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JOINT COMMITTEE PRINT

A SIMULATION OF THE ECONOMIC  
IMPACT OF TAX EXEMPT HOME  
MORTGAGE SAVINGS ACCOUNTS

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A STAFF STUDY

PREPARED FOR THE USE OF THE

JOINT ECONOMIC COMMITTEE  
CONGRESS OF THE UNITED STATES



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## LETTERS OF TRANSMITTAL

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MAY 7, 1981.

*To the Members of the Joint Economic Committee:*

I am pleased to transmit to the members of the Joint Economic Committee, other members of Congress, and the general public a study by the staff of the Joint Economic Committee entitled "A Simulation of the Economic Impact of Tax Exempt Home Mortgage Savings Accounts."

In recent years, the committee has become much more active in evaluating the impact of proposed policy changes on the entire national economy and on individual sectors. This study is another in a series of publications by the committee of that type. It utilizes a sophisticated econometric model maintained by Wharton EFA to evaluate the macroeconomic impact of a proposed change in the savings incentives provided the residential mortgage industry.

The conclusions of this staff study do not necessarily represent the opinions of the committee or of individual members.

Sincerely,

HENRY S. REUSS,  
*Chairman, Joint Economic Committee.*

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May 4, 1981.

Hon. HENRY S. REUSS,  
*Chairman, Joint Economic Committee,  
Congress of the United States,  
Washington, D.C.*

DEAR MR. CHAIRMAN: I am pleased to transmit a staff study entitled "A Simulation of the Economic Impact of Tax Exempt Home Mortgage Savings Accounts."

The study utilizes an econometric model to evaluate the macroeconomic impact of a proposed change in the savings incentives provided the residential mortgage industry.

All the views expressed herein represent those of the author and do not necessarily reflect the views of the Joint Economic Committee or any of its members.

Sincerely,

JAMES K. GALBRAITH,  
*Executive Director, Joint Economic Committee.*

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# A SIMULATION OF THE ECONOMIC IMPACT OF TAX EXEMPT HOME MORTGAGE SAVINGS ACCOUNTS

By George R. Tyler <sup>1</sup>

## INTRODUCTION

A host of proposals were introduced in the 96th Congress and in the current session of the 97th Congress designed to stimulate savings and boost the national pool of investible funds. Some of this legislation offers a broad-based approach featuring general tax rate reductions, while other legislation targets specific saving instruments or industries. This study focuses on one of the latter. Using the Wharton Econometric Model, it is an evaluation of the macroeconomic impact of excluding interest earned on mortgage-dedicated savings from Federal income taxes. This analysis specifically focuses on S. 701, the "Home Mortgage Incentive Act of 1981," introduced March 12, 1981, by Senator Lloyd Bentsen. This act excludes from Federal taxes the interest earned on savings accounts whose proceeds are utilized by lenders to finance residential mortgages.

## HOUSING INDUSTRY CHARACTERISTICS

The housing industry is one of the most volatile major domestic industries. Housing starts are the most widely recognized indicator of that industry's economic condition. Over the last decade, the annual rate of housing starts has fluctuated in a range from 2.37 million units to 1.17 million units. The swing from year to year has been as large as 705,000 units—a remarkably large 35 percent change for an annual production series.

This volatility is the result of housing's vulnerability to fluctuations in the supply of mortgage funds and in mortgage rates. The primary source of retail residential mortgage funds is saving and loan institutions (S. & L.'s) which hold fully one-half of all mortgages held by institutions. (See table I.) They hold over \$500 billion in mortgages today, the result of a striking growth in assets since World War II: their outstanding mortgage holdings have doubled every 6 or 7 years for the past 40 years, a compound growth rate far above the rate of inflation over that period or even the double-digit rate of recent years.

The other institutional mortgage lenders—mutual savings banks, life insurance companies, and commercial banks—have experienced sizable growth in mortgage assets, as well, although activity at the latter two is generally less oriented to residential property. The share of all mortgages held by individuals has declined to 13 percent from 17 percent as recently as 1970. Residential mortgages constitute 75 percent of all mortgages by value, with the balance

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<sup>1</sup> Economist, Joint Economic Committee.

divided between commercial property (18 percent) and farm property.

TABLE I.—OUTSTANDING MORTGAGE DEBT HELD BY INSTITUTIONS, 1939–80

[In percent]

Year	Savings and loans	Commercial banks	Life insurance companies	Mutual banks
1939.....	20	23	31	26
1949.....	27	27	30	16
1959.....	37	19	27	17
1969.....	42	21	21	16
1974.....	46	24	16	14
1979.....	51	26	13	10
1980.....	50	27	13	10

*Mortgage Holder of Record, 1980*

	<i>Percent</i>
Institutions.....	69
Federal entities.....	18
Individuals.....	13

Source: Economic Report of the President, January 1981, table B-69, and Federal Reserve Bulletin, March 1981, p. A39.

With a substantial portion of their assets in long-term fixed rate mortgage instruments, S. & L's. and mutual savings banks have traditionally confronted a liquidity and profit squeeze in periods when the Federal Reserve Board pursued a relatively tight monetary policy. In fact, they have generally suffered disintermediation as savers convert deposits into higher yielding assets of one form or another.

The reflow from outstanding mortgages provides a base for continued lending activity in periods of tight money by these institutions. Yet, this typically is insufficient to sustain mortgage lending activity at or near the previous peak. For example, the Federal Reserve Board in both 1973–74 and 1979–80 adopted monetary policies designed to minimize the domestic impact of world oil price increases. The New York Federal Reserve Bank's discount rate was increased over 300 basis points in each period. These policies failed to control inflation. The urban consumer price index in 1974 accelerated 40 percent over 1973 to 12.2 percent; it rose 12.4 percent last year. The Federal Reserve policies, however, did slow economic activity in both periods, resulting in negative productivity and economic growth and a reduction in real disposable income. The rise in interest rates during each episode was accompanied by a decline in mortgage lender deposit growth which reduced housing starts by 35 percent in 1974 and by 26 percent last year. These slumps in housing activity occurred despite the variety of new instruments adopted by mortgage lenders during the past decade, including variable-rate accounts and jumbo CD's, designed to increase or maintain deposit growth during such periods.

It has been said, for good reason, that the housing industry is at the whip end of the Federal Reserve Board's monetary policy.

## THE HOUSING INDUSTRY TODAY

A sea change in inflation expectations occurred in financial markets during 1980 which increased mortgage rates, reduced the quantity of housing demanded, and may well leave the housing industry stagnant at a relatively low level of capacity utilization in the future. Investors have come to anticipate the continuation of double-digit inflation rates; and matching double-digit yields on long-term (and short-term) financial instruments are rapidly being institutionalized. Yields on 10-year maturity U.S. Treasury notes, for example, now exceed 13 percent and new home mortgage yields (Federal Home Loan Bank Board) broached that same 13 percent level in April 1980 and again in November where they remain.

The sharp turn in inflationary expectations last year caused the flow of savings into inflation hedges, which began in the late 1970's, to become a flood. Especially favored were short-maturity investments and tangible assets over longer term investments. Corporate, State, and local bonds declined to 17.5 percent by value of all credit market instruments in 1980 from 21.6 percent in 1970, despite vigorous efforts by borrowers to reduce maturities and utilize floating-rate instruments. In 1979 and 1980, the value of money market mutual funds grew a sharp sevenfold to \$74.4 billion from only \$10.8 billion at the end of 1978. The flow of capital to such hedges by inflation conscious investors has continued this year at the expense of mortgage lenders and the housing industry. And, with some \$102 billion of deposits still in low-yielding passbook accounts, S. & L. deposit growth is subject to further erosion.

The marked revision during 1980 in inflationary expectations compounded the housing industry's liquidity difficulties. That expectation revision, however, created an even more permanent and debilitating change in housing. S. & L.'s and mutual savings banks made little if any profit last year. And the impending need this year to refinance over \$200 billion in certificates of deposits will intensify this profit squeeze. This squeeze and the seemingly permanent escalation of inflation and interest rates to double-digit levels pulled mortgage rates up, as well. The resulting slump in mortgage demand has left the housing industry barely utilizing one-half its peak historical capacity. And the future offers nothing better.

This long-term sag in annual housing production occurs in the face of substantial potential demand at lower mortgage rates. Two million new households were formed last year, well above the 1.3 million new housing starts in 1980. This pattern of inadequate supply will persist into the future as children of the postwar baby boom enter their peak years of household formation.

The institutionalization of double-digit interest rates poses an insurmountable hurdle to dealing successfully with this housing gap. In this inflationary environment, S. & L.'s have only been able to maintain deposit flows by issuing money market CD's. These instruments, with average maturities of 6 months, comprise one-half of all S. & L. deposits now. The great volatility of such deposits scarcely warrant an expansion of mortgage lending activity. More significantly, CD's are expensive and have forced mortgage rates up and profits down. The new variable rate mortgages may ease some pressure on mortgage rates as lenders reduce inflation premi-

ums. But, they face uncertain consumer acceptance and will not address the fundamental issue of lagging deposit growth at mortgage lending institutions. Another option, shared-appreciation mortgages, could facilitate an expansion in housing demand. But the delayed return character of such instruments is scarcely appealing to institutions confronting a historic profit squeeze. And volatile NOW transaction accounts are a weak foundation on which to expand 30-year mortgage commitments.

Mortgage lending is a troubled industry facing unknown future capital costs and uncertain deposit flows. And the depressed housing industry tied so closely to it has no prospect for recovery until mortgage rates and inflation decline noticeably.

### A STABILIZED HOUSING INDUSTRY

Initiatives to stabilize the supply of housing will reap the benefits of several factors not characteristically found in other industries. A substantial demand for housing is foreseen at levels well above present rates of production, if mortgage rates can be reduced. In addition, the housing industry may be able to meet that additional demand without adding to inflationary pressures. The median single family new house price last year rose only 2.7 percent, well below the rate of inflation. And, since 1974, new single family house price increases have exceeded the rise in (December over December) consumer prices four times, but have risen at a slower pace three times. Housing construction is a relatively competitive industry, confronting a substantial prospective demand if mortgage interest rates could be reduced.

Steps to increase the flow of savings to mortgage lenders would reduce mortgage rates and assist the housing industry deal with the institutionalization of double-digit interest rates. It would increase the demand for housing and eventually the supply, as well. Savings flows could be increased by a variety of steps. The approach examined here is straightforward and effective: increase the aftertax yield on savings devoted to residential mortgages.

Senator Bensten's Home Mortgage Incentive Act provides for the exclusion from Federal taxes of interest earned on deposits utilized to finance residential mortgages. The macroeconomic impact of this proposal was evaluated using the Wharton EFA annual and industry forecasting model. The impact of this proposal on housing activity, inflation, economic growth, and a host of additional variables was identified, and compared to baseline projections. The results are presented in table II.

TABLE II.—MORTGAGE SAVINGS INTERESTS EXCLUSION SIMULATION RESULTS

(General indexes change from baseline Wharton projection)

Index	Year of enactment	Year following enactment
Growth in real GNP (percentage point change) .....	+0.8	+1.4
GNP price deflator (percentage point change) .....	( <sup>1</sup> )	( <sup>1</sup> )
Unemployment rate (percentage point change) .....	-0.33	-1.1
Personal savings rate (percentage point change in share of disposable income being saved) .....	+1.0	+0.95
Growth in gross real private domestic investment (percentage point change) .....	+3.6	+6.0
Growth in real per capita disposable income (percentage point change) .....	+1.1	+0.7
Productivity growth (percentage point change, all industries) .....	+0.4	+0.4
Expenditure shares of GNP (percentage point difference)—Gross private domestic fixed investment....	+0.3	+0.8



TABLE II.—MORTGAGE SAVINGS INTERESTS EXCLUSION SIMULATION RESULTS—Continued

(General indexes change from baseline Wharton projection)

Index	Year of enactment	Year following enactment
Growth in nonresidential real fixed investment (percentage point change).....	+0.4	+1.1
Change in private housing starts.....	+135,000	+487,000
Housing occupancy rate (percentage point change).....	-0.1	-0.6

<sup>1</sup> Signifies no change from the baseline Wharton control projection.

## SIMULATION FINDINGS

The Bentsen simulation indicates that excluding taxes on interest earned on home mortgage-dedicated savings accounts will generate a notable increase in economic growth compared to the baseline Wharton control projection. The direct impact of this tax exclusion on the housing industry will produce a general economic boom. That boom is projected to add 1.4 percentage points in the year following enactment to the rate of real economic growth projected by the baseline Wharton control simulation. The boom will be broad based, with both consumption and real domestic private investment moving sharply higher. Unemployment will be reduced 1.1 percentage points by the year following enactment, with over 1 million new jobs being created by the Bentsen policy change. Per capita disposable income, adjusted for inflation, is projected to grow 1.1 percentage points faster in the year of enactment due to the Bentsen policy initiative.

Of particular interest is the finding that the boom will not be inflationary. This surprising conclusion results from these phenomena revealed by the Wharton model:

The rise in savings and associated decline in interest rates reduces capital-user costs.

The decline in capital user costs and the associated surge in gross domestic investment, in turn, increases productivity and reduces unit labor costs.

The climb in housing starts to more than 2 million units by the year following enactment is absorbed by the housing industry's large excess capacity without noticeably generating inflationary pressures.

The savings and supply-oriented policy change has a dramatic impact on gross private domestic fixed investment, of which residential construction represents about one-fourth. The simulation found that the first order boost in savings and housing activity yielded substantial second order economic activity. The policy change generates sufficient new savings and investment flows that a diversion of savings from other productive investment to housing was not found to occur; both nonresidential real and residential real private fixed investment increase compared to the baseline Wharton control solution as a consequence of the housing-led economic boom. In fact, the Bentsen simulation projected a rate of real growth in *nonresidential* fixed private investment in the year following enactment which is 1.1 percentage points above the projected real growth rate in the baseline Wharton control solution. As expected, this savings-oriented tax change is projected to alter

the share of GNP devoted to consumption and investment. While the real growth of both variables was larger in the Bentsen simulation than in the baseline Wharton control simulation, investment rose relatively more than consumption; the investment share of GNP is projected to be 0.8 percentage points higher in the year following enactment compared to the baseline Wharton control simulation.

As the initial beneficiary of the policy change, the housing industry rebounds sharply. Housing starts are projected to be 487,000 units higher in the year following enactment and occupancy levels 0.6 percentage points less than projected in the baseline Wharton control simulation.

This evaluation included the Government sector. Because the proposal generates substantial new economic activity, Federal tax receipts recover quickly from the tax cut. The Wharton simulation found that the entire nominal tax revenue loss from the tax exclusion was recovered in higher tax receipts by the year following enactment. The recovery of tax receipts so quickly is unusual. The proposal was found, in effect, to impose only a one-time, 1-year revenue loss. Even this loss is offset to a degree by the Bentsen-induced reduction in Federal expenditures created by the boom. The Wharton simulation found that this boom reduced Federal spending by \$7 billion and the Federal deficit by over \$7 billion in the year following enactment of the Bentsen proposal. The spending reductions consisted largely of unemployment compensation claims (\$4.8 billion) and lower interest charges on the national debt (\$2.1 billion).

This evaluation would be incomplete without a discussion of the baseline simulations used to evaluate the Bentsen tax policy proposal. That proposal was found to generate a broad-based boom independent of the underlying economic program enacted this year by Congress and the administration. The Bentsen proposal will generate a noninflationary economic boom in conjunction with either the full 3-year administration tax and spending program, or with a scaled-down, 1-year variation. It will complement and reinforce either program—adding 1 percentage point to real GNP growth, reducing the deficit, boosting real nonresidential investment, and increasing housing activity compared to the results projected to occur without enactment of the Bentsen proposal.