

Municipal bonds in the housing market

David R. Allardice

The first large municipal bond issue to raise money for residential mortgages was offered in Chicago in July 1978. The program, a \$100 million issue to finance low and moderate-income families in the purchase of single-family homes, was successful from its inception. Under this first offering, 2,100 Chicago families received home mortgage loans at an interest rate of 7.99 percent—about 2 percentage points less than the going rate on conventional mortgages. The next March, the city issued another \$150 million of these tax-exempt obligations.

By then, 50 municipalities across the country had issued mortgage revenue bonds, pushing the total outstanding to \$1.6 billion. But as this innovation in municipal bond financing spread, objections were also raised.

- The President stipulated in his fiscal 1980 budget that the Administration would propose legislation limiting single-family housing bonds to programs intended either to finance housing for low and moderate-income families or achieve “other narrowly targeted public policy objectives.”

- The Congressional Budget Office estimated in April 1979 that state and local single-family housing bonds might reach an annual volume of \$20 billion to \$35 billion by 1984, resulting in a tax loss to the Treasury of between \$1.6 billion and \$2.1 billion a year.¹

- A bill (H.R. 3712) was introduced in Congress that would remove the federal income tax exemption for all Chicago-type housing bonds issued after April 24, 1979.

It now seems likely that further issuance of this type bond may be greatly constrained, if not prohibited altogether. A program with

wide support, private and public, has in less than a year become the object of government efforts at prohibition.

Why municipal bonds?

Municipal spending has traditionally gone for either operating expenses or capital improvements. Operating expenses of carrying on local government are financed primarily through current taxes or other income. Expenditures too large for the current budget and whose benefits will accrue to future as well as current taxpayers, are financed mostly through the sale of bonds. There are generally four types of municipal bonds:

- General obligation—bonds secured by the full faith, credit, and taxing power of the issuing authority.

- Special tax—bonds paid from the revenue of a special tax imposed specifically for that indebtedness.

- Housing authority—bonds secured by a pledge of net revenues to a state or local housing authority.²

- Revenue—bonds paid from revenues generated by facilities built with proceeds from the sale of the bonds.

From the standpoint of investors, one of the attractive features of municipal bonds is that the interest paid on them is usually exempt from federal income taxation. Because reciprocal tax immunity keeps one government from burdening another with its taxes, interest on most municipal obligations is not taxed by the federal government, just as in-

¹Congressional Budget Office, *Tax-Exempt Bonds for Single-family Housing* (Washington, Government Printing Office, April 1979).

²Designed originally for financing multifamily housing, these obligations have been used in recent years to finance programs to lower the cost of homeownership for low and moderate-income families.

terest on federal obligations is not taxed by state and local governments.

The tax-exempt status of municipal obligations is also explained partly on grounds that the funds are used for public purposes. There have been abuses, however, as it is not always clear what constitutes a public purpose.

Until 1968, interest on municipal bonds was exempt from federal income taxes, regardless of the application of the proceeds. State and local governments issued industrial development bonds, for example, to finance construction of private industrial or commercial facilities used by private interests. These bonds were popular in the 1960s. But Congress curbed their use by passing the Revenue and Expenditure Control Act of 1968, which substantially restricted the use of these obligations.

It is this very act, in fact, that gives municipalities authority to issue tax-exempt bonds under home-mortgage programs. As amended, the act gives tax-free status to municipal bonds if substantially all the proceeds are used for certain quasi-public projects. Included among the allowed projects are sports facilities, convention and trade show facilities, airports, sewage facilities, industrial parks, and *residential real property for family units*. According to the Congressional Budget Office study, the “residential real property. . .” phrase, added to the bill in conference, did not specifically exclude single-family homes. But since state housing finance agencies began to finance single-family housing with tax-exempt bonds only in 1970, it may not have occurred to the conferees that tax-exempt bonds could be used for this purpose. Nor is it certain, if they had known, what position they might have taken.

How programs work

All single-family housing bond programs have features of their own, but all work basically the same. Before issuing mortgage revenue bonds, municipalities determine

whether they have authority under state law. Only about a fourth of the states have laws that allow municipalities to issue this kind of obligation. Several, however, are considering changing their laws to allow municipalities to issue these bonds.

Of states in the Seventh Federal Reserve District, only Illinois has a legal framework that allows residential mortgage revenue bonds to be issued.³ The Illinois constitution designates municipalities with populations of more than 25,000 as home-rule units. These units can perform any function pertaining to their affairs. This includes the power to tax and incur debt. The law requires that municipal financing serve a valid public purpose, and various types of home financing have been considered valid in Illinois.

Once a municipality decides its program is permitted under state law, it must decide on the features it wants the program to have, such as income and mortgage limits, whether loans can be made on both new and existing houses, if funds can be used for rehabilitation, and if there are to be any geographic limits on loan extensions.

In evaluating the risks of these obligations, Standard and Poor’s has indicated that the highest quality mortgage portfolio will be “restricted to a large pool of geographically diversified, seasoned, high-equity mortgages on single-family detached, owner-occupied dwellings.” Lower risks tend to translate into lower borrowing costs for municipalities. And the costs of municipal borrowing must remain low relative to conventional mortgage rates if the programs are to be attractive.

When provisions of the program have been established and the bonds marketed, the proceeds are placed in the custody of a financial institution, usually a bank. Other financial institutions designated as part of the program then originate residential mortgages in compliance with the terms and provisions the municipality has established.

³Wisconsin issues substantial amounts of tax-exempt general obligation bonds to finance purchases of single-family houses for veterans.

Originating institutions allocate funds to creditworthy homebuyers, primarily on a first-come, first-served basis—which rewards the well informed. Loans are made in accordance with the usual lending standards of the institution and constraints of the program. Depending on the program, homebuyers may be required to pay an origination fee and a program participation fee. Mortgage insurance may also be passed on to the borrowers. Monthly principal and interest payments are made to the originating institution.

Originating institutions usually sell the mortgages to the custodial institution, but they continue servicing the mortgages, receiving payments, and remitting principal and interest payments to the custodial institution on prescribed dates. For this service, the originating institutions collect a service fee based on the outstanding balance.

The custodial institution, in turn, makes principal and interest payments to the

bondholders. The main risk of default lies with the bondholders. The risk to them is reduced, however, by insurance, reserve accounts, and the structuring of programs to include substantial numbers of loans to moderate or high-income borrowers. Municipalities have only limited risk exposure. They would be exposed only if a large number of mortgages were foreclosed or if the bonds were more than the community could absorb. The institutions originating the mortgages bear no risk.

Programs in Illinois . . .

By mid-1979, 15 municipalities in Illinois had issued \$524.8 million in single-family mortgage revenue bonds. Close to half of that, \$250 million, had been issued by the city of Chicago.

Bonds outstanding, excluding the

Single-family mortgage revenue bonds outstanding June 1, 1979—Illinois

Municipality	Population (thousands)	Issue bond (million dollars)	Date	Features				
				Income limit	Mortgage limit	Institutions participating	Amount ¹ loanable (million dollars)	Mortgage interest rate (percent)
Village of Addison	27	25.0	Apr '79	\$40,000	\$80,000	5	\$21.0	8.45
Belleville	44	25.0	Nov '78	40,000	80,000	8	20.8	8.52
Chicago (1st issue)	3099	100.0	Jul '78	40,000	none	1	83.0	7.99
Chicago (2nd issue)	3099	150.0	Mar '79	40,000**	none	53	132.8	8.125
Chicago Heights	40	12.0	May '79	40,000	80,000	4	9.9	8.95
Danville	42	15.42	Dec '78	30,000	none	10	12.9	8.55
Decatur	90	15.0	Jan '79	40,000	80,000	1	12.5	8.675
Evanston	77	25.0	Jan '79	50,000	100,000	8	21.0	8.25
Highland Park	32	8.0	Feb '79	40,000	85,000	3	6.7	8.45
Joliet	74	27.88	May '79	40,000	80,000	7	22.0	8.45
Pekin	32	15.0	Dec '78	40,000	50,000	1	12.6	8.55
Quincy	44	16.76	Nov '78	40,000	none	3	13.9	8.35
Rock Island	49	20.0	Nov '78	40,000	80,000	5	16.0	8.35
Springfield	87	31.0	May '79	35,000	60,000	12	26.2	8.375
Waukegan	65	23.73	May '79	25,000*	75,000	6	19.8	8.50
Wheeling	19	15.0	Jan '79	40,000	80,000	2	12.5	8.95

*Loans made in designated redevelopment area are exempt from income limitations.

**A portion of funds are earmarked for families with incomes lower than tabled.

¹Amount loanable is gross bond issue net of mortgage reserve fund, capital reserve fund, cost of insurance account, and underwriter discount.

Chicago programs, ranged from \$8 million in Highland Park to \$31 million in Springfield. Eight of the 15 municipalities were in the Chicago SMSA. Funds were loaned at an average rate of 8.47 percent, varying from 7.99 percent for Chicago's first program to 8.95 percent for the Chicago Heights and Wheeling programs.

Loanable funds (gross bond issues net of mortgage reserve funds, capital reserve funds, costs of insurance, and underwriting discounts) generated from these issues amounted to \$443.6 million. That was about 84.5 percent of the face value of the bonds. The ratio varied from 78.9 percent in the Joliet issue to 88.5 percent in Chicago's second offering.

The higher the ratio, the more of the funds that can be loaned back into the community and the lower the underwriting and other costs. Although some consider these ratios excessive, they compare favorably with average ratios at savings and loan associations. Loans outstanding at S&Ls at the end of 1978 amounted to 82.7 percent of total assets.⁴

Illinois programs, and those in other states, have often been criticized for using only a few lending institutions. Five programs used no more than three institutions for originating mortgage loans. Three of these five used only one institution.

This shortcoming was probably attributed, however, to the newness of the programs. The first Chicago program, for example, used only one mortgage originator. The second program used 53.

Although billed in most instances as intended for low or moderate-income families, the programs have income and mortgage limitations aimed more at middle-income groups. Four of the programs in place in Illinois put no limit on the size mortgage that can be acquired. The other 12 set limits between \$50,000 and \$100,000.

All put limits on the annual income allowed for participation. Twelve allow adjusted gross incomes of \$40,000. Only one

limits income to \$25,000. One program allows \$50,000.

Some of the programs, however, have set aside funds for families with lower incomes. The second Chicago program reserved 85 percent of the principal amount of the mortgage loans for borrowers with incomes of no more than \$29,500.

. . . and the outlook for them

Before the introduction of legislation to restrict the issuance of residential mortgage revenue bonds, 67 municipalities in Illinois, including all with populations of more than 25,000, were surveyed concerning their interest and intentions of issuing these obligations. Of the 15 that had already issued bonds, only one indicated it might issue additional bonds in 1979. Indications were that this obligation would amount to about \$20 million.

Ten municipalities indicated they were taking steps to issue residential mortgage revenue bonds. Together, their plans called for about \$170 million in mortgage revenue bonds. If all these obligations were marketed, the total outstanding in Illinois at year-end would be about \$715 million.⁵

Of the 67 municipalities surveyed, 37 indicated they had considered issuing these bonds and turned the idea down. The reasons varied. Some believed they could attract people to their communities even with conventional mortgage rates high, so they saw no need to subsidize mortgages. Some thought benefits of the programs accrued to new residents instead of current residents. Some thought existing neighborhood renewal programs preempted the need for such mortgages. Only a few showed any concern that the bonds would raise the municipality's cost of borrowing or that providing mortgages was not a proper function of local government.

⁵The dollar amount of bonds issued will decline by maturity, assuming no new issues. This is due partly to loan repayments and to mandatory and optional bond redemptions.

⁴*Savings and Loan Fact Book, 1979*, United States League of Savings Associations, Chicago, page 80.

Results indicate most of the communities surveyed (55 percent) had rejected the implementation of a residential mortgage revenue bond program before legislation was introduced to prohibit these bonds.

Disadvantages of the programs

There are advantages and disadvantages to a community issuing residential mortgage revenue bonds. Some of the disadvantages are the result of poorly structured or hastily developed plans. As such they are transitory and can be corrected by restructuring the form of the programs. Others, however, reflect the very nature of the programs and cannot be corrected.

One of the most frequently cited disadvantages of residential mortgage revenue bond programs is their cost to the Treasury in terms of lost revenue. This cost is sometimes called a tax expenditure.⁶

The Congressional Budget Office estimates that without restrictive legislation, new issues of state and local mortgage revenue bonds could increase to an annual rate of \$20 billion to \$35 billion by 1984. And for every billion dollars of obligations issued, the tax loss to the Treasury amounts to approximately \$22.5 million per year for the life of the bonds. (See box.) If these programs are not curbed, the annual tax loss could reach \$1.6 billion to \$2.1 billion by 1984.⁷ With the federal government trying to balance the budget, a tax expenditure of this magnitude could require offsetting cuts in federal aid to state and local governments or tax increases to offset the loss in revenue.

A somewhat related argument contends that the loss of tax revenue to the federal government is greater than the interest

⁶See R. A. Musgrave and P. B. Musgrave, *Public Finance in Theory and Practice*, McGraw-Hill, 1973, page 247.

⁷It is worth noting that the estimated tax expenditure for this program in 1984 is about a tenth of the tax-expenditure expected from tax deductions for interest on owner-occupied homes for the same year. See Joint Committee Print, *Background and Issues Regarding H.R. 3712 Relating to Tax-exempt Bonds for Housing* (Washington, Government Printing Office, 1979), page 49.

savings to state and local governments. Under these circumstances, direct subsidies would be more efficient, and more equitable. It has also been contended that the primary beneficiaries of the programs are investors in high income tax brackets, underwriters, and mortgage originating institutions. Investors

Estimating the mortgage revenue bond tax loss

The following example, taken from the Congressional Budget Office study, *Tax-exempt Bonds for Single-family Housing*, illustrates the calculation of the tax expenditure (potential revenue loss) resulting from the use of tax-exempt residential mortgage revenue bonds.

Revenue loss is partly a function of the marginal tax rate of investors. If it is assumed that investors' marginal tax rates average 30 percent and taxable investments yield 10 percent, \$1 billion transferred from a taxable to a nontaxable status results in a gross tax-loss of \$30 million a year ($\$1 \text{ billion} \times .30 \times .10$ equals \$30 million).

Adjustments can be made to reduce the gross tax loss. It can be assumed, for example, that 15 percent of the proceeds from the bonds are placed in various reserve accounts. It can be further assumed that program participants pay 2 percentage points less than conventional mortgage rates, allowing them less interest deduction from taxable income. Again, with an average 30 percent marginal tax bracket, the result is a \$5 million offset reduction in potential tax loss ($\$1 \text{ billion} \times .85 \times .02 \times .30$ equals \$5 million).

It can be assumed further that investment bankers, insurance companies, and participating lenders generate income equal to 1 percent of the mortgage pool. With a 30 percent marginal tax rate, another \$2.5 million in tax expenditures can be offset for every billion dollars of bonds issued ($\$1 \text{ billion} \times .85 \times .01 \times .30$ equals \$2.5 million).

The net effect is a tax loss of about \$22.5 million a year for every \$1 billion of bonds issued (\$30 million less \$7.5 million in offset equals \$22.5 million).

able to use the tax-exempt features of the obligations interfere with the equity of the tax system (i.e., promote a less progressive federal income tax system), and underwriters and banks earn substantial fees from the sale and servicing of the obligations.

The programs have also been seen as having the potential for raising future costs of borrowing for state and local governments. Though not easily verified, one study shows a billion-dollar increase in new mortgage revenue bonds will raise interest rates on all tax-exempt bonds by between 4 and 7 basis points.⁸ Another study shows residential mortgage revenue bond programs may have already boosted the cost of borrowing for state multiple-family housing bonds by as much as 50 basis points.⁹

Although these programs would be expected to put upward pressure on local home prices, no studies seem to have been made of the actual effects of programs on local markets. Programs already in effect have been large enough to finance a significant proportion of the single-family mortgages made in the communities every year. As a result, there should have been a tendency for them to boost housing prices.

In Chicago last year, one to four-family residential sales and mortgage originations totaled about \$3.1 billion. The city's two mortgage revenue bond programs accounted for a significant 8 percent of the mortgage originations and transfers. Nationwide, state and local single-family housing bonds issued before April 24, 1979, amounted to about 2.6 percent of gross new mortgages on single-family homes. Without constraints, it is reasonable to expect these programs to make up an even larger proportion of new home mortgages.

There are signs in the Chicago area, however, that competing programs are not developing to any great extent between the suburbs and central city. To the contrary,

more than half the Illinois communities surveyed had rejected the idea of a residential mortgage revenue bond program before legislation was introduced to control their use.

Another fundamental issue concerns municipalities making use of tax-exempt bonds to support homeownership. But it can be argued that use of public funds for housing is as justifiable as use of these funds to support such quasi-public ventures as sports facilities, industrial pollution control projects, and trade show facilities.

Advantages of the programs

One advantage of the current mortgage revenue bond programs is the additional mortgage funds they provide—especially at rates 1 to 2 percentage points below conventional mortgage interest rates.¹⁰

Demand for home mortgages has strained conventional sources of funds, partly because of the sharp rise in prices of houses and increases in the cost of living generally. Nationwide, prices of a new single-family house averaged \$62,500 last year, compared with \$35,500 as recently as 1973. And estimates are that mortgage markets will have to support another \$130 billion in debt this year.

Housing, often viewed as a social good, has an unusual position in this country. The nation's housing goal, adopted in 1949 and reaffirmed in 1968, is aimed at providing a "decent home and a suitable living environment for every American family." The government has operated subsidy programs for more than 40 years to increase the flow of real and financial resources into housing. The appropriateness of the housing goal has been questioned, as has the appropriateness of the programs used to reach it. It seems, however, that the goal will remain. Under these cir-

⁸See *Background and Issues*, page 25.

⁹Ronald Forbes, A. Frankel, and P. Fisher, *Tax-exempt Mortgage Bonds*, Council of State Housing Agencies, Washington, forthcoming.

¹⁰The Congressional Budget Office report indicates (page 43) that every \$1 billion in mortgage revenue bonds would add about \$200 million in new money to the mortgage market. The rest would be displaced money that entered the mortgage market through other forms of investment.

cumstances, home mortgage revenue bond programs can best be considered just another means (though an inadvertent one) of enhancing the flow of funds into home purchases.

These programs could be beneficial to the recipients of the funds if they could not otherwise have obtained mortgages. With home prices rising and interest rates up, many people are clearly priced out of markets for houses they want. Some of the benefits to recipients are offset, however, by increased costs to others. Costs of issuing corporate bonds may be higher, for example, as a result of having to compete with other long-term offerings in capital markets.

The programs offer considerable flexibility. Barring legislation to prevent further use of mortgage revenue bonds, every community (state law permitting) can decide for itself whether to adopt such a program, taking into account its own needs and financial circumstances.

If the local government is not in a financial condition to borrow at rates below the conventional mortgage rates, a program is not feasible. But once a community decides to undertake a mortgage revenue program, it has broad leeway. It can choose the size offering it wants to make and it can pick the features it wants for its program. It can decide, for example, to use part of the proceeds to subsidize loans to low-income families—or even all of the funds. Or it can direct the funds into economically depressed areas or geographic areas particularly short of mortgage funds.

Once a community establishes the parameters of its program and the municipality issues the bonds, practically no government resources are needed to operate the program. This is in contrast to the more traditional federal and state housing subsidy programs that have required constant administrative supervision and control.

Other government programs are often criticized as being of questionable value and, although some states have adopted sunset rules requiring the elimination of agencies that have served their purposes, once in place these agencies are hard to dismantle or even

reduce in size or scope.¹¹ Mortgage revenue bond programs, on the other hand, can be undertaken incrementally, expanding or contracting as needs dictate, and they can be discontinued without displacing government workers.

Programs can be structured to stem the flow of migration from inner cities and provide for the redevelopment of deteriorating neighborhoods. The Congressional Budget Office found, on the basis of early results, that mortgage bond programs have been successful so far in inducing people back into the inner cities. Whether such an alteration in migration trends will be enough to correct other problems besetting metropolitan areas is another question.

The enabling ordinance for Chicago's first program noted that

. . . the availability of decent, safe and sanitary housing that most people can afford is essential to the promotion of increased productivity of the residents of the municipality, to retaining existing industry and commercial activities near or within the municipality.

The ordinance also noted that the housing problems of inner cities are neither transitory nor self-curing and that existing institutions had not been able to cope with many of the housing problems. It was conceded that the objectives of state and local programs might not be in harmony with national policies. For that reason, programs needed to be tailored more to local needs.

Conclusion

Growth in the number and volume of mortgage revenue bonds since mid-1978 has provided an additional source of mortgage money at rates below conventional mortgage interest rates. And although the usefulness of mortgage revenue bond programs has

¹¹For a discussion of federal housing subsidy programs, see "Subsidized housing—costs and benefits," William R. Sayre, *Economic Perspectives*, Federal Reserve Bank of Chicago, May/June 1979, pages 3-9.

depended on features of the particular bonds and the communities issuing them, local governments have incurred no direct liability from the bonds, which are neither general nor moral obligations of the issuing municipalities. Investor safety is based on a pool of mortgages, reserve funds, and insurance.

There will continue to be a loss of revenue to the Treasury, and interest rates paid by other types of borrowers will be affected. But the bond programs have made low-cost mortgages available for some families that might not otherwise have been able to buy housing. As these funds are fungible, there is no guarantee that, once borrowed, they have not been used for other purposes, such as to the purchase of a new car or the financing of a college education. They could have gone for any number of expenditures besides housing.

No recommendation can be made either for adoption or rejection of a residential mortgage revenue bond program without knowledge of the particular bond and the issuing municipality. Past experience with legislative prohibition indicates that these changes do not always resolve the basic problem. For example, legislation passed to curtail industrial revenue bonds planted the seeds that brought forth residential mortgage revenue bond programs. Left unanswered is the basic issue concerning the economic merits of tax-exempt status for municipal bonds. Assuming that the tax-exempt status will prevail, then it would seem better to allow markets (to the extent feasible) to regulate the development or curtailment of programs similar to the residential mortgage bond program. Market regulation should tend to maximize the extent of program flexibility at the state and local level.

