The Mortgage Subsidy Bond Tax Act of 1980: A Step in the Wrong Direction

Joseph Edward Broadus
COMMENT

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JOSEPH EDWARD BROADUS*

I. INTRODUCTION

In 1940, 56.4% of all housing units in America were rented; by 1980, the share of rental units had dropped to 33%.1 In the final quarter of 1980, 53 million American households owned their own homes with 34 million of them making mortgage payments.2 Furthermore, 1.5 million new homes are expected to be constructed yearly during the 1980’s.3 As a result of this growth, the nation’s housing stock has been estimated currently to be worth $1.9 trillion, or about 37% of the value of the nation’s capital stock.4 The federal government is estimated to either guarantee or insure approximately 18% of all mortgages in any given year.5

The government’s most significant contribution to homeownership may well be in the area of tax policy where it has encouraged both home construction and ownership by a system of tax preferences.6 This policy would make the tax benefits the largest tax “expenditure” and the second largest federal “entitlement program” after social security.7

In 1980, without much fanfare, a Democratically-controlled Senate acquiesced to a House proposal and passed the Mortgage Sub-

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2. Id.
3. BARRON’S, April 27, 1981, at 27.
5. 1980 STATISTICAL ABSTRACT OF THE UNITED STATES, Table 892 at 539.
6. The tax deduction provided for interest on home mortgages, property taxes and other housing-related tax breaks has been estimated at $35.3 billion, of which $19.8 billion is for homeownership interest deductions. See Miami Herald, supra note 1.
7. BARRON’S proclaimed that the housing industry is the most pampered by Washington, but warned that the Reagan administration intended to withdraw President Carter’s proposed $4.8 billion dollar jump in Federal Housing Administration guarantees, and also proposed to lower the ceiling on the Government’s National Mortgage Association commitments from $72 billion to $64 billion. BARRON’S, supra note 3, at 9. At the same time the administration’s original budget contained a proposal to remove the tax exemption for the interest deduction on homeownership. See Miami Herald, supra note 1, at 1.
sidy Bond Tax Act. The Act, which provided for amendments to section 103 of the Internal Revenue Code, proposed "severe restrictions" on the continuation of mortgage bond programs. Nevertheless, they were hailed as necessary and as embodying moderation and equity.

Prior to the date of this change in the tax code, mortgage bonds were relatively new, with a low level of public recognition and understanding. Although their actual share of the housing market was small, their share of the municipal bond market was considerable. Furthermore, in both the mortgage and municipal bond markets their growth was immediate. Yet, given the Congressional political climate in the late 1970's to control the Treasury, the termination of this viable financial form was inevitable.

8. Despite the claimed modest goals of the amendment, the statute actually provides: "Except as otherwise provided in this section, any mortgage subsidy bond shall be treated as an obligation not described in subsection (a)(1) or (2) of section 103." I.R.C. § 103A(a).

The Act's key provisions included requirements that:
(1) the residence be reasonably expected to serve as the principal residence of the mortgagor, I.R.C. § 103A(d).
(2) Each mortgagor must not have been a homeowner within the last three years, I.R.C. § 103A(e).
(3) the purchase price of each home be limited to 90 percent of the average purchase price in the preceding year in the SMSA in which the mortgage was placed, I.R.C. § 103A(f).
(4) the mortgage be a new mortgage and none of the bond proceeds can be used to acquire or replace an existing mortgage, I.R.C. § 103A(j).
(5) The bond issues statewide must be limited to the greater of $200,000,000 or 9 percent of the average of all mortgages originated in the state in the last three years, I.R.C. § 103A(g).

The Act also had special provisions for residences in "targeted" urban areas which permitted a more generous allocation to blighted or troubled areas in an effort to encourage their revitalization. Another provision permitted tax exempt status to bonds used for rehabilitation loans under certain circumstances. Technical provisions imposed restrictions on arbitrage, and other provisions gave special consideration to bond issues to finance low-income rental units.

9. Section 103(a) provides, in pertinent part:
Gross income does not include interest on—
(1) the obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or the District of Columbia. I.R.C. § 103(a).

11. See notes 58-61 infra and accompanying text.
12. During the first quarter of the year, housing bonds were providing 5% of the mortgage money. Wall St. J., July 18, 1979, at 33, col. 1.
14. In future years, the cost to the Treasury would increase rapidly if Congress fails to act.
The ensuing battle, however, was unevenly waged. While the bonds' enemies were small, coherent groups located in media and governmental centers, the bonds' proponents and beneficiaries were diverse and disorganized. What organization that did exist was at local or state levels. The basic support for the bonds came from local governments and from professional groups such as real estate organizations. Because these groups are regulated on the local and state level and concerned with local economics they have only "shadow" national organization. Accordingly, an imbalance in the public debate was created at the national level.

The purpose of this comment is to argue that Congress was misguided in removing the exemption for housing bonds. First, it will examine municipal bond fundamentals by providing a basic overview of the notion of "subsidy" and the constitutional controversy between the states and federal government on the tax exempt status of the bonds. Second, it will explore the structure of mortgage finance and problems occasioned by inflation. Finally, it will critically examine the arguments utilized in passing section 103A. Analysis will show that the logical basis as well as the substantive proposals contained in the section are miscalculated.

II. The Nature of Municipal Bonds and the Concept of Subsidy

The term "municipal bond" generally denotes evidence of obligations of municipalities, political subdivisions, states, and the territories and possessions of the United States. The "municipality," in the generic sense, promises that it will pay the bondholders back from either taxes, fees, or profits made from a project. Inasmuch as bonds are generally issued to help pay for projects, such as a new sewer system, transportation network, hospital, road, or other

... With half the market dependent on tax exempts, government would effectively control the allocation of credit for housing. The prospect raises troubling questions about whether thrift institutions, the main source of mortgage money for homes, could survive the competition.

Id. at 87, 88.
15. See note 64, infra and accompanying text.
16. "Municipal bonds' is a generic term encompassing the bonds issued by states, territories, possessions of the United States, municipalities and political subdivisions, and by instrumentalities and agencies of the foregoing." Martori & Bliss, Taxation of Municipal Bond Interest—"Interesting Speculation" and One Step Forward, 44 Notre Dame Law. 191 (1968).
17. Id.
public service, municipal bonds permit the governmental unit the joy of spending without the pain of taxing. As a result, most state constitutions contain provisions limiting the capacity of the state or local governments to issue bonds without prior approval of the affected populace. Most states have a fixed amount of debt the legislature may incur. Beyond that limit, twenty-five states require a public referendum, and twenty-four states require either a constitutional amendment or a special majority of the legislature. Bonds, therefore, present options for either the responsible use or abuse of credit spending.

Bonds can be classified into three broad categories based upon what happens when the deal goes bad and the municipality is unable to pay. First, there are “general obligation” bonds, for which the full faith and credit and the taxing power of the governmental entity are pledged. Second, there are limited obligation bonds, known as “revenue” bonds, that pledge only the revenue from a specific project or the proceeds of a special assessment. Finally, there are “moral obligation” bonds which pretend to be revenue bonds when they are issued to avoid constitutional debt limits and requirements for voter approval, but have only a moral, not a legal, purpose.


20. Local governments borrow for three reasons, two of which are generally acceptable to bondholders and one dangerous. The first acceptable reason is to finance long-term capital investment projects—if a locality is building a school that will last for many years, it does not have to pay the entire bill in any one year but can spread the cost out over the lifetime of the school by floating a long term debt. The second acceptable reason is to smooth out seasonal fluctuations in revenues and expenditures by short term borrowing. The final reason, which generally is not acceptable either by a city’s laws or in the eyes of bondholders, is to cover a current account deficit.


21. See generally Heins, supra note 19.

22. As one commentator has amplified:

In general, revenue bonds tend to carry higher interest costs than general obligations with comparable covenants. Presumably, this relationship exists because investors normally prefer the security of an unlimited government tax guarantee to the specific pledge of special taxes, user charge revenues, or rental revenues which commonly apply to revenue bonds.

Heins, supra note 19, at 36.
obligation to pay.\textsuperscript{23}

Despite the possible risks, bondholders love municipal bonds, since the income from them is tax free.\textsuperscript{24} The federal government, on the other hand, dislikes "tax free" municipal bonds, since the government claims it loses money every time a municipality issues a bond. As a result of this "tax free" characteristic, municipal bonds are perceived by some as a "subsidy."\textsuperscript{25}

When viewed as a "subsidy," the exemption is seen as an alternative method of appropriating tax money. Instead of setting up a governmental bureaucracy to disburse tax dollars, an exemption allows the individual citizen to allocate the funds by directly spending his money on those purposes Congress deems worthwhile. Accordingly, it is argued that the government has "subsidized" the preferred activity just as if it had first collected the dollars and awarded them to the worthwhile project through the treasury.\textsuperscript{26}

There is yet another way in which the tax exemption may be thought of as a subsidy. Because the municipal bonds are tax exempt on any facial rate of interest, they provide a higher rate of return than taxable securities. Thus the tax exempt status permits the municipality to borrow money at below-market rates. This advantage is seen as a "subsidy" for the municipality issuing the bonds. The actual ratio of the advantage is variable, however, as a result of the graduated or progressive nature of the tax schedule;\textsuperscript{27} in other words, the value of the exemption to the taxpayer and the cost to the federal government varies with the income of the taxpayer in any given tax year.\textsuperscript{28} The issuing governments, however,

\textsuperscript{23} The obligation of a state to repay the bondholders on default may be subject to a moral obligating clause. This type of "make up" provision is frequently added to bond issues to make them more appealing to investors by implying that the state is obligated in the event of default. The effect of the clause is somewhat misleading because most courts find that the clause does not create any legal liability on the part of the state. Comment, supra note 10, at 485-86 (footnotes omitted).

\textsuperscript{24} See Martori & Bliss, supra note 16, at 191.

\textsuperscript{25} Although most people think of a "subsidy" as a direct payment, in recent times the term has been used to describe what happens when a taxpayer escapes paying federal taxation. See Note, supra note 18, at 243-44.

\textsuperscript{26} See Gabinet, The Municipal Bond Interest Exemption: Comments on a Running Battle, 24 Case W. Res. L. Rev. 64, 73 (1972); Martori & Bliss, supra note 16, at 213.

\textsuperscript{27} Broadly speaking there are three alternatives for tax schedules: proportional, progressive and regressive. "Progressive taxation is now regarded as one of the central ideas of modern democratic capitalism and is widely accepted as a secure policy commitment which does not require serious examination." Martori & Bliss, supra note 16, at 211-12. See generally Gabinet, supra note 26.

\textsuperscript{28} Given that the value of a tax exempt bond is dependent on an individual's taxable
must pay higher interest rates than one would expect, given the advantage they receive, because the number of high income taxpayers is limited. The resulting increase in borrowing costs, a situation termed "leakage," substantially reduces the benefit of the tax exemption to the issuing governments, while increasing the revenue losses to the federal government. Critics of this situation brand it "inefficient" because the state and local governments do not really save in borrowing costs the amounts which the federal income level, investors will select municipal bonds with a lower facial rate of return than standard commercial offerings if the after tax return on the commercial bond proves to be lower than the facial rate of the tax-free bond.

As a practical matter, it is unclear who benefits from the tax exemption because the majority of bondholders are not private individuals but financial institutions who pass the tax exemption benefits on to their customers.

The majority of municipal bonds are held by commercial banks and by fire and casualty insurance companies, both relatively competitive industries. It is likely that benefits derived from owning municipal securities are passed on to customers. Consequently, it can be assumed that an increase in the effective tax rate caused by a change in the tax-exempt status of municipals would be shifted forward to customers, who would bear the actual incidence of the tax. Since customers of banks and insurance companies include everyone from the lowest to the highest income levels, it would be difficult to conclude that any inequity results from large institutional holdings of municipal securities.

Note, supra note 18, at 248 (footnotes omitted).

Although there has been some shift in the mix of holders over the last decade, the basic pattern of large institutional holders has remained dominant; the percentage of bonds held by large institutions which spread the tax benefit over a range of brackets has remained constant at about 60%. For a discussion of the precise percentages that large institutional holders utilize municipal bonds, see id., at 238, n.37.


Mussa and Kormendi have argued that bond holders pay a higher rate of taxation than similarly situated taxpayers in their bracket, and that the bonds are more like a case of revenue osmosis, than a case of revenue "leakage." This can be understood through an analysis of the impact of inflation on long term investments. At inflation rates as modest as 4% to 6%, an effective tax rate of as high as 111% to 141% can result from holding municipal bonds.

The magnitude of this distortion is proportional to the investor's nominal tax rate and, therefore, is greatest for those in the highest tax brackets. Moreover, the distortional effect of inflation on the taxation of interest income is far greater than on income from equity assets or from wages and salaries. . . . This means that the real implicit tax rate paid by holders of municipal bonds increases as a result of inflation. This real implicit tax rate is the proportionate differential between the real yield on taxable bonds and the real yield on municipal bonds of comparable quality. This sacrifice of real yield by investors in municipal bonds accrues as a direct financial benefit to the state and local governments issuing the bonds.

M. MUSSA & R. KORMENDI, THE TAXATION OF MUNICIPAL BONDS 62 (1979). By identifying the differential in yields produced by inflation as an implicit tax, Mussa and Kormendi have attacked a critical soft spot in the subsidy argument's equity case. If this differential is an implicit tax, the bondholders may end up paying more than their fair share.
government gives up in lost revenues. In this light, the federal government is perceived as being unable to control its own budget, and thus lacking the fiscal integrity to effectively carry out its policies.\footnote{30}

These "subsidy" arguments, however, fail to account fully for what their proponents view as permission granted to the wealthy to pay in an alternative method. Furthermore, no empirical data have been offered to indicate that preference programs are less effective than regularly appropriated programs.\footnote{31}

The concept of "subsidy" can be further explored by comparing what happens when a tax preference is awarded with what happens when direct revenue sharing occurs. In revenue sharing, the federal government initially taxes, and then spends by allocating the money to the states for various purposes. In the case of a tax preference, the process of revenue sharing is streamlined. Instead of the federal government collecting and giving the money to the states, the government authorizes the states to collect it directly from the taxpayers. The government then adjusts the tax account of the citizen through the use of the exemption to show that the tax has already been paid. In the federal government's view, then, it has subsidized the state bond issue by paying a portion of the interest. This creates the problem of determining whether the taxpayer has paid the tax to the federal or state government. Since the "subsidy" notion is a federal tax policy analytical tool, it is generally assumed that the tax and allocation of funds which occurs is an incident of federal taxation. Applying the same alternate tax analysis, however, it can be seen that the state equally "taxes" the bond, since the difference between the market rate and the facial rate of the tax exempt bond could be viewed as a tax paid to the state.\footnote{32}

\footnote{30. For a description of the government's inability to control fiscal policy, see Bittker, A "Comprehensive Tax Base" as a Goal of Income Tax Reform, in \textit{Policy Readings in Individual Taxation} 84 (1980).}

\footnote{31. The general argument against preference programs relates to the so-called inefficiency of the tax collection mechanism and not to the program results. For a critical reevaluation of these claims, see M. Mussa & R. Kormendi, \textit{supra} note 29.}

\footnote{32. Analytically, this could leave a gap between the presumed rate of state taxation and the actual but exempted rate of federal taxation. In theory, this provides a measure of both presumed inefficiency and tax avoidance. See M. Mussa & R. Kormendi, \textit{supra} note 29, at 19.}
If these municipal bonds are so troublesome, why has the federal government remained in the background? The answer lies in the nature of the federal system, as there are constitutional limits on the ability of the federal government to tax the states. This doctrine, known as "reciprocal" or "intergovernmental" immunity, was reviewed by the United States Supreme Court in *Indian Motorcycle Co. v. United States*: 33

It is an established principle of our constitutional system of dual government that the instrumentalities, means and operations whereby the United States exercises its governmental powers are exempt from taxation by the States, and that the instrumentalities, means and operations whereby the States exert the governmental powers belonging to them are equally exempt from taxation by the United States. This principle is implied from the independence of the national and state governments within their respective spheres and from the provisions of the Constitution which look to the maintenance of the dual system. 34

State and local officials, accordingly, can conveniently use the doctrine of intergovernmental immunity as their prime defense

33. 283 U.S. 570 (1931).
34. *Id.* at 575.


The sixteenth amendment was passed in response to the second prong of *Pollock* which held the Revenue Act unconstitutional because it failed to apportion the income tax among the states. The amendment was to remove the apportionment requirement but not to extend the government's power to tax. In early decisions the Court held that to "tax the income from securities is to tax securities themselves," *National Life Ins. Co. v. United States*, 277 U.S. 508, 521 (1928). But by 1937 the Court began to define new limits for the application of the doctrine. The Court would permit taxation which neither precludes nor threatens unreasonably to obstruct any function essential to the continued existence of the state. But, in *National League of Cities v. Usery*, 426 U.S. 833 (1976), the Court reaffirmed the doctrine of intergovernmental immunity and used the logic of vital functions to declare unconstitutional a congressional attempt to extend federal wage and hour standards to municipalities. For an exposition on the impact of *Usery*, see Keohane, *The Mortgage Subsidy Bond Tax Act of 1979: An Unwarranted Attack on State Sovereignty*, 8 *Fordham Urb. L.J.* 483, 504 (1980).

against federal attempts to tax the bonds. Thus, if the bonds are simply beyond the reach of the federal taxing power, the exemption contained in section 103 of the tax code cannot be viewed as a "subsidy."

III. THE DEVELOPMENT OF MORTGAGE LENDING

Prior to the Great Depression, a home buyer would typically make a 50% downpayment to get a five-year mortgage with little or no amortization. The Depression, however, crumbled the free market system of banking and mortgage lending. In response to the financial collapse, the government created a federally regulated and insured system of banking with the dual goals of protecting depositors and providing liquidity of funds; at the same time, the system was designed to revitalize the housing industry and to protect homeowners from foreclosure. This governmental mechanism, which encouraged long-term fixed interest mortgages, functioned extremely well for decades, as money was plentiful for housing.

35. See generally Keohane, supra note 34.
36. But the very presence of an "exemption" in the Internal Revenue Code has prevented this question from reaching the Supreme Court. This is because the case and controversy requirement prevents the Court from answering merely theoretical questions. Congress gave the courts an opportunity to review this matter when it amended the Internal Revenue Code to preclude a tax exemption for industrial development bonds. See Note, supra note 18, at 248. But no federal court has considered Congress's constitutional right to tax the bonds; instead, the courts have merely ruled on which bonds are industrial development bonds. Nor is it likely that the courts will attempt a definitive solution, since the problem cuts to the heart of the very complex relation between the states, and between the states and the federal government.

In National League of Cities v. Usery, 426 U.S. 833 (1976) the United States Supreme Court imposed limits on the power of the federal government to regulate state or local government activity. Although the Usery argument concerned the extent of the commerce power, any consideration of the municipal issue must also consider the federal government's right to control its own fiscal affairs. See note 34 supra. In such a balancing analysis the court might well weigh the interests as equal, or it might choose to ignore the matter and permit it to be resolved by the interested parties politically.

37. The "subsidy" argument is based on the presumption that the income is initially a valid object of taxation. But if the federal government is constitutionally prohibited from taxing the income at all, it is impossible to consider any alternative methods of imposing the tax—thus the bond tax exemption cannot be considered a "subsidy." For a discussion outlining the arguments for the elimination of the municipal bond interest exemption, see Gabinet, supra note 26, at 99-100.
38. See BARRO'S, supra note 3, at 24.
40. Id. at 2.
41. The system required a plethora of restrictions on portfolios of "thrifts," the major source of mortgage money. "Thrifts," or "mutual savings banks," were originally known as
Thus, regulations replaced market forces since printed fiats, and not the invisible hand, directed the thrifts. Standard payment long-term home mortgages for assets and short-term deposits for liabilities became the financial paradigm. Because the system could only function when there was a relatively low rate of inflation, this structure functioned with remarkable efficiency until about 1965 when interest rates became unstable.

Due to the staggering impact of inflation on the traditional structure of thrift institutions, the federal housing finance structure was in serious trouble by the late 1970's. In an attempt to balance income with liabilities, the thrifts took a number of innovative, yet misguided, solutions. The most obvious was to raise the interest rates on the mortgages it issued. This permitted the thrift to offer an attractive rate of interest to investors. Unfortunately, it also drove up the cost of homeownership and priced many families out of the market. In addition, it was a very limited remedy because most of the mortgages in the portfolio were issued previously at lower rates.

Another attempt by the thrifts to solve this problem was to preclude the assumption of existing mortgages and to seek authorization to issue new forms of mortgages which afford interest rates which vary up or down over time. These reforms, however, cir-

“five cents savings banks,” a nickname reflecting their emphasis on small deposits. For an historical discussion of the banking institution, see id.

42. Id. at 3.
43. Id. at 2. The causes of inflation in our times are too complex to be dealt with in this comment. Generally, however, the author perceives inflation as a condition of too many dollars chasing too few goods. Under the conventional analysis, current inflation is traced to the “guns and butter” policy of the Johnson Administration, in which the effort of the federal government to fund the enormous expenses of the war in Viet Nam and the anti-poverty social programs at home was not backed by an appropriate level of taxation. The government borrowed money in competition with the private sector to make up the revenue shortfall. This competition triggered the inflationary spiral which has been maintained subsequent to the Johnson domestic and foreign policies by the unwillingness of government to deal with the problems of spending.

44. Savings and loans, which make 75% of the mortgage loans, reported a net loss of $890 million. For 1980, the Home Loan Bank Board estimated that 52% of the nation’s thrift institutions were operating at a loss because their portfolios of long term loans were yielding under 9% while the cost of funds was 8.94%, a return on assets of approximately 0.1% in the second half of the year. It has been reported for 1980, that one third of the savings and loans operated at a loss. See Barron’s, supra note 3, at 9.

45. “Thrift institutions have to pay higher interest rates to savers to prevent the deposit out flow from becoming a hemorrhage. The thrifts have to pass on their higher costs by raising mortgage interest rates, and at the current national average of 13 per cent, many potential home buyers find the price too high.” Newswjek, Jan. 28, 1980, at 62.

46. Tallahassee Democrat, April 19, 1981, § D, at 1, col. 3.
cumvent the fundamental purpose of the traditional mortgage system, inasmuch as the federal structure was designed to make homeownership possible to the widest number of persons and to stimulate the housing industry as a vital sector of the economy.\textsuperscript{47}

In addition to the problems posed by inflation, the thrifts were hard-pressed by new non-banking, non-regulated investment forms, such as money market funds. These funds and the growing assertiveness of certain investment firms were remolding the very environment of banking at an historic rate.\textsuperscript{48} Money market funds, which did not exist a few years ago, had assets of $118 billion by mid-1981.\textsuperscript{49} Furthermore, foreign banks had increased their assets from $24 billion to $200 billion in less than ten years.\textsuperscript{50}

It was in this era of sweeping change that the housing bonds were offered by the cities. Not only were the bonds capable of inflicting near-fatal wounds on the troubled thrifts, but they were also the creature of the hated new money institutions.\textsuperscript{51}

IV. THE EMERGENCE OF MORTGAGE REVENUE BONDS AND THE RESPONSE BY LOCAL GOVERNMENTS

Governmental involvement in the field of housing has been lengthy, sporadic, and somewhat superficial.\textsuperscript{48} Large scale efforts, starting after the Depression,\textsuperscript{58} included the creation of the mortgage finance forms and the exploitation of various tax preferences. These developments, coupled with the deductions for interest on mortgages and real estate taxes, became acute when the federal government increased income taxes to help pay for World War II; at this time, the impact of federal taxation on the average citizen became much greater.\textsuperscript{54} Since the War, tax policy has encouraged and developed decent housing.\textsuperscript{55} Again, the major tax contribution

\textsuperscript{47} See P. HENDERSHOTT & K. VALLANI, supra note 39. For a discussion of the current status of the housing industry, see Wall St. J., July 31, 1981, at 5, col. 1.

\textsuperscript{48} William C. Butcher, Chairman of the Chase Manhattan Bank, warned that America's banks were on the "perilous side of the fault line." He called the current system of regulation an "archaic structure that has abetted the declining efficiency of the United States in world markets" and he predicted that system's demise. Butcher, Upheaval in Financial Services, Wall St. J., May 15, 1981, at 34, col. 4.

\textsuperscript{49} See id.

\textsuperscript{50} See id.

\textsuperscript{51} See FORTUNE, supra note 13, at 87-88.

\textsuperscript{52} See Keohane, supra note 34, at 484-87.

\textsuperscript{53} Id. at 484.

\textsuperscript{54} Id.

\textsuperscript{55} Id.
was in the form of interest deductions for mortgages, and deductions for various state real estate taxes. Thus, homeownership was preferable to renting.

Starting in 1970, when New York adopted a program of mortgage assistance patterned after similar national programs, state and local governments issued bonds exempt under the provisions of Section 103 of the Internal Revenue Code. The mortgage bonds met little opposition at first, apparently because they were small issues; Congress even amended housing legislation to encourage use of the bonds. But in 1978, when the city of Chicago issued $100 million in housing bonds, a revolution was underway.

By the end of 1978, housing bonds were 25% of the municipal bond market. It was predicted that by the mid-1980's, 50% of the housing financed in the United States would be supported by housing bonds. Such speculation sent tremors through the thrifts. Already hard pressed by inflation and novel competition from new investment forms, the thrifts appealed to Congress to ban the bonds. The bond approach was a double threat to the thrifts, since bonds could offer higher adjusted returns to investors while at the same time offering long-term low interest rates to borrowers.

Congress's emerging concern at this time was with the continued drain on the Treasury. The prospects for the Treasury were disquieting, as a revenue loss of $470 million was projected for 1981.

56. See Miami Herald, supra note 1, § H, at 8.
57. See id. See generally A. Downs, Public Policy and the Rising Cost of Housing (1978).
58. See Keohane, supra note 34, at 486.
59. "State housing agencies have issued tax exempt bonds for single family homes for approximately ten years without much opposition from the United States Treasury." Ranspeck, Single Family Mortgage Financing, in Municipal Bonds 1980 13 (Practicing Law Institute Handbook 1980). Prior to the 1980 amendment, I.R.C. § 103(b)(4)(A) provided an exemption from the ban on industrial development bonds for bonds issued to finance "residential real property for family units." Section 103(b)(4)(A) as amended limited that exemption to projects for residential rental property if each obligation issued pursuant to the issue is in registered form and if—
   (i) 15 percent or more in the case of targeted area projects, or
   (ii) 20 percent or more in the case of any other project,
       of the units in each project are to be occupied by individuals of low or moderate income (within the meaning of section 167(k)(3)(B)).

60. Bonds of $2.2 billion were issued by the close of 1978. In the first quarter of 1979, $3.3 billion in bonds were issued as long-term tax-exempt instruments; by year's end, 28% of the long-term bonds were issued as tax-exempt by the nation's state and local governmental units. See id.
61. Fortune, supra note 13, at 87.
with the dollar amount expected to reach $11 billion by 1984.

Major conflicts over the powers of states to issue bonds have been recurrent since the passage of the federal tax code. Nine times in this century Congress has considered amendments to Section 103. Only twice have the previous efforts succeeded. These included the efforts to remove arbitrage bonds and industrial development bonds from the Section 103 exemption. These bonds were presumed to be beyond the constitutional ban on taxing governmental obligations because the state is presumed to be involved in a commercial and not governmental operation when it issues them.\textsuperscript{62}

It was in this atmosphere that the future of the thrifts was linked with Congress's concern for fiscal integrity. Legislation proposing a ban on bonds was introduced. The now oft-repeated arguments about "subsidy" and "leakage" were dusted off and drafted into service to once again obscure the true issues at stake: Whether the thrifts were at all viable under the current economic situations and whether long-term low interest financing, essential to widespread homeownership, could be provided.

Unfortunately, Congress ignored these issues. The author believes that this failure to face the problems of the thrifts was because few, if any, in national policy circles considered long-term inflation or high interest rates possible; in other words, since it would take an extended period of inflation and high interest rates to damage the structure of mortgage finance in the country, it did not appear to be a pressing contemporary problem.

Although political leaders appeared determined to speak of that happy day when interest rates and inflation would return to normal, state and local governments identified housing finance as a critical area of public concern and began to devise various methods to take advantage of the tax exemption contained in Section 103.\textsuperscript{63} Basically, state and local governments responded to the crisis with the view that the housing market is only a collection of local markets.\textsuperscript{64} As homeowners and their proxy representational groups,


\textsuperscript{63}. See N. Bethun, Housing Finance Agencies: A Comparison Between States and HUD (1976). See generally Keohane, supra note 52, at 47.

\textsuperscript{64}. The overriding fact about the housing market in this country is that there is really no such thing. Rather there are housing markets, each largely independent
such as real estate salesmen and developers, are better organized on the local level, local and state governments become responsive to the needs of their areas and capable of crafting programs quickly to meet that need. Furthermore, local governments perceived homeownership as not being effectively organized on a national level.66 Thus, the local officials felt that they had a greater awareness of the problems.

V. Section 103A: Its Misguided Underpinnings

The initial task of Congress in passing the Mortgage Subsidy Bond Tax Act of 1980, which limits mortgage subsidy bonds to 9% of the average volume of mortgages in a state for the prior 3 years, or $200 million,67 was to define which bonds would be banned and which would not. Congress answered that “any mortgage subsidy bond shall be treated as an obligation not described in subsection (a)(1) or (2) of section 103.”68 The new Section 103A, then, imposes requirements for bonds which will be exempt from the ban. The first requirements, which are somewhat neutral and very similar to those contained in the typical local bond program, include the requirement that the mortgage be on the principal residence of the mortgagor and within the jurisdiction that issues the bonds.69 Other requirements, however, are innovative and designed to either limit the growth of bonds per se, limit their competition with the thrifts, or define the groups Congress hopes to benefit from the bonds.70

The Act provides a three-year requirement which prohibits the

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of others in different localities. Within each housing market there are various sub-markets, many of which are also nearly independent of one another, in the sense that a prospective buyer in one submarket would not consider a dwelling in other submarkets. Thus one market might be based on structure (single-family vs. apartment or row houses), another on tenure (owner-occupancy vs. rental), still another on the value or rental rates (low income, middle-income, or high-income), and finally one on locational criteria (type of neighborhood being sought).

H. Wolman, Politics of Federal Housing 22-23 (1971).

65. Dahl may be correct in asserting that America is a pluralistic democracy in which “there is a high probability that an active and legitimate group in the population can make itself heard effectively at some crucial state in the process of decision.” But, this assumes that the group is organized and active, and in the case of homeowners this has not been true because of the general failure to recognize the potential impact of national policy. See R. Dahl, A Preface to Democratic Theory 145 (1956).

66. I.R.C. § 103A.
67. Id.
68. Id.
69. See id.
use of bond funds to aid anyone who has owned a home in the past three years.\(^{70}\) Although the provision is intended to aid first time home owners, it also prohibits the rollover of high interest loans,\(^{71}\) which limits the versatility of bonds in helping families to relocate to new areas. Many families could not afford their current homes if they were forced to relocate and finance homes in new areas at the prevailing rate. Inflation has so deflated their prospects that even with high equity and a large downpayment many families would be unable to relocate and continue with homeownership. This creates a situation where bonds cannot be used to help attract middle-level managers and technicians to a community by providing an adequate supply of housing at a reasonable cost.

This provision, however, does not apply to “targeted” areas.\(^{72}\) Thus the exemption may lead to a physical regeneration of some inner city areas; but it may also contribute greatly to the process known as gentrification, the return of the middle class to the urban core. The problem with gentrification is that it encourages higher income people to compete with lower income people for the available low income housing stock. While this results in the physical restoration of the area, its cost is the conversion of modestly priced home rentals into the comfortable living quarters of the middle class. This in turn promotes overcrowding and subsequent degeneration of adjacent urban areas. The provisions of the bond subsidy tax act serve as a blueprint for gentrification. This becomes more disturbing because other provisions make gentrification even more attractive. Once the “targeted” area home is purchased, mortgage bond money can be used to make both home improvement and rehabilitation loans. This combination amounts to a “subsidy” for the process of destroying lower income homes in the city. They may be physically restored, but socioeconomically this measure could devastate the available housing stock for modest income families. Since the median home in America costs about $62,500, with the average about $56,000, it is unlikely that this measure will prevent many middle class families from participating in the program.\(^{73}\) Only families solidly in that category can afford

\(^{70}\) Id.
\(^{71}\) Id. at (j)(2).
\(^{72}\) I.R.C. § 103A(e)(2)(A).
\(^{73}\) The legislative history of Section 103A clearly demonstrates that the drafters’ intention was to preclude just such a situation from occurring.

(1) Limitations targeting subsidy to individuals and areas of greatest need

The Committee believes that the individuals who have the greatest need for the
homes at 15% to 17% interest rates.74

In any event, Congress provided three reasons for removing the exemption for housing bonds.76 First, there was a primal urge to protect the treasury. Federal officials saw the bonds as raids on the federal treasury, while congressional critics tended to view them as unauthorized and uncontrolled appropriations.78 Second, there were the equity objections to the bonds, in that they helped the wrong people.77 The theme basically is a variation on the notion of welfare for the rich. Third, there were objections to mortgage revenue bonds on the basis that they are inefficient. As Smith has charged: "[S]ome 15 percent of each issue goes to pay underwriters', lawyers', and other fees and to provide a financial reserve."78

This reasoning ignores several factors. First, the equity objection is invalid, inasmuch as some higher income buyers must be in the pool of mortgagors in order to insure that the bonds are financially sound. Furthermore, many persons of modest means have been forced into higher income brackets by inflation alone and not an increase in actual wealth. Finally, the equity objection does not

subsidy are those of low or moderate income who have difficulty obtaining mortgage money and who are purchasing their first home. In addition, the Committee believes that it is appropriate to assist certain areas of chronic economic distress. Accordingly, Title IX contains a number of requirements to target the subsidy towards this group of individuals and certain distressed areas.


74. Lower cost housing might be available through town houses or condo-style projects. But this could result in a wave of condo conversion subsidized by mortgage bonds.

75. Representative Ullman in his attack on the bonds' tax exempt status accused them of subverting the goals of national housing policy. Cf. 42 U.S.C. § 1441(a) (1976). (Since the passage of the National Housing Act of 1949, the nation had adopted the goal of a "decent home, and a suitable living environment for every American family.")

In his arguments against the tax exempt status of housing bonds, Representative Ullman asserted: "The primary goal of Federal housing policy has been to provide shelter for low income families." 125 Cong. Rec. H 2349 (daily ed. April 25, 1979). This is somewhat at odds, however, with the functioning of that program which resulted in the construction of 26 million housing units, of which only 6 million were earmarked for low or moderate income families. See Keohane, supra note 34, at 45.

The Ways and Means Chairman also argued that federal revenue loss occurred. Finally, he argued that the programs were a misallocation of "federal" resources, as he apparently viewed the tax exempt bonds as diverting "federal dollars" without the benefits of the appropriations process or federal management. "[I]t amounts to a subsidized housing program with no exercise of any judgment or restraint over the use of the funds by either the administration or Congress." 125 Cong. Rec. H 2349 (daily ed. April 25, 1979).

76. See Fortune, supra note 13, at 86-87.

77. Typical of programs under attack was the mortgage bond program in Chicago which permitted maximum incomes of $40,000 a year. See Comment, supra note 10, at 495-96 n.129.

78. See Fortune, supra note 13, at 88.
properly view homeownership as an investment strategy. So-called semi-luxurious homes often are merely those which appreciate faster and permit families to protect their investment; besides, many of the high income homes are merely modest structures greatly driven up in price by inflation. Second, the inefficiency objection ignores the nature of capital reserves as the single largest expense associated with the issuance of bonds. State law requires that a certain percentage of the bond sale proceeds be held in "reserve." Instead of being expended on the program, these funds are retained as protection against contingencies. These requirements help induce bondholders to buy, and provide a measure of safety to the bond issuer. Without the reserve feature, it might be necessary to pay higher rates of interest to induce bondholders to accept the risk implicit in revenue bonds. Thus, this "safety net" feature of bonds is not inefficient or wasteful, but a prudential expense.\(^7\)

Third, the reasoning overlooks the goal of mortgage bonds as providing for mortgages whose interest is lower than regular commercial sources.\(^8\)

As a result of the faulty reasoning employed in passing Section 103A, Congress's efforts against the bonds have not saved the thrifts. Instead, Congress intervened with precisely the wrong response at a pivotal moment. During the eighteen-month period that Congress debated the bond tax reform, the very uncertainty of the reform exercised a death hold on bond activity.\(^6\) It did not aid the thrifts, because their problems related to the swiftness of a revolution in the money and banking area and not to municipalities issuing bonds. It is the established pattern of short-term obligations and long-term low interest assets which is the core of the problem. This structure cannot perform in a highly inflationary era. Under the traditional model, in times of high inflation, the cost of new money will always exceed the rate of established income from the portfolio. Thus only by radically changing the nature of the mortgage, or abandoning this area altogether can thrifts survive long-term inflation.\(^8\)

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79. "Although the investor carries the risk of default, the actual risk is minimal. The pool of mortgage loans and a reserve account provide adequate security for the issue." Comment, supra note 10, at 492.

80. See Bethun, supra note 63.

81. See Fortune, supra note 13, at 87.

82. In March, 1981, alone, 114 S & L's were placed on the Federal Savings and Loan Insurance Corporation's problem list—this brought the total to 246, an increase of 86%. The Wall Street Journal reported, "The agency concedes that 120 may be left with little or no net worth by year-end and that another 100 could be in the same fix by 1982." Wall St.
Therefore, the problem was structural and not occasional. Proposed remedies to the troubled situation of the thrifts included authorization for United States Treasury loans up to $3 billion as opposed to a current level of $750 million. In addition, another proposed remedy for bailing out the locals was by selling off market entry rights to large banking corporations in major market centers. The regulators were even willing to consider major changes in the system including steps which could lead to a national banking system.

Furthermore, taking away the exemption is not apt to prevent either a revenue loss to the Treasury or distortion in the proportionality of the tax base, inasmuch as high bracket tax payers will most likely merely transfer their investments to other tax shelters. In the absence of a bond tax exemption for mortgages, the overall revenue lost will still be determined by the tax avoidance policy of high bracket tax payers, who will merely switch their investments to the shelter of other tax code provisions.

The drive against the mortgage bond tax exemption also failed to consider the economic alternative to the long-term low interest bond financing presented by the mortgage bonds. The alternative has proven to be a highly volatile market of ever escalating interest rates for mortgages. Since the introduction of the Mortgage Bond Tax Act in 1979, mortgage interest rates have increased by almost 50%, from 12 or 13% to about 18%. Every dime of that increase is tax deductible. Even more disturbing is that much of that new interest debt is under new mortgage forms which vary over time. Thus, the Treasury has exchanged the predictability of an established rate of debt for long periods for unpredictable losses tied to economic indicators. In an era of ever increasing inflation, this means the Treasury has exchanged a stated low level of loss (the low facial rate of the bonds), for an ever increasing high level of loss (the ever escalating variable interest on mortgages and escalating rates on certificates of deposit).

The Bond Tax reform has also created, on a practical level, two tax exemptions where there was once one, and thus doubled the likelihood of loss to the Treasury. While the high income tax payer

J., May 21, 1981, at 1, col. 6. Meanwhile, the Home Loan Bank Board chairman warned Congress that, "We are at a point . . . where truly significant increments of assistance must come from Congress." Id.

83. See Wall St. J., supra note 81.
84. See id.
85. See id.
will continue to shelter his income by shifting it to other shelter provisions, lower bracket taxpayers will find themselves faced with the burden of high interest rates, a burden at least partially lightened by the mortgage interest exemption. Thus, the government has merely imposed the burden of high interest rates on lower income taxpayers, while suffering a loss by definition greater than that of the bond interest deduction. This occurs because the new debt has variable interest which will increase over time, causing greater Treasury losses. Further, it cannot be assumed that interest rates will go down, as banks would not issue variable interest mortgages if they expected interest rates to decline.

Through the logic of an alternate tax, the Mortgage Tax Act can be seen as a shifting of the incident of taxation from high income taxpayers (thrifts) to lower bracket homeowners, since the ultimate beneficiaries of mortgage bonds are not just the cities but the mortgagors as well. Accordingly, a new implied federal tax burden imposed through high interest rates is placed on lower bracket taxpayers. This violates the cardinal rules of tax equity, and distorts the proportionality of the tax base.

An apparent casualty of the financial disarray was the long-term fixed interest mortgage, which, for almost half a century, had been the stable backbone of the American system of home finance. With these rapid changes come prospects which could shock the roots of the American economic order if not properly diverted. Despite a drop in the prices in the housing market, over which the Federal officials were overjoyed, this contribution to fighting inflation is mostly illusory in impact. One of the reasons that the selling price was increasing at a rate slower than the Consumer Price Index was that the housing component is a crucial factor in the Consumer Price Index. In addition, it was the Fed’s high interest rates which were both pricing families out of the market and driving up the monthly cost of owning a home. Thus, this situation represented a loss and not a gain to the consumer.

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86. By April, 1981, BARRON’s was reporting a near glacial change in the structure of America’s housing market. See BARRON's, supra note 3. The report concluded that “[r]eports of the death of the long-term, fixed-rate mortgage may be exaggerated, but because of raging inflation and attendant uncertainties, no institution can afford to write them.” Id. at 25.

87. The Consumer Price Index, somewhat more realistically than the Fed, does not look to selling price but to the monthly expenditure for mortgage payments and other similar costs to determine the cost of living.
VI. Conclusion

A central concern of legislation should be a system which provides for homeownership. In the face of a financial crisis caused by skyrocketing inflation, the federal government has failed to articulate a clear and forcible policy that will secure the dream of homeownership for millions. Instead, it has given in to requests which have only aggravated the situation and delayed any organized consideration for reform of the housing finance structure. Despite the federal government’s shortsightedness, the states and localities were responding well to the needs of the people; their efforts, however, were aborted by the Congressional action on the Bond Tax Act. Because the situation has continued to deteriorate, reconsideration is inevitable. At that time, the central issue of discussion should be how to restore long-term, relatively low interest financing, within the framework of a federal system which encourages mass homeownership.