THE PRESIDENT'S COMMISSION ON HOUSING

INTERIM REPORT

OCTOBER 30, 1981

THE PRESIDENT'S COMMISSION ON HOUSING

October 30, 1981

Dear Mr. President:

On behalf of the members of the President's Commission on Housing, I am pleased to transmit to you the Interim Report you requested when you established the Commission last June.

Our goal in this report has been to provide an overview of the nation's housing, to establish what we believe should be the basic principles to guide future housing policy, and to make specific recommendations for the reform of federally subsidized programs.

The scope of the Commission's Final Report to you next April will be expanded to include consideration of the full range of housing issues that you specified in your Executive Order of June 16, 1981.

We applaud your courage and your determined and effective leadership in pursuit of economic recovery. We understand the immensity of the challenge you inherited on assuming the Presidency and we support your continuing efforts to turn the economy around. We recognize that without the genuine and lasting recovery your program envisions, the housing needs of Americans cannot be met and greater opportunities for home ownership cannot be achieved and sustained throughout the decade ahead.

We support your commitment to control the growth of government spending and your determination to arrest the pace of government borrowing which fuels the fires of inflation and high interest rates--common enemies of a truly healthy housing market.

It is within this frame of reference, and in recognition of the fact that only a vigorous and growing economy can bring about a healthy housing market, that your ongoing program for economic recovery is viewed by the Commission. Consistent pursuit of the Administration's program for economic recovery is the most effective contribution government can make to restore health to the nation's housing sector.

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This Interim Report is the product of four months of intensive and dedicated volunteer effort by citizen members of the Commission--assisted by an able and professional staff. The conclusions in the report were reached by consensus of the Commission members.

It is our hope that the report may serve to assist you and members of your Administration as you address the concerns of housing in the months ahead.

Sincerely,

W. F. McKenna

William F. McKenna
Chairman

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WASHINGTON, D.C.
OCTOBER 30, 1981

THE PRESIDENT'S COMMISSION ON HOUSING

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Preface

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

The Commission's mandate is to advise the President and the Secretary of Housing and Urban Development on options for the development of a national housing policy and the role and objectives of the federal government concerning the future of housing.

The Executive Order directs 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. . . ."

To accomplish this mission, the President appointed a Commission of 25 members, and as a starting point, the Commission organized into four reporting Committees.

The *Committee on Housing and the Economy* was asked to examine social, demographic, and economic issues related to housing and the appropriate role for government. The *Committee on Federal Housing Programs and Alternatives* was asked to review current federal housing policies and subsidy programs, and to develop recommendations for their reform. The *Committee on Private Sector Financing of Housing* was asked to address the present problems of and possible innovative remedies for the nation's system of housing finance and financial institutions. 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 possible ways to reduce these regulations. These four Committees have provided an important beginning; additional committees, subcommittees, and/or task forces will be established in the course of the Commission's continuing work.

This document fulfills our directive to submit an Interim Report to the President and the Secretary of Housing and Urban Development no later than October 30, 1981. The intent of the Interim Report is two-fold: (1) to enunciate a basic set of principles and a housing policy framework to serve as guides for the Commission's deliberations and decisions; and (2) to offer our recommendations for basic reform of federally subsidized housing programs.

Accordingly, the Interim Report addresses only a fraction of the many complex issues confronting the Commission. This limited focus does not imply any judgment about the relative importance or priority among these issues. It simply reflects the immediacy of addressing the federally subsidized housing programs, so that our recommendations can be weighed as part of the fiscal year 1983 budget now being formulated.

Nor should this emphasis obscure the fact that the Commission is extremely concerned about the housing problems confronting Americans today: young families unable to buy their first homes; owners unable to sell; renters who cannot find decent housing at prices they can afford; and many others. The Commission is equally concerned about the current state of the entire housing industry as revealed by record high mortgage interest rates, depressed levels of housing construction and real estate activity, and ailing thrift institutions. The Commission is considering these urgent problems, and will submit its recommendations on them in later reports.

Many other important issues are on the Commission's continuing agenda. On the subject of housing finance, the Commission seeks to develop a coherent set of policy options to help create a more viable mortgage credit system in the years ahead. The legislative proposal recently submitted by the Administration to restructure the thrift institutions is a major development. We have appointed a special task force to address this topic in depth and to report to the Commission by December 4, 1981. The Commission is also reviewing these other topics related to the private sector financing of housing: secondary mortgage market institutions and instruments, federal credit programs and private sector alternatives, and alternative forms of mortgage instruments.

In addition, the Commission is deeply concerned about the continuing over-regulation of housing. Consequently, we are reviewing regulations at the federal, state, and local levels to recommend what deregulatory actions, including modifications and repeal, are needed. Some of the regulatory and policy areas selected for review are: housing construction standards, environmental restrictions, Davis-Bacon wage requirements, the Federal Flood Insurance Program, municipal rent control and condominium/cooperative conversion laws, and local land-use policies. Further, the Commission is examining what changes are needed in procedures for issuing and revising regulations at all levels of government, so that only those necessary to protect vital public interests are promulgated.

The above concerns are not exhaustive of the topics still to be addressed, which include:

- Homeownership, especially the problems of first-time homebuyers.
- The role of federal credit programs, including those of the Federal Housing Administration (FHA), the Farmers Home Administration (FmHA), the Government National Mortgage Association (GNMA), and other agencies.
- The rental housing market.
- The policy of using tax-exempt revenue bonds to finance housing.
- The use of government-owned land for housing.
- The role of urban homesteading.
- Special housing problems of minorities, the elderly, and those in rural areas.
- Programs to use and revitalize existing housing.
- The future role of public housing.
- Possible recapture of Section 8 commitments.
- The impact of federal tax policy on housing.

It is apparent that the Commission's continuing agenda is diverse and substantial, and will command our energies and careful deliberations in the months ahead. The Final Report of the President's Commission on Housing will be submitted no later than April 30, 1982.

This Interim Report contains four chapters. Chapter 1 sets forth an assessment of current housing problems, a statement of principles and a policy framework, and the Commission's recommendations to date. Chapter 2 presents data to depict the problems of availability, adequacy, and affordability in housing for renters and homeowners. In Chapter 3 the Commission provides the rationale for recommending consumer housing assistance grants as a basic reform of federally subsidized housing. Chapter 4 expands on our recommendations for improving the availability of adequate housing.

Chapter 1
SUMMARY AND RECOMMENDATIONS

The United States has long been committed to the goal of a decent home and a suitable living environment for every American family. The President has recently reaffirmed this commitment: "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."

In pursuit of this goal, the nation has employed two strategies. It has sought to establish and preserve a healthy housing sector—including both housing production and housing finance industries—in a healthy economy, in order to ensure that the vast majority of Americans are able to find decent housing at prices and rents they can afford. And it has established programs to provide housing assistance for low-income Americans who otherwise could not afford to live in decent housing.

For much of the postwar period, progress toward the goal has been steady and substantial. Each decade has seen a new record volume of housing production. The American dream of owning one's own home has become reality for an increasing share of the population. The housing finance industry has been able to provide funds for these impressive achievements at affordable interest rates. The quality of American housing has been improving, both for the population as a whole, and for the poor and other disadvantaged groups within the society. The vast majority of Americans now live in decent housing.

However, in recent years a series of problems have beset housing, making it increasingly difficult to continue this record of progress, until at present the nation faces severe difficulties. These problems in housing are largely the result of problems in the overall economy. The reasonably stable monetary and fiscal policy that prevailed through much of the postwar period has been succeeded by rapid growth in government spending, increasing federal deficits, and expansion in the supply of money at a rate greater than basic economic growth would justify. The cumulative effect of these policies over a period of years has been an inflation unprecedented in the peacetime history of the country, extraordinarily high interest rates, a decline in the rate of economic growth, and a very low rate of increase in real income for the American family.

The President is greatly concerned with both the general economic situation and the special problems of housing. His economic recovery program of tax and expenditure reductions and other financial measures is directed at the broader problems, and by alleviating them the economic recovery program will also improve the housing situation. In addition, because of his particular concern with housing, the President has established this Commission, and directed it to address the full range of housing problems. The Commission shares his commitment to the goal of decent, affordable housing, and his concern over the problems of the present. It is our belief that we can contribute to the important and difficult process of renewing the nation's progress in housing.

HOUSING AND THE ECONOMY

The impact of inflation on interest rates has had particularly severe repercussions in housing. Housing prices have been rising faster than incomes in recent years, and mortgage rates are at historic high levels, so that individuals are increasingly unable to buy homes. As a result, housing starts are near their lowest level since World War II, the latest stage of a downturn in housing production that has continued for almost two years. The current downtrend and low production level are manifestations of the increasing volatility of housing production over the past 15 years. Housing has long been a cyclical industry, but the swings have been getting more extreme.

It has also become increasingly evident that the traditional mode of operation of thrift institutions has become untenable; they can no longer channel large amounts of funds into the residential mortgage market at reasonable rates of interest. The basic problem of the thrift institutions results directly from inflation. They have made long-term mortgage loans in the past at the lower rates of interest then prevailing, but must now finance those mortgages by paying their depositors the high current inflation-generated interest rates in order to attract and hold funds. Thus, many institutions face severe earnings and net-worth problems, and the state of the industry has caused serious concern. Unless decisive action is taken, the ability of the housing industry, including the financial institutions, to perform efficiently in the future may be severely damaged.

Past federal government actions to address these problems have not been notably successful. As inflation has worsened, the government has tried to mitigate its impact on housing through various credit and other programs intended to reduce the cyclical volatility of housing production and to channel a greater volume of funds into the mortgage market, instead of dealing systematically with the fundamental problem. The specific palliatives for housing have not achieved their immediate aims. The relatively mild housing cycles of the first two postwar decades have been succeeded by increasingly severe fluctuations that create greater problems for home builders and buyers. And despite the federal programs to channel credit to the mortgage market, the share of real investment going to housing did not rise in the 1970s. The problems the government sought to remedy remain beyond the reach of these solutions.

HOUSING FOR THE POOR

The deterioration in the general economy also has affected progress toward achieving a decent home for low-income Americans, but in a different way. As stated earlier, the fraction of the housing stock that is substandard has been steadily declining, and this decline has continued in recent years; it has not been reversed by inflation. But inflation has made the programs used to advance the goal increasingly costly. Federal housing programs have historically been designed to build physically sound housing for the poor, on the presumption that decent housing was unavailable in the private market. These housing production programs have become progressively more expensive to the taxpayer, as the cost of new housing construction has risen, and especially as mortgage interest rates and federal borrowing costs have risen as well. Because of the high cost of each government-subsidized unit, only a small number are built each year; the result is that a few low-income families receive a very large subsidy and live in very good housing—among the most expensive rental housing on the market—while a large number of equally deserving families receive no housing assistance at all.

At the same time, the nature of the housing problem confronting the poor has changed, so that the government programs have become increasingly directed at inappropriate targets. For example, there are now some 2 million low-income renters who live in physically inadequate housing, the lowest level on record. By comparison, there are more than 5 million who live in decent housing, but have to pay a disproportionately high percentage of their income in order to do so.

Because of these problems, which have been increasingly recognized in recent years, the Commission was directed to review the present federal subsidized housing programs and to develop program options for their reform.

A STATEMENT OF PRINCIPLES

After reviewing these problems, analyzing how they have developed, and observing the effects of past government endeavors to resolve them, the Commission has found it useful to formulate and adopt a set of principles that can serve as a guide in meeting these problems in the future. Although these principles are applicable in other aspects of economic life as well as in housing, they apply with special relevance to the housing issues confronting the country. In order to address these problems successfully, the Commission believes that the nation must:

- Achieve fiscal responsibility and monetary stability in the economy;

- Encourage free and deregulated markets;
- Rely on the private sector;
- Promote an enlightened federalism with minimal government intervention;
- Recognize a continuing role of government to address the housing shelter needs of the poor;
- Direct programs toward people, rather than toward structures; and,
- Allow maximum freedom of housing choice.

Throughout our deliberations, in developing a policy framework and proposing our recommendations, we have used these principles to organize our thoughts and assess our conclusions.

A HOUSING POLICY FRAMEWORK

In considering the present housing situation, the Commission has identified three distinct but related areas of concern: housing availability, adequacy, and affordability. These categories provide a policy framework for the analysis and shaping of issues. Our basic principles illuminate the problems within each and offer guidance in meeting them.

Before discussing these areas separately, the Commission wishes to stress an important issue embracing all three, where our principles apply with particular force: housing market discrimination. Reliance on the private market as the fundamental mechanism for resolving housing problems can be fully effective only in an open, freely functioning market system. Therefore, the government should continue its efforts to eliminate discriminatory practices that create artificial barriers and inhibit freedom of choice in housing.

Housing Availability

Problems in the overall economy have affected the production and financing of housing. The housing sector has been a particular victim of the inflation over the past 15 or more years. The well-known cyclical nature of residential construction results from the sensitivity of housing prices to the level and fluctuations of interest rates and the sensitivity of private new construction to housing price changes. Inflation has raised the level and increased the fluctuation of interest rates, thereby making housing construction still more volatile.

To deal with this problem, it is necessary to bring down the rate of inflation through long-term and consistent monetary and fiscal restraint, which will reduce mortgage and other interest rates. This is the most effective contribution government can make to housing stability and to the economy as a whole. Fluctuations in housing construction have historically counteracted fluctuations in other sectors, thereby promoting overall economic stability. With stable monetary and fiscal policies, those fluctuations should be smaller and more manageable.

Attempts by the government to shield housing construction from the effects of high interest rates have been ineffective. Further, these attempts are destabilizing to the general economy in the short run, and by increasing government borrowing and the budget deficit, they tend to increase the rate of inflation at the same time that they try to protect housing from inflation.

Instead of pursuing ineffective housing credit and production programs, the government should seek to provide resources for housing through unrestricted access to the private capital markets, helping to make the national mortgage delivery system workable in the short run and more efficient through appropriate structural change in the long run. It should also encourage a stable economic environment for homebuilding by reducing restrictions on the industry and terminating excessive regulation of land development and housing production. The free market would then be able to provide housing at lower prices and thereby make housing more widely available.

These measures will enable the market to meet future housing demand. As in the past, that demand will be met not only through new housing construction, but also through the repair and modernization of the existing housing stock, changes in the rate of abandonment, and the conversion of nonresidential structures to housing. 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 now be foreseen 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." These projections can be useful, but they frequently have failed to forecast accurately or to reflect the dynamic nature of the interaction between economic changes, household formation rates, and private sector responses. Thus, this Commission will not attempt to make any finding of a specific numerical "need" for future housing units.

Housing Adequacy

Standards of adequacy for housing have risen as the general standard of living for the nation has improved. By the standards of the 1940s—housing units should have indoor plumbing and should not be dilapidated—a relatively small and steadily decreasing percentage of the housing stock is now inadequate. Almost half of the United States housing stock was classified as substandard according to these criteria in 1940; by 1970, the fraction had dropped to less than 10 percent. Although this improvement still implies a severe hardship for several million people, it suggests that the size of the problem has been dramatically reduced.

In general, the residual inadequacy of housing today is attributable to inadequate incomes rather than to the lack of available, adequate housing stock. Government efforts to improve access to housing for the poor should therefore emphasize measures to improve incomes and, where necessary, grants to pay for housing obtained in the private market.

Housing Affordability

Many low-income renter families and many would-be first-time homebuyers, particularly young families, often cannot afford suitable housing.

Renters with very low incomes are often forced to bear a heavy rental burden to be able to live in adequate or standard housing. In 1977, almost two-thirds of all very low-income renters living in housing deemed adequate by present standards paid more than 30 percent of their income for rent. A quarter of them paid more than half. In contrast, renters with incomes above this level seldom have a serious rent burden.

For homebuyers, high prices are a major difficulty. In recent years, home prices have increased faster than the incomes of young families, making it harder for them to accumulate the down payment and become homeowners. Their greatest problem, however, is high interest rates and the consequent high monthly mortgage payments. Some younger homebuyers are being forced to devote an unusually high proportion of their income to mortgage payments. This is especially true at inflated housing prices, because mortgage rates already include a component representing anticipated inflation. Other young families are unwilling or unable to allocate to homeownership so high a proportion of their income.

The affordability problem for the homebuyer can be made more manageable through appropriate financial deregulation; the continued development of alternative mortgage instruments; the reduction of excessive federal, state, and local regulation of land development and housing production; and community-based initiatives. But the eventual solution to the affordability problem can be found only in the restoration of a healthy, stable economic and financial environment.

RECOMMENDATIONS

The Commission has identified and described both the severe problems presently confronting housing consumers and the housing construction and finance industries and the problems resulting from current federal programs designed to provide decent housing for the poor. This report addresses the latter set of problems, and presents recommendations intended to offer a more effective and efficient means of meeting them. The coverage reflects the Commission's response to its mandate to submit an interim report on the federal subsidized housing programs. The report does not attempt at this point to make recommendations to alleviate the broader problems in housing. However, this emphasis does not reflect the priority that the Commission gives to the problems of the industry.

The subsidized housing programs present important fiscal and programmatic issues that deserve attention in the course of formulating and considering the federal budget for fiscal year 1983. We therefore offer our recommendations on this issue to the President, the Secretary of Housing and Urban Development, the Congress, and other policymakers in order to contribute to the developing discussion about appropriate changes in federal housing policy to aid low-income Americans.

Our recommendations on government housing subsidies for the poor have been guided by the principles and the housing policy framework that we have reviewed. Three important concerns in housing have been recognized—availability, adequacy, and affordability. For low income households, the Commission believes that affordability is the most serious problem, and recommends consumer-oriented housing assistance grants as the primary program for addressing the housing shelter needs of the poor. This program is consistent with the basic principles adopted by the Commission. It recognizes the continuing role of the government in addressing the housing needs of the poor, while at the same time it targets the scarce public resources for housing on those most in need, and directs those scarce resources toward people, not toward structures.

Although the Commission recommends housing assistance grants as the basic mechanism for meeting the affordability problems of lower-income families and individuals, it also believes that problems of adequacy and availability merit national attention. The Commission is particularly concerned about local housing markets where shortages may inhibit the effective working of a housing assistance grant program. These may include tight housing markets, where an increase in the housing stock may be needed before assistance recipients can find decent housing; places where the stock of lower-priced housing may be physically inadequate to a disproportionate extent; or places where owners do not feel the incentive to be sufficient or are unwilling to upgrade substandard units in order to attract tenants with housing assistance grants.

In the past, federal policies to address such problems have been directed at structures—incentives for new construction, substantial rehabilitation of housing, and the preservation of the existing stock. Although much has been accomplished, federal resources have not been targeted efficiently to those most in need. Furthermore, federal government programs have been formulated without recognition of the diversity of local housing situations and the wishes of the people most affected. Housing availability problems are best solved by those at the state and local level who know local market conditions.

The Commission believes that a new federal housing policy should include:

- Reliance on the experience and flexibility of state and local agencies to finance and produce housing, including both rehabilitation and new construction.
- Tax policies to encourage housing supply and preservation.
- Access for the private sector to the capital markets to insure the availability of mortgage credit and appropriate secondary mortgage markets.
- Encouragement of private initiatives and programs dealing with the housing problems of the poor.

CONSUMER HOUSING ASSISTANCE GRANTS

The Commission recommends that the primary federal program for helping low–income families achieve decent housing be a consumer–oriented housing assistance grant. This grant system should replace future commitments to build additional units under Section 8, Section 202, and public housing. The relationship of a consumer housing assistance grant to these and other subsidized housing programs will receive further Commission study.

Discussion

The primary housing problem today is inadequate income: poor families simply cannot afford decent housing. The U.S. Department of Housing and Urban Development (HUD) housing allowance experiments of the 1970s and the Section 8 Existing Housing program have shown that the consumer–oriented approach enables low–income families to pay for decent housing. These programs have reduced the burden of high housing costs for families already living in decent housing, and have provided the means for others to move from inadequate housing into decent and affordable housing. Resources can be targeted effectively on families and individuals most in need, and a larger number of these families can be helped within federal budget limitations than is true under the producer–oriented programs.

In designing a consumer–oriented housing assistance grant program, a number of issues must be resolved. Outlined below are the Commission recommendations concerning these issues:

- 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 order to target the assistance dollars to those with the greatest needs.
- The program should not be an entitlement program, open to all eligible households. Within the eligible income group, priority for assistance should be based on income and on such criteria as: living in inadequate housing, paying rent in excess of 50 percent of income, or suffering involuntary displacement.
- Recipients should be required to live in decent housing in order to qualify for assistance; but local quality standards, subject to basic national criteria, should apply because housing market conditions vary widely across the country.
- There should be no limitation on the share of their own income that subsidy recipients can choose to spend on housing.
- The payment formula should be adequate to enable subsidy recipients to obtain decent housing, but not so high as to drive rents up or enable recipients to live in better housing than unsubsidized, moderate–income households, unless the subsidy recipients choose to pay a larger than normal share of their income for rent.
- The system should include a substantial local support component for open housing and the enforcement of antidiscrimination statutes, including current federal fair housing laws.

Establishment of a consumer–oriented housing assistance grant poses questions of transition from the present programs and coordination with welfare and other programs for the poor. The Commission intends to give future attention to these issues. We plan to investigate the possibility of recapturing funds already committed for Section 8 New Construction and Substantial Rehabilitation projects, where this recapture is mutually agreeable to project sponsors, mortgagors, mortgagees, bondholders, and state and local agencies, and does not adversely affect households that are currently assisted. We also believe that public housing subsidies eventually should be replaced with consumer housing assistance grants. This would provide tenants with a greater range of choices and would require current public housing projects to compete on equal terms with private housing suppliers.

IMPROVING THE AVAILABILITY OF ADEQUATE HOUSING

The Commission's recommendations in this area are designed to facilitate meeting local housing needs in the context of a program of consumer-oriented housing assistance grants. They should not be regarded as all inclusive. The Commission has so far dealt almost entirely with HUD programs to provide low-income housing assistance and with the role of mortgage revenue bonds in financing housing. Other low-income housing issues, including rural housing and homeownership, will be considered in the coming months.

New Construction Within the Community Development Block Grant Program

The Commission recommends that new housing construction be added as an eligible activity for Community Development Block Grants in order to expand local decisionmaking flexibility. Additional funding, giving weight to local housing problems, that would enable localities to support this activity, would be desirable when budget circumstances are favorable.

Discussion

The Community Development Block Grant (CDBG) program has become an increasingly effective way for municipalities to address local housing problems as well as other community development needs in a coordinated and comprehensive manner. At present more than a quarter of CDBG funds are being spent on a wide variety of local housing programs. The Commission believes that this successful ongoing program should be strengthened by allowing localities to use CDBG funds for new housing construction in addition to the present range of activities. This would help localities to meet isolated supply problems in the absence of the categorical Section 8 New Construction program, without adding the administrative complexity and expense of another federal program.

Mortgage Revenue Bonds

The Commission has considered the following three options for state and local agency tax-exempt financing of housing:

1. **Continue tax-exempt bonds as an instrument for financing new construction and rehabilitation with appropriate targeting (the Commission is not making any recommendations at this time as to appropriate targeting), or**

2. **Withdraw tax-exemption on all such bonds and provide direct unrestricted federal payments instead, in the form of a subsidy to make up the difference between tax-exempt and taxable yields, or**

3. **Offer bond-issuing agencies their choice of the alternatives of either continuing tax-exempt status for their bonds or switching to taxable bonds with a compensating direct unrestricted federal payment to make up for the switch from tax-exempt to taxable status.**

Discussion

In view of the Mortgage Subsidy Bond Act of 1980, the Commission will establish a task force to review the fiscal policy, market, and regulatory implications of the use of tax-exempt revenue bonds, whether for housing or other purposes.

Rehabilitation Tax Credit

The Economic Recovery Tax Act of 1981 provides owners of nonresidential real estate with a 15 percent tax credit on rehabilitation expenses for structures 30 to 39 years old and a 20 percent credit for older structures. The Commission recommends that owners of residential rental structures enjoy the same investment tax credit for rehabilitation expenses.

Discussion

Current tax policy encourages the rehabilitation of nonresidential real estate, low-income rental housing, and certified historic structures, through tax credits or accelerated depreciation. Owners of ordinary rental housing, however, receive no such rehabilitation incentives.

Housing rehabilitation, including conversions from commercial uses, is essential to preserving and adding to the housing supply. A rehabilitation tax credit would encourage private decisions to undertake rehabilitation under the test of marketability and independent of direct federal subsidies.

Private Institutions

The Commission recommends that private foundations, religious groups, and other private institutions be encouraged to continue their sponsorship and financing of innovative programs in housing construction, rehabilitation, and access to homeownership.

Discussion

Local organizations across the country have a wealth of experience, and have shown imagination and dedication in helping to resolve the housing problems of the poor. This experience has included not only sponsorship of housing production and management under federal programs, but a variety of innovative efforts to promote equal opportunity and low-income homeownership. Consistent with the President's strong support of voluntary activity, the Commission wishes to encourage the continued involvement of these interested and committed persons and organizations. The Commission's recommendation to shift future housing assistance from production programs to consumer-oriented assistance grants would obviate further nonprofit sponsorship under those construction programs, but we hope that the recommendation to expand the CDBG program to include new housing construction under local option would open the way toward even more creative sponsorship opportunities.

Homeownership

The Commission will consider a program of Individual Housing Accounts to encourage and assist savings for a downpayment by the first-time buyer and other savings incentives to increase the volume of mortgage funds available to homebuyers, subject to careful review of the fiscal implications.

Discussion

A task force, including outside experts, will address the issues of homeownership for later consideration by the Commission. Proposals such as Individual Housing Accounts (new tax-free savings accounts) and modifications of Individual Retirement Account rules to facilitate homebuying will be considered among other options.

Federal Housing Administration Insurance Programs

The Commission supports the continuation of Federal Housing Administration insurance programs for segments of the housing market not adequately served by the private sector.

Discussion

The Commission recognizes that the availability of Federal Housing Administration (FHA) insurance has been important in meeting certain mortgage credit needs, such as those of first-time homebuyers facing problems because of high down-payment requirements in some markets and buyers of modestly priced urban housing. A more intensive review of specific FHA programs will be conducted for the final report of the Commission. This review will attempt to identify areas (including experimental programs) where FHA insurance is needed to serve sectors of the housing market not served by the private sector, and how best to achieve an orderly transition towards a greater reliance on private sector financial markets.

Pension Funds

The Commission recommends the elimination of those provisions of current regulations or laws that inadvertently limit the housing investments of pension funds, insurance companies, and other potential major sources of housing capital.

Discussion

The Commission is addressing a broad range of issues about mortgage finance. Of particular concern in this report are the apparent impediments to private pension fund investment in mortgage loans and mortgage-backed securities. Private pension funds currently have a very small proportion of assets invested in residential mortgage instruments of any kind, partly because of complications and costs involved in complying with the standards established by the Employee Retirement Income Security Act of 1974 (ERISA).

The Department of Labor, which has responsibility to implement ERISA, recently has taken some actions to address the problems that private pension funds face when considering investments in mortgages and mortgage-backed securities. However, some serious problems remain, and there have been a number of delays in making appropriate adjustments. The Commission strongly urges that the Department of Labor promptly revise those segments of the regulations, including definitions, that unnecessarily impede mortgage investment by private pension funds.

Chapter 2
HOUSING ADEQUACY AND AFFORDABILITY

INTRODUCTION

Housing conditions in the United States have been improving steadily during the postwar period. Americans now live in housing that is much better in quality and much more affordable than at the end of World War II. This should not be especially surprising; in general the period has been one of continuing and substantial increases in economic well-being for nearly every American family, and the improvement in housing is basically part of that overall record of progress. But a significant number of citizens, particularly the very poorest, still confront serious housing problems.

This chapter describes both the housing achievements and the problems that still exist. It discusses first the physical condition of the housing stock, focusing on the bottom end of the quality distribution and the quality of housing occupied by low-income families. Then it considers the ability of American families to afford decent housing, again concentrating on the poor. It treats owners and renters separately, because the trends in affordability and the current problems are different for each group. In describing the problems of the poor, it concentrates on renters, because most poor families are renters. Finally, it looks at the special problems of the first-time homebuyer, typically a young family attempting to establish itself in the community as well as improve its housing.

Although housing adequacy and affordability have shown broadly similar patterns of improvement, the current problems are quite different. Far more Americans, even among the poor, live in decent housing but pay a disproportionate share of their income in order to do so, than live in housing that is seriously inadequate.

During most of the 1970s, despite rising house prices, homeownership became more affordable rather than less so, largely because of special tax advantages available to homeowners and the failure of mortgage interest rates to keep up with inflation. In the past few years, however, this situation has been reversed. Moreover, the incomes of young families have failed to keep up with house prices, creating special difficulties for them in buying a first home. The affordability problems of the first-time buyer will be given particular attention by a task force of the Commission and will be analyzed in more detail, with policy recommendations, in the Final Report.

HOUSING ADEQUACY

Trends

Traditionally, the adequacy of the housing stock has been measured along two dimensions: available space and quality. Steady improvement has been registered in both in each decennial census since the end of World War II, according to every measure that can be consistently constructed over time.[1]

Availability

Today there is a larger physical stock relative to the population than ever before. In 1940 one dwelling unit served 4.3 persons, on average; by 1979 it was 2.8 persons, a 36 percent increase in the availability of housing relative to the population over the period. Stated another way, during

[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, the *Annual Housing Survey*. Family incomes are from U.S. Department of Commerce, Bureau of the Census, *Current Population Reports*, Series P-60, 1950–1979.

this 40–year period the number of housing units grew at a rate that was 10 percent faster than the overall rate of population growth.

The availability of housing has also improved by other traditional measures such as amount of space. Americans have substantially more space per person and far fewer households living in crowded circumstances. In 1940 there were fewer than 1.5 rooms for every person in the United States; by 1979, there were slightly more than 2 rooms per person. A room, of course, may be large or small; it is an imprecise measure of space. But the floor area per person in housing units also has been increasing steadily, as far as the data show. The typical new home in 1979 had more than twice as many square feet as in 1950; indeed, the typical new mobile home in 1979 was as large as the typical new postwar home.

The most common criterion of crowding is a ratio of more than one person for each room within the housing unit. Using this measure, overcrowding declined from 20 percent of all households in 1940 to four percent in 1979. "Severe overcrowding" (more than 1.5 persons per room) fell from 9 percent in 1940 to 1 percent in 1979. (See Figure 2.1.)

Increased consumption of housing services is associated with the decreased size of households. In addition, the investment motivation for increased consumption of owner–occupied housing and ownership as an inflationary hedge by two–income or other high–tax bracket households has become increasingly important.

Quality

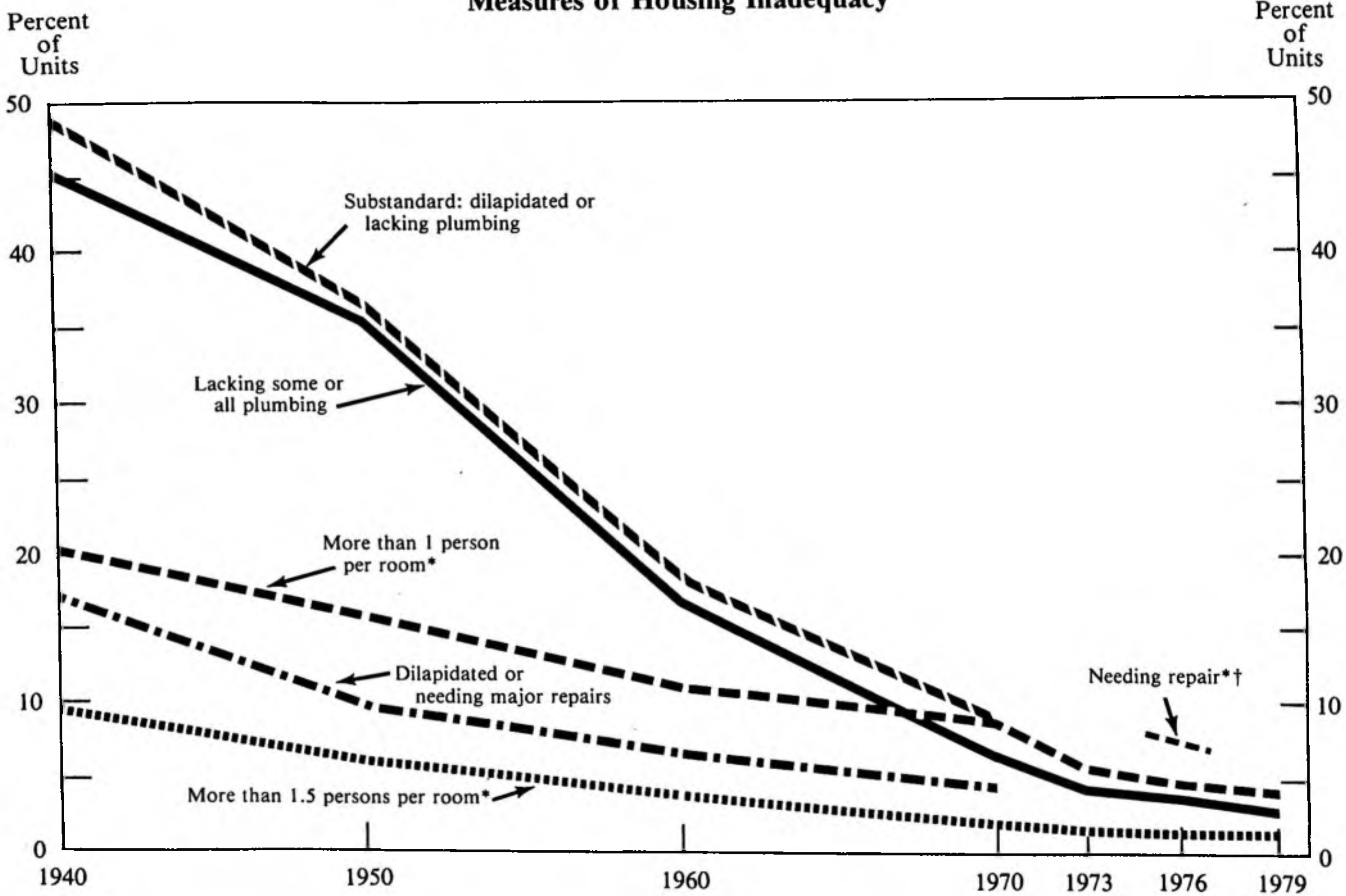
An even more pronounced rate of progress has occurred in the physical quality of the housing stock. By traditional definition, a housing unit was considered substandard if it was in poor structural condition ("dilapidated" or "needing major repairs"), or if it lacked complete plumbing. Almost half of the United States housing stock was classified as substandard according to this criterion in 1940; by 1970, the fraction had dropped to less than 10 percent. Because of difficulties in identifying precisely which housing units were "dilapidated," the traditional quality measures were discontinued after the 1970 Census, but the number of units without complete plumbing has continued to fall, declining from 6 percent of the stock at the beginning of the decade to less than 3 percent by 1979. Figure 2.1 shows the trends in all these measures in detail.

These figures apply to the population as a whole, 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 households lived in such housing in 1950, compared with 7 percent of black households in 1978. Insofar as data are available, they indicate that parallel improvements have occurred for Hispanic households.

Beginning in 1973, new measures of housing quality 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 of facilities, but also about their functioning—for example, 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 are asked about the heating, electrical, and other major systems of the unit. Instead of providing a single question on overall physical condition, as in the decennial census, the AHS 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 2.1 shows how some of these measures have changed in recent years. Generally, the measures point to continued improvement of the housing stock, although there are exceptions.

Figure 2.1

Measures of Housing Inadequacy



*Percent of occupied units.
†According to the Congressional Budget Office definition.

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

Table 2.1

Percentage of Occupied Housing Units with Specified Defects–1973, 1975 and 1977

*Type of Defect**	1973	Percent of Occupied Units Reporting the Defect 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

*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.*

Housing Adequacy Today

The AHS information on specific structural and systemic problems has been used by a number of government agencies recently—including the Department of Housing and Urban Development (HUD), the Office of Management and Budget (OMB), and the Congressional Budget Office (CBO)—in an attempt to find a new definition of inadequate housing.

In this Interim Report, the Commission uses the CBO definition to measure the number of inadequate housing units. The definition is presented in Table 2.2. It is typical of the others; all show about the same number of inadequate units and the same patterns within the housing stock. We have chosen the CBO definition in this report because the definition has been used in evaluating the Section 8 housing program recently, as described in Chapter 3; but we are confident that the use of another definition would not change our conclusions.

As Table 2.2 shows, the CBO definition divides housing defects into two categories. The first seven are either structural deficiencies that would probably be corrected only in the course of major rehabilitation, or continuing serious problems in the plumbing and heating systems that are likely to require either replacement or major repair. Any of these problems is fundamental. The last eight items in the table are more ambiguous. These problems may arise periodically in any housing unit, and be repaired in the course of normal maintenance activities. Generally speaking, the same units do not suffer from these defects each year. For example, 89 percent of the housing units with leaky roofs in 1974 no longer had the problem two years later; similarly, repairs had been made in 88 percent of those with broken plaster or peeling paint. Thus a single deficiency of this type does not seem sufficient to characterize a unit as "inadequate." The requirement that a unit have two of these defects at the same time is an attempt to differentiate those with normal maintenance problems from those actually in need of major rehabilitation.

According to the CBO definition, the fraction of the housing stock "in need of major rehabilitation" (i.e., inadequate) has declined slightly from year to year; it was 8.1 percent in 1975, 7.7 percent in 1976, and 7.5 percent in 1977. This decline is roughly consistent with measured declines in crowding and incomplete plumbing using the older standards. 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 criteria. The following section describes these occupants.

Who Lives in Inadequate Housing?

The Commission is concerned not only with the trends in housing quality and the total number of currently inadequate units, but also about the Americans who live in low-quality housing. The Commission believes that it is helpful and important in formulating housing policy to identify specific groups within the population that suffer from housing problems.

Figure 2.2 shows the incidence of inadequate housing among various segments of the population. Two basic patterns emerge: inadequacy is far more common among renters than owners, and it is concentrated at the bottom of the income distribution.

Both of these findings are to be expected. Homeowners have much more control over the quality of their housing than do renters. When a problem occurs, it is easier for the owner to make arrangements for repairs, or even to fix it personally, than for the renter to contact the landlord and make arrangements for the repairs. This pattern holds for owners and renters with similar income. Thus, there are almost twice as many very low-income renters living in inadequate housing as there are owners with similar incomes (18.6 percent versus 9.4 percent). For both owners and renters, the incidence of inadequacy is much greater among very low-income families (those with incomes of 50 percent or less of their local area median income, for a family of four); nearly one fifth of very low-income renters live in inadequate housing, compared with slightly more than one-tenth of those with moderately low incomes (between 50 and 80 percent of area median).

Table 2.2

Conditions That Cause a Housing Unit to be Judged as "Needing Rehabilitation" by Congressional Budget Office

A unit is classified as needing rehabilitation 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 last 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.

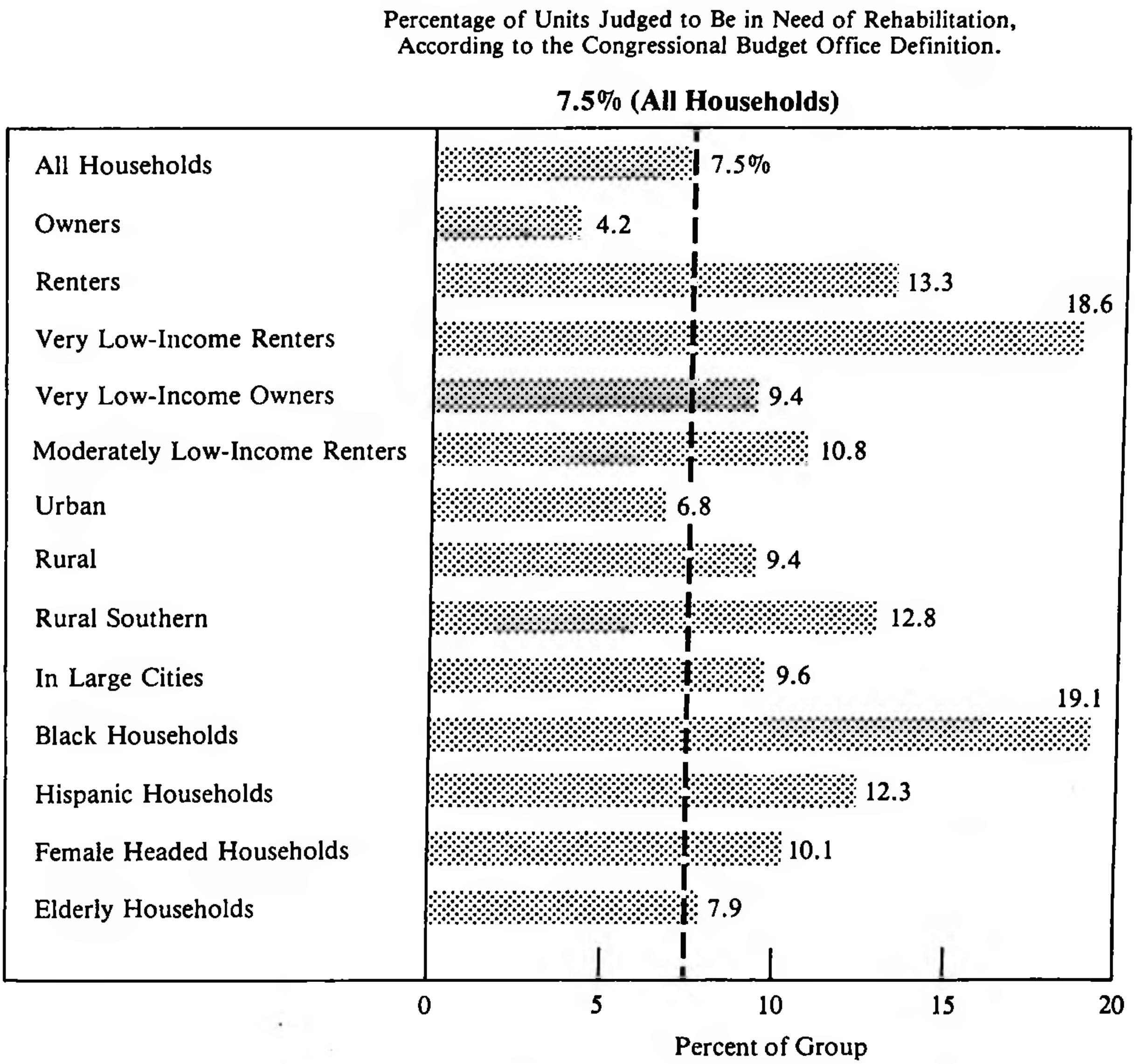
or if the unit had two or more of the following conditions:

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.

Figure 2.2

Incidence of Deficient 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.*

To a lesser extent, there are some geographic concentrations of inadequate units. They are found disproportionately in rural areas in the South and in older large cities. New York City and the nearby New Jersey cities of Newark, Paterson, and Jersey City showed 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 Annual Housing Survey and for 9 percent of all deficient housing in the country. Miami and Washington, D.C. both had more than a 16 percent incidence of inadequate units.

Inadequate housing is also more frequently found among certain types of households. Minority households—particularly black households—occupy such housing much more often than nonminority households. Female-headed households and the elderly also have above-average incidence of housing inadequacy. For the latter two classes, 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.

HOUSING AFFORDABILITY: RENTERS

Trend

The trend in housing affordability for all households, renters and owners alike, shows the same steady improvement over the postwar period as does the trend in housing adequacy. This improvement is not often recognized, because the common measures of affordability do not take account of the shift to homeownership or the changing quality of the housing stock. Thus, for renters, the usual measure is simply the ratio of rent to income; a household spending more than 25 or 30 percent of its income for rent is assumed to be spending "too much" and suffering from a "rent burden."

Rent-income ratios have risen over time: in 1950, some 32 percent of all renters paid more than a quarter of their income for rent, while in 1979 this fraction rose to 51 percent. However, changes in the rent-income ratio, unadjusted for quality changes, misstate the trend in affordability, because much of this increase can be accounted for by the shift of better-off renters to homeownership. 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 better-off households remained renters, the current high concentration of apparent affordability problems among renters would have been reduced.

Part of the increase is also 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, and the typical rental unit also had more rooms. The reported rent increases that have occurred over time reflect improved quality and greater space, as well as changes in the cost of a given quality rental unit. The rent increases result from growing incomes and the ability to spend more on housing, as well as from inflation in the rents for dwellings of constant quality.

A more appropriate way of analyzing rental affordability is to compare the change in income with the change in rent on a precisely specified type of rental unit over the same period. Affordability has improved if income increases more rapidly than rent; affordability has deteriorated if the reverse is the case. The best-known measure of rent changes on units of the same quality over time is the residential rent component of the Consumer Price Index (CPI). This 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 increase on utilities paid for directly by the tenant. Adjustments for both of these omissions have been made by independent housing market analysts; this review of affordability therefore uses a rent index with these adjustments.[2]

[2]Ira S. Lowry, "Inflation Indexes for Rental Housing," Working Draft (Santa Monica, Calif.: The Rand Corporation, 1981), pp. 1–24.

The importance of distinguishing between quality-constant rent changes and "average" changes for the actual rental stock is shown by the differences between the adjusted CPI rent component and median rents. Between 1950 and 1979, the adjusted index increased by 200 percent, while median rents rose by 400 percent. Quality improvements, therefore, accounted for about as much of the increase in rent payments as did cost increases. Median rent increases were double the rent index increases in the 1950s and 1960s and 20 percent higher in the 1970s, indicating continued quality improvement throughout the period. Table 2.3 shows the comparisons.

The income trend used to compare rental costs should reflect changes in incomes for similar households over time. There have been changes in the composition of households over the past 30 years that distort the meaning of average income changes in much the same way as the changing quality of rental housing distorts the meaning of median rents. Thus, the change in income for the typical family was 491 percent from 1950 to 1979; for single persons, a much greater 625 percent; and for the poorest families, 493 percent. (The latter two groups are predominantly renters.) All of these increases are much greater than the 200 percent increase in the rent index, meaning that the typical household in each category was able to afford better rental housing.

The incomes of renters in 1979 were 257 percent higher than the incomes of renters in 1950. The increase is smaller than that for any of the household categories, but still much larger than the change in the rent index. The observed income change for renters over the period understates the growth in incomes for particular renter households, both because there was 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 the tax 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 2.3 summarizes these trends since 1950, comparing incomes with actual rents and the rent index. This comparison shows that incomes increased faster than the rent index in each decade, but by the smallest margin in the most recent decade. It also shows that actual renter incomes increased less rapidly than actual rents in the 1970s, which is consistent with the observed rapid increases in rent-income ratios because of the switch to homeownership and the improved quality in rental housing, not because of higher costs for the same kind of housing. Rental affordability improved, not deteriorated, in the past decade.[3]

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 2.4 shows the incidence of excessive rent burdens for three classes of households—very low-income, moderately low-income (between 50 and 80 percent of median), and all others.[4] 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-emphasizes the concentration

[3]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. The Administration's economic policies to slow inflation and reduce interest rates as well as the stimulus to investment in the Economic Recovery Tax Act of 1981 should provide a better environment for profitable rental housing investment in the coming years. Even with this improvement, however, current conditions in rental housing, both for owners and tenants, merit and will receive further review by the Commission.

[4]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 ongoing federal housing programs. Ratios of 25 and 50 percent 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 2.3

Incomes and Rents
1950–1979

Dollars and Index Levels

Year	Median Income: Families	Median Income: Renters	Median Gross Rent	Constant Quality Gross Rent Index
1950	$ 3,319	$ 2,800	$ 43	67.8
1960	5,620	4,200	71	89.2
1970	9,867	6,300	108	112.1
1979	19,600	10,000	217	203.3

Percent Changes

Year	Median Income: Families	Median Income: Renters	Median Gross Rent	Constant Quality Gross Rent Index
1950–60	69%	50%	65%	32%
1960–70	76	50	52	26
1970–79	99	59	101	81
1950–79	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, the 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," Working Draft (Santa Monica, Calif.: The Rand Corporation, 1981), p. 30. Commission staff extended the series back to 1950.

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.

Table 2.4

Percent of Renter Households
Who Pay 30 Percent or More of Income to Rent Adequate Housing
(Congressional Budget Office Indicator)

	Lower Income Households		
Gross Rent as Percent of Income	Very Low Income	Moderately Low Income	All Other Households
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 incomes are less than 50 percent of median family income for a family of four. Moderately low incomes are between 50 and 80 percent.

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.

The magnitude of the affordability and adequacy problems among very low–income households is summarized in Table 2.5. The table also shows the incidence of problems for very low–income elderly households and for blacks. Both groups have a slightly lower incidence of affordability problems: 57 percent of the elderly and 58 percent of blacks compared with 64 percent and 63 percent of all non–elderly and non–black very low–income renters, respectively. Comparing the elderly with other low–income renters, the most notable difference is the somewhat larger fraction of the elderly who have neither adequacy nor affordability problems—35 percent compared with 27 percent of all non–elderly very low–income households (30 percent for all very low–income households). For blacks the most notable difference is the higher proportion in substandard housing—27 percent, compared with 15 percent for non–black very low–income renters.

However, the most striking feature of Table 2.5 is the comparison of the magnitude of the adequacy and affordability problems. Of the 10.5 million very low–income households identified in the 1977 Annual Housing Survey, 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 the poor.

Table 2.5

Adequacy and Affordability of Housing for Very Low-Income Renters

Gross Rent as a Percent of Income	Adequate: Number (000)	Adequate: Percent of Total in Class	Inadequate: Number (000)	Inadequate: Percent of Total in Class	Total Households: Number (000)	Total Households: 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.

HOUSING AFFORDABILITY: HOMEOWNERS

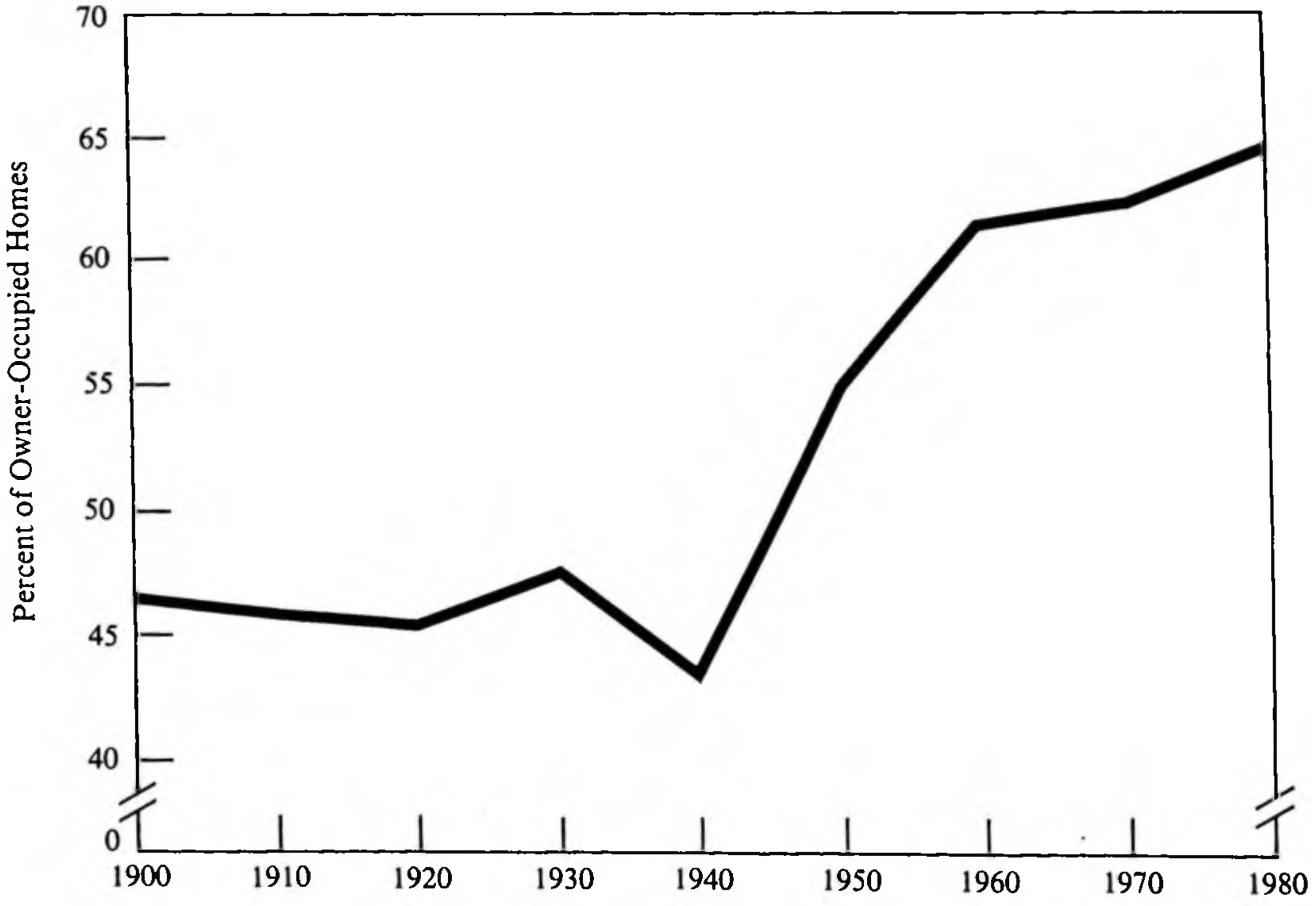
The encouragement of homeownership has traditionally been a major objective of housing policy at all levels of government. For many homeowners, their home is the most important factor in their general economic well-being, and gives them a direct financial stake in the society. As President Reagan has said, "The American home. . . represents our strength and much of what we strive for." In addition, owners appear to invest more effort and money in the maintenance of their homes and to take a leading role in local civic affairs, thus creating a better living environment for their neighborhoods as well as themselves.

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 2.3 shows that about two out of three American households own their own home today, compared with fewer than half in 1940. However, in the past several years, as a result of inflation, homeownership has become increasingly difficult to achieve for those who were not already owners. The Commission is concerned that this important opportunity continue to be available for all American families.

The costs of homeownership, and therefore the problems of affordability for homeowners, are more complicated than they are for renters, and inflation has increased the complexity. The renters' costs are simply the rent payment and perhaps the utilities. Homeowners, however, not only have the direct payments for mortgage principal and interest, taxes, insurance, maintenance, and utilities, but they also benefit from the income tax deductibility of interest and property taxes, which partly offset the direct outlays. They also reap capital gains when they sell their home; it is an investment as well as a place to live.

Figure 2.3

Homeownership in the United States, 1900 to 1980



Source: U.S. Department of Commerce, Bureau of the Census, *Decennial Census of the United States, 1900-1980.*

Exclusion of any particular cost component can create a misleading picture. This was particularly apparent in the 1970s when accelerating inflation made the less visible capital gains from homeownership a major consideration for the homebuyer, while simultaneously creating higher monthly mortgage payments, which were immediately visible. Public focus on only the current cash payments made by homeowners caused observers to miss much of the motivation for buying a home during this period.

In essence, the question of affordability for homeowners has come to be recognized as three distinct questions. The first is the net effective cost of homeownership, taking taxes and capital gains into account. The second is the degree to which households are able to bear the burden of high monthly payments in order ultimately to achieve significant financial gains. Lastly, there has been increasing concern that the first hurdle to homeownership, the down payment, has become higher.

Trends in Homeowning Costs

The trends in both current costs and net costs of homeownership are depicted in Figure 2.4. The current cash costs are important in determining whether a household qualifies for a mortgage. The difficulty of qualifying is an important barrier to homeownership, a problem that is evaluated in the next section. However, once a household does qualify, it is the net effective cost of homeownership that most determines the affordability of a home.

The net effective costs shown in Figure 2.4 are an estimate for a typical household, in terms of income, household size, tax bracket, and geographic region. In addition, it is necessary to estimate the household's expectations about capital gains at the time of purchase. The calculations shown in the figure are based on an extrapolation of actual capital gains during the previous eight years, which implicitly assumes that the household expects those trends to continue. Because these "average" assumptions will be incorrect to some degree for nearly every household, the trend shown in the figure will not be precisely applicable. But the basic pattern holds for nearly all demographic groups in each region, and different assumptions about expected capital gains will not affect the trends.

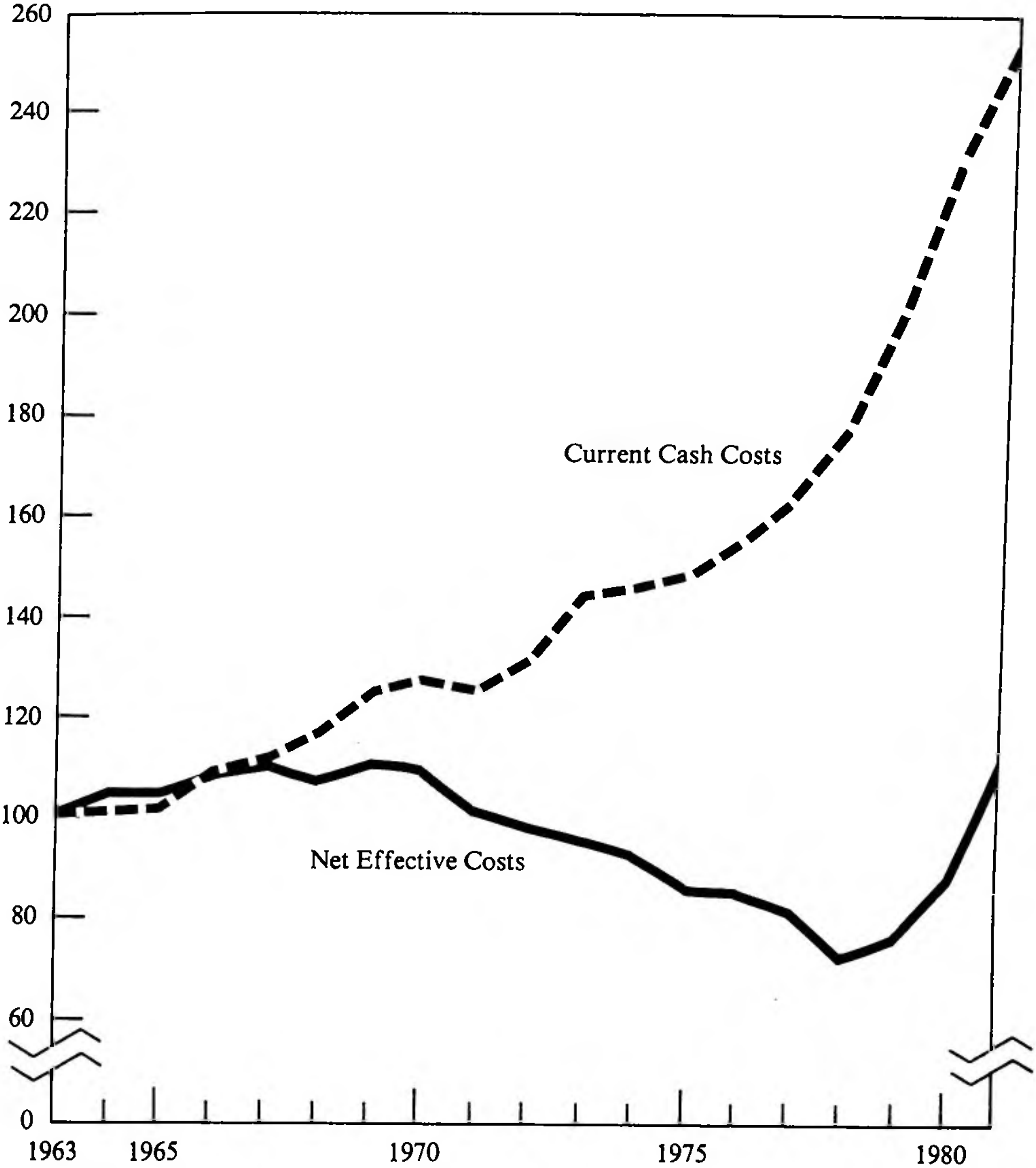
There have been three major trends in net homeowner costs since 1963. The first began in or before 1963 (the earliest year for which data are sufficient). It reflected the combined effects of a slow rise in inflation-adjusted (real) home prices and property-tax rates, capped by the "credit crunch" of 1970. The decline that set in after 1970 was due first to lower interest rates immediately following 1970, and then to accelerating expectations of appreciation. At the same time, inflation was pushing more households into the more rapidly rising range of income tax rates, further enhancing 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.

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 is evident from a few calculations based on two numbers. 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 bracket—which includes nearly all taxpayers—the effective cost of borrowing was negative, because the interest rate net of taxes would be reduced to less than 8 percent. In this case, the only real cost of owning a home would be the operating costs.

The current trend in net homeownership costs shows a sharp rise beginning in 1978. To a great extent, this rise reflects the catching-up of interest rates with the inflationary experience since 1965. There were unusually low real interest rates in the 1970s and these helped to buffer the sharp rise in the real prices of houses. But when these low rates disappeared, the impact of the 30 percent rise in real house prices over the decade became effective. Thus at present, interest rates have "caught up" with inflation, and now include a premium for the expected rate of inflation which greatly offsets the expectations of appreciation in house prices.

Figure 2.4

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: U.S. Department of Housing and Urban Development. Methodology is reported in D.B. Diamond, Jr., "Taxes, Inflation, Speculation, and the Cost of Homeownership," *Journal of the American Real Estate and Urban Economics Association*, Fall, 1980.

Homeowners who made purchases on the basis of the future sale value of their homes were in fact spending unrealized capital gains, and assuming the risks 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.

Mortgage Design and the Cash Flow Problem

Thoughout the 1970s, the current cash payments needed to finance and operate a home were rising in real terms. Monthly payments on new level-payment fixed-rate mortgages rose because interest rates were rising, creating a special kind of affordability problem. Although escalating prices of homes were providing appreciation which made high current mortgage payments economically minor in the long run, the higher prices of homes were also pushing up current mortgage payments, straining the immediate financial resources of many households. As shown in Figure 2.5, the initial monthly payment on a typical new house passed 25 percent of median family income in 1978 and was well past 35 percent at recent interest rate levels.

The cash flow problem arises largely from the design of the traditional mortgage instrument. The level-payment, fixed-rate mortgage requires immediate cash compensation to the lender in the form of a higher monthly payment for the expected decline in the purchasing power of the loan principal. This implies a larger drain on the current cash flow of the homeowner, forcing the homeowner either to borrow against future income (or future appreciation of the home) or to reduce other current expenditures. Beyond some point, both of the alternatives become either too difficult or too undesirable to the household. Before that point is reached, lenders usually choose not to rely on the financial discipline of the household and simply refuse to make the loan. Because of this cautiousness on the part of lenders, it has become more difficult for financially sound households to qualify for loans.

The long-run solution to the cash flow problem in housing finance is the reduction of inflation. About two-thirds of current mortgage payments stem from high interest rates set to compensate for the expected decline in the purchasing power of a dollar.

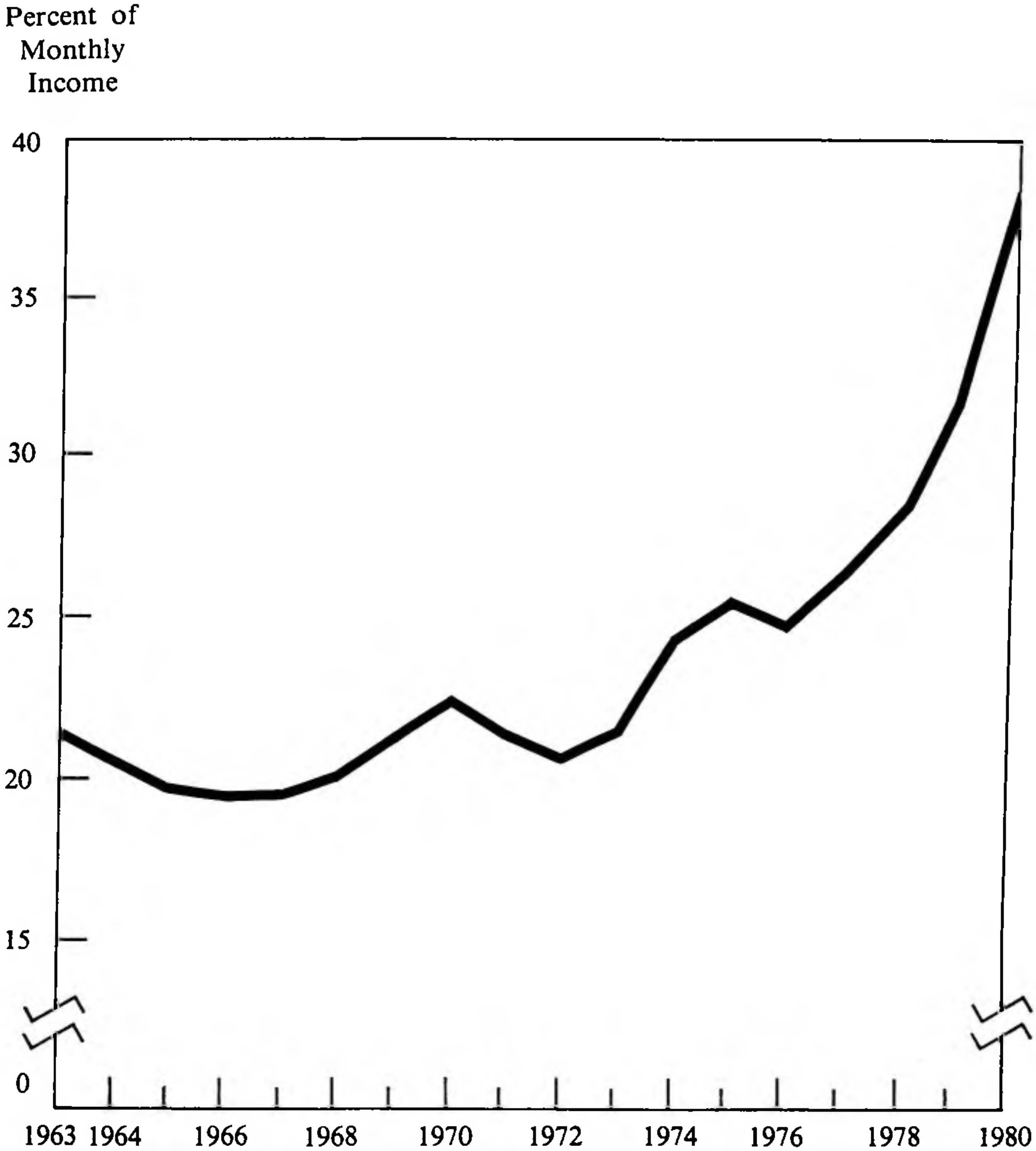
Appropriate monetary and fiscal policy will increase the prospects for reducing the inflation premium. Pending a return to lower mortgage interest rates, however, the housing finance industry and its regulatory agencies have been attempting to restructure the mortgage instrument. Although some compensation for inflation is necessary to preserve the real return on a loan, lenders may not need all of their return in the form of immediate cash. Certainly the homeowner, with relatively limited ability to borrow, may prefer to defer payment of this compensation. This problem has led to the formulation of a number of different mortgage designs. Generally these alternative mortgage instruments involve deferral of part of the current interest due until some future time. For example, the Graduated Payment Mortgage permits the household to make higher payments in the future in compensation for lower payments now. The deferred payments are added to the principal as they accrue.

Unfortunately, rising inflation has also meant that many lenders are facing cash flow problems of their own and cannot always afford to defer part of the payment on new loans. The cash flow problem of lenders arises from the fixed-rate aspect of the traditional mortgage. As the interest due on deposits has risen unexpectedly high, the interest received on mortgage and other assets has lagged far behind. The long-term solution to the mismatched maturities in lender portfolios is the adjustable rate mortgage. These mortgages permit variation in the effective interest rate as the cost of funds to the lender varies, although they do not always entail variation in current cash payment. Adjustable rate mortgages do not directly help the household's cash flow problem. However, there is no reason why the concepts of adjustable rates and graduated payments cannot be combined within a single mortgage to meet—at least in part—the needs of both borrowers and lenders. Such innovations may become common if mortgage lenders can satisfactorily resolve their immediate cash flow problems.

Figure 2.5

Initial Monthly Mortgage Payment Burden for a Constant-Quality Housing Unit

(New Houses, 1963 to 1980)



The initial monthly payment on a 1977 constant-quality house — with the prevailing mortgage rate, a 25% downpayment, and a 25-year term — divided by the median family income.

Source: U.S. Department of Commerce, Bureau of the Census, *Construction Reports* and *Current Population Series, P-60;* and Federal Home Loan Bank Board.

The Down Payment Problem

The down payment problem is especially important for the first-time homebuyer. All homeowners face the cash flow problem posed by high nominal interest rates. However, the higher rates of inflation have meant that the homeowner's equity, and thus the potential down payment on another house, builds up rapidly. Thus, unless the household is moving from a very low- to a very high-priced part of the country, it is insulated from the escalation of real down payments that has occurred and, to some extent, from the cash flow problem.

The first-time homebuyer has no such protection. Such households have traditionally accumulated this housing "grubstake" through saving and by borrowing from relatives. This process has never been easy, but it has been made somewhat more difficult recently by the low after-tax rates of return available on most forms of savings. The after-tax return on these savings recently has been less than the rate of inflation. Much more importantly, the prices of houses have risen at a rate faster than incomes. The result is that an extra effort or longer period is required to meet any given percentage down payment.

The extra effort is reflected in Figure 2.6. The real price of a home of given quality has risen steadily to a level more than 30 percent higher than in 1970. Meanwhile, the real incomes of young families have barely changed. Morever, there has been a shift towards more single person households, who tend to have lower incomes. However, these figures mask a great variation in the trend for specific households. Certainly, those households settling in the northeastern states, who faced a rise in real prices from 1970 to 1979 of only 18 percent, were much less affected than those attempting a home purchase in the West, where real prices rose 60 percent in the same period.

The impact of a higher down payment burden on housing consumption differs from that of increases in either the cash flow problem or the net effective cost of housing. The latter pose permanent and not easily avoided constraints on housing consumption. Down payments, though, represent a hurdle for the first-time buyer that can be cleared by either deferring the purchase until enough funds are saved or by a number of other alternatives, such as increasing savings, increasing consumer debts or personal debts to relatives, or by a lower down payment. Once the hurdle is cleared, the household is in a position to build up equity and avoid a cash flow problem in the future.

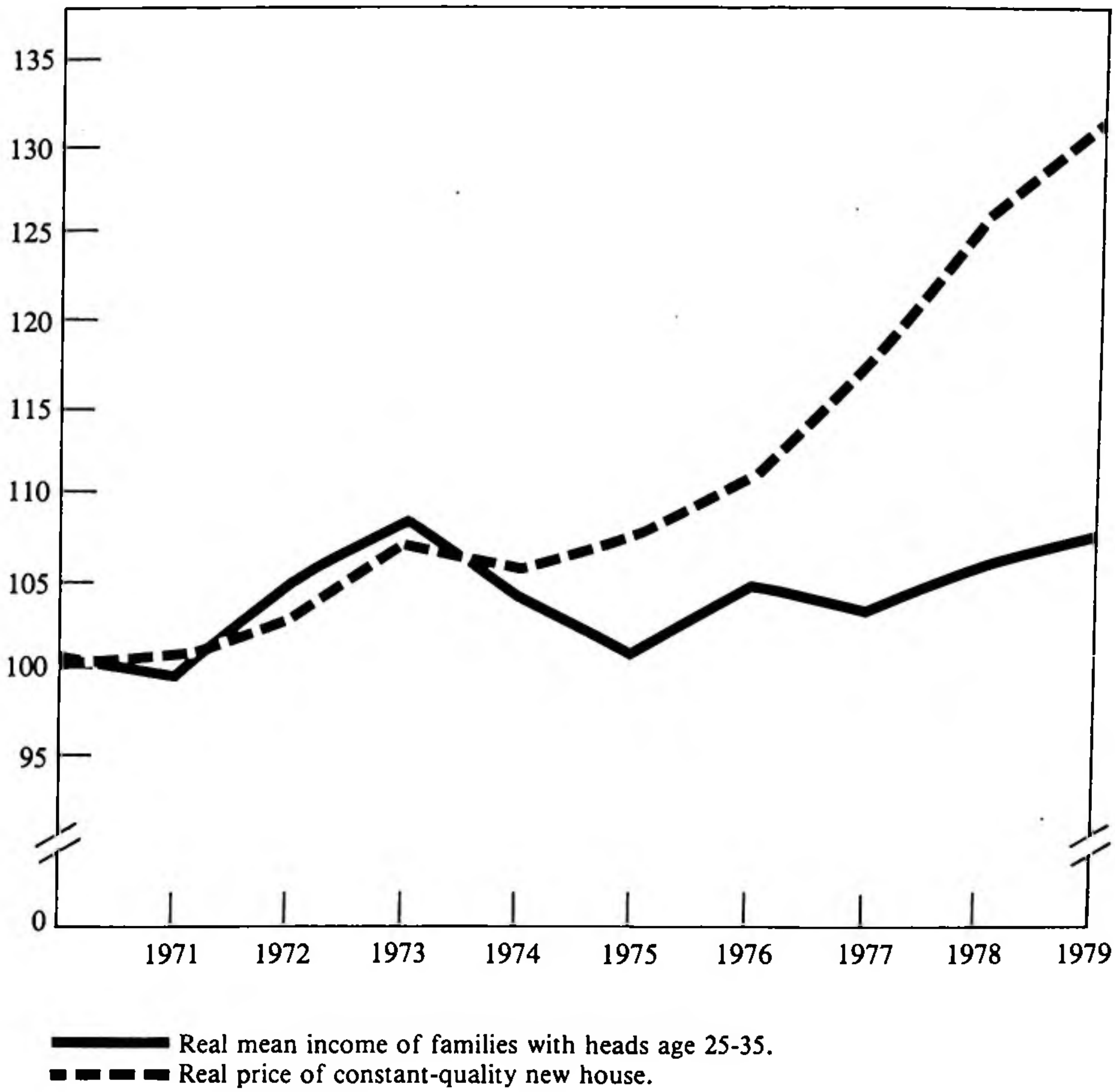
The most important force countering this rise in the down payment hurdle has been the availability of low down payment mortgages. There are no systematic data on the role over time of low down payment mortgages in assisting first-time buyers. What available evidence there is suggests that the Federal Housing Administration, the Veterans Administration, and private mortgage insurance are used extensively by first-time buyers. For example in 1978, 55 percent of all first-time buyers made down payments of 10 percent or less. Most of these loans would probably require some mortgage insurance. This implied a down payment of $5,000 or less for modest housing in most markets.

Perhaps because of the widespread availability of mortgage insurance, the down payment problem does not seem to have excluded first-time buyers from the market. About 2 million households—over a million of them under 35 years old—were first-time buyers in both 1977 and 1978, the most recent years for which data are available. The rise in home prices relative to incomes should have reduced the affordability of homeownership for young families buying their first home. Thus, at least through 1978, by some means and perhaps at significant personal cost, a large number of young families have continued to be able to surmount the down payment problem.

Responding to the charge given by the President, the Commission intends to research and study this situation more thoroughly in order to identify the needs of the first-time homebuyer. With this information, we will consider options for helping them, such as the individual housing account. The Commission also wishes to ensure that any recommended option is appropriately targeted on those first-time buyers who would be unable to buy homes in the absence of the option, rather than providing assistance to those who would buy homes anyway.

Figure 2.6

Indices of Real Price of New Homes and Real Mean Income of Younger Families



NOTE: Both indices are deflated by the GNP Implicit Price Deflator for Personal Consumption Expenditures.

Source: U.S. Department of Commerce, Bureau of the Census, *Construction Reports* and *Current Population Series, P-60;* and Bureau of Economic Analysis, *The National Income and Product Accounts of the United States.*

Chapter 3
CONSUMER HOUSING ASSISTANCE GRANTS

The Commission recommends that the primary federal program for helping low-income families achieve decent housing be a consumer-oriented housing assistance grant. This grant system should replace future commitments to build additional units under Section 8, Section 202, and public housing. The relationship of a consumer housing assistance grant to these and other subsidized housing programs will receive further Commission study.

INTRODUCTION

In the past, federal housing programs have attempted to address issues of affordability, adequacy, and availability of housing for low-income renters primarily through subsidized construction programs. These traditional approaches can be termed "producer subsidies," because the federal government makes payments directly to housing producers—either private individual owners or local agencies—that in turn provide housing to poor households at reduced rents. The size of the payment may depend on the income of the tenant household, but the payment is still paid to the producer, not to the tenant. The government and the producer make the decisions determining the characteristics of the housing that is provided. The tenant's choice of housing is restricted to the specific units produced under the subsidy program.

If the basic nature of the housing problem were a lack of new, subsidized housing units, the producer-oriented programs certainly would be judged successful. They have produced a large number of housing units. The New Construction and Substantial Rehabilitation components of the Section 8 program alone have produced nearly 500,000 units of rental housing since the program was enacted in 1974.

Important concerns about the producer-oriented programs, however, are their focus upon providing new units, their per unit subsidy costs, and the long-term nature of the subsidy commitments that must be made. In recent years, the major housing problem faced by the poor has been their inability to afford decent housing. The production programs are not the most direct way to address this problem. Moreover, the production programs involve 20- to 40-year commitments to subsidy payments, thereby limiting federal budget flexibility to meet changing housing needs. For all these reasons, the Commission believes that production programs are in general an inefficient way to meet the housing needs of poor people.

A clear and viable alternative to these programs exists in the form of a consumer-oriented housing assistance grant program. By consumer-oriented the Commission means a system in which the subsidy is not tied to a particular unit but is either paid directly to the program participant or to the landlord of a housing unit selected by a program participant. Advantages of this system are numerous. The affordability problem is addressed in the most direct and efficient way—providing cash assistance for use in housing in the private market. More eligible households can be served because the subsidy per unit is less than for newly constructed units. Tenant choice can be exercised in the market and is not limited to units specifically subsidized.

The Commission's recommendation for focusing on a consumer-oriented housing assistance grant system rests on the basic principles presented in Chapter 1, on the current nature of the housing problem, and on the substantial positive experience with consumer-oriented assistance programs in the Existing Housing component of the Section 8 program and in the Experimental Housing Allowance Program (EHAP).

The idea of consumer-oriented assistance is not new. In 1968, the President's Committee on Urban Housing recommended that this type of assistance be tested. Congress called for an experimental demonstration of housing allowances in the Housing and Urban Development Act of 1970. An ambitious experimental program, called the Experimental Housing Allowance Program, was launched by the Department of Housing and Urban Development (HUD) in 1972.

FHAP was conducted in 12 cities over the past decade to assess just how a consumer-oriented housing assistance grant program would operate and what its effects would be on participants and on local housing markets.

Drawing upon the initial experience in EHAP and an early leased housing program operated by local housing authorities (known as Section 23), Congress created an Existing Housing component in the Section 8 program enacted in the Housing and Community Development Act of 1974. The Existing Housing program has grown rapidly and now serves approximately 630,000 households.

Both the Existing Housing program and EHAP attest to the cost effectiveness and workability of consumer-oriented housing assistance grants as the basic approach to meeting the housing needs of low-income households. Housing assistance grants address the affordability problem directly and effectively, but participants may have difficulty in markets with insufficient adequate housing. The Commission considers this issue in Chapter 4.

CONCERNS WITH PRODUCTION-ORIENTED PROGRAMS

The ascendance of affordability as the primary housing problem of the poor would suggest at this pcint focusing on a consumer-oriented housing assistance program and discontinuing the construction programs, except to meet particular local needs. These conclusions are underscored, moreover, by a series of cost and equity concerns surrounding new construction programs.[1]

A basic equity problem of all subsidized housing is that relatively few obtain program benefits from among the eligible population. Failure to concentrate scarce program resources on cost-effective program choices exacerbates this problem. Twice as many households can be served at any given level of funding under the consumer-oriented programs as under the construction programs. In addition, under the Section 8 New Construction program, a few fortunate tenants obtain very high-quality housing at rents that are lower than the vast majority of their peers pay for lower-quality, sometimes substandard, housing.

Programs oriented to new construction are more expensive than those relying upon the existing housing stock in part because newly constructed buildings cost more to build than older structures do to maintain. A direct result is that the amount of federal subsidy required is higher in construction programs than in programs using the existing housing stock. The differences in rents charged in the New Construction and Existing Housing components of the Section 8 program lead to federal subsidies in the New Construction units that are about twice the subsidies required in Existing Housing units, as shown in Table 3.1.

Table 3.1

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

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.

[1]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).

The New Construction rents are clearly at the high end of the rental housing stock. The 1979 average project rent was $362 per month. Only 11 percent of renters in the 1979 *Annual Housing Survey* had rents higher than $350. Nationally, only 4 percent of the one-bedroom and efficiency units typical of the New Construction program had rents higher than $350.[2] The rental value of the project units was estimated to be lower, $291 per month, based on their characteristics and location; this is the rent such units would command in the private, unsubsidized market. The actual average project rent of $362 was 24 percent higher than this estimated market value of the project units. But even based on their market value rather than their costs, the New Construction program units are of high quality compared with what moderate-income families can afford. As one indicator, the market value of $291 per month represents housing 45 percent higher in value than that normally obtained by unsubsidized households having incomes just at the eligibility limit, 80 percent of area median income (for a family of four).

Total government costs 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 and from tax exemption for housing finance bonds, as well as from the Government National Mortgage Association (GNMA) Tandem Plan subsidy needed to provide loans at below-market interest rates in some cases. 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 the public housing agencies administering the program. Figure 3.1 summarizes these costs as estimated for a sample of units in the Existing Housing program and in New Construction projects. The figure also illustrates that these other costs are equivalent to about 20 percent of the directly budgeted subsidy cost in either program.

The construction programs are consistently more costly than the consumer-oriented programs. Total costs for public housing have been found to be similar to those in Section 8 New Construction, while costs for units in the Experimental Housing Allowance Program were comparable with Existing Housing, based on data from the Demand Experiment sites. An analysis of costs in West Germany found a similar pattern for the corresponding production and consumer subsidy programs there.[3]

A final cost issue is the budget "overhang" that results from the long term nature of the subsidies committed to specific buildings. Payment contracts extend over a period of 20 to 40 years and average 24 years. This reduces the budget flexibility of the government. The budget overhang (technically termed outstanding obligations) for the Section 8 program is summarized in Table 3.2 as of the beginning of fiscal year 1981. Of the $119.5 billion in obligations accumulated since the program's inception in 1974, $9.5 billion had already been paid through fiscal year 1980. The outstanding obligations of $110 billion represented commitments to pay subsidies for fiscal year 1981 and beyond. The Section 8 program is just the most recent in a series of programs for which long-term subsidy commitments have been made, including the public housing contracts to pay for debt service on construction bonds and the interest subsidy payments under the Section 235 homeownership and Section 236 rental housing programs. The obligations in all these programs, including Section 8, now total $250 billion.[4]

For the New Construction and Substantial Rehabilitation programs alone, the outstanding budget obligations of the federal government amounted to $[illegible] billion. These obligations covered reservations of funds for approximately 740,000 units; [illegible] units are actually occupied. The Section 8 Existing Housing program added only another $[illegible] billion, even though that amount covered more units. The average annual obligation for the New Construction and Substantial

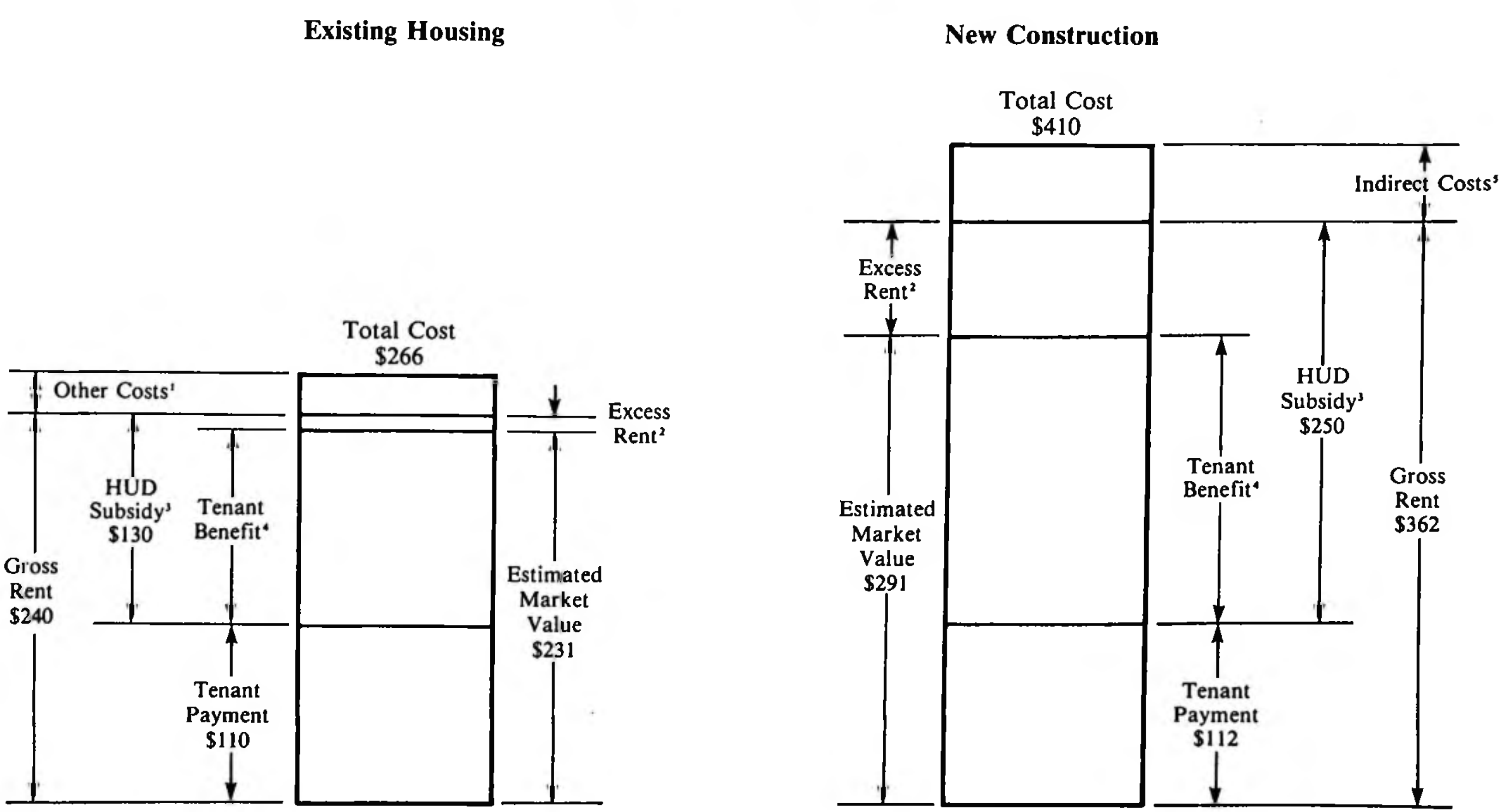
[2] In Section 8 New Construction [illegible] one-bedroom units. *Annual Housing Survey* data are [illegible] *Current Housing Reports*, Series H-150-79, Part C [illegible] U.S. Department of Housing and Urban Development [illegible] March 1981 [illegible]

[3] Stephen K. Mayo and Jörn Barnbrock, [illegible] in Germany and the U.S.: A Comparative Program Evaluation [illegible] 1980).

[4] U.S. Department of Housing and Urban Development [illegible] *1982 Budget* [illegible] March 1981 [illegible]

Figure 3.1

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] HUD Subsidy (Gross Rent Minus Tenant Payment)
[4] Tenant Benefit (Estimated Market Value Minus Tenant Payment)
[5] Indirect Costs (Including Federal Revenue Losses)

Source: James E. Wallace, *et al.*, *Participation and Benefits in the Urban Section 8 Program: New Construction and Existing Housing* (Washington, D.C.: U.S. Department of Housing and Urban Development, January 1981), Vol. 1.

Table 3.2

Budget Authority for the Section 8 Program (September 30, 1980)

Program Element	Units	Cumulative Obligations[a] ($ million)	Average Annual Cumulative Obligations (per unit)[b]	Outstanding Obligations ($ million)
New Construction	617,691	$71,838		$69,183
Substantial Rehabilitation	121,294	15,859	$4,945	15,404
Existing Housing	873,318	31,792	$2,427	25,484
Total	1,612,303	$119,489		$110,071

[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] Assumes 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.

Rehabilitation programs of $4,945 per unit is approximately twice the average annual obligation of $2,427 per unit under the Section 8 Existing Housing Program.

These cost comparisons reiterate the potential that the consumer–oriented programs have for serving more eligible households than the construction programs. But a broader view, encompassing more than sheer costs, is important in making program choices. The producer– and consumer–oriented programs must be assessed fundamentally in terms of how well they deal with the housing problems of the poor, especially affordability and adequacy. The next section makes these assessments in comparing the Section 8 New Construction program with the consumer–oriented programs.

EXPERIENCE WITH CONSUMER-ORIENTED HOUSING ASSISTANCE GRANT PROGRAMS

Experience with the Section 8 Existing Housing program and the Experimental Housing Allowance Program provides substantial information on the ability of this type of program to meet the shelter needs of low–income households.[5] Before reviewing that experience, it is useful

[5]Data on the Section 8 Existing Housing program are taken from the report cited above by Wallace, *et al.* 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, editor, *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 J. Struyk and Marc Bendick, Jr., editors, *Housing Vouchers for the Poor: Lessons from a National Experiment* (Washington, D.C.: The Urban Institute Press, 1981).

to summarize the main features of Section 8 Existing Housing and the Experimental Housing Allowance program.

The Department of Housing and Urban Development administers the Section 8 Existing Housing program as a consumer-oriented program using the existing private rental housing stock. The program permits eligible households to choose where to live as long as their chosen dwelling meets the program housing quality standards or can be made to meet them. Under this arrangement households may choose to stay in place or move to another dwelling. Payments are made directly to landlords on the tenants' behalf, but the payment is portable in that the tenant may elect to locate a qualifying dwelling anywhere within the jurisdiction of the administering agency, and the subsidy goes with him or her to the new unit. The Section 8 Existing Housing program provides direct contrast with the Section 8 New Construction program. Both are fully operational national programs.

The Experimental Housing Allowance Program was conducted under HUD sponsorship over the past decade to test the broad concept of consumer-oriented housing assistance, subject to a program housing standard. The experiment involved more than 30,000 households in 12 different locations across the nation. The research investment, including payments to families, will amount to about $160 million and has already produced more than 300 technical reports.

The Supply Experiment was an open enrollment program conducted in Saint Joseph County (South Bend), Ind. and Brown County (Green Bay), Wis. It included homeowners as well as renters. The program was announced publicly, and all who wished to enroll were accepted. (As in all of the experiments, housing assistance payments were made only to households when their housing met the program housing standard.) The housing market was carefully monitored to assess changes in rents, conversions, repairs and maintenance, and new construction resulting from the program.

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

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 experience and the Section 8 Existing Housing program provide the opportunity for comparisons with the Section 8 New Construction program on the key policy concerns—affordability and adequacy. The comparisons only peripherally address the issue of availability of adequate housing, part of which is covered in Chapter 2 and part in Chapter 4.

Affordability

Chapter 2 shows that affordability is the primary housing problem of the poor. All of the federal housing assistance programs for low-income people deal directly with the affordability problem, because the recipients must pay only a modest fraction of income for housing—typically 25 percent. The programs can differ, however, in terms of their ability to serve those among the eligible population with the worst problems of affordability. The New Construction program serves households with pre-program rent burdens about typical of the eligible population, but the Existing Housing program reaches households whose pre-program rents were very high fractions of their income. Eighty percent of the Existing Housing program households were paying in excess of 35 percent of their income for rent before entering the program, compared with 54 percent of New Construction program households paying this much. These differences reflect the larger proportions of very low-income households in the Existing Housing program (89 percent compared with 75 percent in the New Construction program); such households are especially likely to be paying high fractions of income for rent. The housing allowance experiments also reached eligible households with above average rent expenses relative to income; more than half of the participants were paying pre-program rents of more than 35 percent of their income.

Part of the reason Section 8 Existing Housing and housing allowances have been so successful in solving the affordability problem is that households with excessive housing costs relative to income can be given assistance without having to 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 obtain major repairs. The New Construction program is not as direct a way of solving the affordability problem for these households, because it requires a decision to move in order to receive the assistance.

Housing Adequacy

Both the Existing Housing and New Construction components of the Section 8 program reach households in physically inadequate housing. Approximately one-fifth of eligible households are in inadequate housing as measured by the Congressional Budget Office (CBO) indicator of Annual Housing Survey items. The proportions of participants in Section 8 Existing Housing and New Construction living in inadequate housing in their pre-program dwellings roughly match the proportion of eligible households in inadequate housing.

The New Construction program deals convincingly with the housing adequacy problem by providing new units. The percentage of participants in inadequate housing dropped from 20 percent in their pre-program dwellings to 1 percent in the project units.

Those who originally live in physically inadequate housing have three options under a consumer-oriented program. They can move to standard housing; they can fix up their present residence so that it meets program standards; or they can drop out of the program. Information about those remaining in the Section 8 Existing Housing program indicates that 58 percent moved and 42 percent chose to improve their present housing. Generally, movers tended to have housing with more numerous and serious deficiencies; most "stayers with repairs" indicated that they or their landlord spent less than $200 in order to meet the program standard.

The Housing Allowance Supply Experiment offers further detail about the behavior of renters originally living in substandard units. About 60 percent of them chose to make repairs, 20 percent moved, and the remaining 20 percent dropped out of the program. Again, the repairs that were undertaken were generally small and inexpensive. The average cash outlay was $70 for materials, and the work was done by the tenants or the landlords. This small effort was enough because few of the housing units were severely inadequate; most had minor health and safety hazards that were easily corrected. A quarter of all substandard units in the Supply Experiment cities (and 40 percent of substandard rental units) were brought up to standard, at modest cost, by program participants during the initial five years of the Supply Experiment. Annual housing inspections led to repairs for units in which defects had developed over the year. Direct assistance thus encourages upgrading and maintenance of the existing housing stock, so that some housing units remain in good condition that would have become substandard in the absence of the consumer-oriented subsidy.

The experimental results also show that the housing quality standard adopted in the program has an important effect on the participation of households in "inadequate" housing. The higher the standard, the more housing units will fail it, the more serious the margin of failure will be for these units, and the more households will choose not to participate. In the Demand Experiment, with more stringent housing standards, only 17 percent of participants' housing passed the standard initially, compared with half in the Supply Experiment. Further, 60 percent of those originally in deficient housing ultimately dropped out of the Demand Experiment, as against 20 percent in the Supply Experiment.

The choice of quality standard also appears to affect who participates. In the Demand Experiment, those households most likely to be in substandard housing—the very poor, large families, and minorities—were least likely ever to receive program benefits. In the Supply Experiment, such households participated more in proportion to their shares of the eligible population.

Some uncertainty remains concerning low participation by households in substandard housing. For most households in substandard housing, the allowance payments were greater than the amortized cost of repairs or the incremental rental costs of adequate housing for movers. Non-participating households apparently did not value the allowance payment and the required changes enough to incur the trouble and cost of making repairs, the burden of getting the landlord to make them, the difficulty of moving, or the nuisance of continued program compliance.

Minority Experience and Supportive Services

Consumer-oriented assistance programs exemplified by Section 8 Existing Housing and the housing allowance experiments rely upon access to a full range of choice in the private housing market. There has been some concern whether discrimination or expected discrimination would impede the ability of minority households to make full use of the program, either in terms of access to adequate housing or in 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 government presumably has more influence over outreach and tenant selection policies. The experience in the Section 8 program (New Construction and Existing Housing) and EHAP suggests that neither approach automatically insures success with regard to minority access.

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 were 15 percent of project residents versus 35 percent in the eligible population. Minorities are underrepresented in each age category, most disproportionately among the elderly, who constitute 80 percent of subsidy recipients. Table 3.3 shows these comparisons. By contrast, minority households appear to be fully represented in the Existing Housing program; they constituted 50 percent of program participants, compared with 44 percent among eligibles in the 15-city 1979 study.

Black households in both the New Construction and Existing Housing programs were able to move to neighborhoods with a lower minority concentration. Although there were relatively few minority households in the New Construction program, on average their pre-program neighborhoods had a 54 percent minority population, while the project neighborhoods were 35 percent minority for these households. The Existing Housing program had a larger proportion of minority households, but they 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 programs certainly did not exacerbate the housing problems of minority households. Some inferences can be drawn, however, about the potential for supportive services to influence these patterns.

Table 3.3

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.

Both the Demand and Supply Experiments offered a standard group presentation on neighborhood choices and provided support in cases of complaints of discrimination, 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.[6]

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 four of the 22 households reporting discrimination called the lawyer. None of the cases provided enough evidence to file a formal complaint. Possibly most participants felt that legal redress was unlikely to succeed or too time consuming.

The Demand Experiment provides other detailed information on the housing search of minority households. The allowance payments apparently had no locational impact because they did not alter the way in which people searched 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 non-minority households, in large measure because this information often came through friends and relatives; racial separation tends to result in separate information sources as well.

A more positive finding on support services comes from the Administrative Agency Experiment. The participating agencies were allowed great flexibility in the kind and degree of support services provided. One agency provided specific information on available units to minority households outside of traditional minority areas and thereby influenced housing choices of minority households. Another agency had very low minority participation or movement out of minority areas because black households were segregated into areas of poor housing, housing standards were rigidly enforced, and little supportive services were provided. Comparisons across all the Administrative Agency Experiment cities indicated that supportive services oriented to responding to individual problems of enrollees were important in enabling black households in tight housing markets to qualify for the program, in part because of expanded information and locational opportunity.

[6]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, racially associated differences in treatment were noted upon comparison of their experiences that 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 Market Practices Survey" (U.S. Department of Housing and Urban Development, Office of Policy Development and Research, Division of Evaluation, April, 1979).

The experience from the 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.

Rent Inflation and Housing Supply

Before the experiments were run, there were concerns about the possibility of housing allowances driving up housing prices as the allowances 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 Supply Experiment results indicate that the fear of rent inflation was not justified. And the experience of the Section 8 Existing Housing program suggests that a rather large program of this kind can be provided for eligible households in cities and rural areas across the country. As mentioned earlier, 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.

The amount of 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 made up 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, including both cities and suburbs. 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 to check for this kind of rent inflation found little problem: rents for enrollees already living in standard housing rose 2 percent after enrollment. In the Section 8 Existing Housing program, the program rents increased by 6 percent above the pre-program rents for such households. The payment mechanisms and competitive pressures of the private market were sufficient to keep landlords from making large increases in recipients' rents.

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 in the impacted markets.[7]

PROGRAM FEATURES

The Commission believes that a consumer-oriented housing assistance grant system should draw on the experience in Section 8 Existing Housing and EHAP in moving toward a more flexible program that provides maximum freedom of choice for the subsidy recipient, consistent with assuring decent housing. The program should also take advantage of the administrative expertise that has already been acquired by state and local agencies in the course of Section 8. 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. The Commission intends to give further attention to these and other issues in its Final Report. If a housing assistance grant system is proposed by the Administration and adopted by Congress, details of program design can best be left to HUD and the state and local agencies charged with program administration.

[7]Howard Hammerman, "The Impact of Housing Vouchers on Rent Inflation," unpublished report (U.S. Department of Housing and Urban Development, Office of Policy Development and Research, July 15, 1981).

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, as in the Section 8 formula. (The Commission understands that HUD has under review the current adjustments for family size.) The Section 8 Existing Housing program is already heavily targeted to this group.

Priorities for Eligibility

Current data indicates 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. It is not proposed that the consumer housing assistance grants be an entitlement program open to all eligible households. Instead, the Commission believes that priority for providing assistance should be based on income and such criteria as: currently living in inadequate housing, paying rents in excess of 50 percent of income, or suffering involuntary displacement—not necessarily in that order. The Commission has not attempted to develop a detailed set of priorities among the categories. For this report the Commission has not addressed the issue of homeowner eligibility.

Housing Quality Standards

Because the objective of national housing policy is a decent home for every American family, recipients of housing assistance grants should be required to occupy standard housing. At a minimum, the standards adopted must insure the health and safety of the assisted family. Beyond that, the precise standards must be a balance between the competing goals of housing quality and program cost. 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 in order 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—where they exist and insure the health and safety of the assisted family without imposing unnecessarily stringent requirements—are preferable to federal standards. Local standards should not impose high costs on the program and should not inhibit open access.

Rent Limits

The Commission believes that there should be no restrictions on the rent paid by assisted households. This would provide more freedom of choice than does Section 8 Existing Housing, where the Fair Market Rent (FMR) is the ceiling for tenant rents. In the Existing Housing program the subsidy payment makes up the difference between the tenant payment and the rent, up to the FMR as a limit. 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. If households wish to occupy a unit costing more than the FMR, for example, they should be allowed to do so by paying the additional amount out of their own income. At the same time, households should have an incentive, similar to that in the housing allowance experiments, to find housing renting for less. The allowance experiments indicate that this incentive system is an effective way of encouraging tenants to shop and of encouraging landlords to set rents according to market value instead of the payment standard.

Payment Levels

The Commission has considered two approaches for setting levels: the FMR system now in use or a fixed percentage of local median income. The FMR system has the advantage of considerable development in the Section 8 Existing Housing program, but this system also requires somewhat elaborate calculations and is subject to a variety of administrative appeals and exceptions. The percentage-of-income system would be an administratively simple method, but it may not be a good measure of housing cost in some cases. Both alternatives require further development and analysis. Under either system, the payment would be conditioned on the income of the recipient, so that those with lower incomes would receive more.

Whatever the mechanism for setting the payment level, it must meet multiple objectives. Most obviously it must be high enough that recipients typically could find dwellings that meet program quality standards. But the payment level should not be set so high that it enables subsidy recipients to live in housing better than that of unsubsidized, moderate-income households, unless the subsidy recipients choose to pay a larger than normal fraction of their income for rent. The percentage-of-income method for setting payment levels could be designed so as to achieve this goal, which is necessary to preserve equity between recipients and ineligible households and to maintain incentives for the subsidy recipient to earn more than 50 percent of median income. Finally, the payment standard must reflect the higher housing cost of larger families; the payment level, like the income limit, needs to be set for each size household.

Administrative Mechanisms

The system should be administered through the same mechanisms and agencies as the Section 8 Existing Housing program, including state agencies as well as local housing authorities. This will help to avoid the creation of additional program administration levels. Experience of agencies administering both EHAP and Section 8 Existing Housing indicates that the allowance form of an assistance payment is more easily administered. This suggests that administrative agencies should play a smaller role in a housing assistance grant program than they do in Section 8; for example, Section 8 requires a payments contract negotiated between the agency and landlord as well as a lease between landlord and tenant, rather than leaving all the contractual arrangements to the landlord and the tenant.

Term of Contract

The term of each payments contract with the administering agency should be three to five years. More than half of all renters normally move within five years. Moreover, the housing allowance experiments show that many households are only eligible for a few years, or less, before their incomes rise above the program limit. The federal government should have the flexibility to make short-term adjustments reflecting changing housing needs.

Equal Opportunity and Housing Access

Housing assistance grants 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 contrary to existing law and would prevent the full realization of the potential benefits of the program. The issue of steering is also of special importance for purposes of effective operation of the program. If minorities are steered exclusively 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 housing that are available. 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 current federal fair housing laws.

OTHER ISSUES

Relationship to Other Housing Programs

At present, the subsidy cost of a Section 8 New Construction unit is almost twice that of a Section 8 Existing Housing unit. For this reason, the Commission thinks that it would be useful to explore the recapture for housing assistance grants of the Section 8 subsidy funds committed for new construction and substantial rehabilitation, where mutually agreeable. The Commission assumes that any such recapture of Section 8 subsidy funds would require the agreement of project sponsor/mortgagors, mortgagees, bondholders, and affected state and local government agencies. This policy should not deprive any existing tenant of comparable housing assistance. All budget authority so retrieved should be applied to consumer–oriented housing assistance grants or other low–income housing assistance. The Commission believes that some projects might agree to switch to unsubsidized status, while the current low–income subsidized tenants would receive housing grants. These possibilities merit further investigation.

With respect to public housing, the Commission believes that the goal should be eventually to replace public housing subsidies with consumer–oriented housing assistance grants. This approach would provide tenants with a greater range of housing choices and would require public housing projects to compete with private housing suppliers for tenants. Federal operating subsidies, which totaled $1.2 billion in fiscal year 1981, would be converted to assistance payments, and public housing tenants would be eligible for payments.[8]

The Commission recognizes that a transition period will be needed for some authorities. Some large authorities are in such weak financial condition or have projects in such poor physical condition that they cannot now compete effectively, while others are doing quite well. Any such change should be carried out so as to avoid either jeopardizing the present situation of public housing tenants or focusing payment unduly on public housing tenants. The Commission has formed a study group to address the possible integration of public housing with a consumer housing grants program.

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, which 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. Non-cash benefits provided by welfare programs should be further considered for inclusion in determining the assistance payments to individual households.

[8] A HUD analysis indicates that, on average, operating subsidies combined with annual subsidies for debt service and modernization for public housing would equal the subsidy under a voucher payment based on Section 8 Existing Housing Fair Market Rents; there are large variations around this average, however, and the median unit cost for public housing is much lower. (U.S. Department of Housing and Urban Development, Office of Policy Development and Research.)

Chapter 4

IMPROVING THE AVAILABILITY OF ADEQUATE HOUSING

INTRODUCTION

If the consumer-oriented housing assistance grant is to operate effectively in local housing markets across the country, federal housing policy for low-income households must be concerned with the maintenance and expansion of an adequate supply of decent housing. The experience with housing allowances and Section 8 Existing Housing indicates that housing assistance payments are highly effective in alleviating the affordability problem that most commonly faces low-income households. These programs are less successful in reaching the poor who live in physically inadequate housing, and do not stimulate new construction or substantial rehabilitation. In particular, units that require relatively minor repair or upgrading are frequently brought up to program standards, but those with severe deficiencies are less often rehabilitated.

Thus, there may be special problems of adequate housing supply remaining even after a consumer-oriented housing assistance grant program is fully operational. For this reason, the Commission believes that it is important to provide the means for local communities to increase the supply of adequate housing through upgrading or new construction in places where there is short supply or a relatively large share of the current stock is seriously physically inadequate. In these markets, assistance recipients may have difficulty in finding decent housing, without some supply expansion.

The success of the consumer housing assistance grant program also will be substantially enhanced by the elimination of excessive regulation of housing production. Providing better housing opportunities for the needy requires not only consumer-oriented assistance but also the existence of competitive, productive housing markets. The general availability of housing and the productivity of the building industry will be maximized by the elimination wherever possible of government restraints. For its Final Report, the Commission will consider recommendations for the removal or modification of federal, state, and local regulations that impede housing production.

This chapter presents Commission recommendations designed to increase housing supply, particularly in those areas where it is needed to facilitate the housing assistance grant program. These recommendations embrace tax policies, the provision of mortgage credit, and mechanisms to strengthen the ability of state and local government agencies to expand housing supply; specific areas include the Community Development Block Grant (CDBG) program, mortgage revenue bonds, tax incentives for rehabilitation, pension fund investments in mortgages, and nongovernmental initiatives in housing. Other recommendations on Federal Housing Administration (FHA) mortgage insurance and assistance for first-time homebuyers, as mentioned in Chapter 1, will be developed in detail in the Final Report.

These recommendations are not limited to housing supply for low-income families. By expanding the available supply of decent housing in a variety of ways, they should enable the poor as well as middle- and upper-income Americans to find and afford better housing. The Commission intends to continue its study of the issues of housing supply, both with respect to low-income households and in the housing market as a whole.

NEW CONSTRUCTION WITHIN THE COMMUNITY DEVELOPMENT BLOCK GRANT PROGRAM

The Commission recommends that new housing construction be added as an eligible activity for Community Development Block Grants in order to expand local decisionmaking flexibility. Additional funding, giving weight to local housing problems, that would enable localities to support this activity, would be desirable when budget circumstances are favorable.

Discussion

Because of its conviction that the housing supply problems of low-income families are more readily identified and understood 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 problems, should be expanded to permit localities a wider range of housing supply activities. In particular, new construction, one of the few housing-related activities not now permitted, should be eligible under CDBG. New construction was omitted from CDBG activities in the 1974 Housing and Community Development Act because Section 8 of that act provided explicitly for housing construction. Given the Commission's recommendation to terminate future Section 8 construction, the 1974 act's prohibition on new construction with CDBG funds would no longer be appropriate, and indeed would be counterproductive.

This expansion of the CDBG program will give to the localities the flexibility and innovative possibilities that are offered by a housing block grant without the necessity of creating an additional program. It would enable those localities with special housing supply problems to assist the production of new units, if they believe that new construction is the most appropriate way for them to increase supply. At the same time, because of the statutory objective that CDBG expenditures primarily assist low- and moderate-income households, we believe that any new construction activities would be likely to benefit those most in need. And the administrative safeguards of the CDBG program would be available and applicable to the added option of new construction. Under CDBG, such allocation decisions are made locally, within the basic framework of a plan established by the community.

The inclusion of new construction within the CDBG program should also enhance the local government's ability to address the full range of local housing and community development problems with a coordinated strategy. An increasingly important component of decent housing for the poor is a decent neighborhood. Too often housing programs in the past have neglected this dimension, and have provided structurally sound housing in a deteriorating community. Solutions of the problems of housing adequacy through new or rehabilitated units may not be solutions at all unless coordinated with basic infrastructure improvements in streets, public facilities, and public services. The CDBG program, by providing for local decisions as to the proper balance between direct housing activities and neighborhood infrastructure, has avoided this problem.

Even though new construction would become an allowable activity, the annual funding feature of the CDBG program would be maintained. Under this arrangement, grant recipients must finance chosen activities within the amount of the grant and cannot assume a continued federal contribution. Although this requirement may limit the scope of new construction activities that can be financed, it also limits federal budget exposure. Grant recipients may still choose a variety of applications of the funds, including land clearance and write-down as at present, capital grants of whatever depth deemed appropriate, commitments to annual subsidies for debt service, or operating expenses—within the limits of the funds available to them.

The Commission's desire to expand CDBG's housing supply options stems in part from the vigorous and innovative approaches already undertaken by local governments. Even with the comparatively limited scope for local housing program development that has been feasible under current federal policy, it is nonetheless true that many of the most innovative ideas in housing programs have been devised and implemented on the local level, and adopted by the federal government only after the local programs proved to be successful. These local program initiatives include Urban Homesteading, the Neighborhood Housing Services program, and even housing allowances, to some extent. Urban Homesteading was devised in Wilmington, Del., several years before the federal government began to utilize it as a way of reducing the inventory of housing owned by the Department of Housing and Urban Development (HUD) and 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.

In the CDBG program, localities have already devoted substantial effort to housing and closely related activities. More than a quarter of the grant funds have been used for housing rehabilitation, and the share is gradually increasing. Over 250,000 housing units have been rehabilitated; more than 80 percent of them are single-family homes. This is far more than categorical federal housing rehabilitation programs have financed in a comparable period. In addition, about one-sixth of the funds have been used for land acquisition and clearance; with some of this money, sites for about 50,000 subsidized rental units have been prepared.[1] Localities have also succeeded in attracting private funding to supplement CDBG rehabilitation efforts. In fiscal year 1980, an estimated $400 million in private funds were added to the $1 billion of CDBG housing rehabilitation expenditures.[2]

Thus, the already functioning CDBG program has many features of a block grant for housing, but with new construction excluded. Adding new construction incorporates the full concept of a housing block grant within the CDBG program and strengthens the proven ability of localities to augment housing supply.

MORTGAGE REVENUE BONDS

The Commission has considered the following three options for state and local agency tax-exempt financing of housing:

1. **Continue tax-exempt bonds as an instrument for financing new construction and rehabilitation with appropriate targeting (the Commission is not making any recommendations at this time as to appropriate targeting), or**
2. **Withdraw tax-exemption on all such bonds and provide direct unrestricted federal payments instead, in the form of a subsidy to make up the difference between tax-exempt and taxable yields, or**
3. **Offer bond-issuing agencies their choice of the alternatives of either continuing tax-exempt status for their bonds or switching to taxable bonds with a compensating direct unrestricted federal payment to make up for the switch from tax-exempt to taxable status.**

Discussion

In view of the Mortgage Subsidy Bond Act of 1980, the Commission will establish a task force to review the fiscal policy, market, and regulatory implications of the use of tax-exempt revenue bonds, whether for housing or other purposes. A primary issue is the revenue loss to the federal treasury because of the tax exemption. For the purpose of this Interim Report, the Commission believes that the three approaches all deserve consideration as means to facilitate the continued provision of adequate housing by state and local governments.

Tax-Exempt Bonds

The first tax-exempt state housing finance agency (HFA) bonds were issued in 1961 by the New York State agency. In the late 1960s, other states began establishing such agencies, and the volume of bonds has grown at an accelerating rate since 1970, particularly after 1975. Thus from 1961 to 1978 state HFAs issued more than $12 billion in bonds; more than $4.5 billion of this amount was issued in 1978, so that year alone accounted for some 40 percent of all state HFA bonds issued until then.[3]

[1] U.S. Department of Housing and Urban Development, Office of Community Planning and Development, *Sixth Annual Community Development Block Grant Report* (Washington, D.C.: U.S. Government Printing Office, 1981), pp. 57-71.

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

[3] George E. Peterson, *Tax Exempt Financing of Housing Investment* (Washington, D.C.: The Urban Institute, 1979).

Part of the reason for this rapid growth was the increased use of tax-exempt bonds for financing single-family housing. Until 1978, tax-exempt bonds were used primarily to finance the construction of multifamily rental projects for low- or moderate-income households. By mid-1978, an estimated 300,000 apartments were financed by state agencies, compared with some 85,000 single-family homes. (These include both purchases of existing homes and construction of new ones.) Thus, apartments accounted for more than three-quarters of HFA activity. But in 1978, single-family bond issues increased rapidly, so that more than 60 percent of the bonds issued by state agencies were used to finance single-family homes.

This shift in state agency activity paralleled the development of home mortgage programs by city governments. Beginning in 1978, localities began to issue bonds to provide funds for mortgages for middle-income homebuyers, including purchasers of both single-family homes and condominiums. The tax exemption permitted mortgages to be issued at interest rates about 2 percentage points below the conventional market. These bonds became extremely popular; a total of about $2.2 billion was issued by the spring of 1979.

Thus, 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 utilizing the bond proceeds in the production of multifamily housing for low- and moderate-income households and the sale of single-family homes. This capability represents an important resource in the provision of housing, particularly in those local situations in which additional housing supply is desired to facilitate the effective working of the consumer-oriented housing assistance grant. State and local governments, with their record of experience, should be able to respond quickly to local supply problems, while the federal government, with less comprehension of local circumstances, would probably require a longer period to react.

The most attractive feature of tax-exempt financing is the reduction in financing costs for homebuyers and rental housing developers. Because debt service on the bonds is lower, there is a reduction in the monthly mortgage payment or rent necessary to support that debt service. The lower costs in turn bring homeownership and new rental housing within the reach of households with lower incomes than would otherwise be possible. The exact reduction in financing costs cannot be ascertained in advance, but depends on conditions in both the tax-exempt bond market and the mortgage market at any particular time.

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.

However, tax-exempt bond financing of housing does create potential problems. The very success of tax-exempt bonds for housing has attracted attention because the tax exemption creates a substantial loss of federal tax revenue. This revenue loss either imposes a greater tax burden on all taxpayers, or else increases the federal budget deficit, with possible inflationary consequences. Further, the housing bonds compete with tax-exempt bonds issued by states and localities for other purposes; the additional volume of tax-exempt borrowing increases interest rates paid by all states and municipalities when they borrow. Concern over these issues, particularly in light of the rapidly growing volume of local home mortgage revenue bonds in 1978 and 1979, led Congress in 1980 to pass the Mortgage Subsidy Bond Act (known as the Ullman bill) that restricts issuing authority for bonds for homeowner mortgages. It prohibits issuing these bonds after 1983, and restricts their use in the interim.

Taxable Bonds

Taxable bonds offer an alternative means of enabling state and local governments to provide housing. 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. Thus, in order for projects financed by taxable bonds to offer mortgage payments or rents within the reach of moderate– and low–income households, it is necessary for the effective interest cost to the state or local agency to be reduced below the market rate for conventional financing. One way of doing this is through a subsidy from the federal government, perhaps corresponding to the difference between taxable and tax–exempt bond interest rates. The state or local agencies can then issue bonds that pay interest at the taxable rate to the bondholder.

The taxable bond concept has several merits. The subsidy mechanism provides for greater budget control than does the tax–exempt bond, because the subsidy rate can be established by the federal government and changed when market conditions change. If there is a particular desire to stimulate multifamily production, for example, the subsidy could be set at a higher rate than that needed to bring the taxable bond interest cost to the level of tax–exempt instruments. Similarly, a shallower subsidy rate could be established when desired. Furthermore, the federal subsidy could be used in other ways. Front–end subsidies, site acquisitions or other inducements could be offered instead of lowering future interest payments.

Taxable bond financing is likely also to result in a lower revenue loss to the federal treasury than does tax–exempt financing, when the taxable rate is subsidized down to the tax–exempt rate. In this case, the federal subsidy for the taxable bond is simply the dollar amount of the difference between taxable and tax–exempt rates, while the tax–exempt revenue loss depends both on the rate difference and the tax brackets of all tax–exempt bondholders.

It is generally agreed that the relationship of the tax–exempt rate to the taxable rate is determined by the tax bracket of the marginal purchaser—the purchaser whose after–tax return is the same for either a tax–exempt or taxable bond. Historically, the tax–exempt interest rate has averaged about 30 percent below the taxable rate, meaning that the after–tax return on a taxable bond is the same as the return on a tax–exempt bond for bondholders in the 30 percent tax bracket.[4] For those in higher tax brackets, however, the after–tax return on the tax–exempt bond is greater than for the taxable; in the 50 percent bracket, the net return (or after–tax interest rate) would be 50 percent of the (before–tax) taxable interest rate. When such an investor switches from taxable to tax–exempt bonds, the Treasury loses 50 cents for each dollar of interest it would have been able to tax. Thirty cents of this loss is the interest saving to the state or local government resulting from its ability to issue tax–exempt bonds. The difference between 50 cents and 30 cents is a revenue loss to the Treasury that is not offset by any lower interest cost to the issuing state or local agency. With the taxable bond, all of the revenue loss does translate directly into lower interest cost to the issuing agency.

The amount of revenue savings from switching to taxable bonds can only be estimated. Past estimates have ranged from insignificant to substantial savings, and the 1981 tax changes render these estimates obsolete. The lowering of the maximum tax rate on interest income from 70 to 50 percent, the gradual lowering of other individual tax rates over the next three years, and institution of all–savers certificates will alter the revenue loss on tax–exempt bonds, either directly or indirectly, through their effects on the interest differential between taxable and tax–exempt bonds.

The issuance of taxable bonds for housing might enable state and local governments to issue their tax–exempt bonds for other purposes at lower interest rates. The tax–exempt bond market is relatively shallow, so that expanded use of tax–exempts to finance housing tends to drive up the interest rates that states and localities must pay on all of their tax–exempt borrowing. The greater volume of taxable bonds implies that taxable housing bonds can be issued without having as great an effect on overall taxable interest rates. Moreover, the shift to taxable bonds should lower tax–exempt rates because of the reduced volume of tax–exempts.

4 The interest rate on tax–exempt general obligation bonds of states and municipalities with an AAA rating has averaged close to 70 percent of that for AAA corporate bonds since 1947. However, the spread varies over time. Tax–exempt rates have been under 50 percent of the taxable rate (early 1951) and over 80 percent (1969 and early 1971).

Local Choice

The third option is to leave the choice of taxable and tax-exempt financing to each bond issuer. Between now and the end of current provisions for mortgage revenue bonds in 1983, state and local agencies could experiment with alternative uses of the taxable bond for housing, such as the federal subsidy arrangement, as well as continuing some use of tax-exempt financing. This range of experience would be helpful for state and local governments making the transition to the post-1983 environment. It would also be useful to Congress and the Administration is assessing just what that environment should be.

REHABILITATION TAX CREDIT

The Economic Recovery Tax Act of 1981 provides owners of nonresidential real estate with a 15 percent tax credit on rehabilitation expenses for structures 30 to 39 years old and a 20 percent credit for older structures. The Commission recommends that owners of residential rental structures enjoy the same investment tax credit for rehabilitation expenses.

Discussion

Prior to the 1981 act, federal tax law contained special incentives for rehabilitation of nonresidential real estate, low-income rental housing, and certified historic structures. Ordinary rental housing, however, received no rehabilitation incentives. The 1981 act accentuated this pattern. The tax credit for commercial and industrial real estate was raised to 15 percent for structures at least 30 years old and 20 percent for those aged 40 or more years. The tax incentive for rehabilitation of low-income rental housing, Section 167(k), was liberalized as well. Section 167(k) permits five-year, straight-line depreciation for up to $20,000 of rehabilitation per dwelling unit. The 1981 act raised this limit to $40,000 under certain conditions. Also, the tax credit for rehabilitation of certified historic structures was raised to 25 percent. However, the 1981 act provides no incentive for the majority of rental housing, which is neither low-income nor certified historic. (Table 4.1 details the 1981 act's rehabilitation incentives.)

Table 4.1
Rehabilitation Tax Incentives for Real Estate

Tax Feature	Commercial & Industrial	Historic Structures	Low-Income Rental Housing	Other (Ordinary) Rental Housing
Credit Incentive	15%, aged 30-39; 20%, aged 40+ yrs. Depreciation basis reduced by credit amount	25% No reduction in depreciaton basis	None	None
Depreciation Incentive	None	None	5-year straight-line; disregard of salvage value	None
Minimum Rehabilitation	Greater of $5,000 or adjusted depreciable basis	Same as Commercial & Industrial	$3,000	Not applicable
Maximum Rehabilitation	None	None	$20,000/unit; $40,000/unit if sold to tenants	Not applicable

Source: U.S. Department of the Treasury, Internal Revenue Code.

The Commission believes that tax credits are a useful way of encouraging private, market controlled rehabilitation without the administrative complexity and cost of an additional program. Relative to other real estate, however, tax policy discourages rehabilitation of ordinary rental housing. The Commission finds this result to be undesirable. Extending the commercial and industrial rehabilitation tax credit to ordinary rental housing would restore greater equity in the incentive structure.

Improved incentives for rehabilitation of rental housing are an integral part of the Commission's proposals. The Commission is recommending a balanced program to augment the ability of low-income families to afford decent housing (the consumer housing assistance grants) and, where necessary, to augment the supply of decent housing. One of the important sources of augmented supply for the assistance grant program is the upgrading of substandard housing. Evaluations of the Section 8 Existing Housing program and the housing allowance experiments have found that assistance payments alone provide insufficient incentive for major rehabilitation of substandard dwellings. They do stimulate small repairs, but not many major ones. As a result, most dwellings with major defects remain unavailable for program participants, and current occupants of these dwellings are discouraged from participating in the program, because they would have to move.

Tax incentives for upgrading of housing could redress this shortcoming, if they were broadly available. The current Section 167(k) provisions offer incentives primarily for higher-income owners (typically limited partners) of a large number of rental units. The incentives take the form of accelerated depreciation, and the value of the depreciation depends on the owner's tax bracket. In addition, the law applies only when low-income tenants occupy the rehabilitated structure. But a landlord who rehabilitates in order to satisfy assistance grant program standards cannot be sure in advance of attracting and keeping a grant recipient, and low-income renters without assistance are less able to afford an upgraded unit. To stimulate rehabilitation for the assistance grants, without creating a new categorical rehabilitation program, the incentive to upgrade needs to be independent of the tenant's income. An extension of the nonresidential rehabilitation tax credit to ordinary rental housing would provide an appropriate, broadly available incentive.

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 by 6 to 7 percent. For a more substantial upgrading, where rehabilitation costs are three times original structure value, the 20 percent credit raises project value by 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. Further study of the likely number and the average extent of rehabilitation in projects using the credit needs to be made before total revenue losses can be estimated. The Commission intends to examine further a number of issues involved in this proposal, including revenue loss, impact on the stock of privately owned low-rent housing, and potential displacement of low- and moderate-income renters.

PRIVATE INSTITUTIONS

The Commission recommends that private foundations, religious groups and other private institutions be encouraged to continue their sponsorship and financing of innovative programs in housing construction, rehabilitation, and access to homeownership.

Discussion

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, and others in efforts to meet housing needs. It is clear that federal funds are not available to meet the housing needs of all low-income households. Meeting the nation's housing problems will, therefore, require the strong involvement of these private institutions.

The focus of the Commission's deliberations has been on those engaged in one aspect or another of producing, financing, and managing housing for profit because this is quantitatively the most significant part of the housing market. The Commission does not wish to underestimate, however, the importance of nonprofit organizations, neighborhood and community groups, cooperatives, and others concerned with housing and the quality of life, and often particularly suited to meet the needs of low- and moderate-income families. For many decades, private foundations, religious organizations, and others have contributed to building or improving housing. Prior to their inclusion as developers in federal programs, churches, foundations, and other private institutions sometimes provided the entire amounts needed to carry out housing activities.

The Commission recognizes that its proposals would curtail development activity that these groups have sponsored under federal programs. But the Commission also believes that its proposals will enable private institutions to continue to work in concert with federal, state, and local housing programs. In particular, the availability of Community Development Block Grant funds to assist new construction will broaden the range of activities in which local groups and local governments can work together on neighborhood improvement and housing efforts.

PENSION FUNDS

The Commission recommends the elimination of provisions of current regulations or laws that inadvertently limit the housing investments of pension funds, insurance companies, and other potential major sources of housing capital.

Discussion

There has long been interest in the possibility of increasing mortgage investment from nontraditional sources of funds, particularly pension funds. Private pension plans held more than $400 billion in assets at the end of 1980; three-fifths of this amount was held by noninsured plans and the balance was accounted for by plans with life insurance companies. In addition, roughly $200 billion in assets was held in retirement plans for employees of state and local governments.[5]

Some public pension funds have acquired substantial amounts of residential mortgage assets. However, mortgage investment by private pension funds has been small. As nearly as can be ascertained, residential mortgages and mortgage pass-through securities held by private, noninsured plans account for less than 1 percent of the total assets of these funds, and mortgage assets constitute only a minor share of the investments of insured pension funds that utilize separate investment accounts. Of course, private pension plans with life insurance companies commonly do not involve separate accounts, and thus information on the types of investments behind 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.

[5]Board of Governors of the Federal Reserve System, Flow of Funds Accounts.

Pension and retirement funds have very long-term liabilities, which should make long-term residential mortgages potentially attractive investments. In this respect, pension funds are more favorably situated for mortgage investment than savings and loan associations, which traditionally have borrowed in the short-term (deposit) market and made long-term mortgage loans.

In the case of private pension funds—both noninsured funds and insured funds that utilize separate investment accounts—implementation of the Employee Retirement Income Security Act of 1974 (ERISA) has imposed constraints upon mortgage investment. 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 that are prohibited as well as standards that investment managers of pension funds should follow when making investments. The main difficulties have been posed by broad Department of Labor regulatory definitions of the circumstances and conditions under which pension plan investments can and cannot be made. The regulations have attempted to ensure that investment managers do not enter into conflict-of-interest situations and unwise investments, but they have failed to recognize the realities of the housing finance marketplace and have had the effect of limiting pension plan investment in mortgages and mortgage-related securities. Moreover, adjustments to the ERISA regulations have been slow to evolve, and those modifications that have been implemented are not fully adequate to meet the needs of the marketplace.

It is important to ensure that transactions involving possible conflicts of interest are not made to the detriment of the pension plan beneficiaries, but it does not appear reasonable to prohibit the development of relationships that arise in the normal course of business between the pension plans and such parties as loan originators, sellers, servicers, and mortgagors. The Department of Labor has recently begun to ease the restrictions on pension fund investment in mortgage-backed securities. It should undertake further actions along the following lines:

1. The Department of Labor should promptly issue the housing portion of proposed regulations that would exclude from ERISA regulations mortgage pools 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.
2. The Department of Labor should expand its recent class exemption for mortgage pass-through securities that are not issued or guaranteed by a federally related entity, in order to cover pools of second mortgages and to clarify the treatment of forward-purchase commitments that are commonplace in mortgage market transactions.
3. In the case of whole mortgages or mortgage participations, the Department of Labor should issue a class exemption in order to permit normal business transactions.
4. The mechanisms for evaluating applications for mortgage-related exemptions should be streamlined and improved. To accomplish this goal, the Department of Labor should rely upon the mortgage and housing expertise that already exists at the Federal Home Loan Bank Board and at HUD.

The Commission intends to investigate more fully the potential for improving access of pension funds, insurance companies, and other sources of private capital to the mortgage market. The Commission considers it important that no artificial constraints be imposed by government at any level, or by others, that impede the free flow of funds into the mortgage market from such investment sources. These issues will receive the Commission's careful attention in the course of developing its Final Report.