where applicable) should specifically define what constitutes vital and pressing governmen-

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[2] *National Land and Investment Co.* v. *Easttown Township Board of Adjustment*, 419 Pa. 504, 532, 215 A.2d 597, 612 (1965).

[3] *So. Burlington County NAACP* v. *Tp. of Mt. Laurel*, 67 NJ 151, 336 A.2d 713; *cert. den.* 423 U.S. 808 (1975); *Oakwood at Madison, Inc.* v. *Tp. of Madison*, 72 NJ 481, 371 A.2d 1192 (1974); *Urban League of Greater New Brunswick* v. *Mayor & Council of Borough of Carteret*, 142 NJ Super. 11, 359 A.2d 526 (1976); and *Berenson* v. *The Town of New Castle*, 38 NY 2d 102, 378 NYS2d 672 (1975).

[4] Statement of Carl Bisgaier, Director, Division of Public Interest Advocacy, New Jersey Dept. of Public Advocate, Dec. 3, 1981, to the President's Commission on Housing.

[5] Vital and pressing governmental interests that zoning ordinances should serve include adequate sanitary sewer and water services; flood protection; topographical conditions that permit safe construction and accommodate septic tank effluence; protection of drinking-water aquifers; avoidance of nuisance or obnoxious uses; off-street parking; prohibition of residential construction amidst industrial development; and avoidance of long-term damage to the vitality of historically established neighborhoods.

tal interests, thereby leaving to the genius of federalism the ultimate contours of this standard. However, a locality should have the burden of proving that any zoning restriction it imposes on housing meets the new standard in later judicial review.

The Commission's proposed standard would apply only to housing. Thus, all decisions related to size of lot, size or type of housing, percentage of multifamily, or other housing types and locations would be left to the market, unless government intervention is justified by the locality as serving a vital and pressing governmental interest.

A possible problem of deregulation is that it may adversely affect those who in good faith made their purchase or investments in reliance on the old rules. A change to the proposed "vital and pressing" standard would pose such a problem. Persons who purchase a home or a lot for construction of a home near vacant land assume that it will not be arbitrarily reclassified to allow other uses. The reasonable investment expectations of these homeowners should be protected. When vacant land is proposed for a use that would have required rezoning, homeowners entitled to notice under the old rules should be protected under the requirements and procedures of the old rules.

Nor is the proposed standard intended to limit a municipality's power to plan and build streets, parks, public buildings, schools, storm and sanitary sewers, and water mains and other public facilities or to designate homes or districts for historic preservation—unless those powers are used intentionally to limit the production of housing. (Historic preservation generally is not regulated under zoning ordinances.) Finally, the standard would not affect reasonable community-imposed development fees, dedications, servitudes, parking requirements, or other exactions that are not intended to limit production of housing. Municipalities should, of course, limit production if vital and pressing governmental interests require.

Constitutional Validity of Zoning Restrictions

The President should direct the Attorney General to analyze the constitutional validity and jurisprudential ramifications of the "vital and pressing" standard for judicially determining the validity of zoning ordinances and related standards that strike a balance between legitimate governmental interest and individuals' rights to property; if the Attorney General then concludes that a change should be sought in the existing Euclid standard, he should seek an appropriate case for urging the Supreme Court to adopt a new test.

The Commission believes that in recent years our legal system has weakened the property rights of owners of real property and largely ignored the implicit rights of newcomers deprived of affordable housing by excessive or exclusionary zoning. This imbalance should be redressed by State legislatures. But there is another potential source of protection—the courts.

In the past 25 years, the courts and legislatures have expanded the traditional meanings of property in applying due process protections. Yet the ownership of real property continues to be governed by a 50-year-old precedent that constitutes a significant departure from the traditional judicial role of protecting such property rights against government interference.

The framers of the Constitution were clearly concerned with property rights—the most obvious, in that era, being the right to own and use real property.[6] The Fifth Amendment prohibited the taking of property without just compensation or the deprivation of property without due process.[7]

The Supreme Court first dealt with the conflict between zoning restrictions and the Fifth Amendment's prohibitions in deciding the landmark 1926 case, *Euclid* v. *Ambler Realty Co.*[8] In *Euclid*, the Court found that "with the great increase and concentration of population, problems have developed which require, and will continue to require, additional restrictions in respect of the use and occupancy of land in urban communities."[9] Accordingly, the Court held that "before [a zoning] ordinance can be declared unconstitutional [it must be shown to be] clearly arbitrary and unreasonable, having no substantial relation to the public health, safety, morals or general welfare."[10] Moreover, anyone challenging a zoning ordinance had the burden of showing its unconstitutionality.

Writing for the Court, Justice George Sutherland excepted from this broad standard cases "where the general public interest would so far outweigh the interests of the municipality that the municipality would not be allowed to stand in the way."[11] Nonetheless, the succeeding half-century has marked a near-abdication of any meaningful judicial review of zoning decisions based on the *Euclid* standard.

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[6] A detailed discussion of the historical context of constitutional protections of property rights appears in Bernard H. Siegan, *Economic Liberties and the Constitution* (Chicago, Ill.: University of Chicago Press, 1980), pp. 3–59; see also *Vanhorne's Lessee* v. *Dorrance*, 2 U.S. (2 Dall.) 304 (1795); *Fletcher* v. *Peck*, 10 U.S. (6 Cranch) 87 (1810); *Terrett* v. *Taylor*, 13 U.S. (9 Cranch) 43 (1815).

[7] The Fourteenth Amendment made such due process protections applicable to the States' actions.

[8] 272 U.S. at 365, 71 L.Ed 303, 47 S.Ct. 114 (1926).

[9] 272 U.S. at 386–87.

[10] 272 U.S. at 395.

[11] 272 U.S. at 390.

Euclid was controversial in its day and still has critics. Experience indicates that the broad land-use charter it afforded localities has been abused—often at the expense of housing. At the time *Euclid* was decided, zoning was an appropriate governmental response to the need to separate noncompatible land uses within the community. In today's more complex environment, zoning has been employed to do far more. It is used not only to separate land uses but also to exclude people from the community. The promising line of State court decisions on exclusionary zoning represents a valuable response to this abuse of zoning.[12]

The Commission believes the pendulum has swung too far away from the right to enjoy the ownership of real property and the important societal interests of increasing mobility and access to housing opportunities. Accordingly, the Commission believes the *Euclid* doctrine should be reexamined. The Commission recommends that the Attorney General seek an appropriate case in which to request review of the *Euclid* doctrine in the context of modern land-use issues and the due process protections afforded other property rights in the 50 years since *Euclid* was decided. Most Commissioners believe that the "vital and pressing governmental interest" standard, described elsewhere in this report, represents an appropriate redress of the balance.[13] Nonetheless, the Commission suggests the Attorney General consider the "vital and pressing" and other potential standards in his review.

Several Commissioners are concerned that adoption of this proposed new standard as a constitutional doctrine raises serious dangers of an expanded role for the judiciary and believe that judges are ill-equipped to balance the social and environmental concerns inherent in zoning. These commissioners are concerned that the police power, of which zoning is an example, not be so constrained; rather, it should be dynamic, and able to adjust as economic and social conditions vary. They would rely on the legislation recommended by the Commission to confine the exercise of discretionary local land-use decisions.

Recently, a majority of the Supreme Court expressed concern about what remedy to apply when zoning ordinances are declared unconstitutional as a taking of property. While *Euclid* seemed to limit the remedy to a judicial declaration of invalidity, the 1981 *San Diego Gas and Electric Co.* decision warned that just compensation might be appropriate in the future.[14] The case was disposed on procedural grounds unrelated to this issue. Justice William J. Brennan, Jr., dissenting in a 5–4 decision, wrote for the minority:

> In my view, once a court establishes that there was a regulatory "taking" the Constitution demands that the government entity pay just compensation for the period commencing on the date the regulation first effected the "taking," and ending on the date the government entity chooses to rescind or otherwise amend the regulation.[15]

Justice William Rehnquist voted with the majority on the procedural issue and in his opinion implied that he supported Brennan on the issue of compensation, suggesting a possible majority view on this issue.

Although the Court has yet to formally accept this position, the Brennan opinion has been cited as precedent in several Federal and State court decisions, possibly signaling increasing judicial concern for protection of private property rights.[16]

Because the remedy Justice Brennan proposed is also important in its impact on zoning practices of municipalities—the imposition of monetary compensation for wrongful zoning—the Commission advises the President to ask the Attorney General also to review the constitutional and jurisprudential ramifications of Brennan's opinion.

Specific Zoning Standards

While adoption of the general standard is the cornerstone of the Commission's zoning deregulatory proposals, there are a number of specific actions States and localities can take in the meantime. Like the general standard, these actions would be aimed at the restoration of property rights as well as the stimulation of the housing market and the provision of affordable community housing.

To those ends, the recommendations below stress the Commission's view that limits should be imposed on zoning practices such as density requirements, mobile-home restrictions, size-of-dwelling limits, growth controls, and farmland preservation. Three themes are common to all these recommendations: they do not propose zoning limits contrary to vital and pressing public interests; they seek to protect property owners who purchased prior to dezoning; and they advocate shifting to government the burden of justifying zoning that

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[12] See footnotes 1–3, Chapter 15.

[13] The proposed change to a vital and pressing standard would substantially elevate the level of judicial scrutiny similar to that utilized for reviewing gender classifications, *Craig* v. *Boren*, 429 U.S. 190, 50 L. Ed. 2d 397, 97 S.Ct. 451 (1976); *Califano* v. *Westcott*, 443 U.S. 76, 61 L. Ed 2d 382, 99 S.Ct. 2655 (1979).

[14] 450 U.S. 1188, 67 L.Ed.2d 551, 101 S. Ct. 1287 (1981).

[15] 67 L.Ed.2d. at 573–574.

[16] *Hernandez* v. *City of Lafayette* 643 F.2d 1188 (5th Cir., 1981) *cert. denied*, 50 U.S.L.W. 3570 (No. 81–605) (Jan. 18, 1982); *Burrows* v. *City of Keene* 432 A.2d 15 (N.H. 1981).

limits housing. (The absence of discussion of a particular zoning practice does not imply the Commission's approval of the practice; rather, these practices would be subject to the general zoning standard.)

Density of Development

The density of development should be left to the conditions of the market except when a lesser density is necessary to achieve a vital and pressing governmental interest.

Required minimum-lot size is commonly used to bar higher densities. More than a third of the 75 municipalities in a 1976 survey of New Jersey municipalities, for example, required minimum lot sizes greater than one-quarter acre. A sixth of the communities had minimum lot sizes greater than a half-acre.[17]

Using the same data, a recent study of vacant residentially zoned land found that large-lot zoning is more prevalent in areas where new housing is being developed than in more stable communities.[18] While there have been no similar national surveys of large-lot zoning since 1976, it is believed that as many as 20 percent of communities with more than 10,000 people now require minimum lot sizes of a half-acre or more.[19]

The density at which residential land is developed has a significant impact on the cost of land and infrastructure per unit. Regulations limiting density prevent the market from responding to consumer demand. Thus, land that could have accommodated 10 or more attached townhouses per acre may be underdeveloped if zoned for only two or three detached units per acre (or even lower densities). Indeed, significant economies result from higher densities compared to single-family detached construction. The impact of large-lot zoning on housing costs also can be dramatic in terms of increasing per-unit infrastructure costs. Below, for example, are variations in 1980 costs in Westchester County, N.Y. As density decreases, the costs for infrastructure dramatically increase.

Table 15.1
Infrastructure Cost Per Dwelling Unit[20]

Lot size Lot width	1 acre 125 feet	½ acre 25 feet	Cluster; 2 units/acre 35 feet
Infrastructure costs (streets, curbs, lighting, sidewalks, sanitary water lines)	$30,125	$18,075	$8,435

Unless a locality can demonstrate that there is a vital and pressing governmental interest associated with density of development, the market mechanism should be allowed to function without density constraints. Only in this manner can the market respond to economic realities and changing household preferences.

Zoning Restrictions on Manufactured Housing

States and localities should remove from their zoning laws all forms of discrimination against manufactured housing, including off-site fabricated housing systems or components conforming to requirements of one of the current nationally recognized model codes.

Because of sharply rising housing costs, manufactured housing today offers many households their only option for homeownership. Indeed, in 1980, manufactured ("mobile") homes amounted to 29 percent of all single-family homes sold. The marketplace demand for mobile homes has come from improvements in the product as well as from a competitive price.

Despite the increasing attractiveness of manufactured housing, local zoning laws continue to discriminate against mobile homes. In many localities, mobile homes are segregated into special areas, often in disadvantageous locations set aside as "trailer parks."

There is increasing recognition that the quality of manufactured housing has improved. Since 1976, manufactured housing has been built under a national code, supervised by HUD, setting health and safety requirements. Vermont, California, and Indiana have enacted laws precluding discrimination against manufactured homes. The Michigan Supreme Court last year struck down a zoning law because it violated the State constitution: "The *per se* exclusion of mobile homes from all areas not designated as mobile home parks has no reasonable basis under the police power, and is therefore unconstitutional."[21]

[17] Stephen Seidel, *Housing Costs and Regulations: Confronting the Regulatory Maze* (New Brunswick, N.J.: Center for Urban Policy Research, 1978), p. 174.

[18] The data were adapted by Burchell and Listokin of the Center for Urban Policy Research as reported in *Reducing the Development Costs of Housing: Actions for State and Local Government* (Washington, D.C.: Department of Housing and Urban Development, 1979), p. 17.

[19] Based on phone discussions with National Association of Home Builders and the American Planners Association.

[20] *The Effects of Environmental Regulations on Housing Costs* (Cambridge, Mass.: Urban Systems Research and Engineering, Inc., 1982), p. 71.

[21] *Robinson Township* v. *Knoll* 410 Mich. 293, 302 N.W. 2d 146 (1981).

Manufactured housing can be as safe and healthy as comparable site-built housing. Housing systems or components satisfying a nationally recognized model code similarly should not be excluded from use in a locality. Exclusionary zoning provisions based on type of manufacture are arbitrary and unrelated to legitimate zoning concerns.

Size of Dwelling Units (Single and Multifamily)

No limits (minimum or maximum) should be placed on the size of individual dwelling units.

"The purpose of . . . minimum-building-size ordinances may be stated quite simply: To force up the cost of housing," wrote Norman Williams.[22] The ordinances, he claimed, are designed, first, to protect property values by prohibiting construction of housing smaller than that already in the zone and, second, to exclude people who cannot "pay their way" in terms of their demands on municipal services.

As an illustration of contrasting approaches to size restrictions, consider the experience of Houston and Dallas/Fort Worth, two Texas metropolitan areas with very different development regulations. As one homebuilder testified before the Commission, Houston's land development ordinances allow new dwelling unit designs without restriction as to size and type.[23] As mortgage rates rise, for example, the developer is able to reduce the size of units (to 800–1,000 square feet) and build in Houston for a selling price of about $55,000. In many suburbs of Dallas, on the other hand, where zoning regulates dwelling unit size and type, it is nearly impossible to construct a unit of less than about 1,500 square feet. These units sell for less than $80,000.[24] So the Dallas developer is simply prevented from meeting the demands of these areas. Consumer demand rather than government regulation should determine the size of dwelling units. To do otherwise is to infringe upon individual lifestyle preferences and ignore financial constraints on more and more households.

Growth Controls

Except where justified by a vital and pressing interest, governments should avoid growth controls that limit production of housing.

Many communities use regulation to control future growth. Ordinary zoning controls or special restrictive ordinances can be used to limit or phase construction or manage the pattern of growth to achieve certain goals. There is nothing wrong with city planning related to the installation of schools, roads, sewers, parks, water facilities, public buildings, and other public services and facilities. These are legitimate exercises of local authority. However, the Commission opposes controls to limit the production of housing if the regulation is not justified by a vital and pressing governmental interest.

Growth management techniques often have been used to prevent housing construction in areas where the demand is great and to direct construction into areas where it may not be politically or economically possible to build. The consequences are limited growth, regardless of demand, and increases in housing prices.

Some municipalities have used annual quotas to limit the number of building permits. To be effective, a quota must be set at a lower level than what results from the operation of normal market forces.

A more sophisticated approach employs a point-based permit system, wherein communities plan for growth by long-term allocation of public investments for facilities. Such planning also can be instituted for exclusionary purposes. Development proposals receive points based on the availability of certain public facilities such as sewerage, drainage, roads, etc. Where facilities do not exist, these localities allow developers to provide the services. Phased development can be used for the orderly installation of facilities as part of a deliberate effort to limit unreasonably the production of housing. Under a well-known development ordinance of Ramapo, N.Y., the building rate was reduced by two-thirds after the ordinance was adopted.[25]

Studies of Petaluma, Calif., and Boulder, Colo., reveal the way growth management controls affect the cost of housing. A 1970–77 study by researchers at the University of California at Davis found that prices for a single-family, detached home in Petaluma (which imposed growth controls in 1972) showed an 8 percent greater increase than for a comparable house in Santa Rosa, the nongrowth control comparison city in the study. Thus, a home that sold in 1977 for $100,000 in Santa Rosa cost approximately $108,000 in Petaluma. The study attributed a signficant portion of the $8,000 difference to growth control limitations. In addition, a practical result of Petaluma's growth controls was the virtual disappearance of modest "starter" homes. The city's scoring system for awarding de-

[22] Norman Williams, *American Land Planning Law* (Chicago, Ill.: Callaghan & Co., 1975), Vol. 2, p. 624.

[23] Statement of Harlan E. Smith, President of Homecraft Land Development Inc., December 14, 1981.

[24] Conversation between Smith and Commission staff, February 3, 1982.

[25] Task Force Report sponsored by the Rockefeller Brothers Fund, *The Use of Land: A Citizens Policy Guide to Urban Growth* (New York: Crowell Co., 1973) p. 94.

velopment permits places a heavy emphasis upon high-amenity housing.[26]

Another study reflected similar results in Boulder, Colo., which limits housing production based on a target annual population growth of 2 percent. Boulder's "Danish Plan" also combines a cap on the number of building permits with a point system, evaluating each permit application so that only high-scoring (high-quality and therefore high-cost) projects are awarded permits.

Boulder's housing costs between 1976 and 1979 (before and after growth control) rose 25 percent while the cost of a comparable house in two nearby communities increased only 11 percent. Since the analysis used constant 1975 dollars and the same type of house, the differential is attributable to Boulder's growth controls.

Boulder limited not only the number of units built, but—through a point system designed to achieve high-quality housing—caused more expensive housing to be built on larger lots. Builders in neighboring cities not under such controls built smaller homes on smaller lots during this period. Thus, for homes actually built, average Boulder prices increased by 29 percent, those in the other two communities by only 10 percent and 6 percent, respectively.[27]

Some governments also impose various environmental controls. For example, the approval of the California Coastal Commission, established by public initiative in 1972, is required for any development or new construction on the 1,100-mile California coastline, up to two miles inland.

Michael L. Fischer, Executive Director of the California Coastal Commission, a strong advocate of the program's environmental goals, testified that his commission's regulatory efforts "undoubtedly" increase the cost of housing: "No question about it. . . . When we reviewed development proposals, we would place at the top of the list projects like hotels, restaurants, and campgrounds. . . . Down at the bottom of the priority list, of course, would be single-family homes, an inefficient use of this precious resource . . . [T]hese mitigation measures would clearly add to the cost of housing projects."[28]

In regulatory situations like the Coastal Commission, the only way a developer can get a project approved is to cut its size drastically either in total number of units or density. Bernard Frieden has supplied two illustrations of these imposed density constraints. A 1972 plan for a 2,000-unit project was finally approved in 1976 for only 275 units. One hundred units were priced between $100,000 and $200,000. The remaining units ranged from $40,000 to $60,000—twice the original estimated average sales price. The second plan called for 9,000 condominium units priced between $21,000 and $37,000. The 1972 plan was altered in 1976 to contain 3,000 units with an average price tag of $65,000.[29]

Thus, because of local opposition, some developments which were intended originally to house average-income families have been changed so significantly that they provide shelter only for the wealthy, a primary conclusion of Frieden's examination. The critical question becomes whether developers can continue to make compromises that secure political approval, and still sell houses to anyone but the most affluent.[30]

Farmland Preservation Controls

Regulation restricting land to farming use should not be adopted if it would limit housing production.

As the nation's population increased, market forces caused the conversion of some farmland to uses in greater demand, such as housing. In response, State and local governments tried a variety of strategies to retain farmland, including agricultural zoning. Such zoning imposes legally binding controls on all owners of land in the agricultural zone and can raise housing costs by limiting the supply of land.

As discussed in Chapter 14, the Commission is persuaded that no need exists for protecting farmland from urban development. Prohibiting the conversion of farmland to urban uses may waste far more resources than it saves. The added cost of development on less well-located sites increases the cost of capital and labor. This policy also may increase transportation expenditures and require expansion of sewer and water lines and roads by forcing the development of sites farther from already-developed areas.

As "exclusionary zoning" practices of some communities have come under attack, the agricultural land issue may become a means for establishing extraordinary large-lot zoning—160 acres and sometimes more. While this requirement is ostensibly designed to preserve the minimum operating size of farms, its real effect will be to exclude

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[26] Seymour Schwartz, David Hansen, and Richard Green, "Suburban Growth Controls and the Price of New Housing," *Journal of Environmental Economics and Management*, Vol. 8 (1981), pp. 303–320.

[27] *The Danish Plan Retrospect: A Look at Growth Management Issues in Boulder, Colorado* (Washington, D.C.: National Association of Home Builders, 1981).

[28] Testimony before the Government Regulations Committee, Oct. 30, 1981.

[29] Bernard Frieden, *The Environmental Protection Hustle* (Cambridge, Mass.: MIT Press, 1979), Chapter 10.

[30] *Ibid.*

housing developments from the community.[31] The beneficiaries of large-lot zoning usually are affluent homeowners, while lower-income renters and young families pay the additional price. In evaluating the effects of farmland preservation, government agencies must keep in mind the substantial costs that may be imposed on those least able to bear them.

This recommendation does not suggest disapproval of special State tax treatment of agricultural lands. In some States, when farmland is rezoned for nonfarm purposes, the State will not increase the tax rate from farm to nonfarm levels until the property is sold for nonfarming purposes. At the time of sale, however, the State will recapture the tax savings from the seller.

Development Regulations

The standards adopted by municipalities to govern land development and the way in which these improvements are financed represent a substantial component of total construction costs. The recommendations that follow are designed to provide regulatory relief and to allocate the costs of these improvements more equitably.

Financing Infrastructures

Municipalities should consider using innovative financing approaches to assist developers in providing infrastructure for new residential development.

Site-improvement costs are a major reason for the recent escalation of new housing costs. Nationally, the cost of a finished lot now averages nearly 25 percent of the selling price of a new house.

Innovative ways of financing required infrastructure must be found if these costs are not to be absorbed directly into the selling price of the house. Some cities have the authority to earmark special financing for such infrastructure and can issue bonds at a lower interest rate that can be amortized over many years. This approach should be encouraged wherever possible. It should be noted, however, that the cost to society remains high under tax-exempt municipal financing, since the expense of providing infrastructure is passed on to the general taxpayer.

For local governments lacking this authority, one promising method for lowering infrastructure costs is the municipal utility district (MUD). This approach has been used successfully in the Houston area to avoid costly hookups to established sewer systems far from new residential developments.

In the Houston area, the MUD has issued revenue bonds and used benefit assessments to pay off the bonds. When an area is annexed by the city of Houston, the MUD is absorbed. Houston then retires the bonds and issues its own. This method avoids requiring the developer to finance the installation of infrastructure, thus adding the developer's *pro rata* share of those costs to the selling price of the house. Under such municipal financing, the homebuyer also enjoys lower interest in paying for his share of infrastructure costs.

MUD or a similar approach also could be adapted to redevelopment projects where major infrastructure replacement must be made but where the imposition of these costs on the developer may make the project infeasible.

Cost-Sensitive Standards

HUD should contract with the National Institute of Building Sciences to develop cost-sensitive subdivision standards for State and local government consideration.

Subdivision controls specify conditions for dividing a parcel of land into lots for development. Their purpose is to ensure that new development meets community standards and that the developer and the new homeowner absorb much of the costs of a new development. As these regulations became increasingly detailed—they now contain requirements for public improvements ranging from sidewalks and streetlights to parkland—charges that they add unnecessary costs to housing development mounted. A 1976 study of housing development in New Jersey found that unnecessary site improvement increased housing costs by an average of 2.3 percent of the selling price of the unit.[32]

A 1978 General Accounting Office (GAO) study,[33] one of the most thorough reports on this issue, analyzed the effects of 17 commonly used site-improvement standards in a sample of 87 communities. It found:

- significant variation in standards specifications for the same requirement, suggesting arbitrariness in arriving at the standard;
- widely varying potential savings, depending upon local standards, averaging $1,295 (about 2 percent of housing costs) but as high as $2,655 in one community; and
- many overspecifications for road widths, driveway widths, and other items, but few for more expensive items like concrete

[31] William A. Fischel, "The Urbanization of Agricultural Land: A Review of the National Agricultural Lands Study," *Land Economics*, Vol. 58, May 1982.

[32] Seidel, *op. cit.*, pp. 45, 51.

[33] *Why Are New House Prices So High, How Are They Influenced By Government Regulations and Can Prices Be Reduced?* (Washington, D.C.: U.S. Comptroller General, General Accounting Office, May 1978).

pavement specifications, water-main pipe sizes, or cul-de-sac diameter.

A Colorado study found that changes in local regulatory practices and requirements added between $1,500 and $2,000 to the cost of the typical home built between 1970 and 1975. Part of this additional cost was a result of new requirements for wider and thicker streets, underground storm sewers, and fences.[34]

In 1972, it cost approximately $4,800 to improve a typical lot in Orange County, Calif., to meet local subdivision requirements, about 13.7 percent of the average selling price of $35,000 for a house in the county. In 1978, it cost $28,561 to meet the subdivision standards—about 21.3 percent of the selling price of the average home ($135,000).[35]

No cost-sensitive set of standards for subdivision development now exists that is responsive to both health-and-safety and cost issues. The Commission believes that a national advisory standard should be prepared that can provide guidance to government and the private development community.

Wastewater Technology

No development should be barred for lack of municipal sewer capacity if the developer is prepared to install at his cost proven innovative and alternative wastewater technologies that meet public health and safety requirements. To this end, the U.S. Environmental Protection Agency should support both public and private research activities related to innovative wastewater technologies.

Housing development in many markets is limited by a lack of public sewer facilities or by marginal soils that limit the use of conventional, individual septic systems. To deny development in areas of limited public sewer capacity would be arbitrary where developers are capable of installing adequate on-site disposal technologies. The use of proven small-scale wastewater technologies, such as cluster systems, would ease land-supply problems in many housing markets.[36]

The lack of central sewerage facilities, especially in high-growth areas, continues to result in the imposition of sewer moratoria. The number of communities reporting sewer moratoria at any one time increased from 330 in 1976 to more than 500 in 1979. Capital spending for needed infrastructure at the local level is constrained in many communities by tight budgets and opposition to property taxes.

The situation may soon get worse. The passage of the Municipal Wastewater Treatment Construction Grant Amendments of 1981 (P.L. 97–117) would eliminate funding by the Environmental Protection Agency (EPA) of *any* reserve capacity in wastewater treatment facilities after October 1, 1984.

While conventional on-site septic tank/soil absorption systems are allowed in most areas without public sewers, these systems often are impractical because of marginal soils that do not permit proper absorption. There are proven, cost-effective innovative wastewater alternatives suitable for use on marginal soils, but many developers are unaware of them and regulatory agencies have been indifferent to them. Proposed EPA cutbacks in research and promotional activities supporting the performance and management of small-scale wastewater alternatives will further hinder the acceptance of these technologies.

EPA and organizations such as the National Association of Home Builders and the National Sanitation Foundation also could help promote small-scale wastewater technologies. EPA should support organizations in disseminating technology for such alternatives.

Builder/Developer Fees

Builders and developers should be obligated only for such fees, dedications, servitudes, parking requirements, or other exactions as are specifically attributable to the development. Likewise, communities should not be required to subsidize new housing development infrastructure or facilities relating thereto. Builders and developers should pay only their pro-rata share. They should be permitted to install at their own cost facilities not publicly available.

In addition to infrastructure costs, municipal fees also adversely affect housing affordability. The previously cited 1978 GAO report[37] found that some communities charge fees for permits, inspections, utility tap-ins, and the like which add significantly to the cost of new houses. In the 87 communities sampled, the median fee was about $930 per house, ranging from a low of $56 in one community to $3,265 in another. Utility tap-in fees represented by far the largest portion of the total fees charged by

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[34] Bickert, Browne, Addington and Associates, *An Analysis of the Impact of State and Local Government Intervention on the Home Building Process in Colorado 1970–75* (Denver: Colorado Association for Housing and Building, April 1976).

[35] Alfred Gobar Associates, *Housing Cost Analysis: Orange County*, Californians for an Environment of Excellence, Full Employment and a Strong Economy Through Planned Development (Brea, California: 1980).

[36] *The Effects of Environmental Regulations, op. cit.*, pp. 112-139.

[37] *Why Are New House Prices So High, How Are They Influenced By Government Regulations and Can Prices Be Reduced?, op. cit.*

communities. The median fee charged for utilities was $605, but 15 communities charged more than $1,500 per house, and one charged more than $3,000 per house. There is little nationwide consensus among local officials on what is a fair and reasonable charge for specific municipal services.

Under growing fiscal pressure, local governments have increasingly altered the financing and pricing of their urban infrastructure. These new methods, which draw a distinction between existing residents and buyers of new homes, often require the builder (and ultimately the homebuyer) to make a capital contribution for the direct new service, either in the form of cash or by actually providing the infrastructure. Pricing methods also have changed; many proposals require new residents to pay more per unit of consumption than old customers.

Where the infrastructure in question is not principally attributable to the new development, there is no economic rationale for distinguishing between old and new residents.[38] Thus, while infrastructure improvements developed for the primary use of the new homeowners should appropriately be charged to them, charges for municipal improvements used by the community in general should be apportioned among the developer (and therefore the new residents) on the same basis as all other residents.

Local Permit Processing

Any homebuilder who has had to go through the applications process knows that time is indeed money. From the moment he purchases or takes an option on a piece of property, he begins to incur "carrying costs"—interest, insurance, property taxes, inflation, and office overhead—tying up capital and even losing markets. The following discussion addresses various techniques that can be used to reduce delays in processing applications.

Wherever possible, procedures for obtaining permits for subdivision and construction should be reduced and consolidated to a single comprehensive permit to minimize the time between purchase of land and occupancy by homeowners and tenants.

The previously cited GAO report on housing costs[39] determined that the average time for review and approval is 7-1/2 months from the time a developer submits his preliminary plans to the day a building permit is issued. Extreme cases range from a month to two years or more. Generally, larger developments (250 or more units) in the high-growth areas experience longer review times. In any case, added development time means increased carrying costs for the developer, varying from 1 percent to 10 percent of the final selling price of a house. In periods of high inflation, this percentage could be even higher.

The Rice Center Study of the costs of regulatory delay in typical single-family divisions compared total project duration in the late 1960s to that in the more heavily regulated 1970s, hypothesizing that any difference was due to an increase in regulation. The average duration was found to have lengthened between 1967 and 1976 by more than five months, resulting in costs ranging from $560 to $840 per single-family lot in the Houston area. Projects involving the creation of utility districts averaged delays of 13 months, costing an estimated $980 to $1,460.[40]

Local Initiatives

The Commission realizes that it is not possible to achieve immediately a single consolidated local development permit, especially in view of the plethora of independent agencies in so many local governments. Short of this, however, local governments have taken steps to expedite the permit process, among them the following:[41]

Create a central authority that provides all permit applications required in the development process. In communities where each department operates its own permit system, applicants now must make the rounds to obtain multiple permits.

Conduct pre-application conferences. Developers need the opportunity to discuss with experienced staff such matters as community opposition, probable conditions for approval, and how other projects have been decided in the past. Such informal information can be as important as the official rules.

Establish a joint review committee whenever several departments are involved in a project approval. An increasing alternative to sequential routing of applications is a review committee or team of staff from each relevant department that meets regularly to review proposals, jointly solve problems, and reach a final agreement. Before the committee

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[38] Stephen Hanke and John T. Wenders, "Costing and Pricing for Old and New Customers," *Public Utilities Fortnightly* (April 29, 1982).

[39] *Why Are New House Prices So High, How Are They Influenced By Government Regulations and Can Prices Be Reduced?, op. cit.*

[40] *The Delay Costs of Government Regulation in the Houston Housing Market* (Houston: Rice Center for Community Design and Research, 1978).

[41] For a more extensive discussion, see American Planning Association (with assistance of the Urban Land Institute), *Streamlining Local Land Use Regulation: A Guidebook for Local Governments* (Washington, D.C.: U.S. Government Printing Office, 1980).

meets, the application is usually sent to the respective departments for technical review by specialized staff.

Implement "fast tracking" procedures for projects with minor impacts. Fast tracking abbreviates the review and approval process for smaller projects. The process should be expanded to cover certain larger subdivisions, as well as other routine applications with no major impact.

Institute the simultaneous review of multiple permits. Reviews must follow sequentially when one permit is made a prerequisite for the next. In many cases this is logical and efficient for both developer and the review staff, but some applications lend themselves to simultaneous review.

Consolidate or eliminate multiple public hearings. The typical sequence of land review envisioned under most State laws was supposed to entail one, or at most two, public hearings per project. But where an applicant must obtain a change in zoning before submitting a subdivision application, this can add another two public hearings, and perhaps upwards of four, in some States. The multiple-hearing process should be simplified or consolidated if the time delays associated with the process are burdensome.

Employ a hearing officer. A hearing official is an appointed officer who conducts quasi-judicial hearings on applications for parcel rezonings, special use permits, variances, and other such devices. In addition to freeing the time of commissioners and elected officials, the hearing official can help reduce delay and uncertainty for both large and small projects.

CHAPTER 16

CONSTRUCTION STANDARDS AND BUILDING CODES

All levels of government and many private-sector organizations have a hand in regulating the way a home is built. Indeed, the fragmentation of the process of regulating residential construction often discourages builders and manufacturers from adopting innovative products and methods as quickly as in other parts of the economy.

This chapter addresses construction standards, Federal regulations, State and local building codes, and licensing requirements as an integrated unit, to provide guidance to alleviate this fragmentation. The Federal role is examined in the context of the evolution of private-sector construction standards, followed by a discussion of product evaluation and approval systems to facilitate adoption of cost-effective innovations.

Development of private-sector voluntary standards and the general workings of the market make it increasingly appropriate for the Federal government to rely more on the private sector and less on standards it develops itself. Such Federal standards apply chiefly to manufactured housing (mobile home) construction, energy, access for the handicapped, and the FHA Minimum Property Standards.

With respect to State and local building codes, the Commission's recommendations are intended to help remove duplication, eliminate unnecessary variation in requirements from one jurisdiction to the next, develop more cost-effective standards, and improve the caliber of enforcement at all levels. This can be accomplished through greater use of nationally recognized model codes, increased training for building officials, and creation of an authoritative national private-sector certification and approval process for innovations. The appropriate Federal role is to respond to the identified needs of the private sector and support State and local efforts to improve code administration. Finally, the Commission proposes reform of restrictive licensing requirements for the construction trades that impose unwarranted barriers on skilled craftsmen.

The Federal Role

The Federal presence in establishing standards in the housing construction industry dates back to the National Housing Act of 1934, when the Minimum Property Standards (MPS) were developed as part of the FHA's insurance programs for Federal underwriting of risk and as a means of assuring lenders and consumers that housing insured by the Federal program would be of uniform quality. The absence then of a voluntary national standard and the uneven quality of codes and inspection processes necessitated the Federal presence. Over the years, the Federal government has increasingly used construction standards.

The Commission concluded that separate Federal standards often are no longer needed. Consumers now demand a market product at least as good as that required under MPS standards. Moreover, the rapid growth and acceptance of various model building codes and the model One and Two Family Dwelling Code underscore the private sector's growing leadership in addressing building-standard concerns. Indeed, OMB Circular A-119, "Federal Participation in the Development and Use of Voluntary Standards," encourages Federal agencies to use private standards when possible and to participate in development of standards by the private sector.

Public-sector use of private standards is widespread. Most State and local governments increasingly adopt model building codes based on private standards. The Federal government also relies heavily on private standards. The Minimum Property Standards reference private standards, for example, and the Manufactured Housing Standards are based on the American National Standards Institute (ANSI) standard for mobile homes. The Federal Trade Commission has relied on private standards in adjudications, as has the Occupational Safety and Health Administration. Private standards are extensively used for procurement purposes: the National Commission on Government Procurement in a 1972 study reported that the General Services Administration references more than 4,000 private standards.

Private-Sector Standards

Federal agencies, in their housing programs, should use appropriate voluntary private-sector construction standards and rely upon appropriate private-sector processes for development and revision of standards.

Government should rely only on sound, fair private standards. The standards-setting processes of the American Society of Testing Materials (ASTM) and similar consensus systems have demonstrated their reliability in most cases. A consensus approach, when properly followed, seeks to ensure fairness by inviting participation and challenge.[1] Construction standards promulgated by such groups as ANSI or ASTM represent the work of more than 100,000 individuals in hundreds of technical committees that follow the consensus process.

Most building standards are developed through the ASTM process, which ensures that technical data on the standard are considered and that the procedures followed take negative views into account. Committee memberships are drawn from material producers, designers, engineers, and others familiar with technical issues. Thus, when committee members develop or review a standard, they try to consider a variety of criteria including health, safety, durability, and ease of maintenance. The committees are intended to be balanced in that producers of material — who stand to gain most by the specific standard selected — cannot outnumber nonproducer members. Finally, any reasonable negative view, raised either within or outside the committee during review of the proposed standard, must be resolved before the adoption process can continue.

After a construction standard is developed, it is reviewed by model-code organizations for adoption. This review establishes that the standard meets health and safety concerns and that it is enforceable. The standard may be modified to meet these criteria before being adopted by the model code organization.

Model codes include building codes as well as codes applying to fire safety and to plumbing, electrical, and mechanical systems. While the latter are adopted through the consensus process, model building codes are promulgated by associations of building officials. The Building Official and Code Administrators, Inc. (BOCA), the International Conference of Building Officials (ICBO), and the Southern Building Code Congress International (SBCCI) each publishes a model code.[2] In addition, the Council of American Building Officials (CABO), an umbrella group of the other three, publishes the CABO One and Two Family Dwelling Code. Only building officials are full voting members of the model building code organizations, although the relevant committees and subcommittees include other technically competent professionals. Last year BOCA considered — but, regrettably, rejected — opening its voting membership to architects and engineers.

During the 1970s, the building-code organizations began trying to harmonize their model code requirements and to unify code enforcement and interpretation, and these efforts show significant progress. For example, the three model-code groups have adopted the CABO One and Two Family Dwelling Code and the Model Code for Energy Conservation. Also, CABO's Board for the Coordination of Model Codes has made some progress in combining provisions of the three model codes.

Model codes are used by many State and local governments as the basis for their codes. It is only when officially adopted by a government body that a standard or code has the force of law.

Building-Product Evaluation and Approval Systems

Reciprocity should be established between public and private building-product evaluation and approval systems with the objective of developing a single, nationally recognized private-sector system upon which the public sector can rely.

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[1] See David J. MacFadyen, "A Case History of the Integrity of the National Electrical Code," a study of difficulties with the consensus process in changing the code to incorporate innovative flat conductor-cable wiring (Cambridge, Mass.: Technology & Economics Inc., 1979).

[2] The BOCA Basic Building Code tends to prevail in the East and North Central States, the ICBO Uniform Building Code in the Western States, and the SBCCI Southern Standard Building Code in the South.

An innovator must surmount many obstacles before he can market a new product for use in residential construction. Local code officials usually are wary of untried products or processes; they can incur substantial liability if they approve a product that later injures people or damages property.[3]

Authoritative evidence is needed to show that an innovation meets basic health and safety concerns. If appropriate test methods and a consensus standard already exist for the product, an innovator may turn to a recognized competent laboratory for testing and issuance of a report indicating compliance with the standard.

Of course, this requires performance standards that allow flexibility in meeting requirements, rather than prescriptive standards that specify the means. The code process should have a dual system of standards: Performance standards can be used by innovators and those who test new products, and prescriptive standards can be used for routine construction activity.

To support the credibility of the laboratory tests, both the American Association for Laboratory Accreditation (AALA) and the National Voluntary Laboratory Accreditation Program (NVLAP, now a part of the National Bureau of Standards) will accredit laboratories that are competent to conduct the appropriate specific tests.

There are several ways an innovator can demonstrate to local code officials that his product complies with a code: by approval from CABO, one or more of the model-code groups, or HUD.

The innovator may submit his product to CABO's National Research Board (NRB) for a research report attesting that the product conforms to model-code requirements. Alternatively, an innovator may seek approval from any one of the nationally recognized model-code groups, but the process can take a year or more. Moreover, periodic renewal fees must be paid to the group that has approved the product. Approval probably is necessary if the product is to be marketed in areas using the model code. The advantage of this approach for the applicant is that rejection by one code group does not imply rejection by the other two. On the other hand, the approval process must take pains to ensure that a new product does not endanger health or safety in the home.

Even the model-code research approval process may not guarantee acceptance by a local official, especially if the locality does not enforce an unmodified version of a model code. Litigation may be the only means of obtaining fair consideration of an innovation.[4]

The innovator who seeks permission to use a product in HUD programs faces a separate process called the "Technical Suitability of Products Program." HUD does not charge a fee, but the approval process may take a long time. Moreover, no other Federal agencies are bound by the Department's determination.

An authoritative body is needed to certify approval of new products and processes after enough scrutiny to ensure they meet basic health and safety requirements. The Commission calls upon HUD in collaboration with the National Institute for Building Sciences (NIBS), chartered by law to work in this area, to set criteria for the structure and procedures of such a body. Once such an entity is established, HUD may wish to provide start-up funds.

An effective national laboratory accreditation system must be an integral part of any private-sector certification program. Existing programs must be harmonized to meet the needs of a viable certification system.

Participants in the approval process should include not only building officials, who are represented on the research boards of the model-code groups, but also technical experts in appropriate test methods and performance standards, who are not. A certificate from the panel would show local building officials that an innovation was thought to meet basic health and safety requirements, that a building official can accept an approved product without incurring liability, and that consumers can rely on the product subject to any qualification issued by the approval body. A sound approval process is needed to overcome the problem of product liability that makes new products unattractive to designers, manufacturers, and installers. This process could also provide a safeguard for code officials who fear liability suits if they approve a product with which they are unfamiliar.

Manufactured-Housing Construction and Safety Standards

Consistent with its legal authority, HUD should revise its manufactured-housing construction and safety standards, using, to the extent feasible, nationally recognized voluntary standards organizations.

Manufactured housing ("mobile homes") serves an increasing number of American families; by the end of 1980, more than 3.8 million families

[3] Liability for violations of the constitutional rights of individuals involving monetary damages is covered under 42 U.S.C. Section 1983. See *Owen* v. *City of Independence*, 445 U.S. 622, 100 S.Ct. 1398, 63 L.Ed.2d 673 (1980); *Monell* v. *New York City Dept. of Social Services*, 436 U.S. 658, 98 S.Ct. 2018, 56 L.Ed.2d 611 (1978).

[4] See Charles G. Field, "Judicial Solutions to the Tension Between Codes and Innovation," *Urban Law and Policy*, 4 (1981), pp. 107–159.

lived in manufactured housing on a year-round basis.[5] Manufactured housing is the only segment of the U.S. housing industry that is regulated through a national building code and a nationally controlled enforcement system. The 1974 law establishing this regulatory system called for the Secretary of Housing and Urban Development to develop the "highest level of protection" in the standards and for these standards to "be reasonable."[6]

The Manufactured Housing Construction and Safety Standard is based largely on a national consensus standard promulgated by the National Fire Protection Association (NFPA) and ANSI. HUD has made changes to deal with such items as transportation and durability.[7]

The existence of a nationwide building code enables manufactured housing to avoid the expensive local-code variations that inhibit development of economies of scale in conventional home construction. This is not to say the nationwide code is without problems. HUD is only now revising the standards for the first time since they were promulgated in 1975, in sharp contrast to conventional model codes that are revised on a three-year cycle. This lag is even more surprising in light of studies relating to health and safety (e.g., fire safety) that have indicated a need for revision.[8]

HUD — required by law to follow a formal rulemaking process when amending its code — would do well to call on private voluntary standards groups to develop revised standards on which revised HUD standards could be based. Because of HUD's increased stake in manufactured-home finance and the importance of private-sector participation in the development of the standard, the process of adoption and revision of manufactured-housing standards may be a worthy prototype for the broad-based negotiated rulemaking process described in Chapter 14.

Energy-Performance Standards

The Federal government should repeal the building energy-performance standards legislation and consider limited funding of private research on total building performance.

In August 1976, Congress enacted the Energy Conservation and Production Act (ECPA), in response to the "energy crisis."[9] Title III, "Energy Conservation for New Buildings," directed HUD to develop and promulgate building energy-performance standards (BEPS) for new residential and commercial buildings. The legislation also provided for the development of sanctions for noncompliance, subject to approval by Congress.

Recent trends in energy conservation, industry performance, and State and local efforts reduce the need for a Federal role in setting energy performance standards. As new construction becomes increasingly efficient, the amount of additional energy that can be saved by performance standards is reduced. The architectural and engineering professions have substantially modified their certification and continuing-education programs to accommodate the latest skills in energy-conscious design and computer-aided design analysis.

Further, State and local efforts to improve the energy efficiency of buildings also have increased substantially since 1975. Forty-six States as well as many local communities now have energy conservation standards; most are based on ASHRAE Standard 90-75, developed by the American Society of Heating, Refrigerating, and Air-Conditioning Engineers (ASHRAE). This standard, privately developed through a consensus approach, has wide support throughout the building industry and is now being upgraded and modified. Federal standards that duplicate State and local energy codes are unnecessary and should be eliminated.

The Commission supports actions by Congress to eliminate mandatory Federal standards. To avoid the possibility that voluntary standards might be made mandatory in a new energy crisis, the underlying BEPS legislation should be repealed.

However, the Commission does not recommend eliminating Federal research in this field unless it is determined that there are adequate private-sector alternatives. Industry conducts research on improved energy performance of particular materials or building subsystems (e.g., mechanical; heat, ventilating, and air-conditioning; and electrical), but the Commission found no privately funded studies aimed at improving energy use by improving the design and operation of the whole building. The BEPS research is useful in identifying ways to conserve energy, and the Federal government should consider providing limited funding for such an approach.

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[5] Thomas E. Nutt-Powell, *Manufactured Homes* (Boston: Auburn House Publishing Co., 1982), p. 76.

[6] National Manufactured Housing Construction and Safety Standards Act of 1974, P.L. 93–383, 88 Stat. 633, 42 U.S.C. Section 5401.

[7] See House Subcommittee on Housing and Community Development, *Hearings: National Manufactured Home Construction and Safety Standards*, Parts 1 and 2 (Washington, D.C.: U.S. Government Printing Office, September 1981).

[8] See Edward Budnick and David Klein, *Mobile Home Fire Studies: Summary and Recommendations* (Washington, D.C.: National Bureau of Standards, 1979), and the companion cost-benefit analysis, *Economic Cost-Benefit and Risk Analysis of Results of Mobile Homes Safety Research: Fire Safety* (Cambridge, Mass.: Technology & Economics, Inc., 1980). Other studies are cited in Nutt-Powell, *op. cit.*, chapter 2.

[9] P.L. 94–385, 90 Stat. 1125.

The Federal government should continue to explore the feasibility of rating building designs for their energy efficiency. While such a rating is difficult because of differences in building-usage patterns, information on new and existing residences could satisfy the needs of the principal participants in the home-sales process. Homebuyers need information to make intelligent decisions; real estate agents and homebuilders need an additional sales tool; appraisers need data to determine the value of increased energy efficiency; and lenders need energy-efficiency estimates in their underwriting practices.

The greatest potential for short-term building energy conservation may be in modifying the existing housing stock. For example, the National Institute for Building Sciences is working on a Building Energy Efficiency Program to advise home and building owners about cost-effective energy conservation measures. The government should support such programs to improve energy conservation of existing buildings.

Access for the Handicapped

The Federal government should use the American National Standards Institute (ANSI) standard for access for the handicapped in order to meet the special construction needs of the handicapped population. Furthermore, appropriate Federal agencies should request ANSI to develop, at the earliest opportunity, a methodology for establishing scope requirements to determine local handicapped housing needs. In the interim, Federal scope requirements would be controlling.

To comply with federally assisted housing-development requirements in this regard, builders should certify that the construction complies with the ANSI standard and, where appropriate, with the Federal scope standards.

It has been estimated that more than 9 million handicapped people would benefit from increased independence in personal care and mobility in a more barrier-free environment, including those who would benefit from more accessible housing and improved public facilities, workplaces, and transportation.[10]

HUD is required to develop standards to be used in making its programs accessible to the handicapped. The Architectural Barriers Act of 1968[11] was passed to "insure that certain federally funded buildings were designed and constructed to be accessible to the physically handicapped." This act covered housing owned by local housing authorities. Section 504 of the Rehabilitation Act of 1973 expanded the coverage by requiring that "No otherwise qualified handicapped individual in the United States...shall, solely by reason of his handicap, be excluded from the participation in, be denied the benefits of, or be subjected to discrimination under any program or activity receiving Federal financial assistance or under any program or activity conducted by any Executive agency or by the United States Postal Service...."[12] The legislation required each agency to develop its own Section-504-related regulations based on guidelines developed by the then-Department of Health, Education and Welfare (HEW). The act also established the Architectural and Transportation Barriers Compliance Board to ensure compliance.

As of April 1982, HUD had not published final Section-504 regulations, but the most recent draft would apply the new ANSI A117.1 (1980) standard. The regulations require that enough accessible units be included in new construction of HUD-assisted and -subsidized projects to meet locally determined needs, but the methodology for determining such needs is not well developed. If no new construction is planned to meet those needs, ongoing HUD-sponsored rehabilitation programs must be used.

The ANSI standard was developed with the participation of the major interest groups in the building and design industries and those representing the handicapped community. The National Association of Home Builders and the American Institute of Architects helped develop the standard, and both have actively supported it. As the authoritative consensus document defining accessibility, the ANSI standard should continue to be the basis for Federal accessibility documents.

ANSI A117.1 is solely a technical specification. It describes the design requirement for door widths, acceptable heights for controls, turning space for wheelchair users, etc. Other than requirements of at least one of an accessible item, however, it does not specify scope, i.e., the proportion of components — bathrooms, doorways, etc. — built to the accessibility standards. Current HUD policy is for 5 percent of new construction to be accessible to the handicapped.

The proportion of units that should be available for the handicapped will vary by locality because the percentage of the population that is handicapped varies by locality. ANSI can develop methodologies for determining the size of the local handicapped population, but should not determine the actual percentage requirement for a project.

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[10] U.S. Department of Housing and Urban Development, *Access to the Built Environment: A Review of the Literature* (Washington, D.C: U.S. Government Printing Office, 1979), p. 30.

[11] P.L. 90–480, 82 Stat. 718, 42 U.S.C. 4151.

[12] P.L. 93–112, 87 Stat. 355.

Minimum Property Standards

The Department of Housing and Urban Development, the Farmers Home Administration, and the Veterans Administration should phase out their use of the single and multifamily Minimum Property Standards and depend entirely on locally enforced building codes that are consistent with the One and Two Family Dwelling Code or one of the current nationally recognized model building codes. Additional marketability and durability criteria may be used for federally subsidized multifamily rental housing if required to establish a reasonable level of risk for Federal funds.

In the absence of such a locally enforced building code, the three agencies should enforce the One and Two Family Dwelling Code or whichever of the current nationally recognized model building codes is most widely used in the immediate area of the individual project.

The Minimum Property Standards (MPS) were an integral part of the Federal government's efforts to rescue and restructure the nation's housing markets in the 1930s. In addition to its Federal use, the MPS has been widely employed by homebuilders, lending agencies, and manufacturers of residential building products across the country. The evolution of the various model codes with comparable standards and their broad acceptance by local authorities, insurance companies, and banks further reinforced movement toward a common market standard.

In the last 25 years, housing consumers also have come to expect a certain size and amenity level and would continue to do so even if the MPS ceased to exist. In fact, the buying public now demands most of the underwriting or marketability features required by the current MPS. In jurisdictions where they are adequately enforced, sound local codes, in effect, replace the necessity for Federal enforcement of an additional layer of standards. It seems fair to conclude that it is time for a transition from the MPS to dependence upon the codes and the demands of the market.

The currently recognized model building codes for multifamily homes and the CABO One and Two Family Dwelling Code for single-family homes provide enough assurance of basic quality that the Federal government need not be involved in separate minimum property standards. For multifamily properties, HUD should rely on locally enforced codes when these are reasonably consistent with one of the nationally recognized model building codes.

Standards mandated by statute or representing reasonable FHA insurance fund underwriting concerns for durability are important supplements to model code requirements in the case of HUD-subsidized multifamily housing. For FHA-insured nonsubsidized housing, HUD should recommend elimination of requirements that do not meet basic health and safety concerns. Where additional standards are used, HUD should justify them by demonstrating that they meet underwriting concerns not met under local codes, land-use regulations, and general marketplace demand. HUD eventually may not need to promulgate its own standards but may rely instead on local building and land-use codes.

HUD should phase out the MPS in favor of reliance on local codes that are consistent with one of the current nationally recognized model codes. The developer should submit data showing that the local code is satisfactory. Consistency is presumed unless HUD determines otherwise. Where there is no appropriate local code, HUD field staff should have the discretion to select one of the model codes and other land-use regulations used in the area. HUD should not unreasonably require more of the builder than these public- and private-sector codes do.

State and Local Building Codes

Building codes were created to provide basic protection for the health and safety of consumers of housing and users of buildings of all types. To this end, many States and localities rely on a model code for their basic regulatory framework. Besides codes applying to construction, there are fire safety, mechanical, electrical, and plumbing codes, and special codes for nursing homes, hospitals, schools, etc.

Over the years, State and local governments have tended to add extra elements of protection to those in the original building code, usually in the name of providing further consumer safeguards. Pressures to raise the minimum level of protection have come from many sectors of the building industry.

State and local governments have not acted uniformly, thereby creating differences not only among States but among adjoining communities. In a 1976 survey of local building departments, the Center for Urban Policy Research found that where the code was either locally adopted or State-recommended, one-third of the localities reported "significant variations" between their code and those used by neighboring communities.[13] These differences in levels of protection create additional costs for those who manufacture building products, those who specify them, and those who install them. States with mandatory statewide codes do not

[13] Stephen R. Seidel, *Housing Costs and Government Regulations* (New Brunswick, N.J.: Center for Urban Policy Research, 1978), p. 85.

have this problem when the code is uniformly applied.

A further problem is that enforcement and interpretation of identical code requirements vary greatly from community to community, thereby adding more costs to the supplier, designer, and builder. Estimates of the cost of all unwarranted variations range from 1.5 percent to 8 percent of the selling price of the average house, but whatever their magnitude, they are unnecessary and ultimately borne by the consumer. The problem is compounded by the generally low priorities and budgets most local governments assign to their building departments.

Some States with mandatory codes impose prohibitions on more stringent local requirements and require code officials and inspectors to be competent in the enforcement and interpretation of the code. New Jersey, for example, has adopted a statewide mandatory code consisting of five subcodes; each is a nationally recognized model code adopted without technical amendment. While local governments enforce the code, the State's Department of Community Affairs licenses code-enforcement officials. Under New Jersey law, all inspectors used by localities have been required since January 1, 1981, to be tested for competence and licensed.

Other States enacting statewide codes with local enforcement include Massachusetts, Connecticut, Oregon, and Kentucky. Virginia in 1972 adopted a notable "industrial building unit" law to cover manufactured and modular housing. As long as such units meet the industrial unit standards, they are exempt from the statewide building code and local building regulations.[14]

Where States have allowed local government to adopt more stringent minimum requirements than the State's, the same variances among local communities occur. The efforts of the model-code organizations to harmonize their requirements will be fruitless if communities continue to add unnecessarily divergent requirements to local codes.

Below are recommendations to limit the present broad scope of building codes, adopt model codes with minimal amendment, upgrade the professionalism of code officials, expand membership of model-code groups, improve coordination of building and fire safety codes, adopt rehabilitation guidelines, and provide limited Federal funding for research and demonstration of code reforms. Finally, recommendations are offered for reforming State and local licensing laws for construction craftsmen.

Health and Safety Requirements

All building codes should be limited to health and safety requirements; those responsible for developing or adopting such codes should remove existing requirements that do not meet this basic test.

The standards and model codes produced by the private sector take into account factors other than essential health and safety, and these factors are in turn reflected in local building codes. The problem is exacerbated when States and localities add code provisions irrelevant to health and safety requirements. These additional provisions are often suspect in terms of balancing benefits and costs.

Important community concerns may sometimes require adopting code provisions that do not deal with health and safety but rather with energy, security, the handicapped, and noise, for example.

On the other hand, provisions relating solely to aesthetics and marketability should be removed from model codes and those codes adopted by State and local governments. Such matters of taste are best left to the marketplace rather than the regulatory process. Moreover, expensive aesthetic and market-related requirements may serve an exclusionary function if inserted into codes, much as exclusionary zoning provisions arbitrarily increase housing costs.

State and Local Use of Model Building Codes

States should adopt or require their local governments with building codes to adopt, with little or no amendment, one of the current nationally recognized model building codes and the CABO One and Two Family Dwelling Code.

It is important to reduce the wide differences among local codes so builders and suppliers can take advantage of scale economies to serve a large potential market.

Although localities increasingly base their codes on one of the model codes, variations in requirements among jurisdictions still exist and constitute a major obstacle to cost reductions. Two solutions have been tried with what appears to be some success: States have taken over regulation of construction through the implementation of statewide mandatory building codes, and Federal safety and construction standards were enacted to regulate mobile homes produced and shipped interstate. While the data are incomplete, the State approach appears to work without dislocation of construction activity. Judging by the manufactured-housing in-

[14] Council of State Community Affairs Agencies, "State Actions to Promote Affordable Housing," unpublished report prepared for the President's Commission on Housing (1982), pp. 46–50.

dustry's firm support of the single code, the Federal code works, too.

Many observers point to the mobile-home industry as an example of how manufacturing can become more efficient when it answers to a uniform — rather than greatly varied — set of governmental regulatory requirements.[15] While the Commission deems it inappropriate for the Federal government to preempt State powers in determining conventional building codes, there is much the States themselves can do to promote building-code uniformity. For example, a statewide building code may greatly reduce the number of disparate regulatory bodies a builder or supplier must satisfy in order to market a safe and beneficial product.

To date, 25 States have adopted statewide building codes. However, 14 of these States have so-called "minimum" codes that permit localities to set more (but not less) restrictive requirements. Three States have enacted so-called "maximum" codes, setting maximum standards that localities may not exceed in their code requirements. Another eight States have adopted mandatory statewide codes applicable to all localities imposing building-code requirements.

Exercise of a State's authority to impose a statewide mandatory building code can reduce costs by providing developers advance knowledge of a clear set of building standards that apply uniformly to all localities and enable builders and suppliers to use more efficient production techniques to serve the statewide market. The Commission does not call for all States to adopt a mandatory code, however.

The Commission urges States and localities to minimize technical amendments to model codes they adopt; appropriate local variations might include administrative provisions. As recommended, States and localities should adopt the other nationally recognized model codes — including the One and Two Family Dwelling Code — with little or no modification. These include fire, electrical, plumbing, mechanical, elevator, and other codes applicable to single or multifamily housing.

Finally, the Commission urges the model-code organizations to accelerate their efforts to reconcile their provisions, and especially to use a common format so their provisions can readily be compared.

Professional Code Administration

State and local governments should recognize and utilize existing building-department personnel certification systems as an integral element of evaluating the technical competence of such personnel.

The professionalism of code officials has increased appreciably since the last Presidential housing commission in 1968. The various model-code organizations have adopted in-home and seminar training programs, offering formal examinations for building inspectors. CABO recently adopted a formal certification program for building officials including semiannual examinations.

The model-code organizations estimate some 5-10 percent of building inspectors have passed the examinations, mostly in recent years. Even in jurisdictions that do not require formal certification, officials and inspectors study for the examinations as a means of showing their competence and qualification for professional advancement.

Despite greater professionalism by local code officials, the problem of uneven interpretation continues to plague the building industry. New Jersey now requires State certification of building officials and inspectors, even while retaining enforcement powers at the local level. Because of the continuing need for more professional code enforcement, States should consider approaches like that used by New Jersey while utilizing existing programs in order to create nationwide uniformity of building-official certification. Certification examinations could be made a condition of employment and promotion.

The Commission urges States and localities to grant reciprocal recognition of existing certification programs so that building officials can retain their professional status if they move. Such reciprocal arrangements, with appropriate training in the new State's specific requirements, are common in many State-certified professions and should be encouraged.

Because improved professionalism can lower housing costs, the Commission urges States and localities to support financially — and perhaps require — continuing training programs for building officials. Several witnesses told the Commission that because of budgetary pressures such training opportunities are being curtailed rather than expanded. Budgetary pressures also result in a salary structure too low in many jurisdictions to attract and retain the most capable personnel.

In contrast to other safety services, such as police and fire departments, a building department is not dramatically visible to the public it serves. Indeed, health-and-safety requirements for building tend to be most publicized in the event of tragedies such as a major fire or the collapse of a building; when a building department does its job well, no one seems to notice. In many areas, the consequence is that the modest sums needed for training and professional administration are only grudgingly granted, if at all. States and localities should recognize the costs of inadequate code ad-

[15] See Seidel, *op. cit.*, pp. 92–93; Nutt-Powell, *op. cit.*, pp. 9–39.

ministration and undertake cost-effective measures to ensure high performance in their building departments.

Building-code enforcement may be a candidate for contracting to private firms, as many other local services are now contracted. Certification would ensure that individual inspectors meet necessary standards of competence. A State or locality then would monitor the performance of the private firm to ensure that it was performing as required.

Such an inspection system monitors the quality of mobile-home construction. The National Conference of States on Building Codes and Standards (NCSBCS), under contract to HUD, oversees the performance of the private and public mobile-home inspection agencies approved by HUD to enforce the Federal mobile-home construction and safety standards.

Membership of Model-Code Organizations

The model-code organizations should include other technically competent interested parties as full voting members in their deliberative processes.

As in the case of private standards groups, the basic fairness of the process of model-code revisions is important in influencing government bodies to adopt privately developed codes.

The Commission is encouraged by progress in fostering communication between code officials and other technically competent people, especially architects and engineers. The BOCA Code Change Committee includes an architect, an engineer, and other noncode officials appointed by the BOCA president. In 1981, BOCA considered but rejected a proposal to expand voting membership to include architects and engineers, not just building officials. ICBO includes architects, engineers, and other advisory members who influence the ICBO committees, although only building officials are formal voting members. Subcommittees of SBCCI's Code Change Committee include architects, engineers, and manufacturers, among others, although only code officials are on the full committee. CABO in 1978 created a broad-based committee to review changes to the One and Two Family Dwelling Code; among the professionals appointed were an architect, a professional engineer, and homebuilders.

These, it is hoped, are steps toward full voting membership for such professionals.

Conflicting Codes

The Board for the Coordination of Model Codes (BCMC) should be encouraged in its effort to resolve differences between building codes and fire-safety standards.

The nationally recognized model building codes contain fire-safety standards promulgated by the National Fire Protection Association (NFPA) — e.g., those governing the installation of automatic fire sprinklers. The National Electrical Code promulgated by NFPA is most often adopted by State and local governments as a companion document for their own or one of the national model building codes. However, the model codes and NFPA promulgate differing fire-safety exiting requirements that often are impossible to resolve. In these instances, the architect and builder are required to follow the most stringent requirements, and this usually results in added cost to the consumer.

In 1981, BCMC, created by the model-code groups to harmonize the contents of their codes, invited NFPA to become a full voting member. NFPA's participation should harmonize the contents of the model building codes with the NFPA Life Safety Code. The Commission — recognizing that much remains to be done — enthusiastically supports this effort.

It is also important that the BCMC accelerate its work to harmonize the model building code requirements, and especially to create a common format to help compare them.

In many instances, fire safety and building safety at the State and local level remain at cross-purposes, since State and local amendments to both codes inadvertently increase conflicts between their requirements.

Complete harmony between national fire- and building-code requirements will not by itself resolve State and local amending practices. A closer liaison between State and local building officials and fire officials also is needed, all in the interest of ensuring reasonable and minimal fire-safety requirements for consumers of housing. In 1980, the NFPA — in an effort to establish broader participation by building officials in the deliberations of NFPA — created an Architects and Building Code Officials' Section. But that effort has yet to generate greater cooperation. Building officials should take advantage of the NFPA's attempt to create the harmonious relationship needed to benefit all consumers of housing.

Rehabilitation Standards

State and local governments should apply the HUD rehabilitation guidelines as the basis for further development of their own rehabilitation standards.

When applied to building-rehabilitation projects, building codes oriented to new construction can add high, unnecessary costs. In 1978 hearings, the Senate Banking Committee heard architects, trade associations, building officials, and others

testify that code-generated costs can range from 10 percent to 20 percent of total project costs and add unnecessary project-approval time — reportedly as much as 16 months longer than for comparable new construction.[16]

These constraints strongly affect the nation's growing rehabilitation activity, including preservation, adaptive re-use, and renovation. Building codes for new construction present difficulties when applied to rehabilitation. First, codes may not address the types of construction present in many older buildings. Second, codes apply to new construction processes rather than rehabilitation of an existing building that must be analyzed for a reasonable degree of code compliance. Third, codes limit innovative solutions because building officials feel that there is not enough technical flexibility to allow code deviations.[17]

HUD in 1980 adopted Rehabilitation Guidelines, including the "Guideline for Setting and Adopting Standards for Building Rehabilitation." Both the American Society of Civil Engineers (ASCE) and the American Society for Testing and Materials (ASTM) have begun developing voluntary standards that embody the purposes and methods of the HUD guidelines. These guidelines reflect the kind of private-sector participation the Commission encourages, and it urges States and localities to apply them to rehabilitation projects in place of expensive and unnecessary new construction requirements.

Building Code Research

The Federal government should consider providing limited funding for research and demonstration projects to enhance the technical content and the administration of building codes.

The Commission found there is a continuing need for research to enhance the technical content of building codes.[18]

Appropriately, much of this work is left to the resources of the private sector — often, firms with a large direct financial stake in the adoption of their product. Manufacturers of plastic pipe or flat-wire cable have successfully undertaken the research and development needed to secure approval of their products by the national code organizations and, increasingly, by State and local governments.

On the other hand, some innovations — improved design practices, for instance — may have such wide industrial application that no single firm is willing to spend the money needed to secure their adoption into building codes. Recent examples are the appropriate test methods and standards for unvented heaters or for barriers behind wood-burning furnaces. This is also true of innovations that involve building systems rather than single products: for example, an alternative framing system for houses that involves less labor or materials, or improvements in air conditioning that include a variety of components in specially designed systems.

Where this kind of improved technical content in building codes promises overall savings in housing costs, the Commission finds it appropriate for the Federal government to consider providing the necessary research funds to the most appropriate private or public organizations. A particularly advantageous arrangement would be to support research at land-grant universities in States that have expressed a commitment to statewide regulatory reform based on university-State cooperation.

While Federal funding would originate with a department such as HUD, the National Institute for Building Sciences (NIBS) is a forum that could develop a research agenda for Federal consideration.[19]

In addition, the unique capability, facilities, and expertise of the National Bureau of Standards (NBS) have played and should continue to play a significant role in improving the technical content of codes through technical data and test methods, performance criteria, and background technical work.

Most of the obstacles to building-code reform are institutional rather than technical. Only the most affluent innovator, for example, can afford the estimated half-million dollars spent annually by the plastic-pipe industry to get its technical innovations adopted by the model-code organizations, State and local governments, and local building officials.[20]

In addressing these institutional issues, a number of possible reforms should be investigated through research and demonstration, with successful changes brought to the attention of other States and localities. Areas of study could include:

- *Assessment of the cost-effectiveness of innovations in building-code administration at*

[16] U.S. Senate, *Impact of Building Codes on Housing Rehabilitation*, hearings before the Senate Committee on Banking, Housing and Urban Affairs (Washington, D.C.: U.S. Government Printing Office, March 24, 1978).

[17] James G. Gross, "Improving Building Regulations for Rehabilitation" (Washington, D.C.: National Bureau of Standards, 1981).

[18] See U.S. Comptroller General, General Accounting Office, *Greater Use of Innovative Building Materials and Construction Techniques Could Reduce Housing Costs* (Washington, D.C.: 1982).

[19] The 1974 Housing and Community Development Act (P.L. 93-383) specifies that NIBS is to address the problem "of the difficulty at all levels of government in updating their housing and building regulations to reflect new developments in technology..." (Sec. 809(a)(1)).

[20] Seidel, *op. cit.*, p. 91.

the State and local levels. Subjects for study include the New Jersey and Massachusetts statewide codes, the Los Angeles system of product approval and research reports, and the Detroit system of "one-stop service" in the building permit process. These States and localities have innovated in their code adoption and enforcement, but the results have not been analyzed, nor have successful experiences been widely shared.

- *Development of models of efficient building department administration appropriate to various-sized States and localities.*
- *Assessment of the cost-effectiveness of reforms focusing on the qualifications and professionalism of building officials*. Assessment would cover multidiscipline inspectors, mandatory continuing education requirements, State certification programs, and the effective introduction of performance rather than prescriptive requirements into everyday code enforcement. It also would include research on the accountability and liability of building officials for their decisions, with development of sound legal and administrative models.
- *Examination of the budget issues involved in building departments*. Reviews are needed of "user pay" concepts and the costs implicitly associated with using the building department as a net-revenue-generating device. Again, models would be made available to localities seeking to reform their systems of administration. Demonstration of building-code enforcement contracted out to private firms also might be studied.
- *Examination of the longer-term possibility of substituting warranties for building-code requirements*. This would include analysis of the French system, which imposes warranty requirements in place of building codes, and analysis of the conditions for cost-effective adoption of such a system in the United States. This possibility is attractive because building codes and warranties both address the requirement that homes be constructed to meet basic health and safety needs. If properly implemented, it could significantly reduce housing costs. Warranties are less expensive to administer than building codes; they are implemented through the private sector rather than through a regulatory bureaucracy. Warranties are essentially performance standards rather than the prescriptive standards found in codes. An effective demonstration project is needed to test the cost effectiveness of this concept on a limited scale. Also needed is evaluation of proposals to permit innovators to market their products so long as they provide insurance against harm caused by exceptional failures.[21]

Licensing Construction Craftsmen

States should reform their laws relating to licensure of specialized construction workers (1) to remove licensure requirements not related to basic health and safety and to remove testing and scoring not closely and directly related to job performance; (2) to establish statewide licensure so licensed craftsmen may operate anywhere within the State; and (3) to grant recognition to comparable licenses issued by other States.

States and some localities license construction craftsmen, such as plumbers and electricians, to ensure that construction is done by qualified people. However, a number of recent studies[22] indicate that many licensing laws create barriers to entry and impose unnecessary construction costs. They also operate to restrict interstate mobility of craftsmen, thereby exacerbating the effects of housing cycles.

Licenses are granted by States or localities and sometimes by both. There is evidence that the most restrictive licensing of electricians and plumbers occurs at the local level or when both a State and a locality have license requirements.

Before electricians or plumbers can be licensed, States or localities require that they pass examinations and satisfy specified minimum requirements. Prerequisites vary by jurisdiction but include in at least some jurisdictions: (1) recommendation by members of the occupation; (2) years of experience or apprenticeship; (3) years of schooling; (4) minimum age; (5) U.S. citizenship; (6) years of local residence; or (7) literacy in English.

Several of these requirements are difficult to justify if we assume the only valid reason for licensing is to protect public health and safety. These include items (1), (4), (5), (6), and possibly (7). The

[21] See John McClaughry, "A New Approach to Building Safety," in Donald Pinkerton (ed.), *Building Rehabilitation Research and Technology for the 1980's* (Des Moines, Iowa: Kendall/Hunt, 1980), pp. 65–75.

[22] See Benjamin Shimberg, *Occupational Licensing: A Public Perspective* (Princeton, N.J.: Educational Testing Service, 1978); Shimberg, Barbara F. Esser, and Daniel H. Kruger, *Occupational Licensing: Practices and Politics* (Washington, D.C.: Public Affairs Press, 1973); Jeffrey Perloff, "Plumber and Electrician Licensing Laws," *Construction Review* (Sept/Oct. 1979); Perloff, "The Impact of Licensing Laws on Wage Changes in the Construction Industry," *Journal of Law and Economics*, 23 (1980), p. 409; and Morris Kleiner, Robert S. Gay, and Karen A. Greene, "Licensing, Migration, and Earnings: Some Empirical Insights," *Policy Studies Review*, Vol. 1, No. 3 (February 1982).

others, notably schooling and experience requirements, have been applied with great variation among licensing jurisdictions in ways that are difficult to justify.

Some cities and States require two years of experience to become a journeyman electrician or plumber, while other States, and localities such as New York City, require considerably more. Again, studies indicate that the more extreme requirements tend to increase construction costs without offsetting benefits in terms of minimum acceptable competence.

Finally, licensing examinations for many trades are said to be arbitrarily administered. Economics Professor Elton Rayack[23] of the University of Rhode Island conducted a detailed study of licensing failure rates in 12 professions, including electricians and plumbers, in Connecticut, Massachusetts, and Rhode Island. Among his findings: When labor market conditions worsen, licensing boards tend to fail a higher percentage of applicants for licensure, irrespective of the qualifications of the applicants, in order to reduce the flow of new entrants into the market and thereby strengthen the competitive position of the licensed.

Rayack concluded that such variation in examination-failure rates indicates the tests were not appropriate to determine "minimum socially acceptable standards of skill and ability." Circumstantial evidence supports this conclusion. In 1973, for example, 2,149 candidates took the Florida Construction Industry Licensing Board examination to become general contractors — and all failed. "Then after a flood of protests, the board took a second look at the results and decided that 88 percent had passed."[24]

The Commission found sufficient evidence to call on the States to reform licensing requirements for workers in the construction industry, as follows.

- License requirements not essential to the protection of health and safety should be eliminated. Concern about incompetence often can be addressed adequately through certification or a system requiring no more than registration and the policing of registrants where abuses are alleged to have occurred.[25]
- Only testing and scoring directly related to job performance should be permitted. When the implementation of these rules is challenged judicially, a government agency should bear the burden of proving the regulation complies with the foregoing standards.
- States should create statewide licenses or reciprocity so practitioners are not arbitrarily confined to the locality where they receive their license. Statewide licensing requirements should not preempt less restrictive standards at the local level.

Finally, the Commission calls on States to recognize comparable licenses from other jurisdictions. Especially in view of the growing prevalence of model building codes and widely adopted codes such as the National Electrical Code, there is little justification for many present restrictions on the mobility of skilled construction craftsmen. There is much evidence that these skilled people would move to States with higher construction wages if they could retain their licensed status there. Such migration, in turn, would contribute to lowering housing costs and, in particular, to mitigating the impact of housing cycles as they variously affect different parts of the country.

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[23] Elton Rayack, "An Economic Analysis of Occupational Licensure," unpublished paper for U.S. Department of Labor, 1976.

[24] *Consumer Reports* (April 1976), p. 204.

[25] Ernest Gellhorn, "The Abuse of Occupational Licensing," *University of Chicago Law Review*, 44 (1976), pp. 6–77.

CHAPTER 17

IMPLEMENTATION OF DEREGULATION

Earlier chapters in this section have documented the need for nationwide, systemic change in the structure of housing regulation. That need was underscored by a number of Commission findings: the continued growth of regulation, despite the warnings of the Douglas Commission and the Kaiser Committee; the impact of those regulations on the cost of housing; and the need to provide access to affordable shelter for the millions of new households with limited resources.

The Commission recognizes that not all governments or their constituent agencies will respond the same way to the Commission's deregulatory recommendations. Some may initiate actions willingly; others may strongly resist change. But many State and local governments probably would be receptive to regulatory change if the problem of housing affordability is effectively communicated to them and proper technical support is provided. It is this large group of uncommitted State and local agencies and governments that the Commission is especially interested in reaching through the recommendations in this chapter.

The Commission's recommendations on deregulation are summarized in Table 17.1. This table points out the extent to which housing deregulation is a shared governmental responsibility. It also shows the magnitude of the task that all levels of government face if they are to achieve regulatory reform in a manner that avoids duplicative or counterproductive policies and actions. Implementation of these recommendations cannot be accomplished unless all affected parties are significantly involved in the process.

There are major obstacles, however, to achieving broad support for deregulation—the perceived self-interest of the various institutions and individuals that produce, regulate, or consume housing:

- *Economic Interests*. Institutions and individuals that benefit from the regulatory system in a direct economic sense (ranging from manufacturers of products, service industries, trade unions, and building-code officials to planning consultants and attorneys) collectively represent a powerful force that often resists rapid or dramatic change.
- *Governmental Inertia*. Officials in government agencies and organizations often perceive change as a threat to competing public concerns or to their own personal interests. The staff of these institutions sometimes reflect the narrow interests of the constituencies they serve rather than a broader public interest.
- *Homeowner Politics*. Whether in the form of growth controls or opposition to rezoning, resistance to new development appears to have gained strength in the 1970s; many local ordinances have restricted the use of land and excluded newcomers from the community.

Thus, change is essentially a political rather than a technical process. For this effort to succeed, these barriers must be substantially reduced or neutralized.

To facilitate this change, the Commission has developed recommendations in the following areas: special regulatory relief for Federal housing actions and regulations; HUD implementation initiatives; and State and local government deregulation actions. In addition, this chapter identifies a number of public and private initiatives already under way, demonstrating that awareness of the housing affordability issue is growing and that change is possible.

Implementation Recommendations

The following recommendations urge all levels of government to act immediately and decisively to expand their deregulatory efforts: revision or

Table 17.1
Implementation of Commission Deregulation Recommendations: Governmental and Private Sector Responsibilities

Recommendation	Chapter Number	Implementing Level: Federal	State	Local	Private
A. FEDERAL RECOMMENDATIONS					
1. Environmental Regulations	14				
a. Eliminate duplicative Federal and State environmental requirements.		X	X		
b. Amend Section 404 of Clean Water Act to limit Federal wetland provisions.		X			
c. Review of Executive Order 11990 (wetlands).		X			
d. Raise the HUD EIS threshold to 2,500 dwelling units or lots and use two-stage review processes or environmental assessments.		X			
e. Increase use of HUD Local Area Certifications.		X			
2. Floodplain Management/Insurance	14				
a. Task Force on Regulatory Relief should review and revise:					
(1) 100-year floodplain standard;		X			
(2) Executive Order 11988 (floodplains).		X			
b. Coastal barriers delineation and definition should be amended to reflect increased sensitivity to uses of coastal property.		X			
c. Promote private insurance industry assumption of flood insurance.		X			X
3. HMDA and CRA	14				
Congress and appropriate regulatory agencies should review burdens on depository institutions resulting from Home Mortgage Disclosure Act (HMDA) and Community Reinvestment Act (CRA).		X			
4. RESPA	14				
Section 8 of the Real Estate Settlement Procedures Act (RESPA) should be revised to permit development of new settlement services.		X	X		
5. Davis-Bacon	14				
Exclude housing construction from coverage under Davis-Bacon Act.		X			
6. Timber Production	14				
Revise national timber harvesting policy. Pass legislation to support conclusions of policy review. Encourage States to reform forest		X	X		

Table 17.1 (continued)

Recommendation	Chapter Number	Implementing Level: Federal	State	Local	Private
property tax policies and forest practices regulations that impede efficient private investment.					
7. Farmland Preservation	14				
Repeal Federal Farmland Protection Policy Act of 1981.		X			
8. Rulemaking Recommendations	14				
a. Hold Federal agencies to a stricter level of justification under the Administrative Procedure Act (APA) and reverse burden of proof.		X			
b. Implement procedures to encourage Federal agencies concerned with housing to use negotiated rulemaking procedures.		X			
c. Institute management system to facilitate HUD clearance of rules.		X			
9. Warranty Insurance	6				
Congress should amend the law to require that homes insured by FHA, FmHA, and VA be administered through private-sector programs.		X			X
10. Public Land Policy	8				
a. The Bureau of Land Management (BLM) should complete land inventory and land-use plans.		X			
b. Federal government (BLM and Forest Service) should develop unified procedures for disposal of public lands and should work closely with State and local governments in preparing for land availability for housing and community development.		X	X	X	
c. The Secretaries of the Interior and Agriculture should be authorized to permit payments in excess of the statutory 25 percent of appraised value to equalize the difference in valuation between a parcel of public land being exchanged for a parcel of private land, where the public land is being acquired by a public entity for public purposes.		X			
d. The Secretary of Agriculture should issue a regulation that specifically directs that land conveyance under the Townsite Act for housing use should be		X			

Table 17.1 (continued)

Recommendation	Chapter Number	Implementing Level: Federal	State	Local	Private
encouraged. The Commission endorses the passage of legislation to permit the Forest Service to sell or exchange small tracts of land.					
e. The Secretary of Interior should direct the Bureau of Land Management to develop a consistent program for the leasing of land, for a definite time period, for housing use to State or local government entities or nonprofit groups.		X			
f. BLM and the Forest Service should reassess their land appraisal methods to provide price mitigation, where Federal leasing or land policies have contributed to escalating land costs.		X			
g. The White House Property Review Board should ensure the prompt disposal of Federal surplus property, especially for housing use.		X			
h. States and localities should initiate programs to review their policies with regard to sale and transfer of land and to identify parcels of their own public land.			X	X	
B. STATE AND LOCAL RECOMMENDATIONS					
1. General Zoning Standard	15				
State and local governments should eliminate zoning unless necessary to achieve a vital and pressing governmental interest.			X	X	
2. Judicial Zoning Standard	15				
U.S. Attorney General should review judicial zoning standard for determining validity of zoning ordinances.		X			
3. Specific Zoning Regulations	15				
a. Density of Single and Multiple Family Developments					
Density of development should be determined by marketplace.			X	X	X
b. Zoning Restrictions on Manufactured Housing					
States and localities should remove all forms of discrimination against manufactured housing.			X	X	

Table 17.1 (continuted)

Recommendation	Chapter Number	Implementing Level: Federal	State	Local	Private
c. Size of Dwelling Unit Place no limits (minimum or maximum) on the size of individual dwelling units.			X	X	
d. Growth Controls Oppose growth controls, except where justified by a vital and pressing governmental interest.			X	X	
e. Farmland Preservation Controls Oppose any farmland preservation controls whenever they operate to limit the development of land for housing purposes.		X	X	X	
4. Financing Infrastructure Encourage municipal use of innovative financing approaches.	15		X	X	
5. Cost-Sensitive Standards HUD should contract with the National Institute of Building Sciences for the development of advisory, cost-sensitive subdivision standards.	15	X			
6. Wastewater Technology Encourage use of innovative wastewater technologies.	15	X	X	X	X
7. Builder/Developer Fees Builders and developers should be obligated for only local exactions directly related to their activity.	15		X	X	
8. Local Permit Processing Consolidate local development permit processing.	15		X	X	
9. Condominium/Cooperative Conversion	6				
a. Support conversion to condominium or ownership and oppose undue restrictions thereon, and urge the States to adopt conversion procedures generally in accordance with those established in the Uniform Condominium Act.			X	X	
b. Undertake review and removal of any tax regulations at all governmental levels which discourage condominium conversions.		X	X	X	
c. HUD should not restrict the conversion of Federal unassisted multifamily rental housing into cooperatives and condominiums.		X			

Table 17.1 (continuted)

Recommendation	Chapter Number	Implementing Level: Federal	State	Local	Private
10. Rent Control	7				
a. State legislation should remove local rent control authority.			X		
b. Preemption from rent control of mortgages for rental housing where direct Federal financing, federally insured or guaranteed loans, or federally insured lending institutions are involved.		X			
C. CONSTRUCTION STANDARDS AND BUILDING CODES					
1. Private-Sector Standards	16				
Federal agencies should utilize private-sector voluntary construction standards.		X			X
2. Building Product Evaluation and Certification systems	16				
Establish reciprocity between the public and private-sector building product evaluation and approval systems.		X	X	X	X
3. Manufactured-Housing (read "Mobile Home") Construction and Safety Standards	16				
HUD should revise manufactured housing construction and safety standards, drawing upon nationally recognized voluntary-standards organizations.		X			X
4. Energy-Performance Standards	16				
Repeal the Building Energy-Performance Standards legislation and give limited funding to private research on total building performance.		X			X
5. Access for the Handicapped	16				
Utilize American National Standards Institute (ANSI) standards for access for the handicapped.		X			X
6. Minimum Property Standards	16				
a. Phase out use of the minimum property standards and depend upon locally enforced codes consistent with nationally recognized model building codes.		X			
b. In federally subsidized multifamily rental housing programs, add standards where justified by		X			

Table 17.1 (continuted)

Recommendation	Chapter Number	Implementing Level: Federal	State	Local	Private
marketability and durability criteria.					
7. Local Building Codes	16				
a. Building codes should be limited to health and safety requirements.			X	X	X
b. State and local governments should adopt a model building code.			X	X	
c. State and local governments should use personnel certification systems.			X	X	
d. Model code organizations should expand voting membership to include professionals such as architects and engineers.					X
e. Resolve conflicts between building codes and fire safety standards.			X	X	X
f. State and local governments should use HUD rehabilitation guidelines.			X	X	
g. Provide limited Federal funding for research and demonstration.		X			
h. States should reform existing construction trades licensing laws.			X		
D. IMPLEMENTATION OF DEREGULATION					
1. The President should designate either Cabinet Council or Vice President's Task Force on Regulatory Relief to coordinate Federal housing actions.	17	X			
2. HUD should undertake an extensive affordable-housing implementation program, including: (1) identifying a single office for promoting and coordinating housing affordability and (2) creation of an Office of Housing Productivity.	17	X			
3. State and local governments should take immediate action to enact deregulatory changes in support of affordable housing.	17		X	X	

elimination of unnecessary statutes and regulations; and implementation of a comprehensive public information and education campaign to promote broad-based support for regulatory change.

Special Regulatory Relief

To achieve special regulatory relief for housing, the President should designate either the Cabinet Council or the Vice President's Task Force on Regulatory Relief to coordinate agency actions concerning housing and to review the aggregate impact of regulations and Federal programs on the housing sector.

Federal housing regulation is diverse and pervasive, involving more than 100 Federal programs or regulatory areas under the jurisdiction of at least

50 executive or independent agencies.[1] Some programs cover a broad range of housing activity (e.g., Consumer Product Safety Commission standards), while others have more limited application (e.g., Interstate Land Sales Registration). Some regulation may significantly affect the progress of a project (e.g., floodplain and wetland requirements), the technical construction aspects of housing (e.g., manufactured housing construction and safety standards), or major procedural requirements (e.g., OMB Circular A-119 on private standard-setting activities). In short, some programs and regulations of nonhousing agencies have significant effects on housing costs.

There appears to be little Federal awareness that the cumulative proliferation of these programs and regulations has imposed significant burdens on the housing industry. While the Vice President's Task Force on Regulatory Relief in 1981 singled out the automobile industry for regulatory relief and in 1982 announced a similar effort for small business, no such focus for housing has yet been announced.

Executive Order 12291, which governs the development of Federal regulations, provides for a cost-benefit analysis of proposed regulations. Major rules must undergo a particularly rigorous examination before they are issued. However, unless specific efforts are undertaken to identify both proposed and existing regulations that affect housing, existing regulations will remain unchanged and new regulations will be issued without knowledge of the Office of Management and Budget (OMB) or the issuing agency of the impact of the regulations on housing development.[2]

Most regulations affecting housing are classified as minor and therefore not subject to the same scrutiny as given to major rules by OMB. The Commission believes, however, that the aggregate effects of these minor rules are substantial and warrant careful and continuing scrutiny. Either a working group of the Cabinet Council or the Vice President's Task Force on Regulatory Relief would be an appropriate body to coordinate such a review and to give the necessary Presidential focus to this process. When an issue involving two Federal agencies arises, a higher authority is needed to resolve their differences.

By placing this responsibility with either the Cabinet Council or the Task Force on Regulatory Relief, the Commission clearly intends to avoid the creation of a new level of review. The Commission recommends that this necessary oversight be integrated with the OMB process under Executive Order 12291, and that the Department of Housing and Urban Development (HUD), as the principal housing agency, play a key role.

Because of the diverse structure of the housing industry and the many Federal regulations and agencies involved, the designated group would benefit from the expertise and experience of the housing industry, State and local government, and consumer groups. These interests should participate from the outset in the review process of identifying priority regulations for regulatory relief and understanding the practical effects of specific regulations on the housing industry. The National Institute of Building Sciences, The National Governors' Association, and the Federal Trade Commission, for example, could perform a helpful role in the process.

To ensure timely oversight by OMB, a procedure should be developed to signal OMB staff that an existing or proposed rule may have an impact on housing. The Commission considered the use of a housing impact statement for all rules, but rejected this approach as burdensome and likely to result only in *pro forma* attention by both agency and OMB staff. A more efficient approach would be for the Cabinet Council or Task Force group to screen an agency's actions or proposed regulations that will affect housing and then notify OMB of the potential problems.

Once the designated group determines that an existing or proposed Federal regulation may significantly affect housing, the regulating agency should assume full responsibility for analyzing the regulation, discussing it with all involved parties, and reporting its results pursuant to the established Executive Order 12291 process.

HUD Initiatives

The Department of Housing and Urban Development should undertake an extensive affordable-housing implementation program. Such an effort should include (1) identification of a single HUD office for promoting and coordinating housing affordability, and (2) creation of an Office of Housing Productivity.

A number of recent initiatives by HUD show how HUD is moving toward housing deregulation. In terms of its own regulations, the Department has taken numerous regulatory relief actions, as discussed in Chapter 14.

Through demonstrations, the agency also has identified opportunities for regulatory relief at the

[1] "Federal Regulatory Programs That Affect the Building Process" (Washington, D.C.: National Institute of Building Sciences, September 1981).

[2] See Executive Order 12291 (February 17, 1981) 46 Fed. Reg. 13193. Section 2 of E.O. 12291 requires that a new regulation not be issued unless the potential benefits outweight the potential costs to society. No analytical requirements are specified to make this finding. The requirements of a regulatory impact analysis are set forth in Section 3.

local level. In 1979, HUD and the National Association of Home Builders launched "Approach 80" to demonstrate reductions in housing costs through subdivision design, site improvement modifications, and innovative construction techniques. As a result of increased density and construction innovations, 38 single-family, duplex, triplex, and quadraplex homes were built at savings of 10 to 20 percent compared with conventional units of similar size in the area.

In 1980, HUD initiated three public/private (city/developer) demonstrations to show how the cost of housing could be reduced through changes in local government zoning, subdivision, and building codes and through expedited permit processing by the city and HUD field offices. This effort generated important additional insight into the cost of State and local regulations. Regulatory relief was shown to be beneficial in:

- *Allegheny County, Pa.*, where manufactured housing was erected on surplus public land to reduce development and construction costs. Savings attributable to both on-site and off-site work and reductions in processing time for local permits were achieved. The result was new homes that were priced from $42,000 to $45,600, a 24-percent reduction over comparable units in the area.
- *Hayward, Calif.*, where a nonprofit corporation was used to develop 58 townhouses close to the downtown area. Selling prices ranged from $53,000 to $65,000, down a third from the $79,500 to $97,500 cost of comparable units. This price reduction was primarily a result of substantially reduced processing time.
- *Shreveport, La.*, where only four and a half months after HUD held initial meetings with the developer and the city, the first model townhouse units were available on three inner-city sites. Savings of 21 percent over conventional development ($55,000 as opposed to $70,000 for a comparable unit) were attributed to increased density ($8,500), reduced overall development time ($4,400), and reduced construction costs ($1,000), which included modest changes in code requirements.

HUD's most recent effort, the Joint Venture for Affordable Housing, launched in January 1982, is a significant multifaceted expansion of earlier programs; it includes local affordable housing demonstrations, technical assistance, preparation of various guides and case studies, and the development of a national network for information-sharing among communities that are experiencing housing problems. The strength of this effort relates in part to the close working relationship between HUD and several State and local associations and trade groups, including the National Association of Counties, the International City Management Association, the National Association of Home Builders, and the Council of State Community Affairs Agencies. This arrangement provides an excellent basis for an expanded effort.

HUD's Role in Housing Affordability. The Commission commends HUD for these prototype efforts. The scale of the effort—appropriately small at the beginning—should now be expanded. Recent evidence of receptivity to change at the State and local levels, combined with housing cost and availability problems, justify an expansion of Federal efforts to support State and local initiatives. Specifically, the Commission recommends that a single office within HUD be assigned the responsibility of assuring coordination of all contributing agencies and organizations to support a sustained and continuing national effort of deregulation for the country's housing future. Increased emphasis should be placed on producing information and technical materials (prepared by staff or in conjunction with appropriate private groups). These materials could include guidebooks and case studies describing the implementation of change, analyses of the impact of deregulation, model development standards, and publications designed to supplement on-site training and technical assistance to government and private groups. Although some technical materials have been produced, serious gaps exist. Model cost-efficient subdivision and infrastructure standards, as well as a layman's guide to facilitate local regulatory change, are but two examples of potentially useful documents. Such technical reference sources are especially important for proponents of change who face stiff local opposition.

A national clearinghouse also should be established to collect and disseminate information and publications produced by other groups; to serve as a broker in assisting national organizations and State and local governments interested in promoting housing affordability among their respective memberships and constituencies; to provide grants to stimulate State and local efforts; to conduct specialized types of training that might be more appropriately carried out at a national or regional level; and to maintain a national register of individuals and organizations with various types of related expertise.

In addition, the Commission endorses the establishment of a HUD national awards program for communities that have carried out significant housing-deregulation programs. Throughout its deliber-

ations and public hearings, the Commission was impressed by the growing, though still limited, number of local governments that have demonstrated sensitivity to the impact of statutes and regulations on the cost of housing and have taken steps to create a more positive environment for affordable housing. This kind of constructive activity should have greater visibility.

Office of Housing Productivity. The Commission finds that there is an urgent need for analysis of productivity problems in housing and for development of effective solutions. Given the magnitude of the problem, there has been little systematic progress toward devising solutions to low productivity. Therefore, the Commission urges that HUD establish an Office of Productivity to meet these important needs.

To date, HUD's primary emphasis in this area has been to stimulate the development and introduction of new building technology. This focus must be complemented by a concerted effort to remove regulatory and institutional constraints that discourage the acceptance of technological innovation in the marketplace.[3] These constraints include a variety of regulatory impediments that make it difficult to market even the most beneficial improvements. The result is to discourage innovators from developing and marketing cost-effective products or methods, creating low productivity in the industry.

As noted in Chapter 16, the Commission has identified several areas where a relatively inexpensive effort could produce significant results:

- Building-code reforms, including certification and training of local code officials and technical assistance to support improved administration of building departments;
- Action on anticompetitive licensure requirements and examinations, including development of standards for licensing to ensure health and safety while removing anticompetitive requirements;
- Collaboration with the National Commissioners on Uniform State Laws and individual legislatures to secure legislative reforms;
- Economic analysis of the cost-effectiveness of institutional reforms;
- Improvement in product-approval systems to promote acceptance of cost-effective new technologies, materials, and designs, including reform of standards for the legal liability of code officials;
- Conduct of research on institutional barriers and information dissemination;
- Competition among innovators so as to give national recognition to worthy innovations and dissemination of the results to facilitate acceptance by building officials.

The proposed Office of Housing Productivity should be given the authority and resources to devise and implement a strategy for reducing regulatory and other institutional barriers. Of necessity, this office must deal with the entire system of Federal, State, and local regulation that governs construction practices and the acceptance of technical innovation. Its staff must be sensitive to the problems, needs, and interests of the various parties in the traditional regulatory process and balance these needs and interests against the greater public interest for increased productivity. At the same time, the staff should work closely with State and local governments to promote institutional reforms that allow the marketplace to function efficiently without unnecessary regulatory barriers.

Improving productivity and acceptance of new technology will take time, especially where institutional change is necessary. Many productivity problems stem from attempts by builders, suppliers, subcontractors, and State and local governments to adjust to severe housing cycles; productivity solutions rest with new methods that accommodate the unstable business environment and fragmented industry. Steady progress directed at manageable changes—rather than breakthrough-sized ambitions—should be the goal.[4]

State and Local Deregulation

State and local governments should take immediate deregulatory actions consistent with the recommendations in this report.

The Commission believes that for deregulation to succeed, necessary information and technical knowledge should be communicated to appropriate audiences that seek to participate actively in the process of regulatory change. Thus, while a first-level effort should create a favorable climate for regulatory change by pointing out the impact of existing regulations on housing costs, a second-level effort requires a more technically oriented assistance program if people are to have the necessary tools to engage in the decisionmaking process.

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[3] U.S. General Accounting Office, "Greater Use of Innovative Building Materials and Construction Techniques Could Reduce Housing Costs" (Washington, D.C.: 1982).

[4] See, e.g., John M. Quigley, "Residential Construction and Public Policy," in Richard Nelson (ed.), *Government and Technical Change* (Elmsford, N.Y.: Pergamon Press, 1982); Robert Guttman, Building Research Advisory Board, 1977 Building Futures Forum, "New Strategies for the Building Community," *The Importance of the Built Environment to the Quality of American Life* (Washington, D.C.: National Academy Press, 1980), pp. 99–104.

To begin, the Commission urges governors and local chief executives to take the lead in implementing deregulation; this means (1) seeking the advice of those groups with substantial interests in deregulation and affordable housing; (2) identifying the magnitude of the problem within the affected jurisdictions; and (3) perhaps establishing special commissions to focus public attention and to participate in providing leadership and direction to deregulation efforts. Governors and State legislatures—by virtue of their constitutional and statutory authority and their experience with resident needs and preference—are well suited to assume this responsibility. State legislatures also may be in a better position to take the political "heat" on certain issues (such as rent control) that cannot be handled locally.

In addition to defining the magnitude of the housing problem, States should begin a public education effort in support of deregulation; provide State technical support to local governments; and encourage private-sector efforts to inform housing consumers about the cost impacts of excessive governmental regulations.

A number of such initiatives are under way. California, New York, Pennsylvania, and Wisconsin have formed commissions to inform the public about housing-cost issues. In Oregon, the governor has appointed a State Housing Council of seven lay members to provide advice on the impact of changes in Oregon's laws on housing costs and to monitor the State regulatory system to streamline the housing delivery system. In New Jersey, members of the General Assembly have formed an Emergency Housing Action Team, which produced a report on statewide housing needs and costs issues. New Jersey and Virginia both have held statewide housing-costs conferences in which hundreds of public officials and private citizens met to discuss housing-costs issues and to develop policy options. In Wisconsin, the State Housing Task Force, formed in 1981, is composed of representatives of local government, nonprofit organizations, lenders, brokers, developers, and contractors. The task force is charged with looking at ways to reduce housing costs, to preserve housing, and to identify alternative methods for increasing available capital for housing development.

A few States provide technical support to municipalities specifically in support of affordable housing. The New Jersey Department of Community Affairs is assisting several communities. In Passaic, for example, the State is working with local officials to promote increased use of manufactured and modular housing. In the Hackensack Meadowlands District, State planning assistance helped establish a development standard that encourages the provision of affordable housing and the use of density bonuses to stimulate greater developer interest. New Jersey State officials also are helping a Middlesex County housing coalition to develop an affordable housing program.

The Pennsylvania Department of Community Affairs administers a local technical assistance program that stresses direct one-to-one problem-solving assistance in areas such as planning and housing development/rehabilitation. A State municipal training program complements these efforts through a series of educational and "how to" seminars in least-cost housing construction, rehabilitation, innovative land development, and housing finance techniques.

Georgia provides assistance to localities to help promote greater use of manufactured housing through informational materials and specific training programs.

Despite these examples, most States have yet to act decisively. While currently it may be easy to blame the cost of housing chiefly on interest rates, State governments must acknowledge their primary role in imposing regulatory costs and take whatever steps are necessary to help solve the problem.

Industry Initiatives. The Commission is encouraged by the active role of the housing industry in seeking regulatory relief. State chapters of both the National Association of Homebuilders and the National Association of Realtors have carried out efforts aimed at educating the public on housing-costs problems and possible solutions. The Northern California Building Industry Association, for example, has used the services of both a polling firm and an advertising agency to educate the public on these issues. In Florida and California, builders provide the homebuyer at closing time with a separate itemization of all the systems charges and impact fees imposed by governmental entities over and above normal housing costs. The homebuilders association in the Portland, Oreg., metropolitan area conducts an annual "parade of homes," in which one of the new models is left in a semi-finished state and price tags are affixed to various components explaining the extra costs resulting from government regulation. This technique—"The Visible House"—is also used in Florida, California, and elsewhere. Local homebuilder chapters in some States, including Colorado, Washington, and Michigan, use newspaper advertising to point out how regulations affect housing costs.

Nationally, the Urban Land Institute (ULI)—a trade association of major developers and allied professionals—in 1980 organized and carried out an effort entitled "Development Choices for the '80s." ULI brought together leading State and local elected

officials and private developers to identify improved ways of undertaking development in light of major demographic and economic changes. During this effort, affordable housing became a major focus and led to the formation of the Partnership for Affordable Communities, an embryonic consortium of public-interest groups and housing-industry associations. The Partnership's primary mission is public education, and it is currently developing a number of programs to promote affordable housing.

The Dynamics of Change

Before the political process necessary to implement regulatory change can take place, concerned individuals or groups must determine that (1) an existing regulation no longer fulfills the purpose for which it was created; (2) the reason for which the regulation was created has been eliminated; or (3) the negative effects of a regulation outweighs its positive effects. At that point, those who perceive the need for reform must demonstrate sufficient public support to convince the political leadership that change is desirable—not to mention convincing those who benefit from the system and thus wish to retain it as it is.

To overcome the major barriers to change identified at the beginning of this chapter—economic, governmental, and homeowner politics—broad-based coalitions that reflect the major housing constituencies must be organized. Thus, homeowners must become aware of the way restrictive regulation adversely affects the local tax base and prevents their children from enjoying the same kind of residential expectations as their parents. Prospective homebuyers must know the extent to which excessive regulation either thwarts their ownership ambitions or artificially inflates the cost of the home they eventually buy. The business community needs to come to grips with the fact that its livelihood is being compromised by unreasonable restrictions on market growth and, in more and more cases, by those firms' inability to recruit competent staff because of high local housing costs. Community and civic groups, traditionally concerned with efficient government and social equity, must be apprised of the impact of excessive regulation on these objectives.

Communicating the facts behind the need for change to all these parties is fundamental to any successful deregulatory effort. If these voices are heard in concert, the political climate necessary to effect regulatory change should become more favorable. The timing is right. Whereas earlier regulation studies were undertaken during periods of high production and low interest rates, such is not the case today. Problems of low production and high costs have created a new sense of urgency.

While the nation faces a formidable task at the State and local levels, the process of deregulation has begun; if encouraged, it could lead to significant savings for many Americans. The Commission was impressed by the success of some States and localities in overcoming the various institutional and economic barriers blocking regulatory relief.

To illustrate the various types of State and local deregulation actions, the following discussion provides several examples. The review of State actions covers initiatives in land use, permit procedures, construction codes, and manufactured and modular housing. Local actions relate primarily to efforts to expedite the permit process.

It is important to note that this list is not comprehensive. The Commission was not able to undertake an exhaustive survey of State and local actions, although many State examples were drawn from an inventory prepared for the Commission by the Council of State Community Affairs Agencies.[5] Hence, it is possible that this report fails to identify many significant efforts that are equally deserving of attention. In addition, because most of these actions are quite recent, it is unclear how successful or desirable they will prove to be in the long run. Rigorous analysis of the results of these initiatives is necessary so that others may learn from these experiences.

State Actions

Land Use. The amount of land available for housing, the permitted densities, and the required site-development standards all play a direct role in determining the cost of housing. Recognizing this, several States have acted to discourage local land-use practices that unnecessarily inflate land costs or to place the burden of justifying such practices on the municipalities.

California has enacted a number of State laws to remove local barriers to housing production. The State has amended its zoning-enabling law to require cities and counties to designate and zone enough vacant land for residential use to meet future as well as present housing needs. A recent statute (A.B. 3253) requires local growth-control proponents to bear greater responsibility for justifying growth limits. Under this statute a growth-control ordinance is presumed to have a negative effect on the supply of residential units available in the area. A locality must show that the growth-control ordinance is necessary for the protection of health,

[5] Council of State Community Affairs Agencies, "State Actions to Promote Affordable Housing" unpublished report prepared for the President's Commission on Housing and the Department of Housing and Urban Development, (Washington, D.C.: February 1982).

safety, or welfare. Recent legislation allows local governments to issue zoning variances or to use permits for the addition of a second dwelling unit on land that is zoned single-family, if the unit is occupied by someone 60 or older and the accessory unit is not larger than 640 square feet.

Massachusetts has coupled the provision of State grants for acquisition of land for conservation to a municipality's housing practices. Specifically, in 1979 the State Executive Office of Communities and Development and the Executive Office of Environmental Affairs executed a memorandum of understanding whereby funding for local acquisition of conservation land is withheld unless a community has accepted its fair share of all housing growth. In addition, the governor has just promulgated an executive order directing all State agencies to withhold awards of State development assistance to communities that have unreasonably restricted housing growth.

The Pennsylvania Planning Code includes a "curative amendment" process, which gives developers the opportunity to change local zoning statutes through amendments presented directly to the governing body, thus bypassing staff and planning commissions. Curative amendments may be presented to the governing body only where zoning provisions pose "unreasonable" economic barriers to development. In the past several years, developers have employed this approach to promote housing development.

Pennsylvania officials—concerned with the regulatory costs associated with HUD and FmHA housing requirements for "standard" sewer and wastewater treatment facilities—are experimenting with several alternative systems, including elevated mounds and shallow systems. The Department of Environmental Resources also has developed (in conjunction with State universities and engineering firms) demonstrations for Small Flows Treatment Facilities, which allow localities to "certify" in advance their adherence to operating and effluence regulations without continual State inspection. The Community On Lot Disposal Systems (COLDS) allows several communities to share one system for wastewater disposal. Initial estimates for these demonstrations show a potential 50 percent savings compared to standard systems in the same area.

Permit Procedures. The amount of time a developer needs to secure the necessary development permits results in carrying costs that are ultimately reflected in the cost of the units constructed. Part of the problem often relates to a fragmented local permit-granting structure. In other cases, delay may be used by a jurisdiction as a means of discouraging development. In at least two States, this problem has resulted in State-imposed requirements designed to mitigate the problem.

Recent California legislation (Statute 65913.3) requires that every city and county, on or before January 1, 1983, must provide for coordination of review and decisionmaking and information regarding the status of all applications and permits for residential development by a single administrative body.

A 1981 Oregon law (H.B. 2735) prohibits municipalities from "engaging in a pattern of conduct of failing to provide timely State building code inspections or plan reviews." S.B. 419 (1981), another recent act, requires local governments to take final action on applications for a subdivision plan or a major partition within 180 days of a filing.

Construction Codes. The establishment of mandatory statewide building codes often can be helpful in controlling housing costs by allowing builders to construct to one standard and thus avoid the diseconomies of meeting a multitude of local building codes. Moreover, improvement in code enforcement at the State and local levels is vital to faster processing and acceptance of cost-saving building technologies. In addition, the enactment of rehabilitation codes that meet basic health and safety standards but are more flexible than new construction codes is certain to facilitate more affordable housing among the existing stock. Several States have taken action in this area.

The Massachusetts Rehabilitation Code covers the repair, alteration, and change of use of existing buildings without requiring the builder to meet new construction requirements if all hazardous conditions are corrected and the degree of compliance after changes is not below that existing before the changes.

New Jersey's Uniform Construction Code (c. 217, 1975) is mandatory throughout the State and is intended "to eliminate restrictive, obsolete, conflicting, and unnecessary construction regulations that increase construction costs or retard the use of new materials, products, or methods of construction" and "to eliminate unnecessary duplication in the review of construction plans and the inspection of construction." New Jersey also has implemented a mandatory certification program for all building officials.

Virginia is another of several States that have established mandatory building construction standards for localities. In 1979, the State adopted the Uniform Statewide Building Code, which superseded State and local building codes and regulations. Virginia's Board of Housing and Community Development is responsible for adopting code standards that allow construction "at the least possi-

ble cost consistent with recognized standards" for public health and safety.

Manufactured and Modular Housing. The elimination of local land-use and building-code barriers to the acceptance of manufactured and modular housing can significantly increase the availability of affordable housing. For a variety of reasons, local resistance continues to be substantial. As the housing-cost problem becomes more acute, States appear increasingly prepared to preempt local authority in this area.

State statutes that prohibit local zoning ordinances from unduly restricting manufactured and modular housing have been enacted in California (S.B. 160, 1980), New Hampshire (S.B. 279, 1980), Vermont (Act 236, 1976), and Indiana (H.B. 1032, 1982).

The Ohio Revised Code authorizes the manufacture and placement of factory-built housing units and components within the State. Industrialized units authorized by the Ohio Board of Building Standards may be used anywhere in Ohio, subject to specified conditions. Pre-approval for the portion of the unit built in the factory allows it to be shipped to the site for installation.

In 1972, Virginia adopted an "industrial building unit" law to cover manufactured and modular housing. As long as these units meet the industrial unit standards, they are exempted from the statewide building code. This law supersedes local ordinances and promotes increased use of manufactured and modular housing.

Local Actions

The following municipalities have demonstrated that change is possible at the local level, too.

Baltimore, Md., in an effort to encourage inner-city rehabilitation, has employed a number of streamlining procedures, including preparation of a development guidebook for use by developers; creation of a task force of builders and city officials to reform regulatory procedures; use of a permit expeditor; pre-application conferences; joint agency reviews; a centralized information source for developers; and encouragement of informal meetings between the developer and affected neighborhoods.

Beaumont, Texas, has carried out a comprehensive streamlining of its development regulations. Excessive requirements relating to residential lots have been eliminated. Minimum lot sizes for single-family homes have been significantly reduced (as much as 55 percent), and cluster housing is now allowed without a special permit. On the permit-processing side, the city has reduced the number of required public hearings by consolidating special hearings for rezoning and special exceptions into the regular planning-commission hearing.

Brattleboro, Vt., has completely revised its subdivision regulations to make them less burdensome and is currently revising its zoning ordinances, using performance standards. The community also has expedited permit approvals through fast-track processing, simultaneous review of permits, the use of permit expeditors, informal pre-application hearings, and developer checklists.

Fort Collins, Colo., has eliminated traditional zoning and created a Land Use Guidance System. Under this approach, the city no longer has fixed residential, commercial, and industrial development areas. Instead, each proposed development is evaluated on the basis of several criteria, including its compatibility with existing surrounding uses. This new system has reduced processing time dramatically because time-consuming rezoning procedures are eliminated.

Kitsap County, Wash., has instituted fast-track processing. The county issues a builder a permit for a basic design. Every time he builds a particular house utilizing the approved design, he does not have to resubmit his plans and go through the approval process again.

Los Angeles, Calif., formed a task force on housing production composed of key public officials, private developers, and lenders to identify ways in which the city's development permit system could be streamlined. As a result, the average time required to secure a permit for a major project has been reduced from three years to 18 months; efforts are continuing to reduce this time even further.

Montgomery County, Md., has revised its zoning ordinance to permit mobile homes to be located in residential areas as long as the design is compatible with the neighborhood. The mobile homes must be doublewides, have pitched roofs, and be permanently secured to a foundation.

Peoria, Ill., has taken a number of steps to expedite the development process, including (1) combining preliminary and final plat reviews by the planning commission and city council; (2) consolidating all hearings for development permits into a single process for the central business district and in portions of the abutting residential area; and (3) using multidisciplinary inspectors in residential construction who perform all code inspections. Each of these techniques has reduced the amount of time consumed in the permit-approval process.

Phoenix, Ariz., has been a leader in local land-use regulatory reform. Efforts are under way to increase efficiency; to reduce the costs of development and city administrative procedures; and to

promote housing rehabilitation, downtown redevelopment, and urban infill. Phoenix has revised its residential zoning ordinances to give developers greater flexibility on neighborhood design without the need for waivers, variances, and rezoning. Permissive zoning districts ("conservation districts") have been established; in these districts, normal requirements are waived to encourage development while preserving overall neighborhood integrity. The city also has streamlined its regulation and permit processes by setting up a telephone permit process for certain projects, conducting administrative hearings, and utilizing fast-track processing.

Sacramento County, Calif., has streamlined its regulations in order to allow routine land-use decisions to be handled at a staff level and thus free officials to focus upon more pressing matters. Actions to date include preparation of informational materials for developers; pre-application conferences; revision of the zoning ordinance; staff reorganization into geographic teams; use of a Master Environmental Impact Report prepared at the county level to save applicants time and money; delegation of approval authority to staff for certain types of projects; employment of a hearing official; and substitution of conditional-use permits for previously required zone-change approvals.

Salinas, Calif., has implemented land regulation reforms aimed at promoting affordable housing and new industrial development. The community development director is empowered to waive certain permit procedures and public hearings for noncontroversial projects. The city also has a pre-application review system to enable developers to get early feedback on projects before spending all the money necessary to bring the project before an official planning commission meeting.

Commission hearings in St. Louis, Mo., indicated that both the city and St. Louis County have begun extensive streamlining of their development-permit processes through "one-stop" permitting and amendments (reductions) to the Subdivision Standards requirements. These have resulted in developmental savings, both in direct costs previously imposed by the higher standards and indirect costs formerly encountered through time delays imposed by multi-stop permitting.

San Jose, Calif., a city that grew from fewer than 100,000 people in 1950 to more than half a million by 1980, has implemented a number of procedural reforms to provide housing development the same kind of treatment afforded commercial and industrial development. Techniques include the preparation of brochures to explain development procedures to developers; use of a hearings officer; pre-application conferences; delegations of some permit approvals to staff; and establishment of a task force for streamlining procedures.

Westchester County, N. Y., has promoted cluster development since 1972 as part of an affordable-housing strategy. Thirty subdivisions in 12 municipalities have been constructed using cluster development. Several municipalities within the county are drafting accessory apartment ordinances to bring an estimated 11 percent of the county's housing stock into conformance with the law. In some communities, as much as a fourth of the housing has been converted to accessory apartments.

* * * * *

These examples indicate progress by State and local governments in implementing deregulation. In some cases, action resulted from the identification of a regulatory problem by the building industry or a staff member of the administering agency. In other cases, the impetus came from consumers aggrieved by the unreasonableness of a statute or regulation. Whatever the stimulus, the situation required effective communication of the issue to the appropriate decisionmakers.

Housing affordability is no longer just a local problem. The response must be nationwide. The intergovernmental nature of this deregulation responsibility within a Federal system dictates a comprehensive program of national support for State and local action along the lines of the Commission's recommendations.

APPENDIX

METHODOLOGY

In order to conduct its business more effectively during its 10 months of operation, the Commission formed a variety of committees, subgroups, and task forces. Housing experts from around the country were consulted, extensive citizen testimony was received—all at the committee, subgroup, or task force level—and numerous background papers were prepared and reviewed. This appendix outlines the organization of the Commission and describes the methods used to arrive at the recommendations contained in this report.

Commission Organization

Shortly after the Commission was formed in June 1981, a *Steering Committee* was appointed to direct the Commission's deliberations and to develop its rules of conduct and procedure. In July 1981, the Commission organized itself into four operating Committees. The *Committee on Housing and the Economy* was asked to examine social, demographic, and economic issues affecting housing and the appropriate role for government. The *Committee on Federal Housing Programs and Alternatives* was asked to review current Federal housing assistance policies and programs and to develop recommendations for their reform. The *Committee on Private Sector Financing of Housing* was asked to address the problems of and to develop options to strengthen the nation's system of housing finance. The *Committee on Government Regulation and the Cost of Housing* was asked to assess the impact of Federal, State, and local government regulations on the cost of housing and land and to recommend possible ways to reform these regulations. In addition, a *Coordinating Committee* was established to provide consistency in the ongoing operations of the Commission. To facilitate the issuance of its reports, the Commission appointed several different *Drafting Committees* to coordinate the development and production of the reports. Under this committee structure, the Commission produced its *Interim Report* in October 1981.

Following completion of the *Interim Report*, the Commission reorganized its committee structure to better focus on the broad range of housing issues that were identified during the first four months of the Commission's activity. A number of task forces were identified, and a new committee structure was developed. The *Economics Committee* had four task forces: the Task Forces on Taxation and on the Restructuring of Thrift Institutions focused on tax and finance issues; the Federal Credit Programs Task Force examined government financing programs; and a Special Topics Task Force addressed issues such as rural housing problems, housing needs of the elderly, manufactured housing, and historic preservation. The *Housing Programs Committee* examined public housing, Federal subsidy programs, homeownership incentives, and unassisted housing programs through its Task Forces on Assisted Housing, Homeownership, and Unassisted Rental Housing. The *Regulations Committee* continued its assessment of ways to reduce Federal, State, and local regulations and, through its Task Force on Government Land, examined policies concerning disposal of public land and Federal surplus properties to meet housing needs. The *Present Housing Issues Committee*, through its Funds for Housing Task Force, examined immediate housing concerns, including new sources for housing finance and alternative mortgage instruments.

Under this revised committee structure, the Commission issued a preliminary report entitled *Financing the Housing Needs of the 1980s*, in January 1982, and produced the Commission's final report, *The Report of the President's Commission on Housing*.

Hearings

Each of the Commission's substantive committees conducted hearings to gather statements from the public. The following is a list of the dates, places, and topics of each hearing, arranged by sponsoring committees.

Economics, Finance, and Present Housing Issues Committees

1. Date: August 17, 1981
   Place: Washington, D.C.
   Topic: Federal and Federally Related Credit Programs
2. Date: November 6, 1981
   Place: Washington, D.C.
   Topic: Restructuring of Thrift Institutions
3. Date: January 8, 1982
   Place: Washington, D.C.
   Topic: Pension Fund Investment in Housing
4. Date: February 4, 1982
   Place: Washington, D.C.
   Topics: Manufactured Housing
   Rural Housing/Farmers Home Administration
   Housing for the Elderly
   Historic Preservation

Housing Programs Committee

5. Date: July 20, 1981
   Place: Washington, D.C.
   Topics: Assisted Housing Programs
   Mortgage Revenue Bonds
   Housing for the Poor
6. Date: July 30, 1981
   Place: Washington, D.C.
   Topics: Tax Issues
   State Housing Finance Agencies
   Housing Vouchers
   Farmers Home Administration/Rural Issues
7. Date: August 31, 1981
   Place: St. Paul, Minnesota
   Topics: St. Paul Housing Authority Site Visit
   Housing Vouchers
   Public Housing
8. Date: December 3, 1981
   Place: Washington, D.C.
   Topics: Housing Payments Program
   Public Housing
9. Date: December 3, 1981
   Place: Washington, D.C.
   Topic: Homeownership
   Date: December 16, 1981
   Place: Washington, D.C.
   Topics: Housing for the Elderly and Handicapped
   Housing Issues Affecting Native Americans
   Rural Housing

Regulations Committee

10. Date: September 16-17, 1981
    Place: Washington, D.C.
    Topics: Land-use and Environmental Regulations
    Rent Control and Condominium Conversion
    Operations of Existing Multifamily Housing
    Federal and State Regulation (Davis-Bacon)
    Construction Regulations
    Regulation Affecting Mobile Homes and Modular and Component Systems
11. Date: October 29-30, 1981
    Place: Los Angeles, Calif.
    Topics: Rent Control
    Inclusionary Zoning
    Growth Controls
    Permits and Infrastructure: Costs and Procedures
    Implementation of Deregulation
12. Date: November 20—December 1, 1981
    Place: St. Louis (Clayton), Mo.
    Topics: Enterprise Zones
    Floodplain/Stormwater Issues
    Certification and Career Path Opportunities for Code Officials
    Rulemaking Process/Interpretation and Implementation
    Implementation of Deregulation
    Permits and Infrastructure: Costs and Procedures
13. Date: December 2–3, 1981
    Place: New York, N.Y.
    Topics: Multifamily Housing: Construction, Rehabilitation, Operation
    Rent Control
    Conversion from Rental to Cooperatives or Condominiums
    Exclusionary Zoning and the Courts
14. Date: December 14–15, 1981
    Place: Houston, Tex.
    Topics: The Houston System (No Zoning)
    Land Development
    Building Codes

Professional Contributions

The Commission received formal professional contributions of two types. First, in response to a public letter distributed by the Commission in July 1981 requesting information for its analysis, many individuals, trade associations, and other groups submitted position papers, statements, and ideas to the

Commission. Several hundred comments and papers were received; these documents became major elements in the Commission's deliberations and important aids in formulating the specific issues to be considered.

Second, the Commission received background papers from recognized experts in various fields, and a number of background papers were prepared by the Commission's own professional staff. These papers were highly technical treatments of subjects of concern to the Commission, and they formed an important part of the data base used by the Commission in arriving at its recommendations. The number of these papers prevents the listing of their titles and authors here, and the short life and small budget of the Commission preclude their publication as a separate set of background papers. However, they represent important research on the housing issue and many of them will be available through the HUD User Service and/or the National Technical Information Service (NTIS).

These few paragraphs are intended to convey to the reader that many people provided extensive professional contributions to the work of the Commission. It is impossible to acknowledge all, but many—including the authors of several of the background papers—are listed following the Staff Biographies in the Appendix.

SUMMARY OF RECOMMENDATIONS

SECTION I: HOUSING FOR LOWER-INCOME PEOPLE

A Housing Payments Program and Block Grants (Chapter 2)

1. Housing Payments Program

The primary Federal program for helping low-income families to achieve decent housing should be a Housing Payments Program. This program, coupled with housing supply assistance through the Community Development Block Grant Program, should replace future commitments to build or substantially rehabilitate additional units under Federal housing programs. (p. 18)

The Housing Payments Program draws upon the experience and best features of the Experimental Housing Allowance Program (EHAP) and the current HUD Section 8 Existing Housing Program. If a housing payments system is adopted, details of program design are best left to Federal, State, and local agencies charged with program administration. However, the Commission offers the following proposals for design features.

Eligibility: Program eligibility should be limited to households with very low incomes—no more than 50 percent of the area median income for a family of four. In the context of limited Federal resources, priority for providing assistance should be based on income (including the income value of assets such as home equity) and on criteria such as current residence in inadequate housing, payment of housing costs in excess of 50 percent of income, or involuntary displacement—not necessarily in that order. Renters assisted by the housing payments program should be free to use their payments for home purchase. (p. 23)

Standards: Local housing quality standards would be preferable to Federal standards. Some "fallback" Federal standard like the housing quality standards for the Section 8 Existing Housing Program is necessary, because many communities have no applicable housing code whatever. (p. 23)

The Payment Formula: The Commission endorses a payment standard approach to the housing payment, such as the one used in EHAP, that does not depend on the actual rent of a particular dwelling, rather than the rent limit approach now used in the Section 8 Existing Housing Program. (p. 24)

Payment Level: The basic payment level to be used in the payment standard approach should be based on an estimate of local housing costs and set at a level that allows recipients to rent units that meet the minimum housing requirements of the program. (p. 24)

Equal Opportunity and Housing Access: Full information should be provided to eligible families concerning locations and types of available housing; the administrative mechanisms should include a substantial local support-services component for open housing and the enforcement of anti-discrimination statutes, including Federal fair housing laws. (p. 25)

Who Receives the Payment?: Direct payment to the tenant should be the ultimate goal. In the meantime, however, the administering agency should have the option of deciding whether to make payments to the landloard or the tenant. (p. 25).

2. The Community Development Block Grant Program: Adding a Housing Component and New Construction

New construction should be added as an eligible activity of the Community Development Block Grant Program (CDBG), and a Housing Component, weighted to local housing needs, should be added to CDBG to complement the Housing Payments Program in addressing problems of housing availability and adequacy for lower-income households. The purpose of these additions to the CDBG program is to make available standard housing to lower-income households living in substandard units. (p. 27)

Program features of the Housing Component of CDBG should include the following:

Administration: Administration of the Housing

Component of the CDBG program should closely parallel that of the larger block grant program. The Commission recognizes that housing markets and housing problems may require regional and even statewide intervention, and therefore suggests consideration of additions to the basic CDBG administrative framework. These include formation of consortia to carry out housing activities on an areawide basis, and utilization of State housing finance agencies and FmHA offices to operate housing programs. (p. 29)

Fund Allocation: Funds allocated for the Housing Component of the block grant program should be allocated on the basis of objectively measurable housing needs, particularly the need to rehabilitate housing for lower-income households. The annual funding and three-year authorization features of the CDBG program should be incorporated into the Housing Component. (p. 29)

Use of Funds: The Housing Component of the CDBG program should be used to help overcome housing supply problems of lower-income families living in inadequate units. Although it is the Commission's intent that Housing Component funds be used for the above purpose, the majority of the Commission recommends that no specific restrictions should be placed on the use of funds in entitlement cities. (p. 30)

Performance: The Housing Component activities, because they must meet the same statutory objectives as the CDBG program, would be targeted to lower-income households. (p. 30)

Local Control of Public Housing (Chapter 3)

3. Public Housing

Within a specified period of years, public housing should be restored to local management and control, passing to public housing authorities and local governments responsibility and choice in the use and disposition of public housing projects. The future use of each public housing project should be determined on the basis of a joint assessment by the Public Housing Authority (PHA) and the local and Federal government, considering a broad range of options in light of each project's physical, economic, and social characteristics. (p. 31)

Under the primary option, most public housing projects would continue to house low-income tenants and receive operating subsidy, which would be subject to a Federal cost constraint. These projects would be most likely to be those which are in good condition and reasonably free of social problems and which can be operated within the subsidy limits. (p. 37)

Two other options for use of projects would remove them from the public housing stock. In these cases, tenants would receive Housing Payments for use in the project (if it remains in residential use) or in the private market:

- Valuable projects could be sold, with the proceeds used for low-income housing purposes. This option could also result in market-price condominiums or cooperatives or could include tenant purchase.
- Projects with severe social or physical problems that could not be remedied cost-effectively would be demolished.

Alternatively, some projects could remain in public ownership under arrangements which differ from the primary option:

- Projects could charge enough rent to cover operating costs and therefore receive no operating subsidy but continue to receive debt service subsidy. Tenants would receive Housing Payments which could be used to pay public housing project rents or to obtain private market housing.
- Projects could be operated and funded under an alternative that is tailored to the unique circumstances of the project and mutually agreeable to the local government, the PHA, and the Federal government.

During the transition period, the Federal government would continue to provide operating subsidy as well as funds for the physical improvement (modernization) of the projects. Federal requirements and administrative contraints, other than tenant rent and income limits, would be substantially reduced. (p. 38).

Special Housing Problems of the Elderly and Handicapped (Chapter 4)

4. Frail Elderly and Handicapped

The Commission recognizes the special housing needs of the frail elderly and the handicapped and recommends that these needs be addressed by special programs. The Commission further recommends that a White House task force be established to develop a policy framework for addressing these housing needs in the context of the social and health needs of this group. (p. 51)

5. Home-Sharing and Accessory Housing

State and local authorities should act to permit home-sharing by elderly homeowners, including rental of rooms and construction of accessory apartments. (p. 53)

6. The Conversion of Home Equity Into Income

The Commission endorses the use of mechanisms to enable older homeowners to convert their home equity into income while remaining in their homes, and recommends that the Department of Housing and Urban Development, the Federal Home Loan Bank Board, and the Internal Revenue Service facilitate and encourage the use of such mechanisms. (p. 54)

SECTION II: HOUSING OPPORTUNITIES IN THE PRIVATE SECTOR

Homeownership (Chapter 6)

1. Deductibility of Interest and Taxes

The Commission reviewed the current tax deduction for mortgage interest and property taxes. It recommends that there be no changes in the current system at this time. The Commission also recognizes the broad scope of this issue and recommends that any further analysis of this topic be considered only within the context of a thorough review of the U.S. tax system. (p. 75)

2. Downpayment Assistance for First-Time Homebuyers

The Commission has reviewed a number of alternatives to assist the first-time homebuyer in accumulating a downpayment. It finds the evidence concerning costs and benefits of these alternatives to be inconclusive. Further evalution is appropriate, and the Commission recommends that three options discussed below be forwarded to the President for full review as to their cost and incremental impact:

Option 1. Create a separate system of individual housing accounts, with contributions eligible for a credit against Federal income taxes, and with interest on the account tax-exempt.

Option 2. Create a separate system of individual housing accounts, with contributions made from income after taxes to be matched directly on a one-to-four basis using appropriated funds from the Federal government, and all interest on the account fully taxable.

Option 3. Allow tax-free use of funds from individual retirement accounts for the purpose of applying these funds to the downpayment on a first home. (p. 80)

3. Condominium and Cooperative Housing

The Commission recognizes the property rights of owners of rental housing and the substantial benefits to the individual and the community of the homeownership opportunities created by conversion to condominium and cooperative ownership. The Commission has also considered the concerns of tenants affected by such conversion, including the needs of low-income elderly households. On the basis of this analysis, the Commission supports conversion to condominium or cooperative ownership and opposes undue restrictions thereon. (p. 81)

The Commission urges States to consider favorably the adoption of conversion procedures generally in accordance with those established in the Uniform Condominium Act, with comparable coverage for cooperatives. (p. 82)

In the sale or conversion of rental property, disincentives to the seller should be removed. The Commission further recommends that incentives be provided to facilitate sale of rental housing to tenants, particularly when a substantial portion are of low or moderate income. Restrictions on the types of income allowed cooperatives should also be relaxed to allow freer choice of this form of homeownership.

Various impediments to the financing of cooperative purchase should be removed, such as (1) the lack of a secondary market for membership share loans; (2) the failure to implement FHA insurance on membership share loans; and (3) the 30-percent cap on housing loans by the National Consumer Cooperative Bank. (p. 84)

4. Homesteading

The Commission endorses single- and multifamily homesteading as a means of providing homeownership opportunities to low- and moderate-income renters. HUD should continue to make available its single-family properties, acquired by FHA default, for use by local governments in homesteading programs. Appropriate government-held multifamily properties also should be made available for homeownership. (p. 84)

5. Manufactured Housing

The Commission believes that manufactured homes permanently attached to the land qualify as real property and recommends that Federal and State government and quasi-government agencies provide the regulatory and legal framework necessary to permit permanent mortgage financing of such property on the same basis as other real property loans. (p. 85)

With regard to manufactured homes that are not attached to the land, more broadly based access to the credit markets should be developed for the financing of manufactured housing held as personal property. (p. 86)

6. Warranty Insurance on New Homes

Congress should amend the law to require that the present mandatory warranty protection on newly constructed homes insured or guaranteed by FHA, Farmers Home Administration, and VA be administered through private-sector programs, where adequate private programs exist, provided they do not discriminate on the basis of the homebuyer, neighborhood location of the home, or other criteria irrelevant to construction quality. The homebuyer should have the option to decline warranty coverage on such newly constructed homes. All home builders should consider offering insurance-backed warranties as an option with the sale of new homes. (p. 86)

Rental Housing (Chapter 7)

7. Rent Control

The Commission finds that rent control causes a reduction in the quality of the existing rental housing stock and discourages investment in new rental property. Therefore, the Commission opposes, in principle, rent control at Federal, State, and local levels. (p. 91)

State Actions: The adverse effects of rent control spread far beyond the boundaries of municipalities. Therefore, the Commission urges that States pass legislation removing the power of counties, cities, and all other local jurisdictions to adopt ordinances controlling rents. (p. 92)

Federal Actions: The Commission recommends that the Federal government should preempt the application of any State or local rent controls on rental housing financed by a lending institution in which deposits are insured by a Federal agency, and on rental housing financed by the Federal government or which has a mortage insured or guaranteed by the Federal government or its agencies. (p. 93)

8. Tax Incentives

Expensing of Construction Period Interest and Taxes: All rental housing should be eligible for expensing of interest costs and taxes incurred during construction. Section 189 of the tax code, which requires 10-year amortization of these rental housing expenses except for low-income housing, should be suspended through 1984 to create an incentive for all rental housing production. (p. 94)

Rehabilitation Tax Credits: Owners of residential rental structures should enjoy the same investment tax credit for rehabilitation expenses as that for owners of nonresidential real estate. (p. 95)

Historic Investment Tax Credit: The Commission recommends that, as part of the certification process for the 25 percent historic investment tax credit, the Secretary of the Interior be authorized to exempt certified historic preservation projects from the substantial rehabilitation test and from the requirement that the building retain at least 75 percent of the existing external walls. (p. 96)

Other Opportunities (Chapter 8)

9. Sale of Public Lands

Inventory and Land-Use Classification: To facilitate purchase and exchange of land, the Bureau of Land Management should accelerate completion of land inventory and classification and complete all necessary land-use plans, giving consideration to the expansion needs of communities adjacent to public lands and identifying land available for disposal to meet those needs. In addition, these land-use plans should provide for cooperative management, consolidation, and exchange of checkerboard public lands with State and private land holdings. (p. 102)

Cooperation and Coordination with State and Local Government: In disposing of Federal land for housing and community development, the Federal government should be responsive to requests for land from States and localities and should provide for local and State land use plans. (p. 102)

Forest Service Sales: The Secretary of Agriculture should encourage land conveyance for housing use under the Townsite Act and endorse the passage of legislation to permit the Forest Service to sell or exchange small tracts of land. (p. 103)

Land Exchange: Where the land is being acquired by a public entity for public purposes, including community expansion and housing, the Secretary of the Interior and the Secretary of Agriculture should be authorized to permit payments in excess of the statutory 25 percent of appraised value to equalize the difference in valuation between a parcel of public land and a parcel of private land of different size and value offered in exchange. (p. 103)

Leasing: The Secretary of the Interior should direct the Bureau of Land Management to develop a program for the leasing of land for a definite time period for housing use to State or local government entities or nonprofit groups which have proposals meeting the requirements of the Recreation and Public Purposes Act. (p. 104)

Appraisal: The Bureau of Land Management and U.S. Forest Service should consider methods to mitigate prices where Federal leasing or land policies have contributed to escalating land costs. (p. 104)

10. Federal Surplus Properties

The White House Property Review Board should ensure the prompt disposal of Federal surplus prop-

erty, thus making more property available for housing use. (p. 104)

11. State and Local Lands

States and localities are encouraged to review their policies with regard to sale and transfer of land and to identify parcels of their own public land which might appropriately be sold for housing use in both urban and rural locations. (p. 105)

12. Neighborhood Preservation

Private foundations, religious groups, and other private institutions are encouraged to continue their sponsorship and financing of innovative programs in housing construction and rehabilitation and access to homeownership. Neighborhood preservation activities should continue to be used to preserve and upgrade housing in older areas with every effort made to benefit low-income people and to avoid displacing them. (p. 105)

13. Historic Preservation

The Commission endorses the efforts of the National Trust for Historic Preservation to further the goal of local and private-sector historic preservation and further endorses its efforts to preserve the valuable resources represented by our nation's buildings and districts. (p. 106)

14. Enterprise Zones

The Commission endorses the concept of enterprise zones as a method of encouraging community revitalization and new business investment in declining urban neighborhoods and rural communities. Any enterprise zone program should include incentives, similar to those provided for business, for investments in rehabilitation and new construction of housing in order to complement economic development in the zone, minimize displacement of existing residents, and provide housing for new workers attracted by zone businesses. (p. 106)

SECTION III: FINANCING AMERICA'S HOUSING

Traditional Sources of Mortgage Credit (Chapter 10)

1. Liability Structure and Powers of Thrift Institutions

The liability powers of savings and loan associations and mutual savings banks should be expanded to permit these institutions to compete more vigorously for individuals' savings and to serve the demand deposit needs of all sectors of the economy. (p. 124)

Depository institutions should be permitted to offer a federally insured, daily-access market-rate account that would appeal to individuals holding money market mutual fund accounts (p. 126)

Savings and loan associations and mutual savings banks should have authority to accept demand deposits from all types of customers. (p. 127)

2. Asset Structure and Powers of Thrift Institutions

Savings and loan associations and mutual savings banks should be granted new and expanded asset powers sufficient to serve the credit needs of all sectors of the economy and to maintain their viability as financial institutions in a deregulated environment. (p. 127)

Thrift institutions should have expanded authority to invest in secured and unsecured consumer loans, and should be permitted to provide inventory and floor planning loans to dealers of consumer durables. (p. 130)

All thrift institutions should be permitted to invest in secured and unsecured commercial and agricultural loans, and their authority to invest in commercial paper and other corporate debt instruments should be expanded. (p. 130)

All thrift institutions should be permitted to invest in securities issued by States and municipalities, including both revenue bonds and general obligation instruments. (p. 130)

Thrift institutions should have expanded authority to invest in real estate loans, so that they may invest in both residential and nonresidential mortgages, whether first or subsequent liens, without loan-to-value restrictions or mortgage insurance requirements. (p. 130)

While remaining subject to a percent-of-asset limitation and regulatory supervision, the permitted levels of investment in service corporation affiliates should be increased for savings and loan associations and made available to mutual savings banks. (p. 130)

Thrift institutions should be permitted to invest in real estate of various types (including joint ventures with developers) only through service corporations or holding companies. (p. 131)

3. Other Powers of Thrift Institutions

Savings and loan associations and mutual savings banks should be granted such additional operating powers and authorities as may be necessary to provide financial services to all sectors of the economy. (p. 131)

Thrift institutions should have the authority to make over-the-counter sales of mortgage-backed securities, with or without recourse. (p. 131)

Subject to percent-of-asset limitations and regulatory supervision, the powers of thrift institutions should be expanded to permit investment in tangible property for the purpose of engaging in equipment leasing. (p. 131)

Thrift institutions should be provided, where necessary, with the power to engage in activities and ventures incidental to the exercise of authority conferred by law. (p. 131)

4. Industry Structure and Institutional Form

Thrift institutions should be permitted to select their institutional form, with the right to convert from State to Federal charters (and vice versa), from mutual to stock form, and from savings and loan associations to savings banks (and vice versa). (p. 131)

The Federal Home Loan Bank Board should be given power to grant *de novo* Federal stock charters to savings and loan associations and savings banks. (p. 131)

Regulators of financial institutions should permit, where appropriate, interstate and interindustry mergers sought by the private sector. (p. 131)

5. Maintaining Public Confidence in Depository Institutions

The Federal government should clearly and explicitly reaffirm its responsibility to maintain the viability of the financial system, including a commitment to use whatever resources are necessary to assure the safety of deposits insured by FDIC or FSLIC. (p. 133)

6. Regulatory Agency Activity

Regulatory authorites should continue to have, and to use, the power to arrange, in lieu of liquidation, interstate and interindustry mergers and acquisitions. (p. 134)

When determining whether to assist insured thrift institutions, regulatory agencies should be guided by the reasonably anticipated profitability of an institution rather than being bound by tests concerning the essentiality of an institution to a community or arbitrary accounting procedures relating to book value of net worth. (p. 134)

7. Sustaining the Deposit Base at Thrift Institutions

The Depository Institutions Deregulation Committee should take action to forestall the disintermediation of funds upon the maturity of "all savers" certificates. (p. 135)

To permit depository institutions to offer the expanded retirement accounts authorized by law, deposit insurance on IRA and Keogh accounts should be increased to $250,000 per account. (p. 135)

Broadening Private Sources of Mortgage Credit (Chapter 11)

Tax Incentives for Mortgage Investment

8. Tax Incentives for All Mortgage Investors

To encourage greater residential mortgage activity by a broad range of institutions, the same tax incentives should be provided to all types of investors through a mortgage interest tax credit (MITC) on income from mortgages or mortgage pass-through securities. Over time, the special bad debt reserve provision for thrifts should be eliminated. The MITC should be considered a transition device, and should be reconsidered in a thorough review of sectoral subsidies in the entire tax system. (p. 139)

Institutional Sources

9. Private Pension Funds and ERISA

Current provisions of Employee Retirement Income Security Act regulations that limit the housing investments of private pension funds should be eliminated. (p. 142)

The Department of Labor should promptly issue the housing portion of its proposed "plan asset" regulations in order to exclude from ERISA regulations mortgages in pools that are associated with pass-through securities issued or guaranteed by the United States or an agency or instrumentality thereof, including the Government National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Federal National Mortgage Association. (p. 143)

The Department of Labor should expand its recently issued class exemption for mortgage-backed securities to cover pools of second mortgages and to clarify the treatment of forward-purchase commitments that are commonplace in mortgage market transactions. (p. 143)

In the case of whole mortgages or mortgage participations, the Department of Labor should issue a class exemption to permit normal business transactions. (p. 143)

When evaluating future applications for mortgage-related exemptions and rulings, the Department of Labor should rely on the mortgage and housing expertise that already exists at the Federal Home Loan Bank Board and at the Department of Housing and Urban Development. (p. 143)

10. Public Pension Funds and State Laws

States should be encouraged to develop program strategies and regulations that facilitate housing investment by public pension funds. (p. 143)

To assist this effort, the Commission suggests that the National Conference of Commissioners on Uniform State Laws recommend changes to State legal investment statutes to provide authority for regulated fiduciaries to invest in conventional mortgage-backed securities meeting a common set of reasonable investment criteria. (p. 144)

11. Commercial Banks

The powers of commercial banks to invest in residential mortgages and real estate should be clarified and expanded. (p. 144)

Commercial banks should be permitted to establish service corporations similar to those successfully employed in the savings and loan industry. (p. 144)

Commercial banks should be permitted to invest in real estate (including joint ventures with developers) through holding company subsidiaries and to engage in other investment practices permitted savings and loan associations through service corporations. (p. 144)

Commercial banks should be provided, where necessary, with adequate authority to engage in activities incidental to the exercise of authority conferred by law, and they should be permitted to make over-the-counter sales of certificates backed by mortgages, with or without recourse, subject to regulatory supervision. (p. 144)

12. Consumer Finance Companies

The Commission supports changes in state laws and regulations to facilitate the entry of consumer finance companies into the housing finance system. (p. 145)

Conventional Mortgage-Backed Securities (CMBS)

13. Revisions to the Tax Code

The Internal Revenue Code should be amended to provide an exemption for conventional mortgage-backed securities from taxation at the pool/issuer level, provided the CMBSs meet minimum criteria.

The Internal Revenue Code should also be amended to treat the recovery of market discounts on CMBSs on the same basis as such discounts are treated on corporate securities. (p. 145)

14. Registration of Securities and Issuers

The Securities and Exchange Commission should promulgate regulations to provide specific and streamlined shelf-registration procedures designed for conventional mortgage-backed security issues. (p. 146)

CMBS issuers should be permitted, but not required, to register as regulated investment companies. (p. 146)

15. Purchase of Securities on Margin

The Federal Reserve Board should amend Regulation T to allow for the purchase of privately issued conventional mortgage-backed securities on margin. (p. 146)

16. Modification of the Bankruptcy Code

Congress should extend the current provisions of the Federal Bankruptcy Code to all entities that sell mortgage loans, mortgage participations, or conventional mortgage-backed securities. (p. 147)

17. State Laws and Agencies

The National Conference of Commissioners on Uniform State Laws should recommend amendments to relevant State blue-sky laws to exempt qualified conventional mortgage-backed security issuers from State registration requirements, and should recommend changes to State legal investment statutes to provide authority for investment by State-regulated fiduciaries in CMBSs meeting a common set of reasonable investment quality criteria. (p. 147)

States should be encouraged to create public conduit CMBS issuers that draw on the capacity and experience of their existing State housing finance agencies. (p. 147)

Mortgage Instruments

18. Due-on-Sale Clauses

Action should be taken at the Federal level to prevent or to discourage State legislative or judicial actions that restrict the enforcement of due-on-sale clauses in outstanding home mortgage contracts. (p. 149)

Federal regulations should be changed to permit the inclusion of due-on-sale clauses in newly originated FHA-insured and VA-guaranteed home mortgages. (p. 149)

19. Private Sector Development of Innovative Instruments

The private sector should be encouraged to develop new mortgage loan instruments that reduce initial payment levels to borrowers, provide some protection to lenders against future market interest rate increases, have relatively predictable payment schedules, and avoid excessive negative amortization. Within this context, three instruments are worthy of particular attention: graduated-payment, adjustable-rate mortgages; dual-rate mortgages; and growing-equity mortgages. (p. 150)

20. Role of Government

Federal and State governments should make changes in laws and regulations necessary to permit institutions to originate, purchase, and hold new types of mortgage loans. (p. 152)

To facilitate introduction of new instruments, the Federal government should provide mortgage insurance and guarantees on an experimental basis through the Federal Housing Administration and the Veterans Administration, should provide secondary market support through the mortgage-backed securities program of the Government National Mortgage Association, and should encourage the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation to help develop markets for innovative types of mortgage instruments. (p. 152)

Forward, Futures, and Options Markets

21. Exchange-Traded Options

It would be advisable for Congress to take whatever action is necessary to facilitate development of options markets related to GNMAs or to other interest-bearing securities with price movements similar to those of GNMAs. (p. 155)

22. Financial Futures Markets

It would be appropriate for the Financial Accounting Standards Board to act on the recommendations of the American Institute of Certified Public Accountants and adopt accounting guidelines for futures transactions. (p. 156)

Federal regulatory agencies should take a more aggressive role in providing accurate information concerning the uses and mechanics of futures trading. (p. 156)

Government Financing Programs (Chapter 12)

Federal Housing Credit Programs

23. FHA Single-Family Mortgage Insurance

In view of development of the private mortgage insurance industry, the Federal Housing Administration should increasingly complement, rather than compete with, the private market. FHA should provide mortgage insurance where the private market is unable or unwilling to do so, and there should be a continuing demonstration role for FHA in developing and underwriting innovative forms of mortgage instruments. (p. 162)

All FHA home mortgage insurance programs should be streamlined to operate more efficiently and at the lowest possible cost in meeting program objectives. (p. 162)

24. FHA Multifamily Mortgage Insurance

The Federal Housing Administration should continue to insure standard unsubsidized multifamily mortgages and should perform a demonstration role with respect to innovative forms of multifamily mortgage instruments. (p. 164)

Adjustments should be made to permit FHA programs to operate more efficiently and to lower costs to FHA and developers of multifamily projects. (p. 165)

25. GNMA Mortgage-Backed Securities Program

A major goal of public policy should be to develop private markets for mortgage-backed securities (MBS). The Government National Mortgage Association MBS program should be phased down to encourage the growth of private mortgage-backed securities, but this phasedown should be done in concert with the development of the market for private securities. (p. 166)

During the transition to greater reliance on the private market, GNMA should continue to guarantee securities issued against pools of mortgage instruments insured or guaranteed by the Federal government, including innovative instruments. (p. 167)

26. Federally Related Credit Agencies

The Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation should play important roles in the development of markets for conventional mortgage pass-through securities. Federal policy should encourage the operation of FNMA and FHLMC as private corporations that retain limited benefits arising from Congressionally mandated commitments to housing. (p. 167)

27. Rural Housing Credit Programs

The housing credit programs of the Farmers Home Administration should be conducted without subsidy and in a manner that encourages the development of private housing credit institutions in rural areas. (p. 169)

State and Local Government Financing Programs

28. Tax-Exempt Financing

The Administration should promptly bring to the appropriate Cabinet council for thorough review the issue of private sector use of tax-exempt revenue bonds of all kinds and present to Congress an approach covering all categories of tax-exempt fund-

ing and/or specific options for more effective substitutes. Pending the outcome of the recommended study, State and local authorities should be allowed to issue mortgage revenue bonds, under the volume limits and targeting provisions of existing law. Moreover, the technical problems associated with the Mortgage Subsidy Bond Tax Act ought to be addressed by the Administration so that mortgage revenue bond programs can be made operable. (p. 170)

SECTION IV: GOVERNMENT REGULATION AND THE COST OF HOUSING

Federal Housing Regulations (Chapter 14)

1. Environmental Rules

Duplicative Environmental Requirements: The Administration should eliminate overlapping Federal and State environmental permit and compliance requirements, develop procedures for permit coordination, and eliminate the necessity for complying with both the National Environmental Policy Act and comparable State environmental policy acts. (p. 186)

Wetlands: Congress should amend Section 404 of the Clean Water Act and limit its application in the case of housing development to Phase I and II waters, as defined in 1975 by the U.S. Army Corps of Engineers. Furthermore, the Federal government should ensure the same interim result administratively by issuing a general permit by the Corps of Engineers. As a related matter, the government should accelerate its mapping and inventorying of wetlands and place greater reliance on State and local permitting. (p. 186)

Environmental Impact Statements: The Department of Housing and Urban Development should raise the threshold for an environmental impact statement (EIS) to 2,500 dwelling units or lots and use two-stage review processes to limit the necessity for an EIS where an environmental assessment or public response to HUD notice indicates an absence of significant environmental issues. (p. 187)

Local Area Certification: HUD should improve and expand its use of the local area certification procedure as an alternative to project-level assessments and/or environmental impact statements. (p. 187)

Revising Floodplain Regulation: Existing floodplain management regulations and construction standards should be revised, consistent with the overriding need to protect Federal investments and human safety, to be more sensitive to local variations in flood risk and to economic considerations attendant with compliance. (p. 188)

Review of Executive Order 11988: The Vice President's Task Force on Regulatory Relief should designate Executive Order 11988 for review and revision. Revisions should establish a workable definition of "acceptable risk," allow for local variability, and take into account the socioeconomic costs and benefits of occupying floodplains. (p. 188)

Coastal Barriers: The definition and delineations of the undeveloped coastal barriers by the Coastal Barriers Task Force of the Department of the Interior should be changed, consistent with the overriding need to protect Federal investments and human safety, to allow for increased sensitivity to uses of coastal property already approved at the local level and to the suitability of the area for development. (p. 189)

Private-Sector Insurance: The Federal Insurance Administration should continue to develop a program whereby the private insurance industry can assume responsibility for servicing and eventually assume the risk of underwriting flood insurance. (p. 189)

2. Real Estate/Mortgage Disclosure Laws

HMDA and CRA: Upon receipt of the report of the Federal Financial Institutions Examination Council, Congress and the appropriate regulatory agencies should review the approach and structure of the Home Mortgage Disclosure Act and the Community Reinvestment Act and compare the benefits derived from these laws with the burdens they impose on depository institutions. (p. 190)

RESPA Review: Section 8 of the Real Estate Settlement Procedures Act should be revised to permit the development of alternative settlement services and to require timely, full, and adequate disclosure. (p. 191)

3. Other Regulations

Davis-Bacon Act: Construction of housing and related infrastructure should be excluded from coverage under the Davis-Bacon Act. (p. 193)

Timber Production and Policy: The nation's policy for timber management programs, including harvesting and reforestation, should consider fully all relevant economic and environmental data. The economic inquiry should include the opportunity costs involved in withholding timber from the market, the consequences of policy on the price of timber and the cost of housing, and the long-term supply of timber. While this policy can be imple-

mented under existing laws through the Departments of Agriculture and the Interior, Congress should enact appropriate legislation to ensure the permanence of this policy. States in turn should reform forest tax policies and forest practices regulations that currently impede efficient private investment in timber and timber production. (p. 194)

Farmland Preservation Controls: Congress should repeal the Federal Farmland Protection Policy Act of 1981 because it could have a potentially serious and detrimental impact on the cost and availability of land for housing. (p. 195)

4. General Reforms

Modification to the Administrative Procedure Act: The President should consider modifications to the Administrative Procedure Act as a means of limiting the regulatory authority of agencies concerned with housing. (p. 197)

Negotiated Rulemaking: Federal agencies concerned with housing should consider instituting negotiated rulemaking as a means of developing fewer and more effective regulations. (p. 197)

Management of the HUD Clearance Process: The Department of Housing and Urban Development should implement a management system for controlling its clearance process and implement changes to speed up timely resolution of issues. HUD should institute a briefing procedure for new managers to cover the rulemaking process. (p. 198)

State and Local Housing Regulations (Chapter 15)

5. General Zoning Regulations

General Standard: To protect property rights and to increase the production of housing and lower its cost, all State and local legislatures should enact legislation providing that no zoning regulations denying or limiting the development of housing should be deemed valid unless their existence or adoption is necessary to achieve a vital and pressing governmental interest. In litigation, the governmental body seeking to maintain or impose the regulation should bear the burden for proving it complies with the foregoing standard. (p. 200)

Constitutional Validity of Zoning Restrictions: The President should direct the Attorney General to analyze the constitutional validity and jurisprudential ramifications of the "vital and pressing" standard for judicially determining the validity of zoning ordinances and related standards that strike a balance between legitimate governmental interest and individuals' rights to property; if the Attorney General then concludes that a change should be sought in the existing *Euclid* standard, he should seek an appropriate case for urging the Supreme Court to adopt a new test. (p. 201)

6. Specific Zoning Regulations

Density of Development: The density of development should be left to the conditions of the market except when a lesser density is necessary to achieve a vital and pressing governmental interest. (p. 203)

Zoning Restrictions on Manufactured Housing: States and localities should remove from their zoning laws all forms of discrimination against manufactured housing, including off-site fabricated housing systems or components conforming to requirements of one of the current nationally recognized model codes. (p. 203)

Size of Dwelling Units (Single-family and Multifamily): No limits (minimum or maximum) should be placed on the size of individual dwelling units. (p. 204)

Growth Controls: Except where justified by a vital and pressing interest, governments should avoid growth controls that limit production of housing. (p. 205)

Farmland Preservation Controls: Regulation restricting land to farming use should not be adopted if it would limit housing production. (p. 205)

7. Development Regulations

Financing Infrastructures : Municipalities should consider using innovative financing approaches to assist developers in providing infrastructure for new residential development. (p. 206)

Cost-Sensitive Standards: HUD should contract with the National Institute of Building Sciences to develop cost-sensitive subdivision standards for State and local government consideration. (p. 206)

Wastewater Technology: No development should be barred for lack of municipal sewer capacity if the developer is prepared to install at his cost proven innovative and alternative wastewater technologies that meet public health and safety requirements. To this end, the U.S. Environmental Protection Agency should support both public and private research activities related to innovative wastewater technologies. (p. 207)

Builder/Developer Fees: Builders and developers should be obligated only for such fees, dedications, servitudes, parking requirements, or other exactions as are specifically attributable to the development. Likewise, communities should not be required to subsidize new housing development infrastructure or facilities relating thereto. Builders and developers should pay only their pro-rata share. They should be permitted to install at their own cost facilities not publicly available. (p. 207)

8. Local Permit Processing

Wherever possible procedures for obtaining permits for subdivision and construction should be reduced and consolidated to a single comprehensive permit to minimize the time between purchase of land and occupancy by homeowners and tenants. (p. 208)

Construction Standards and Building Codes (Chapter 16)

9. The Federal Role

Private-Sector Standards: Federal agencies, in their housing programs, should use appropriate voluntary private-sector construction standards and rely upon appropriate private-sector processes for development and revision of standards. (p. 212)

Building-Product Evaluation and Approval Systems: Reciprocity should be established between public and private building product evaluation and approval systems with the objective of developing a single, nationally recognized private-sector system upon which the public sector can rely. (p. 212)

Manufactured-Housing Construction and Safety Standards: Consistent with its legal authority, HUD should revise its manufactured-housing construction and safety standards, using, to the extent feasible, nationally recognized voluntary standards organizations. (p. 213)

Energy-Performance Standards: The Federal government should repeal the building energy-performance standards legislation and consider limited funding of private research on total building performance. (p. 214)

Access for the Handicapped: The Federal government should use the American National Standards Institute (ANSI) standard for access for the handicapped in order to meet the special construction needs of the handicapped population. Furthermore, appropriate Federal agencies should request ANSI to develop, at the earliest opportunity, a methodology for establishing scope requirements to determine local handicapped housing needs. In the interim, Federal scope requirements would be controlling. (p. 215)

To comply with federally assisted housing-development requirements in this regard, builders should certify that the construction complies with the ANSI standard and, where appropriate, with the Federal scope standards. (p. 215)

Minimum Property Standards: The Department of Housing and Urban Development, the Farmers Home Administration, and the Veterans Administration should phase out their use of the single- and multifamily Minimum Property Standards and depend entirely on locally enforced building codes that are consistent with the One and Two Family Dwelling Code or one of the current nationally recognized model building codes. Additional marketability and durability criteria may be used for federally subsidized multifamily rental housing if required to establish a reasonable level of risk for Federal funds. (p. 216)

In the absence of such locally enforced building codes, the three agencies should enforce the One and Two Family Dwelling code or whichever of the current nationally recognized model building codes is most widely used in the immediate area of the individual project. (p. 216)

10. State and Local Building Codes

Health and Safety Requirements: All building codes should be limited to health and safety requirements; those responsible for developing or adopting such codes should remove existing requirements that do not meet this basic test. (p. 217)

State and Local Use of Model Building Codes: States should adopt or require their local governments with building codes to adopt, with little or no amendment, one of the current nationally recognized model building codes and the CABO One and Two Family Dwelling Code. (p. 217)

Professional Code Administration: State and local governments should recognize and utilize existing building-department personnel certification systems as an integral element of evaluating the technical competence of such personnel. (p. 218)

Membership of Model-Code Organizations: The model-code organizations should include other technically competent interested parties as full voting members in their deliberative processes. (p. 219)

Conflicting Codes: The Board for the Coordination of Model Codes (BCMC) should be encouraged in its effort to resolve differences between building codes and fire safety standards. (p. 219)

Rehabilitation Standards: State and local governments should apply the HUD rehabilitation guidelines as the basis for further development of their own rehabilitation standards. (p. 219)

Building Code Research: The Federal government should consider providing limited funding for research and demonstration projects to enhance the technical content and the administration of building codes. (p. 220)

Licensing Construction Craftsmen: States should reform their laws relating to licensure of specialized construction workers (1) to remove licensure requirements not related to basic health and safety and to remove testing and scoring not closely and directly related to job performance; (2) to establish statewide licensure so licensed craftsmen may operate anywhere within the State; and (3) to grant

recognition to comparable licenses issued by other States. (p. 221)

Implementation of Deregulation (Chapter 17)

11. Special Regulatory Relief

To achieve special regulatory relief for housing, the President should designate either the Cabinet Council or the Vice President's Task Force on Regulatory Relief to coordinate agency actions concerning housing and to review the aggregate impact of regulations and Federal programs on the housing sector. (p. 229)

12. HUD Initiatives

The Department of Housing and Urban Development should undertake an extensive affordable-housing implementation program. Such an effort should include: (1) identification of a single HUD office for promoting and coordinating housing affordability and (2) creation of an Office of Housing Productivity. (p. 230)

13. State and Local Deregulation

State and local governments should undertake immediate steps to enact deregulatory changes as set forth in, or consistent with, the recommendations in this Report. (p. 232)

COMMISSION BIOGRAPHIES

William F. McKenna, *Chair*
Mr. McKenna, a resident of Los Angeles, Calif., is a Senior Partner of the national law firm of McKenna, Conner & Cuneo (Los Angeles, San Francisco, and Washington, D.C.), and is Chairman of the Federal Home Loan Bank of San Francisco.

He is a graduate of Providence College and Yale Law School.

Mr. McKenna served under President Eisenhower as U.S. Deputy Administrator of the Housing and Home Finance Agency (predecessor of the U.S. Department of Housing and Urban Development). He also served as General Counsel to the House Government Operations Committee, as Chief Counsel to several subcommittees of the House, and earlier as Republican Counsel to the House Committee on Expenditures in the Executive Departments. Also under President Eisenhower, he established the Organized Crime Unit for the Department of Justice.

Mr. McKenna is a Fellow of the American College of Trial Lawyers and is a Founder and Director of the Free Clinic for the Aged Poor (Knights of Malta) in downtown Los Angeles.

Carla Anderson Hills, *Vice Chair*
Mrs. Hills, a resident of California, is a Senior Partner of the national law firm of Latham, Watkins & Hills, which has offices in Washington, D.C., Chicago, and California. Mrs. Hills has managed the Washington office since it opened in 1978.

Mrs. Hills received her A.B. degree from Stanford University and her LL.B. degree from Yale Law School. She is a member of the Bars of California and the District of Columbia and is admitted to practice before the U.S. Supreme Court.

Mrs. Hills served as Secretary of the U.S. Department of Housing and Urban Development (1975–77) and as the Assistant Attorney General, Civil Division, U.S. Department of Justice (1974–75). Prior to entering government service, she was a partner in a Los Angeles law firm and has served as Adjunct Professor of Law at the University of California, Los Angeles, School of Law.

She has served on the Administrative Conference of the United States, on the Advisory Commission on Intergovernmental Relations, as President of the Federal Bar Association in Los Angeles, and as Chairman of the Reagan-Bush Housing Task Force. She currently serves as Trustee of the Urban Institute; Chairman-elect of the American Bar Association, Section of Antitrust Law; and a member of the Advisory Committee of the MIT/Harvard Joint Center for Urban Studies, as well as a number of other civic organizations. She is co-author of *Federal Civil Practice* (1961) and editor and co-author of *Antitrust Advisor* (1971).

Mrs. Hills serves as a member of the Boards of Directors of International Business Machines Corporation, Standard Oil Company of California, The Signal Companies Inc., American Airlines Inc., and Corning Glass Works.

Herbert Barness
A resident of Buckingham, Bucks County, Pa., Mr. Barness is Chairman of the Barness Organization, a real estate, land development, and property management firm in Warrington, Pa., and New Jersey.

A graduate of Bucknell University, he is a Registered Professional Engineer and a Licensed Real Estate Broker.

He has served as a member of the National Association of Home Builders and the National Association of Real Estate Boards, and is a charter member of the Bucks County Home Builders Association.

Mr. Barness is a Trustee of Bucknell University and San Francisco Real Estate Investors and a Director of Unicorp American Corporation, the Pennsylvania Society, and the Washington's Crossing Foundation. He is the recipient of numerous awards for public service.

On the Commission, Mr. Barness served on the Economics Committee.

Robert G. Boucher
A resident of Englewood, Colo., Mr. Boucher is President and Chairman of the Board of First Denver Mortgage Company, a wholly owned subsidiary of The First National Bancorporation Inc. He holds a B.A. degree in economics from Middlebury College.

He is a past President of the Mortgage Bankers' Association of America. He serves on its Board of Governors, Legislative Committee, and Long-Range Planning Committee. He is a Board member and Treasurer of the Colorado Housing Finance Authority. In addition, he serves on a variety of civic and corporate boards.

Mr. Boucher is the recipient of many awards in the housing area, including the U.S. Department of Housing and Urban Development Certificate of Fair Housing Achievement and the Annual Award of the Southwestern Regional Council of the National Association of Housing and Redevelopment Officials.

On the Commission, Mr. Boucher served as a member of the Economics Committee.

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A resident of Washington, D.C., Edward Brooke is a Partner in the Washington, D.C., law firm of O'Connor & Hannan and serves Of Counsel to the Boston law firm of Csaplar & Bok. In addition, he is a Limited Partner in Bear, Stearns & Company in New York.

A graduate of Howard University, he received his LL.B. and LL.M. degrees from Boston University, where he was Editor of the Law Review.

He served two terms in the U.S. Senate from the Commonwealth of Massachusetts and two terms as Attorney General of the Commonwealth of Massachusetts.

As a Senator, he served as the Ranking Republican member of the Senate Committee on banking, Housing, and Urban Affairs. He also held key committee assignments including seats on the Appropriations Committee, Joint Committee on Defense Production, Armed Services Committee, and Select Committee on Aging.

Senator Brooke is a Fellow of the American Bar Association and of the American Academy of Arts and Sciences.

On the Commission, Senator Brooke served as a member of the Housing Programs Committee.

Garry E. Brown
A resident of Schoolcraft, Mich., Mr. Brown is a Director (Partner) in the Pittsburgh and Washington, D.C., law firm of Kirkpatrick, Lockhart, Hill, Chirstopher & Phillips. He was a Michigan State Senator from 1962 to 1966 and served as a Member of Congress from 1967 to 1979.

He is a graduate of Kalamazoo College and received his law degree from George Washington University in 1954.

While in Congress, Mr. Brown was the second ranking minority member on the House Banking, Finance, and Urban Affairs Committee and the ranking minority member on its Housing and Community Development Subcommittee. He was also a senior ranking member on the Government Operations Committee and ranking member on its Commerce, Consumer, and Monetary Affairs Subcommittee. In addition, he was the second ranking House member on the Joint Economic Committee and a member of three of its subcommittees.

On the Commission, Mr. Brown served on the Economics Committee and the Regulations Committee.

Bernard J. Carl
A resident of Washington, D.C., Mr. Carl is a Partner in the Washington, D.C., law firm of Williams and Connolly. Prior to joining the firm in 1977, he served as Acting Assistant Secretary for Policy Development and Research (1976–77), and Deputy Assistant Secretary for Policy Development and Program Evaluation (1975–76), at the U.S. Department of Housing and Urban Development.

Mr. Carl is a graduate of Wesleyan University, and received his law degree from the University of Virginia in 1972.

He was Law Clerk to Supreme Court Justice Thurgood Marshall and to the Chief Judge of the U.S. Court of Appeals for the District of Columbia, as well as Special Assistant to the Assistant Attorney General, Civil Division, U.S. Department of Justice.

He has served on the Reagan-Bush Housing Task Force, on the Republican National Committee Advisory Council on Human Concerns, and as the HUD Development Budget Coordinator for the Reagan Transition Team.

On the Commission, Mr. Carl was a member of the Housing Programs Committee, the Economics Committee, the Coordinating Committee, and the Drafting Committee.

Richard E. Carver
The Mayor of Peoria, Ill., since 1973, Mr. Carver is also President of Carver Lumber Company in Peoria.

A graduate of Bradley University with a degree in business administration, he now serves on the National Council of Advisors for the College of Business Administration.

Mayor Carver is currently a Director of the Illinois State Chamber of Commerce, and a Director of Provident Federal Savings & Loan Associa-

tion of Peoria. He is a past Director of the National League of Cities, past member of the President's Advisory Commission on Intergovernmental Relations, and past President of both the National Conference of Republican Mayors and the United States Conference of Mayors.

Among many other activities, Mayor Carver is Chairman of the Governor's Advisory Committee on Block Grants and was a delegate to the United Nations Conference on Human Settlements (HABITAT) in 1976.

On the Commission, Mayor Carver was Chairman of the Housing Programs Committee and a member of the Coordinating Committee and the Drafting Committee.

Stuart A. Davis

A resident of Webster Groves, Mo., Mr. Davis is President of Laurene Davis Inc., Realtors, a St. Louis area real estate firm.

He is a graduate of Washington University.

Mr. Davis is Regional Vice President of the National Association of Realtors, a former member of the Association's Executive Committee, and past Chairman of NAR's Resolutions Committee (1979). He was President of the Missouri Association of Realtors in 1977 and has served on its Board of Directors since 1968. He was selected "Realtor of the Year" in 1980 by the Missouri Association of Realtors.

He is a past President (1974) of the Real Estate Board of Metropolitan St. Louis and past President of St. Louis Computer List (1969). He is a member of the Executive Council of Nationwide Relocation Services, a subsidiary of Coldwell-Banker.

Mr. Davis was the the 1980–81 Chairman of the Board of the Better Business Bureau of Greater St. Louis and is currently Vice Chairman of the Webster Groves Plan Commission and Special Tax District Commission.

On the Commission, Mr. Davis served as a member of the Housing Programs Committee, the Economics Committee, and the Regulations Committee.

G. Richard Dunnells

A resident of Bethesda, Md., Mr. Dunnells has been a Partner in the Washington, D.C., law firm of Dunnells, Duvall, Bennett & Porter since 1973.

A graduate of Dartmouth College, he received his law degree from the University of Virginia in 1967.

He began his legal career with the Washington, D.C., law firm of Hogan & Hartson, and two years later (1969) joined the first Nixon Administration. From 1969 to 1973, he had various assignments at the U.S. Department of Housing and Urban Development, first as Special Assistant to the Under Secretary (1969), then as Deputy Assistant Secretary for Low-Rent Public Housing and Urban Renewal (1970–71), and as Deputy Assistant Secretary for the Federal Housing Administration and Public Housing Management (1971–73).

Mr. Dunnells was a member of President-elect Ronald Reagan's HUD Transition Team.

On the Commission, Mr. Dunnells served on the Housing Programs Committee, the Economics Committee, and the Drafting Committee.

Richard L. Fore

A resident of Las Vegas, Nev., Mr. Fore has been a Managing Partner of Lincoln Property Company, Las Vegas, since 1977. He was Vice President and General Manager of the Donald L. Huber Corporation, Dayton, Ohio, in 1975–76.

A graduate of Florida State University, he received his M.P.A. from Arizona State University in 1970.

Mr. Fore was Executive Assistant to the General Manager of the New Community Development Corporation and Deputy Administrator of the New Communities Administration, U.S. Department of Housing and Urban Development, from 1973 to 1975, and also was Administrative Assistant to the Secretary of HUD during that period.

Mr. Fore was a member of President-elect Ronald Reagan's Transition Staff and was a member of the Reagan-Bush Housing Task Force in 1980.

On the Commission, Mr. Fore was a member of the Regulations Committee and the Coordinating Committee.

Myra Goldwater

A resident of Palm Springs, Calif., Mrs. Goldwater is a realtor and President of her own real estate firm. She has served as a Director of the National Association of Realtors since 1978. She was President of Palm Springs Board of Realtors in 1973–74 and has been a Director of the California Association of Realtors since 1973. She has been a member of the Palm Springs Chamber of Commerce for 14 years and has served as Director for several of those years.

On the Commission, Mrs. Goldwater served as a member of the Regulations Committee and the Housing Programs Committee.

Lee Goodwin

A resident of Southampton, N.Y., Mrs. Goodwin is President of Integrated Funding Inc., a subsidiary of Integrated Resources Inc. in New York City. Previously, she was a Senior Vice President for Merrill Lynch Huntoon Paige Inc., New York City, from 1976 to 1981.

A graduate of Barnard College she took graduate courses in public law at Brown University.

From 1957 to 1962, she was Assistant to the Chairman, New York State Senate Committee on New York City Affairs, and also was Assistant to the Chairman of the Joint Legislative Committee on Housing, New York State Legislature.

In 1962–63, she was Executive Assistant to the State Commissioner of Housing and Community Renewal and served as Assistant Director of the New York State Housing Finance Agency. From 1973 to 1976, she was Commissioner of the New York State Division of Housing and Community Renewal.

On the Commission, Mrs. Goodwin served as a member of the Housing Programs Committee and the Economics Committee.

Robert F. Hatch

A resident of Los Angeles, Calif., Mr. Hatch is Executive Vice President of Cambrian Energy Systems Inc., of Culver City, Calif. He was previously Vice President and member of the Board of Directors, George Elkins Company, a diversified real estate firm.

Mr. Hatch graduated from Valparaiso University in 1958 and received a J.D. degree from the Northwestern University School of Law in 1960.

In 1962, he was elected to the Illinois State Senate and served four years in that body.

On the Commission, Mr. Hatch served as a member of the Economics Committee.

Jasper S. Hawkins

A resident of Phoenix, Ariz., Mr. Hawkins is an architect and Principal in the firm of Hawkins, Lindsey & Wilson Associates, a firm he founded in 1958.

Mr. Hawkins is a graduate of the University of Southern California.

He is a founding member of the Board of Directors of the National Institute of Building Sciences and currently serves as Chairman of the Board. He has been a member of the U.S. Delegation to the United Nations' Economic Commission for Europe's Working Party on Building since 1978 and a member of the American Institute of Architects National Codes and Standards Committee since 1970. In 1978, he was appointed to the founding Board of the National Fire Academy.

On the Commission, Mr. Hawkins served as a member of the Housing Programs Committee, the Economics Committee, and the Regulations Committee.

Richard K. Helmbrecht

A resident of Ann Arbor, Mich., Mr. Helmbrecht has served as Executive Director of Michgan State Housing Development Authority since 1977. He was Director of the Michigan State Department of Commerce from 1972 to 1977, and held various positions in the Office of the Governor of the State of Michigan from 1962 to 1972, including responsibility for new program development, legislative affairs, and special housing assignments. In 1977, he served as Chairperson of the Governor's Urban Action Group. Mr. Helmbrecht is President of the Council of State Housing Agencies.

He is a graduate of Pennsylvania State University and took an M.A. in political science from the University of Chicago in 1963.

On the Commission, Mr. Helmbrecht served as a member of the Housing Programs Committee and the Economics Committee.

Peter D. Herder

A resident of Tucson, Ariz., Mr. Herder serves as President of three construction firms: Herder Construction Company, Villa Catalina Building Corporation, and Herder Commercial Development Corporation. He also is Vice President and owner of Arizona Brick Company.

A graduate of San Jose State University, he received his master's degree from the University of Southern California.

He has served three terms as President of Southern Arizona Home Builders Association (1969, 1975, 1976). He was named "Inspirational Leader of the Decade" in 1977. He is presently Vice President and Treasurer of the National Association of Home Builders and served as its Vice President for Area 13 (Arizona, Colorado, New Mexico, Nevada, Utah, and Wyoming) in 1978–79. He also is a Director of the U.S. Chamber of Commerce and was President of Tucson Economic Development Corporation from 1977 to 1979. Mr. Herder is a Director of the United Bank of Arizona (Phoenix), the Tucson Electric Power Company, and the Tucson Airport Authority.

On the Commission, Mr. Herder served on the Present Housing Issues Committee, the Housing Programs Committee, the Economics Committee, and the Regulations Committee.

Samuel C. Jackson

A resident of Washington, D.C., Mr. Jackson is a member of the New York and Washington law firm of Strook, Strook & Lavan.

He is a graduate of Washburn University, where he also received a law degree in 1954.

From 1969 to 1973, he served at the U.S. Department of Housing and Urban Development as Assistant Secretary for Community Planning and Development. In 1968–69, he served as Vice President of the American Arbitration Association and Director of its National Center for Dispute Settle-

ment (1968–69). He was one of five Commissioners of the U.S. Equal Employment Opportunity Commission from 1965 to 1968. He has held legal positions with the National Association for the Advancement of Colored People at local, State, and national levels.

Formerly a member of the Administrative Conference of the United States, Mr. Jackson has written for legal and urban affairs journals and has lectured extensively.

On the Commission, Mr. Jackson served on the Housing Programs Committee and the Economics Committee.

Charles E. Klumb

A resident of Biloxi, Miss., Mr. Klumb is President of the Klumb Lumber Company, wholesale distributors and exporters of forest products.

He holds a B.S. degree in chemical engineering from Mississippi State University.

Mr. Klumb is a former past President of the North American Wholesale Lumber Association, the Mississippi Lumber Manufacturers Association, and the National Bark Producers Association.

On the Commission, Mr. Klumb served on the Economics Committee.

Sherman R. Lewis, Jr.

A resident of Ridgewood, N.J., Mr. Lewis is the President and a Director of Shearson/American Express Inc., the investment banking and financial services firm. Before that he had been Vice Chairman and Co-Chief Executive Officer of Loeb Rhoades, Hornblower & Co., and, earlier, of Loeb Rhoades & Co. Inc.

A graduate of Northwestern University, Mr. Lewis received his M.B.A. from the University of Chicago in 1964.

Mr. Lewis is a member of the Visiting Committee of the College of Arts and Sciences of Northwestern University and the Alumni Association Board of Directors of the University of Chicago Graduate School of Business.

On the Commission, Mr. Lewis served on the Economics Committee.

Gordon C. Luce

A resident of San Diego, Calif., Mr. Luce is Chairman of the Board and Chief Executive Officer of the Great American Federal Savings and Loan Association.

He is a 1950 graduate of Stanford University, where he received his M.B.A. two years later.

Mr. Luce served as Secretary of Business and Transportation in the Cabinet of California Governor Ronald Reagan from 1967 to 1969. He has twice served as a delegate to the International Building Societies IES conference in Europe. He was the founding Chairman of the new San Diego Economic Development Corporation.

Mr. Luce is a member of the Board of Overseers of the Hoover Institution (Stanford University). He also serves as an Advisor to the University of Southern California Center for the Study of Financial Institutions.

He is a Director of the Federal Home Loan Bank of San Francisco and the U.S. League of Savings Associations. He also is a former President of the California Savings and Loan League.

On the Commission, Mr. Luce served as Chairman of the Committee on Private-Sector Financing of Housing, as Chairman of the President Housing Issues Committee, and as a member of the Steering Committee and the Drafting Committee.

Maurice Mann

A resident of San Francisco, Calif., Dr. Mann is Vice Chairman of Warburg Paribas Becker Inc.–A.G. Becker, a U.S. investment banking and financial services firm.

A graduate of Northeastern University, with an M.A. from Boston University, he recieved a Ph.D. from Syracuse University in 1955. He holds an honorary LL.D. degree from Notheastern University (1977).

From 1973 to 1978, he was President and Chief Executive Officer of the Federal Home Loan Bank of San Francisco. Earlier he was Executive Vice President of Equibank (1971–72); Assistant Director of the U.S. Office of Management and Budget (1969–70); and Vice President and General Economist of the Federal Reserve Bank of Cleveland (1960–69).

He currently serves as Chairman of the Economic Advisory Board of the National Savings and Loan League and is Chairman of the Federal Savings and Loan Advisory Council. He also is a Chairman of the Policy Advisory Board of the Real Estate and Urban Economics Program at the University of California, Berkeley.

On the Commission, Dr. Mann served as Chairman of the Committee on Housing and the Economy, Chairman of the Economics Committee, Chairman of the Drafting Committee, and a member of the Steering Committee and the Coordinating Committee.

Preston Martin

A resident of Washington, D.C., Mr. Martin is Vice Chairman of the Board of Governors of the Federal Reserve System.

A graduate of the University of Southern California, where he also received his M.B.A., Mr.

Martin received his Ph.D. in economics from Indiana University in 1952.

Prior to his appointment to the Federal Reserve Board, he was Chairman and Chief Executive Officer of the Seraco Group, the financial institution and real estate development arm of Sears Roebuck and Company.

He served as Commissioner of the California Savings and Loan Department under Governor Ronald Reagan from 1967 to 1969. From 1969 to 1972, he was Chairman of the Federal Home Loan Bank Board.

He is a member of the Visiting Committee of the Joint Center of Urban Studies at Harvard and MIT. He also is a member of the Advisory Committee of the Wharton School of Business.

On the Commission, Dr. Martin served on the Committee on Private-Sector Financing of Housing, the Economics Committee, and the Steering Committee. He resigned from the Commission on March 26, 1982.

Robert V. Mathison

A resident of Hilton Head Island, S.C., Mr. Mathison is an inventor. He holds 30 U.S. patents plus 26 patents in foreign lands. In business, Mr. Mathison has served in various executive capacities as a manufacturer of living-room furniture and in other furniture-related industries, for almost 40 years.

Mr. Mathison attended Carleton College and Northwestern University.

He currently is a consultant with Kimberly-Clark Corporation and is a Director of Rowe Furniture Corporation, Salem, Va.

From 1976 to 1980, he was a member of the South Carolina State Housing Authority and was its Vice Chairman for three years. Previously, he served as Chairman of the Housing Authority of the City of Asheville, N.C. (1967–70). He was Vice President of Transcon Investment and Financial Limited (1971–74), a private housing corporation. In 1969, he was the recipient of the Small Business Administration's first Community Development Award.

On the Commission, Mr. Mathison served on the Housing Programs Committee, the Economics Committee, and the Regulations Committee.

Martin Mayer

A resident of New York City, Mr. Mayer is a writer. His 23 books include: *Wall Street, Men and Money* (1955), *Madison Avenue, USA* (1958), *The Schools* (1961), *The Lawyers* (1967), *About Television* (1972), *The Bankers* (1975), and *The Builders*(1978).

He is a graduate of Harvard College and has received honorary degrees (D. Litt.) from Wake Forest University and Adelphi University.

Mr. Mayer has written articles on various aspects of American life in such publications as *TV Guide*, *Fortune*, *Cosmopolitan*, *Harper's*, *Better Homes and Gardens*, *Esquire*, *American Scholar*, *Commentary*, and *Musical America*. He is currently doing research for a book that will deal with the future of banking, based on his study on this subject for the 20th Century Fund.

On the Commission, Mr. Mayer served on the Committee on Housing and the Economy, the Present Housing Issues Committee, and the Economics Committee.

Richard F. Muth

A resident of Stanford, Calif., Dr. Muth has been a Professor of Economics at Stanford University since 1970.

He is a graduate of Washington University, where he received his M.A. in 1950. Dr. Muth received his Ph.D. in economics at the University of Chicago in 1958.

He served as a member of the President's Task Force on Urban Renewal in 1969. He was a member of the Reagan-Bush Housing Task Force in 1980.

He is the author of numerous articles and publications, including *Cities and Housing* (1969), a monograph on *Public Housing* (1974), and *Urban Economic Problems* (1975).

On the Commission, Dr. Muth was a member of the Committee on Housing and the Economy, the Present Housing Issues Committee, the Housing Programs Committee, and the Economics Committee.

George P. Shafran

A resident of Arlington, Va., Mr. Shafran is President and Chief Executive Officer of the Realty Programming Corporation/Homes for Living Network, a marketing and referral organization of Realtors.

Born in Atlas, Pa., he attended Bucknell, Brown, American, and George Washington universities.

A former member of the Virginia General Assembly, he was the Republican candidate for Lieutenant Governor in 1971. He currently serves on the Board of Directors of the American Council for Capital Formation and on Virginia's Department of Conservation and Economic Development.

On the Commission, Mr. Shafran served on the Present Housing Issues Committee, the Housing Programs Committee, the Economics Committee, and the Drafting Committee.

Bernard H. Siegan

A resident of La Jolla, Calif., Mr. Siegan serves as Distinguished Professor of Law and Director of Law

and Economic Studies at the University of San Diego Law School.

A graduate of the University of Chicago Law School, he was a practicing attorney in Chicago for 23 years before moving to southern California. He was a Research Fellow in law and economics at the University of Chicago Law School in 1968–69.

Mr. Siegan was a member of the Reagan-Bush Housing Task Force in 1980. He has authored and served as editor of seven books including *Land Use Without Zoning* (1972), *Other People's Property* (1976), and *Economic Liberties and the Constitution* (University of Chicago Press, 1981). He also was the editor and a contributor to the following books: *Planning Without Prices* (1977), *Regulation, Economics, and the Law* (1979), *Government, Regulation and the Economy* (1980), and *Interaction of Economics and the Law* (1977). Mr. Siegan has written numerous articles for professional journals and publications.

On the Commission, Mr. Siegan served as Chairman of the Regulations Committee and was a member of the Steering Committee and Drafting Committee.

Kenneth J. Thygerson

A resident of Englewood, Colo., Dr. Thygerson is Executive Vice President for Western Federal Savings and Loan Association, Denver, and is Chairman of the Board of WestAmerica Mortgage Company.

A graduate of Northwestern University, he also received a Ph.D. in finance from Northwestern in 1973. He is currently a member of the Advisory Council, Credit Research Center, at Purdue University.

He was Chief Economist and Director, Division of Economics and Research, for the U.S. League of Savings Associations in Chicago, from 1970 to 1981. Dr. Thygerson is a former Director of the American Real Estate and Urban Economic Association. He is the author of numerous books, publications, and articles on housing and housing finance.

He was Assistant Director of Human Services in the Office of Policy Coordination for the Reagan transition.

On the Commission, Dr. Thygerson served as Chairman of the Coordinating Committee and member of the Economics Committee, the Housing Programs Committee, the Committee on Private-Sector Financing of Housing, and the Drafting Committee.

Charles J. Urstadt

A resident of Bronxville, N.Y., Mr. Urstadt is Chairman and President of Pearce, Urstadt, Mayer & Greer Inc., New York City, a mortgage and sales brokerage, building leasing, management, and insurance firm.

A graduate of Dartmouth College, where he also received an M.B.A. in 1951, Mr. Urstadt holds an LL.B degree from Cornell University and studied taxation at New York University Graduate Law School.

From 1973 to 1978, he was Chairman of the Battery Park City Authority in New York. From 1967 to 1973, he was Commissioner of Housing and Community Renewal for the State of New York. He was Chairman of the New York State Housing Finance Agency and served as Chairman of the New York State Building Code Council from 1969 to 1973. He is a former Chairman of New York Construction Users Council, and serves as a director of several publicly held corporations, including the National Corporation for Housing Partnerships.

On the Commission, Mr. Urstadt served on the Housing Programs Committee and the Regulations Committee.

STAFF BIOGRAPHIES

Kent W. Colton is a Professor of Public Management and Finance at Brigham Young University's Graduate School of Management. He is also a Vice President of Public Systems Evaluation, Inc., a nonprofit research corporation. He received his M.P.A. from the Maxwell School, Syracuse University, and his Ph.D. from MIT. He served on the faculty of MIT in Urban Studies for six years, was a White House Fellow at the Department of the Treasury, and worked at the Boston Redevelopment Authority as the Director of Housing Program Development. He is the author of several books and numerous articles on housing finance, housing policy, and a range of public policy and public management issues. Commission assignment: Staff Director.

Charles G. Field is an attorney in the Office of General Counsel, U.S. Environmental Protection Agency. He was formerly an associate with the law firm of Troy, Malin, and Pottinger. While at the U.S. Department of Housing and Urban Development, he served as Director of the Office of Energy Conservation and the Director of Real Estate Practices. He holds a J.D. from Georgetown University and a Ph.D. in city and regional planning from Harvard. He is co-author of *The Building Code Burden* (Lexington Books), as well as several reports and articles on housing regulation and housing policy. Commission assignment: Regulations Committee.

David F. Seiders is a Senior Economist in the Division of Research and Statistics at the Board of Governors of the Federal Reserve System, where he has worked since 1970. He has published numerous papers in the area of housing finance, covering such topics as mortgage-backed securities, borrowing against housing equity, construction loan markets, and risk shifting by mortgage market participants. He holds a Ph.D. in Economics from the Pennsylvania State University. Commission assignments: Economics Committee; Task Force on Restructuring of Thrift Institutions and Task Force on Federal Credit Programs.

James E. Wallace has been a research manager with Abt Associates, Inc., Cambridge, Mass., since 1977. For the past three years he has managed a Section 8 research project of national scope that measures patterns of participation, improvement in housing conditions, and racial and economic integration. Previous projects included managing the experimental design and analysis for the Housing Allowance Demand Experiment for the U.S. Department of Housing and Urban Development. He received his Ph.D. in urban studies and planning from MIT; his dissertation analyzed the role of tax incentives in subsidized housing. Commission assignment: Housing Programs Committee.

John C. Weicher is Resident Fellow at the American Enterprise Institute for Public Policy Research. He is the author of three books and numerous articles on housing and urban economic problems. He served from 1975 to 1977 as Deputy Assistant Secretary for Economic Affairs at the U.S. Department of Housing and Urban Development. He has been Program Director at the Urban Institute, and has taught economics at the Ohio State University and the University of California at Irvine. He is President of the American Real Estate and Urban Economics Association. He received a B.A. from the University of Michigan and a Ph.D. in economics from the University of Chicago. Commission assignment: Deputy Staff Director for the *Interim Report*.

Andrew S. Carron is a Research Associate at the Brookings Institution studying regulatory reform in financial markets. He is the author of *The Plight of Thrift Institutions* (Brookings), published in February 1982. He has consulted for various public agencies and private firms on the subject of government regulation. He holds a Ph.D. in Economics from Yale and an A.B. from Harvard. Commission assignments: Present Housing Issues Committee and Economics Committee.

Connie H. Casey is an Industry Research Economist with the Division of Housing Demographic Analysis at the U.S. Department of Housing and Urban Development, where she has worked since 1974. Her responsibilities include analysis of

housing demand and the social characteristics of households. She has also studied the social impact of housing cost burdens. She was formerly a Market Analyst with the Federal Housing Administration, and is co-author of *Housing Affordability Problems and Housing Need in Canada and the United States*. She received a B.A. in Economics from the College of William and Mary. Commission assignment: Homeownership Task Force.

Nancy S. Chisholm has been with the U.S. Department of Housing and Urban Development for 13 years, and is now Director of the Office of Policy Development and Program Evaluation in HUD's Office of Housing. She designed and directed the Section 8 Existing Housing Program, and has served as Deputy Assistant Secretary for Assisted Housing, Director of Economic and Market Analysis, and in various housing policy positions. Before coming to HUD, she worked for the City of Philadelphia as Director of Housing for the Philadelphia Commission on Human Relations. She received an M.S.W. from Bryn Mawr, an M.A. from the University of Pennsylvania, and a B.A. from Thiel College. Commission assignment: Assisted Housing Task Force.

Richard B. Clemmer has served as a Housing Economist at the U.S. Department of Housing and Urban Development since 1974, where his work has included economic analysis of housing regulations. He was formerly an Assistant Professor of Economics at Georgia State University and recently has been appointed Associate Professor of Economics at Central Michigan University. He holds a Ph.D. from the University of Chicago; his dissertation concerned the measurement of benefits to public housing tenants. He is the author of *Economics of Urban Problems* (Houghton-Mifflin), the third edition of which was published in January 1982. Commission assignment: Homeownership Task Force.

Chester C. Foster is the Director of the Actuarial Division in the Office of Housing of the U.S. Department of Housing and Urban Development. His work involves the analysis of the reserves and insurance funds of FHA programs, the allocation of income to the funds, and determination of dividends for funds with mutual provisions. A 20-year veteran of Federal housing agencies, he recently was instrumental in developing HUD's graduated payment mortgage program. He has published numerous articles, most recently one on the mortgage insurance risk of variable payment mortgages. He holds a B.S. in Economics from the University of Maryland. Commission assignment: Federal Credit Programs Task Force.

Richard H. Francis is Senior Policy Advisor to the Assistant Secretary for Policy Development and Research of the U.S. Department of Housing and Urban Development. He is currently working on developing the Enterprise Zone program. Before joining HUD he was Executive Vice President of the National Multi Housing Council for three years. He also served as Director of Government Relations for the National Association of Independent Colleges and Universities. He holds a Ph.D. in Political Science and Public Policy from the University of Maryland, an M.A. from Yale, and a B.S. from the U.S. Naval Academy. Commission assignments: Unassisted Rental Housing Task Force and Regulation Committee.

Jean M. Freeze is the Administrative Officer to the Director of Personnel for the U.S. Department of Housing and Urban Development. During her 10 years with the Department, she has held positions as Administrative Officer in the HUD Disaster Temporary Housing Program, both in Headquarters and at disaster sites, and in the Office of International Affairs. She served as Assistant to the Administrative Officer to the Secretary in Cabinet-level transitions at HUD in 1978 and 1980 and most recently was a Management Analyst in the Office of Administration. She received a B.A. in urban studies from Wheaton College. Commission assignment: Administrative Officer.

Richard H. Genz was a Presidential Management Intern on the staff of the Senate Subcommittee on Housing and Urban Affairs before coming to the Commission. He received an M.P.A. from the Maxwell School, Syracuse University, and an A.B. from Harvard. He was a Field Representative with the Portland, Ore., housing rehabilitation program. He has also worked as a policy and management analyst for the U.S. Department of Transportation and the Washington Metropolitan Area Transit Authority. Commission assignment: Special Assistant to the Staff Director.

David K. Gillogly is a Consultant to the Office of Policy Development in the Executive Office of the President. He was a Senior Economist for the U.S. Office of Management and Budget from 1968 through 1981. He specialized in the analysis of policies and trends in Federal credit programs, credit market structure, financial institutions, and insurance. Prior to joining OMB, he was Industry Economist for the Federal Housing Administration. He also served for several years as Associate Economics Director of the National Association of Home Builders. He was educated at the University of Miami, in Florida, where he was a Graduate Fellow.

Commission assignment: Special Topics Programs Task Force.

Ellis G. Goldman is a Program Analyst in the Community Planning and Neighborhood Studies Division of the Office of Policy Development and Research, U.S. Department of Housing and Urban Development, where he is involved in land use and community development research and policy issues. He formerly served as a Coordinator in the HUD Financial Management Capacity Sharing Program and as Deputy Commissioner of the Massachusetts Department of Community Affairs for five years. He received his M.A. in city and regional planning from Rutgers University and his B.A. from Brandeis. Commission assignment: Regulations Committee.

Thomas A. Hook is a Senior Consultant for the Federal National Mortgage Association, where he has recently helped to develop FNMA's adjustable rate mortgage and mortgage-backed securities programs. He formerly coordinated FNMA's urban development efforts. Before joining FNMA, he was Director of Mortgage Finance for the National Association of Home Builders. He holds a B.A. in engineering from Grove City College and an M.A. in finance from American University. Commission assignments: Present Housing Issues Committee and Economics Committee.

Judith A. Kennedy is a Consultant for Congressional Relations for the Federal Home Loan Mortgage Corporation, where she is involved in legislation to broaden the secondary market for residential mortgages. She formerly served as a Program Officer for the Assistant Secretary for Community Planning and Development, U.S. Department of Housing and Urban Development, and as a HUD Representative for Multifamily Housing and Community Development in the Pittsburgh Area Office. She was a Congressional Fellow in 1980–81, and worked as a Legislative Assistant to Senator William Proxmire and Representative Stewart B. McKinney. She holds an M.B.A. from the University of Pittsburgh, and a B.S. from Duquesne University. Commission assignment: Assisted Housing Task Force.

A. Thomas King is a Financial Economist in the Office of Policy and Economic Research at the Federal Home Loan Bank Board. He was formerly an Assistant Professor of Economics and a Research Associate in the Bureau of Business and Economics at the University of Maryland. His research on housing economics has been published widely. He currently serves as Editor of the *Housing Finance Review* and is on the Editorial Board of *Land Economics*. He holds a Ph.D. from Yale and an A.B. from Stanford. Commission assignment: Economics Committee.

Michael J. Lea is an Assistant Professor in the Department of Consumer Economics and Housing at Cornell. He served as a Visiting Scholar at the U.S. Department of Housing and Urban Development, where he concentrated his research on the economics of rental housing, the interaction of housing policy and tax policy, and the determinants of condominium conversion. He has also worked at the Federal Home Loan Bank Board. He has published several articles in the areas of housing finance and local public finance. He holds a Ph.D. in Economics from the University of North Carolina and A.B. from Iowa State. Commission assignment: Unassisted Rental Housing Task Force.

Harry G. Meyers is on loan from the U.S. Office of Management and Budget, where he served as a budget examiner dealing with the Department of the Treasury banking regulations and general revenue sharing. He received his B.A. from the State University of New York, Binghamton, and his M.A. and Ph.D. from the Maxwell School, Syracuse University. For six years he was a Financial Economist in the Office of the Secretary of the Treasury. Prior to joining the Federal government, he served as an Assistant Professor of Economics at Rensselaer Polytechnic Institute. Commission assignments: Present Housing Issues Committee and Federal Credit Programs Task Force.

Larry J. Ozanne is on leave from the Urban Institute, where he has worked since 1972 on projects such as computer simulation of alternative Federal housing programs, housing allowance experiments, and studies of housing value determination. He is presently studying housing finance problems at the Federal Home Loan Bank Board. He holds a Ph.D. in Economics from Stanford and a B.A. from the University of Wisconsin. Commission assignment: Housing Programs Committee.

Mary H. Parker is on loan from the Federal Home Loan Bank Board's Office of Community Investment, where, as a Program Analyst, she worked with cooperative housing, service corporations, and enterprise zones and provided technical assistance to lenders in community investment. Prior to joining the Bank Board, she was a consultant to the Farmers Home Administration and the U.S. Department of Housing and Urban Development,

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