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ECONOMIC PERSPECTIVES

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The economy and the banking system*

Banking, as we all know, is inextricably linked with conditions in the economy. How can the strength of banking be maintained in the face of the tremendous economic problems that appear to confront us?

The answer, I think, is becoming increasingly clear. I am convinced that the longer-term success of the economy and of banking in our free world is dependent upon a revitalization of the free marketplace.

Solutions to general economic problems—whether energy, inflation, or recession—cannot be based on short-term myopia or short-circuiting of the free market. Time and time again we have seen short-sighted, stop-gap measures fail, only to witness the reemergence of the same problems with greater intensity a short time later. We are in danger of being drugged.

Whether the current economic problems create major and lasting disturbances to our economy, or simply require modest adjustments, depends on the nature of our response. If, for example, we react to our current inflation problem by adopting drastic policies designed to cure inflation within the next year, we will surely compound our difficulties in the long run. The problem is best attacked by policies of moderation, pursued with unremitting determination, over a period of years.

Similarly, in the case of our oil problem, if we attempt through the construction of a vast set of rules and regulations to ensure equity in distributing the burden of the reduced supply of oil and soften its impact on favored sectors—as the United States is trying so hard to do—we will inevitably suffer far more in the final analysis than if we simply let the market do what it does best—allocate resources where and to whom they yield the greatest return. As an economic consultant was recently quoted in the *Wall Street Journal,* "There aren't any lines of people waiting to buy lobsters."

I believe that the very essence of our economy and our society are in the balance today as we stand poised before the two alternative paths of further government regulation and deregulation. As directors for highly regulated institutions, you must share that sense of concern.

I obviously cannot cover the whole regulatory maze in our society this evening. But let me touch on a few aspects of banking regulation that illustrate the nature of the regulatory problem confronting us.

At the outset, I should make it clear that I do not oppose *all* regulation. That would be a misguided position. Indeed, where the costs arising from any activity are borne by a third party rather than by those engaged in that activity and are very large, and the costs, measured by the administrative difficulty and effectiveness of a regulatory solution are very small, regulation is clearly in order. I would only argue that such situations are not clearly as common as is generally believed.

The contrast between my position on regulation and that of many others may be illustrated by an example taken from a recent conference on regulation jointly sponsored by the National Journal and the American Enterprise Institute. A consumer advocate attacked cost-benefit analysis as a fraud, shot through with technical and methodological errors. An honest person must agree that current approaches to measuring costs and

*Excerpt from a speech made by Mr. Robert P. Mayo, President, Federal Reserve Bank of Chicago, to the Thirty-Sixth Assembly for Bank Directors, Harbour Castle, Toronto, Canda, June 7, 1979.

benefits of public policies are deficient. They are, however, usually the best that are available and are constantly being improved. Be that as it may, my objection to such a remark is not with its appraisal of cost-benefit analysis, but with its conclusions for regulatory policy—which would put the burden of proof on those who oppose a particular extension of federal regulation. This, to my mind, is an example of the conquest of reason by ideology; I would not even consider accepting the nuisance of regulation absent a clear showing that its benefits outweighed its costs by a considerable margin. I think you will be easily convinced that some regulations in banking would not meet this test. Moreover, it seems to me that many of the regulations currently in place in banking are inappropriate for the purposes they are designed to achieve. Many are, in fact, in direct conflict with one another.

There is a fundamental question as to whether or not the banking industry is one in which regulation is likely to offer great public benefits. The answer is by no means as clear-cut as has often been assumed. To be sure, if one looks at the experience of the 19th century, with its recurring business depressions, liquidity crises, and waves of bank failures—which not only wiped out the savings of many depositors but temporarily crippled the payments system—one might conclude that strict regulation of banks was absolutely essential. For many, the ultimate proof of the need for detailed regulation of banking was given by the Depression of the 1930s, when some 9,000 banks closed their doors.

Yet, a more critical appraisal calls into question the usual interpretation of the evidence available about American banking history. For one thing, it has never been satisfactorily answered how much of the distress of the banking system in the 1930s was due to bad banking practice and excessive competition, and how much was due to preventable errors in macroeconomic policy, including the monetary policy pursued by the Federal Reserve. More recent studies of those years have tended to place much more weight on the latter, and correspondingly less on the former, than did students of banking in 1933. Much more important, the primary external cost related to banking that might be cured by regulation—the fact that even well-managed banks often used to fail when a general distrust of banking led depositors to try to withdraw their funds—was, for all practical purposes, eliminated by the introduction of federal deposit insurance. Indeed, it might be argued that the primary justification for regulation of banks today is that the FDIC's insurance assessments are a flat percentage of total deposits rather than assessments based on the relative riskiness of bank portfolios. This subsidizes risk-taking. It makes it necessary to impose constraints on bank behavior.

Perhaps more than anything else, the conventional wisdom has held that it was excessive competition for deposits and the consequent "reaching for yield" in the form of riskier loans and investments that brought about the debacle of the 1930s. As a consequence, the most important restrictions placed on bank activity by the Banking Acts of 1933 and 1935 involve restrictions on entry into banking and on the payment of interest on deposits. During the subsequent 30 years, the effect of new entry restrictions was to reduce new capital investment in banking by an estimated 50 percent below what it would have otherwise been. Meanwhile, the interest ceiling restrictions, becoming inoperative when market rates fell far below the ceilings in the mid-1930s, had little effect. Beginning in the early 1960s, however, interest rate constraints pinched banks more and more as the economy and loan demand expanded and bankers' memories of the Depression faded.

Unfortunately, just as more and more bankers and regulators were becoming convinced that deposit rate ceilings were not necessary for the maintenance of bank solvency, the credit stringency of 1966 brought a new rationale for their existence—the protection of thrift institutions and the residential mortgage market from the ravages of disintermediation. That the use of interest rate ceilings for such a purpose must eventually prove futile has only recently come to be widely recognized.

Concern for maintaining competition in banking, rather than simply solvency, was reawakened in the early 1950s by a wave of bank mergers that threatened increased concentration in local banking markets. This concern, after several attempts to adopt new legislation in the early 1950s, produced the Bank Holding Company Act of 1956 and the Bank Merger Act of 1960. It also resulted in several antitrust suits attacking collusive price fixing by local bank clearing houses. The same concern over the lack of aggressive competition in banking led the Comptroller of the Currency in the early 1960s to ease restrictions on entry and authorize banks to enter a number of new activities.

Thus it was that, by the early 1960s, a distinct inconsistency had developed in bank regulations. On one side, regulation had the expressed purpose of restricting bank competition and risk-taking. Yet other laws and administrative rulings had the clear purpose of enhancing competition in banking. For example, freer entry and legal sanctions against merger or collusion to hold down interest rates on depositors' funds was intended to encourage banks to compete for funds. At the same time, Regulation Q ceilings on deposit rates either prevent such competition from occurring or force it to take other, nonprice forms. This inconsistency of purpose is what I would characterize as the schizophrenia of current bank regulation.

Of course, inconsistency is one thing; simple wrongheadedness is something else. And it is under the heading of the latter that I would like to discuss the phenomenon of interest rate ceilings. Let us accept for the moment the conventional wisdom that banks need to be protected from excessive competition. It is, nonetheless, true that deposit interest rate ceilings, including the zero ceiling on demand deposits, have been the most costly and ineffectual interferences with the free marketplace in the financial arena ever devised by man. They are costly because competition has forced banks to resort to ever more circuitous and ingenious, but highly inefficient, means of circumventing the regulations in order to stay in business. They are ineffectual both because the banks have kept a few steps ahead of the regulators most of the time and because other, less heavily regulated institutions have found ways to invade markets that formerly had been the exclusive preserve of commercial banks.

The net consequence of deposit interest rate ceilings through the years has been that the high costs the ceilings were designed to protect the banks from are still paid, but in a different form. Depositors have been deprived of the option of taking their interest in cash but are in effect forced, instead, to accept stuffed lions or kangaroos or a clock or a rose bush. Banks have lost position in the competitive financial markets. One of the few areas where the ceilings have been relatively effective is on small passbook deposits whose owners have few investment alternatives. There we witness the spectacle of the federal government enforcing a negative real rate of return on the savings to maintain the profits of banks and thrift institutions. This is not a radical's perception of how the system works; it is a simply factual description of the effects of deposit rate regulation. It is this aspect of the ceilings that led the late Professor Ross Robertson of Indiana University to characterize Regulation Q as "wicked."

It would take more time than I have at my disposal to catalog the many and varied direct and indirect social costs of deposit interest rate ceilings through the years. Many of the most renowned financial "innovations" during the past two decades—the development of the negotiable CD market, Eurodollar borrowing by U.S. banks, the sale of loan participation notes, the sale of commercial paper by bank holding companies, the nonbank repurchase agreement market, the advent of NOW accounts, money market mutual funds, telephone transfers from savings accounts, and, most recently, automatic transfer accounts—are all costly and cumbersome means of getting around the law's proscription of the payment of market interest rates on deposits. What any first-year economics student is taught to recognize as an economic absurdity has been codified for more than four decades as the law of the land.

The ramifications of the regulation of interest rates on deposits extend well beyond their costs to banks and bank depositors. One of these, which has come into the limelight recently, is what the ceiling has done to the informational content of the traditional monetary aggregates the Federal Reserve must rely on in formulating monetary policy. The ceilings encourage the long-term growth of money substitutes. This, in turn, tends to produce a long-term upward trend of income velocity based on any narrow definition of money (with pronounced discontinuities marking the advent of major innovations in the financial system). The ceilings also result in a confusing cyclical pattern in the relative growth rates of narrow and broad definitions of money. At the present time, for example, we are seeing a rapid growth of nonbank repurchase agreements, some portion of which functions as demand deposits during most of the day before being taken off the bank's books at the close of business, thus making it more difficult to interpret even the basic thrust of monetary policy.

One may argue with some cogency that the most recent trends in regulation are in a generally sensible direction, toward the elimination of arbitrary price controls in banking. Certainly, the advent of NOW accounts and ATS accounts has moved us a long way toward the simple payment of interest on demand deposits. And the authorization a year ago of the issue of money market certificates tied to the Treasury bill rate has cushioned financial institutions against ceiling-induced disintermediation on the scale that occurred in 1965 and 1969. Moreover, the recent testimony of Governor Partee before a House Banking Subcommittee makes it clear that the Federal Reserve now endorses in principle the payment of interest on demand deposits, desiring only that any such move be tied to a resolution of our Federal Reserve membership problem.

However, at the very time that sanity appears to be emerging on one regulatory front, a disturbing new trend is making its appearance on another front. I am referring to the increasing tendency to regard the regulation of financial institutions as an appropriate means for effectuating broad social goals and the increased willingness to substitute official views of what is desirable for the judgments of the free marketplace.

This trend has it roots in the consumer movement of the late 1960s and 1970s. It has, however, moved far beyond Senator Paul Douglas' Truth in Lending law and its reasonable demand that bankers state, in as uniform, simple, and accurate a fashion as possible, what rate of interest they are charging for various forms of credit. We might speculate that if Senator Douglas were alive today, he would be appalled at how complex and difficult to understand the regulations designed to implement this seemingly simple goal have become. Examples of what I have in mind here are the Fair Credit Reporting Act of 1970, the Fair Credit Billing Act of 1971, and the Equal Credit Opportunity Act of 1974, the Consumer Leasing Act of 1976, the Real Estate Settlement Procedures Act of 1974, the Home Mortgage Disclosure Act of 1976, the Community Reinvestment Act of 1977, and the Financial Institutions Regulatory and Interest Rate Control Act of 1978. These pieces of legislation have laudable purposes. They hopefully ensure that people's credit records are properly reported, that they are billed accurately on their revolving charge accounts and have adequate opportunity to make their complaints heard, that lessees have the terms of leasing contracts fully and accurately disclosed, that homebuyers are advised well in advance of the closing date of all charges related to the extension of credit on home mortgages, and that financial institutions actively serve the credit needs of the communities in which they are located.

On paper, these laws remedy many of the complaints consumers have made about the credit granting process over the past decade or so. In practice, however, it is often difficult to determine whether a particular financial institution is in compliance. It is even more difficult to ensure that the laws will be observed in the future. The process of trying to do so involves enormous costs in terms of reporting, disclosure, surveillance, and litigation. What has not been established with any degree of certainty is whether the benefits actually realized from the laws justify the costs of the regulatory apparatus designed to ensure compliance with the laws. Some recent research suggests that the costs of compliance with the Equal Credit Opportunity Act—estimated at $293 million—exceed any plausible estimate of benefits. Indeed, some of the more careful research done in recent years fails to find evidence of either systematic discrimination in lending on the basis of sex or of the commonly charged offense of redlining, the systematic denial of credit to borrowers in certain areas of cities without regard to the actual lending risks involved.

This is not to deny that these types of discrimination may, in fact, occur in isolated instances. Of course, there is evidence of systematic discrimination in lending in some cases. But it suggests to me that consumers may be better served, in the overwhelming majority of cases, by relying on freer entry and more intense competition to ensure fair treatment—not on forced compliance with an extensive regulatory apparatus. It is especially distressing that these laws were adopted in the absence of any credible estimates of the magnitude of the alleged problems they were designed to deal with or even the most remote notion of the costs of implementing them.

But, let us assume for purposes of argument that there have been some pervasive and well-documented abuses in the granting of credit that need to be remedied and that this can only be done by regulation. Nevertheless, there are serious grounds for objecting to several provisions of the laws enacted in recent years. For they go beyond ensuring that the consumer is fairly treated and knows what he is paying. They go beyond what his obligations are. They arbitrarily dictate the substantive provisions of credit contracts and direct the allocation of credit toward areas or purposes deemed worthy by one or another special interest group or federal agency. Many examples can be cited: High on the list are limitations on the amounts a lender can require for tax and insurance escrow payments under the Real Estate Settlement Procedures Act, the current prohibition of variable rate mortgages to federally chartered savings and loan associations, the federal limitation of cardholder losses from unauthorized use of lost or stolen credit cards to $50, and the requirement under the Community Reinvestment Act that the geographic distribution of a bank's loans be considered in judging its application for a new branch. And it is not ony Uncle Sam who is so zealous. State usury ceilings, and the increasingly restrictive state limitations on such creditors' remedies as wage garnishment, wage assignments, deficiency judgments, and "holder-in-due-course" clauses, all inhibit sound financial dealings.

The least of the undesirable consequences of the restrictions on creditor remedies is to raise the cost of credit to all borrowers and require good credit risks to subsidize the credit extended to poor credit risks. And in conjunction with the liberalization of the personal bankruptcy laws, these restrictions have had the very damaging social effect of undermining the belief, to which most of us have subscribed all our lives, that the repayment of freely contracted debt is a serious moral obligation. The extent to which the recent swing of the pendulum away from the rights of creditors in favor of debtors has altered traditional views of borrowers' responsibilities was documented in a recent article in the Chicago Tribune's Sunday magazine entitled "Bankruptcy and the new state of grace." In it, a Chicago lawyer—who obviously asked to remain anonymous—is quoted as saying:

> People have been brainwashed that it's wrong not to pay their debts no matter what. I want everybody to know that you don't have to. That it's *right* not to pay when they can't. I want everybody to know they have a legal and moral right *not* to pay. And the U.S. Supreme Court in 1973 backed that up.

It would be hard to imagine a more clearcut indication of decline in the moral fiber of our society, or one with more ominous undertones for the continued efficient functioning of a credit-based economy.

Other new laws and regulations attempt to achieve by indirection, goals whose costs the electorate apparently refuses to bear through direct taxation. For example, the Community Reinvestment Act's emphasis on local lending essentially requires the banks' depositors and shareholders to subsidize what is deemed a worthy social goal—i.e., lending in declining areas of cities that pose above-average lending risks. Generally, one would think that the pursuit of such goals, if deemed worthy by the electorate, should be funded by a broadly based tax such as the federal income tax. But the indirect tax approach of forcing financial institutions to invest in ways that are not in their stockholders' interest may be favored simply because the proponents of such measures do not feel that they could get a straightforward, visible subsidy enacted into law. In any case, I think this whole approach of subsidization through what amounts to credit allocation—an approach long confined to policies designed to stimulate residential construction—should come under closer scrutiny.

In the long run, of course, most of the laws and regulations that I have described become superfluous anyway, as ways are found to circumvent them and new institutions are developed to carry on the activities prohibited to existing ones. In the meantime, we suffer higher costs, an inefficient allocation of resources, and all the frustrations and limitations on freedom that accompany any arbitrary and rigid constraints on the market mechanism.

Why the same tired measures continue to be tried, year after year and decade after decade, is something of a mystery. But it is not totally inexplicable. The fact is that many people distrust the free marketplace because they do not understand it. Their basic economic education has been totally neglected. They fail to recognize that our system reflects the interactions of total wants of the entire populace (weighted, to be sure, by purchasing power), as embodied in total demands, with the inescapable fact of limited means, as embodied in supply conditions. They naively believe that the marketplace is likely to yield results that contradict what the populace actually desires. They are led to believe that profits are bad and that anything big is bad. The propensity to regulate also stems from a myopic view of its effects—a view that fails to take into account its side effects and longer-term ramifications. This accounts for the "patchwork quilt" nature of the existing body of regulations, most of which were adopted as short-term, ad hoc responses to immediately perceived needs.

What I would like to leave you with is a considerably greater skepticism toward the frequently made promise of great benefits and minimal costs for someone's pet regulatory scheme. I believe that few such claims can stand up under the glaring light of close analysis. Even fewer can stand up under the longer-term pressures of the free marketplace—and our economic freedoms are at the very heart of our democratic institutions and our personal freedoms. Let us never forget this simple and fundamental truth.

Fuel crisis hits business

George W. Cloos

The economy reeled this summer from the impact of a series of adversities. The most important was the shortage of motor fuel resulting from the disruption of oil supplies from Iran. Others included truck strikes, the airline strike, labor pacts that exceeded Administration guides, soaring interest rates, further price inflation, and still lingering effects of the severe winter. Together, these blows brought an end to a four-year upswing, an expansion already creaky with age by historical standards. Belated recognition of the fact that oil shortages are likely to recur is having a profound effect on patterns of consumer spending, business investment, and real estate development. Rethinking of broad strategies means delays in decision-making and a more sluggish economy.

Real activity declined in the second quarter after a miniscule gain in the first. Inflation was running at an annual rate of 10 percent. Many analysts expect the decline in output and the rapid rise in prices to continue through the year. Surveys of both consumer and executive opinion indicated a pessimism perhaps unmatched since the Great Depression. Cautious spending policies could accelerate the downturn.

Despite the gloom, total activity remained well above the year-ago level, with important sectors remaining vigorous—some excessively so. Motor vehicle sales were hard hit in total, but demand continued strong for popular small cars and heavy trucks. Housing was weak, but nonresidential construction boomed. Tourism was down in many areas, but airline traffic continued to set records. Sales and output of producer goods continued to rise, especially machine tools and transportation equipment. Agriculture was prosperous with higher grain prices and good crops boosting income.

Consumer spending falters

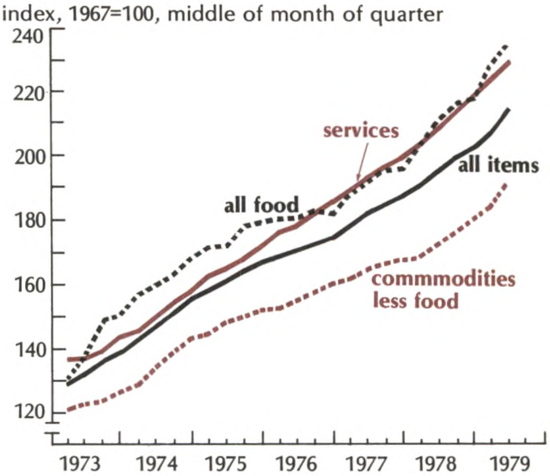
Consumers led the expansion in 1975 and 1976. With brief letdowns or plateaus, they continued spending at high rates through 1978. Even the first quarter of 1979 showed a 13 percent rise in retail sales from the depressed first quarter of 1978. Savings rates were lower than in past years and instalment credit was used freely.

Consumer spending in current dollars was slightly lower in the second quarter than in the first quarter—an extremely rare development. Adjusted for inflation, consumer spending was down significantly. Retail sales were only 8.5 percent higher than a year earlier, while after-tax income was up over 11 percent.

The cutback in consumer purchases has been heavily concentrated in vehicles that get low gasoline mileage. Sales of motor homes mounted on truck chasses have been poor all year. Light trucks favored by consumers, es-

The rise in consumer prices has accelerated

index, 1967=100, middle of month of quarter

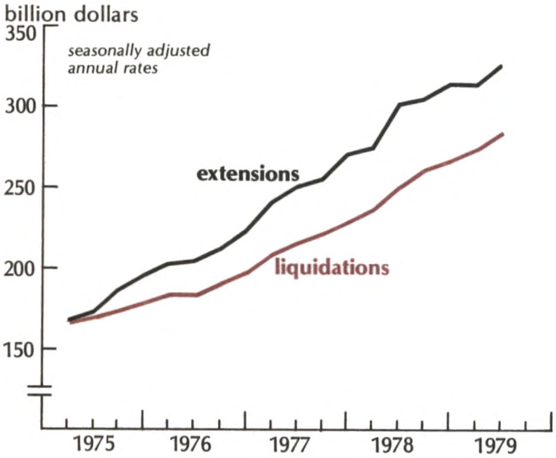


pecially four-wheel drive models, were in short supply early in the year, but sales began fading in March and in June had dropped 35 percent below a year ago. The industry had a 135-day inventory of light trucks at midyear—far more than any previous period. Sales of full-sized cars, also very strong last winter, were down over 40 percent in June, with inventories equaling 150 days' sales for some models—two to three times the preferred level. With the model changeovers coming up, manufacturers were offering historically large rebates to dealers to move surplus vehicles, especially full-size cars.

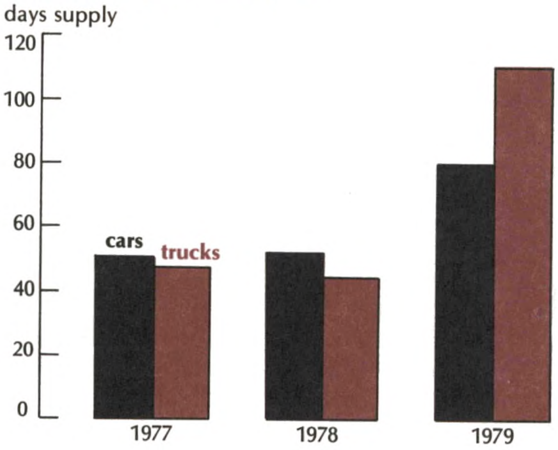
While sales of "gas guzzlers" languished, consumers paid premium prices for small cars. Some signed up on waiting lists that stretched out as much as four months. Sales of U.S.-built subcompacts were up almost 50 percent over June a year before. Sales of imported cars, almost all small, were up 9 percent in June and would have been up more if supplies had been larger.

There had been near-panic buying of small cars in early 1974, following imposition of the Arab oil embargo. Once gasoline supplies improved that spring, however, demand for small cars fell quickly, and full-size models again asserted their supremacy. This summer showed no signs of a revival of big cars similar to that of 1974.

Consumer instalment credit use soars



Car and truck inventories backed up at midyear



Customer traffic, and therefore sales, was reduced at many outlying shopping centers in May, June, and July as consumers tried to hold down gasoline consumption. Part of this loss was captured by higher catalog sales and increased sales at neighborhood stores. Another development was a pickup in home freezer sales.

The rapid rise in consumer prices (at a 13 percent rate in the first half) led by fuel and food encouraged some households to hold back on less essential spending. Increases in spendable incomes have trailed inflation significantly. Many consumers apparently increased their spending on big-ticket items late last year to beat price increases, but such anticipatory spending is usually followed by a letdown.

Another sector of consumer outlays that has suffered from the gas shortage is tourism in areas usually reached by private vehicles. With more people staying closer to home because of the high cost of fuel—and its possible unavailability—volume at less accessible resort areas was reported to be off 30 to 50 percent from year a earlier.

Capital goods retain vigor

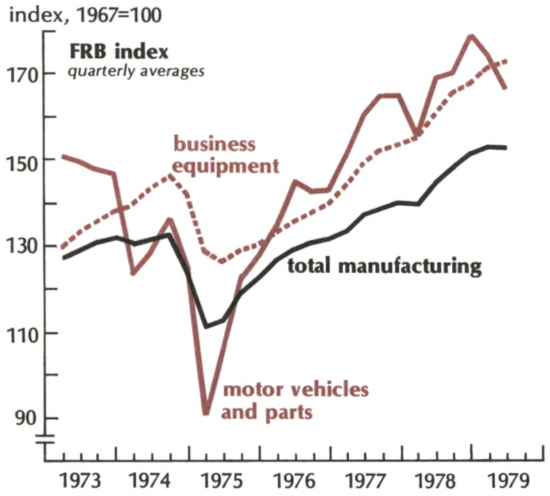
Business expects to boost expenditures on new plant and equipment 13 percent in

1979, according to the most recent government survey. That will be about the same rise as last year. Adjusted for inflation, spending will be up 5 percent, again about the same as last year. The rise in capital spending will, almost certainly, outpace the general economy, through 1979 and into 1980.

All major industry groups plan to increase capital spending substantially in 1979. The leading categories in manufacturing are machinery, paper, and chemicals. In nonmanufacturing, they are transportation (air, highway, and rail), electric utilities, and telephone companies.

In contrast to the weakness in residential construction, nonresidential building will be substantially higher than last year. In the three months ended in May, outlays on new home construction were down 8 percent from a year earlier, after adjustment for inflation. Nonresidential construction was up 11 percent, with industrial construction up 33 percent and office buildings up 20 percent. New construction contracts awarded and bookings for fabricated structural steel indicate the nonresidential construction boom could extend into 1980. Recently, however, there has been a weakening in new contracts for industrial buildings, compared at least with the high level of last year.

Equipment output continues upward, as vehicles slump



New orders for nondefense capital goods leveled off in the spring, but they were still above shipments and backlogs in orders continued to build. The backlog of over $125 billion at the end of June was a third higher than a year before. Backlogs had been rising fairly steadily since December 1976, partly because of inflation.

Order lead times are particularly long for machine tools, commercial aircraft, and some types of freight cars and locomotives. Sales of heavy trucks have been at record highs. They may exceed 200,000 units this year—a new high. Sales are also strong in equipment for construction, agriculture, materials handling, data processing, and electronic control systems.

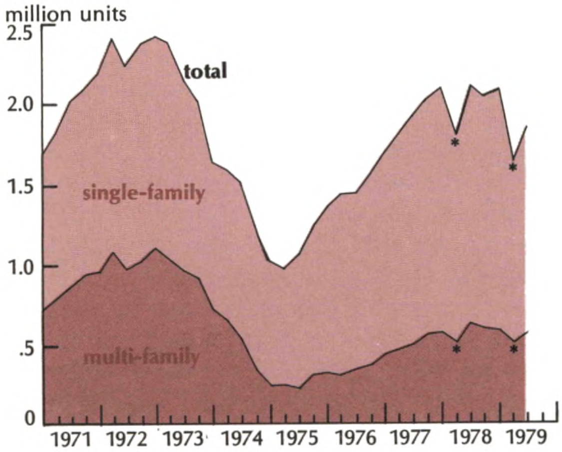
Production of business equipment, measured in real terms by the Federal Reserve's industrial production index, continued to rise through June, although total manufacturing output apparently peaked in March. In June, output of business equipment was up 7.3 percent from a year earlier. Total manufacturing output was up 4.8 percent.

If a general recession develops, some orders for equipment now on the books could be canceled without penalty. This happened in late 1974 and early 1975—and to a surprising extent. The 1974-75 experience is not likely to be equaled in degree, however. Orders are believed to have been booked more carefully this time. Also, more of the equipment on order now is badly needed to cut labor costs, improve energy efficiency, and comply with pollution controls and other regulatory mandates.

Housing starts decline

Monthly estimates of housing starts have been erratic this year, partly because of the hard winter and the catchup that followed. Most analysts expect 1979 starts in the range of 1.6 to 1.7 million units, down 15 to 20 percent from the 2 million levels of 1977 and 1978. Prospects are that starts will not improve next year. The decline in housing starts has been much greater in the Chicago area than in the

Housing starts declined sharply in the first half



*Severe weather limits activity.

nation as a whole. In the first half of the year, new permits were down 40 percent in the Chicago area from the same period a year earlier.

Nationwide, decline in housing starts has been fairly mild this cycle. After a peak of almost 2.4 million units in 1972, a three-year decline brought a drop of over 50 percent to less than 1.2 million in 1975.

Multifamily starts are holding up better in most areas than starts on single-family homes. Many of these apartments, however, will be for sale as condominiums. Of the rental units started, about three-fourths are built under government subsidized housing programs.

The decline in residential construction would have been greater but for the continued general availability of mortgage credit. In past cycles, high market interest rates caused large outflows of funds from thrift institutions and reduced the supply of mortgage funds. Also, usury ceilings in many states prevented loans at competitive rates. Since last summer, savings flows at thrifts have been aided by these institutions being allowed to offer money market certificates at competitive rates. Many states, moreover, have relaxed usury ceilings, allowing more movement in interest rates.

Despite more flexible markets, increases in interest rates to a level of about 11 percent—at least 2 points higher than last year—has priced many buyers out of the market. Rising home prices also have been important as a deterrent to home purchases. Prices of existing homes have doubled since 1972, for an annual compound rate of rise of 10 percent. Increases were even larger in the past three years.

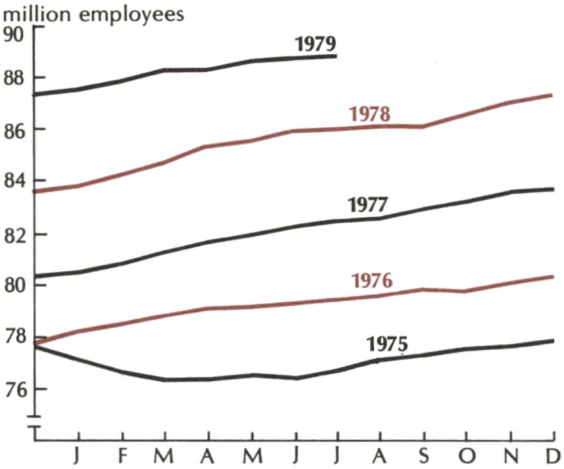
Sales of existing homes have slowed down this year, especially in the Midwest, with substantial price cuts needed to move some homes. The softer market for existing homes in outlying areas has been exacerbated by fuel stringencies. Homebuyers show signs of being more inclined to reject outlying areas in favor of older locations with ready access to public transportation, stores, and other establishments. Slower sales of existing houses hurt sales of new houses because most buyers make downpayments with the equities realized from the sale of their previous homes.

The decline in residential construction raises serious questions about the adequacy of living space in the years ahead. Households are being formed at an annual rate of about 1.5 million, and perhaps 500,000 housing units a year are demolished or abandoned as unfit. Vacancy rates for both apartments and houses are low. The spectre of a serious housing shortage could bring demands for rent controls and additional federal subsidies, despite unfortunate experience with such programs.

Employment and labor costs

One of the most impressive developments of the four-year business expansion has been the rapid rise in employment. Nonfarm wage and salary employment reached a record 88.8 million in July. That was 2.8 mllion more than a year earlier and 10 million more than in October 1974, the peak before the recession. From March to July, the increase in new jobs slowed to 500,000, down from 1 million in the period from December to March.

The long uptrend in payroll employment has slowed



Demand for trained (or trainable) workers has intensified in recent years, serving to push up wage rates. Strong job markets have also encouraged job hopping and absenteeism, which hamper improvements in productivity (output per worker hour).

About three-fourths of the increase in employment since 1974 has been in the trade and service industries and in state and local governments. Changes in productivity in these sectors are hard to measure, but gains are probably well below average—certainly much less than in manufacturing. In some cases, productivity has actually declined.

The combination of rapidly rising compensation and poor performance in productivity has meant a surge in unit labor costs which translates, in turn, into higher product prices. Total hourly compensation for nonfarm private jobs rose more than 9 percent last year. With practically no gain in productivity, unit labor costs rose almost 9 percent.

The change in productivity could be negative this year, particularly if a recession cuts operating rates relative to capacity. With compensation rising at least as fast as in 1978, the rise in unit labor costs could exceed 10 percent, supporting continued inflation at a similar rate.

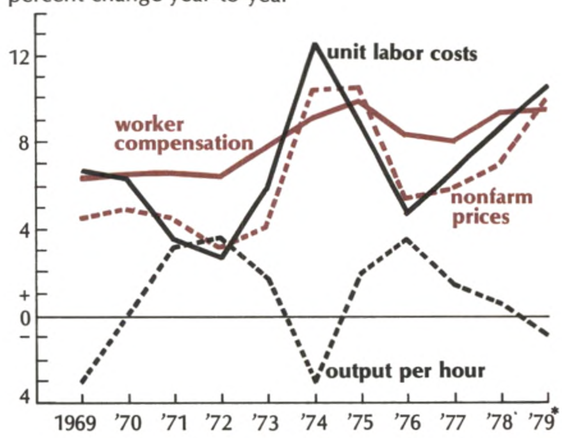
Labor pacts provide large gains

It was known before the turn of the year that 1979 would be marked by heavy bargaining in labor negotiations. Contracts covering almost 4 million workers were due to expire, compared with contracts for 2 million in 1978. Some of the most powerful labor organizations, moreover—those in the trucking, rubber, electrical equipment, auto, and farm and construction machinery industries—would participate in the bargaining.

In an effort to restrain inflation, the President announced voluntary guidelines for wage and price increases in October 1978. The wage guide, which was to cover total compensation (wages and benefits), called for maximum increases of 7 percent a year. That was compared with an 8 percent rise for all nonfarm workers in the 12 months ended in September 1978.

After an 11-day strike and lockout, the Teamsters and the trucking industry concluded a new three-year pact on April 11, providing for an 8 percent increase in the first year—assuming a 6 percent rise in consumer prices—plus substantial increases in the welfare and pension package. Although some analysts concluded that the increase in total compensation would amount to at least 9 per-

Rising labor costs push up prices



*Estimated.

cent, for each of the three years, the Council on Wage and Price Stability interpreted the agreement as being within the guidelines.

United Airlines and the Machinists Union ratified a pact on May 24 ending a 55-day strike. The agreement was said to boost total compensation about 40 percent over three years. Goodrich and the rubber workers agreed on a three-year pact on June 15 said to be worth 40 percent, assuming a 9-percent annual rise in consumer prices. The Council on Wage and Price Stability said the airline and rubber contracts were probably not in compliance with the guidelines.

Much of the confusion over the value of new labor contracts stems, first, from the assumption of future cost-of-living adjustments (COLA), and, second, from the valuation of changes in welfare and pension benefits.

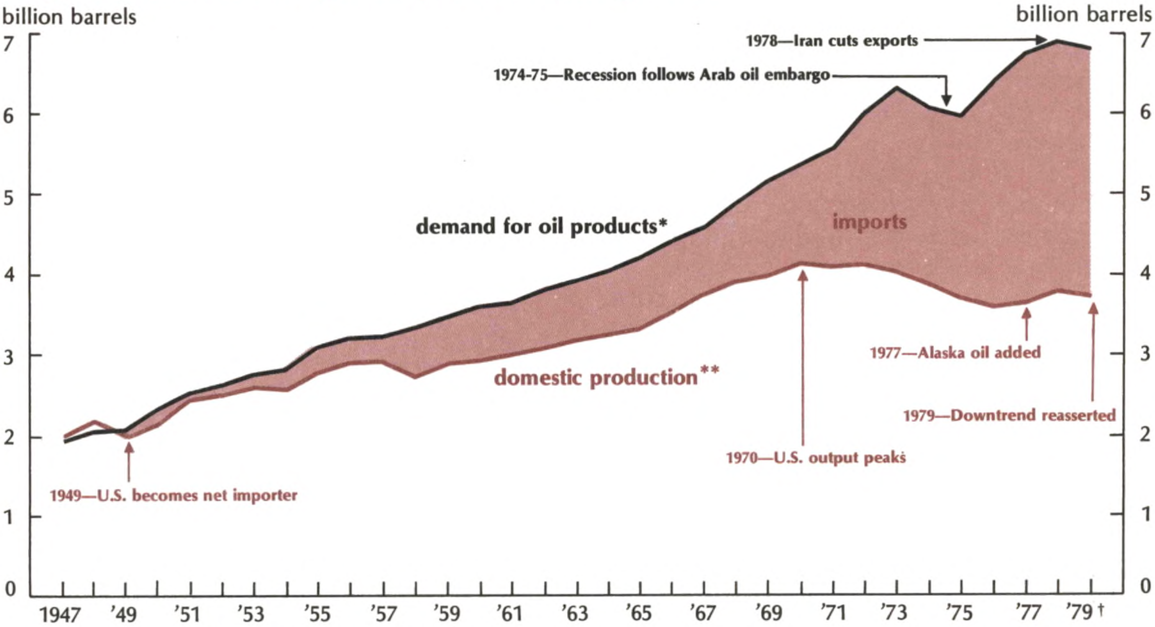
Through September—and maybe beyond if a strike is called—attention will be directed to auto workers' negotiations with the Big Three. About 700,000 auto workers are covered by contracts that expire September 14. That is more workers than were involved in all the other big labor agreements reached so far this year. The farm and construction equipment workers, whose contracts expire September 30, usually take their lead from the auto workers, as do the steel workers, who will be negotiating again next year.

Auto workers, following the example of the rubber and electrical workers, want a full cost-of-living adjustment (up from about 80 percent now), plus "substantial" increases in wages and benefits. They also want COLA for pensioners. Total compensation of auto workers, many unskilled, has increased from an average of $5.76 an hour in 1970 to $15.10 (about $30,000 a year) today. That is an increase of 162 percent in nine years, or 11.3 percent compounded annually.

The oil constraint

Gasoline lines and shortages of diesel fuel have convinced most Americans that the

Dependence on foreign oil perils output growth



*Sales to users from refineries and primary terminals.
**Credit oil and natural gas liquids.
†Estimated.

energy problem is real and immediate. Petroleum analysts concluded in July that a temporary increase in Saudi Arabian production of crude oil would be enough to prevent "serious" supply disruptions through the rest of the year—assuming continued conservation and barring any new interruption of deliveries from major exporting countries. As long as the United States depends on imports for almost half its oil, much of it from the troubled Middle East, a fragile balance between supply and demand is inevitable.

Another complication is the cost of imports. Soon to exceed $60 billion annually, imports put pressure on the dollar in foreign exchange markets. On the domestic scene, sharply higher prices for gasoline, diesel fuel, and heating oil have only begun to find reflection in costs of production and distribution. No sector is isolated from this influence.

In the 20 years that preceded the Arab oil embargo in late 1973, the United States increased oil consumption 4 percent a year. During the same period, real GNP rose at a compound rate of 3.5 percent.

If oil imports are held near the current level, as the president has pledged, total U.S. supplies will decline year-by-year. Domestic production has been declining, with no signs of reversal in sight. New domestic discoveries are only about a fourth as large as current output.

If total oil supplies decline, past standards for estimating future growth will have to be discarded. With population still rising, total per capita consumption—and not just consumption of oil products—will have to decline. Those able to maintain their real income through COLA adjustments or other means will do so at the expense of those less fortunate. A shift from oil and natural gas to other fuels, including synthetics from coal or oil-shale, will take years, requiring enormous investments that, in turn, will reduce resources available for consumption. Nuclear power is under a cloud. A substantial contribution from solar energy is not on the horizon.

What to do?

The growing apparition of recession—or feeble growth at best—coupled with unabated inflation presents policymakers with a dilemma. The problem is compounded by constraints on supplies of fuel, transportation, metals, and vital capital goods, and by limited availability of employable workers, especially professional and skilled people. A large portion of the resources released by declining sectors, vehicles and housing, is not readily transferred elsewhere.

Some people are calling for substantial tax reductions or a dramatic easing in monetary policy. But the federal government already is running a large deficit. Interest rates are near record levels, but money and credit continue to expand. Commercial bank loans and investments were 12 percent higher at midyear than a year earlier. Bank investments were up 4 percent; both total loans and business loans were up 15 percent. In addition, businesses had increased their outstanding commercial paper 40 percent. Capital markets absorbed more than $13 billion in corporate bonds in the second quarter. That was as much as in either of the second quarters of the two previous years. Although less than last year, mortgage loans closed have exceeded the pace of earlier years.

The accepted formula of using more expansive monetary and fiscal measures to counteract lagging demand can be applied only with caution under these conditions. Given pervasive supply constraints, injection of additional purchasing power would serve more to stimulate inflation than to revive production and employment.

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-

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

[2]Designed 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 muncipalities. 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 muncipality has established.

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[3]Wisconsin 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

				Features				
Municipality	Population	Issue bond	Date	Income limit	Mortgage limit	Institutions participating	Amount[1] loanable	Mortgage interest rate
	(thousands)	(million dollars)					(million dollars)	(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.

[1]Amount loanable is gross bond issue net of mortgage reserve fund, capital reserve fund, cost of issurance 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.

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

[5]The 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.

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 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 billion × .30 × .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 billion × .85 × .02 × .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 billion × .85 × .01 × .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).

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

[7]It 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.

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-

[8]See *Background and Issues*, page 25.

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

[10]The 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 inadvertant 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

[11]For 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.