Volume Title: The Impact of Government on Real Estate Finance in the United States

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Volume Publisher: NBER

Volume ISBN: 0-870-14140-6

Volume URL: http://www.nber.org/books/cole50-1

Publication Date: 1950

Chapter Title: Summary: The Environment of Real Estate Finance

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Chapter URL: http://www.nber.org/chapters/c5934

Chapter pages in book: (p. 147 - 160)

CHAPTER 10

Summary: The Environment of Real Estate Finance

ALTHOUGH the existing influence of government on real estate finance in the United States is for the most part the product of a few decades, the encompassing measures of the 1930's and 1940's were not strictly the inventions of that short period. Instead, as it has been the purpose of this study to point out, they were the outgrowth of a long period of mounting tensions, which, in turn, were largely the product of earlier attitudes toward government and earlier expressions of governmental power.

Although the initial course of real estate development in this country was marked by resistance to all forms of social and economic control, the force of government, as a means for advancing popular objectives, was not neglected. The wilderness was a great absorber of capital, and continuous public and private efforts were pursued to make the capital available. State credit was used lavishly for public improvements, and large sections of the federal domain were donated for the same purpose. The desire to attract private capital was reflected in the first era of settlement and expansion by simplifying foreclosure, strengthening the lender's remedies, and regularizing transfer procedures as compared with English precedents. It continued to be reflected in numerous early land bank schemes and, later, in the immersion, directly and indirectly, of state-chartered commercial banks in real estate finance. In this period demands for easy mortgage credit were initiated that have persisted to the present day.[1]

Growth of Conflict

The combination of diffused, small ownership, overexpansion, excessive speculation, and heavy borrowing gave inherent weaknesses

[1] Charles J. Bullock (*Essays on the Monetary History of the United States*, New York, 1900, p. 1) states: ". . . a strong movement for cheap money has existed continuously in this country from the earliest period of colonization."

to both urban and rural real estate investment. At times the risks accepted by borrowers became intolerable. The favored methods of amelioration were the granting of temporary relief from debt payment and the modification of the mortgage laws to give increased protection to borrowers—as, for example, successive moratoria from the panic of 1820 onward, as well as the tendency to increase redemption periods, which appeared at about that time.[2]

The risks were hardly less painful to savers than to lenders, as the repeated waves of bank failures testify, and an assurance of future safety was sought by limiting the freedom of lending institutions to make real estate loans. To the extent that these limitations were effective—and, for the most part, they tended to be so immediately after a severe liquidation—they served to lessen the availability of mortgage funds. At the same time the easing of the mortgage contract in favor of the borrower increased the risk to the lender and hence tended to raise interest rates. The net result of the palliatives was to make mortgage money scarce or dear, or both; in other words, to run squarely in face of the demand for easy credit. The situation was, of course, complicated by the cumbersomeness of legal structure and the apparent unwillingness of the states to maintain the flexibility and adaptability that often characterized early legislation.

The conflict in policy thus engendered found no resolution; and indeed it was incapable of satisfactory resolution so long as borrowers insisted on maintaining their hard-won protections and lending institutions were subjected to rigid limitations on their lending activities. The stage was set for some special intercession that would promise both cheap and plentiful credit and that would still protect the participants from catastrophe. The federal government alone could produce such a prodigy.

And further, as good farm lands were taken up and cities became congested and far-flung, new problems impinging on real estate investment developed. In order to bring an end to, or at least to moderate, the overexploitation of land to the detriment of physical and human resources, state and national governments sought to strengthen their means of control. Conservation became a rallying

[2] Robert H. Skilton, *Government and the Mortgage Debtor* (Philadelphia, 1944) pp. 28-34, shows the dates in which the redemption statutes were enacted in the several states.

cry; building codes were amplified, and zoning codes and other means of regulating urban land improvement, buildings, and occupancy were widely adopted. Under broadened interpretations, economic as well as physical considerations were included within the purview of the police power, and zoning was expanded to cover rural as well as urban areas. Land planning gradually became a governmental function, claiming broad power over methods of land use and hence over the environment and substance of real estate investment.

Because of the dependence of most of these new forms of intervention on the police power, they first appeared, for the most part, through state and municipal action. Excepting for the federal government's diminishing land transactions, its flood control activity, and a tentative approach to conservation and reclamation, the power of intervention was not sought. Nevertheless, it became gradually evident that the problems of settling arid lands, of protecting national resources, of bolstering the farm economy, and of restoring rural and urban districts would not, or could not, be solved by the types of measures already devised. And, to a steadily increasing number of people, the federal government alone appeared to have the power necessary to achieve these large objectives. It was not, however, until after World War I, and, more particularly, until the 1930's, that the pressure for federal action appeared in any large measure and that the constitutional means for effectuating it were discovered.

Shift to Federal Dominance

The first resort to federal authority directly affecting real estate finance grew out of mounting demands for specialized farm credit facilities and resulted in the creation of the Federal Land Bank System in 1916. When this system met the test of constitutionality, the pattern for much future federal intervention was set. Devices of one sort or another to extend or facilitate real estate credit became the principal means of satisfying the demands for federal aid following the mortgage crisis of the 1930's.

The credit authority, however, was not the only means of federal intervention. The power over inland waterways was expanded to permit comprehensive planning schemes such as the Tennessee Valley Authority; the power of eminent domain was invoked in the advancement of public housing; and under World War II emergency powers the scope of the government's influence on realty investment was again greatly expanded through limitations on construction, rents, the sale of new residential properties, and lending activity.

In the resurgence of intervention there was a marked emphasis on the concept of control for the sake of protecting the welfare of the individual, a point of view in marked contrast to that which characterized governmental action in the nineteenth century. Broadly speaking, the main aim of government land policy during the period of national expansion was to encourage enterprise rather than to provide it with physical or economic protection. An individual's welfare, from this viewpoint, rested mainly on the vigor of his own initiative rather than on state aid or support.

In the past, stays of foreclosure were exceptions, and these were always temporary and aimed at restoring the functioning of enterprise and initiative. Another exception was the development of governmental supervision of financial institutions. In this case both the consideration of welfare (that of depositors, shareholders, and the like) and the substitution of governmental restraint and direction (over the investment policies of the institutions) were present. Despite these exceptions, it is still broadly true that until the thirties the main and continuous objective of government (both federal and state) was to encourage real estate as a form of enterprise. Secondary efforts (left almost wholly to the states) were concerned with the temporary support or restoration of enterprise when it was in danger.

With the establishment of the Federal Land Bank System, however, a modification in the government approach became evident. This agency was designed to make credit available under terms and conditions which did not then exist in the private financial market. There was the same point of view in creating the Federal Home Loan Bank System, and it was pursued further in establishing the Federal Housing Administration for the purpose of influencing the specialized use of credit to finance certain classes of housing. As this last-named agency developed, specialization became more definite: certain classes of housing received greater aid than others (single family houses below a set value, cooperatives, nonprofit corporations, etc.); certain classes of borrowers (first, war workers, then veterans, then families of "moderate" or "lower" income) received benefits not available to others. The device, moreover, was used to accomplish ends not strictly germane to the credit transaction, such as the improvement of housing standards, the influencing of land planning, and the regulation of wages paid to construction workers.

During this evolution, the government has become a guardian of individual welfare, exercising an enlarged influence on private decisions and taking greater responsibility for results. The movement is even more clearly evident in the resettlement and tenant-purchase activities of the Farm Security Administration (later the Farmers' Home Administration) and in the subsidized housing activities of the Public Housing Administration and its ancillary local authorities. It was evident also in the continued regulation of rents, in enforcing priorities for veterans in newly built houses, and in the special provisions for maintaining a fixed interest rate for loans to veterans following World War II.

Extent of Control

Out of this development, in which practically every source of governmental power has been invoked, real estate activity and its financing emerge more fully subject to governmental influence, regulation, and control than any part of the economy not distinctly of a public or public utility character. A review of the controls now existing and of the means by which they were brought about will illustrate this conclusion.

The power of the state as the original owner of the land has been asserted in the planning and use of land still in its ownership or reacquired through tax delinquency and purchase. In the reacquisition of land, the power of eminent domain, employed under new and broadened definitions of public purpose, has been a powerful instrument in both local and federal hands. It has permitted local governments not only to provide land for thoroughfares, parks, public buildings, and public utilities, but to remove land for public housing and redevelopment purposes from private ownership, and by so doing to bring about major alterations in the structure of cities. Thus the government goes beyond the mere reassembly of land to support numerous projects in social and economic planning.

In the federal jurisdiction, the power of eminent domain is becoming steadily more important as a means of exercising control over forest and grazing lands, certain mineral deposits, and for carrying through such comprehensive undertakings as the Tennessee Valley Authority. When constitutional limitations impeded the use of the condemnation power, jurisdiction has frequently been obtained (as with TVA) through an interpretation of the federal power to regulate interstate commerce, and, on some occasions (as in the divesting of huge acreages of private farm land for permanent or temporary military purposes), by invoking the emergency power.

The police power has developed to a degree surpassing even that of the power of eminent domain. It now appears in a vast body of state, county, and municipal laws affecting such aspects of real estate investment as the construction of buildings (building codes, sanitary codes, electrical codes, fire regulations), the occupancy and use of buildings (housing codes, sanitary codes, smoke control ordinances, closing and demolition ordinances), and the use of urban and rural land (zoning codes, subdivision regulations, planning restrictions, etc.).

The original ideas about nuisance abatement and the protection of public health and safety have been enlarged to cover matters relating to the general moral and economic welfare of the community. As they are now applied, particularly in cities, but also to a steadily increasing extent in rural areas, nearly all improvement and use of real property are subject to regulation—and there is no evidence that this development has stopped. Greater limitations on the occupancy of housing and more drastic requirements for modernization and demolition, for instance, are possible; less regard may be given in the future to the rights of nonconforming uses under zoning regulations; and planning regulations may go beyond social and economic to esthetic considerations.

The police power, combined with the chartering power, has provided the means for establishing and regulating financial institutions. Through the banking and insurance laws, the types of loans and other investments, as well as the volume of funds that can be made available for real estate investment, are regulated. The decisions of financial institutions are limited not only by the stipulations of the law but also by the attitudes and instructions of examining officials. Moreover, the law of real property, with its complex ritual of transfer and mortgage, adds another strong influence on the flow of institutional funds.

The indirect and passive effects of the taxing power on real estate investment are, of course, manifold. In addition, the taxing power has been directly used as a means of influencing investment. Inducements for investment in industrial property have been offered for many years through a decrease or elimination of the real estate tax for a period of years. The extension of the homestead exemption principle to limit property taxation, and the use of tax exemption and tax limitations, have been employed to encourage home ownership, to induce investment in rental housing property, and to stimulate slum clearance and rebuilding by private investors.

During World War II, special depreciation allowances were permitted under the federal corporate income tax in order to induce private investment for war production. Since the war, suggestions have been made for using a similar method for real estate corporations in order to encourage investment in rental housing. Another form of tax exemption has appeared in the financing of public housing projects by the issuance of the bonds of local housing authorities. Because these are authorities emanating from local government, the interest on their obligations is exempt from federal taxation. This fact, combined with a virtual guarantee of principal and interest, has resulted in a much lower interest rate than is available for other real estate financing.

The power to act in the general welfare and the power to spend in support of welfare measures have been the sources of numerous impacts, both direct and indirect, on the real estate market. Subsidies for public housing and slum clearance, for instance, have been defended on these grounds, as have the extensive measures to support the prices of farm products and hence the value of farm land.

The powers discussed above have been long recognized. Out of World War I, the depression, and World War II, however, has come a new assertion of power, departing from both the legal heritage and the former definition of constitutional limitations of the federal government. The new source of power is that created by Congress, or assumed by the President, on the grounds of "national emergency." During World War I, emergency powers (as regards real estate activity) were invoked to curtail construction, to grant priorities in the use of building materials, and to engage directly in industrial and residential building. The declaration of a national emergency during the thirties gave support to the innovations of that period. For instance, the ease with which such measures as the National Housing Act and the United States Housing Act escaped serious constitutional challenge, as compared with the much less novel Land Bank Act of a few years before, indicated the new force which that crisis brought to the interventionary trend.

With the sweeping assertion of emergency power occasioned by World War II, real estate investment was again affected. The control of construction operations through priorities and limitation orders; the control of rents, sales prices on newly built houses, prices of building materials, wages of construction workers, and the price of certain building operations; the financing of industrial construction and the direct building of emergency housing; the creation of the National Housing Agency and the temporary abolition of the Home Loan Bank Board, all resulted from extraordinary wartime powers. The same powers, in force after hostilities ceased, permitted the continuance of rent control, the limitation of construction, the issuance of priorities, and the range of activity authorized by the Veterans' Emergency Housing Act of 1946.

Although the specific measures enacted under emergency conditions have usually been of limited duration,[3] the right to invoke emergency power to meet new crises may now be considered a settled interventionary principle.

To the powers thus far discussed must be added the right to exert control directly over real estate credit. This stems mainly from broad interpretations of the monetary power delegated to the federal government by the Constitution. In nearly every respect, particularly in the federal sphere, the power to influence credit has in the long run surpassed the importance of other powers. Constitutional limitations prevent the federal government from using the police power except where interstate commerce is involved (a

[3] This has not been true in every case; for instance, the Trading with the Enemy Act of October 6, 1917 (50 App. U.S.C. § 5 (b) [1946]), which was never repealed, provided the basis for the emergency power assumed by the President in closing the banks in 1933, and for many of the executive orders prior to, and during, World War II.

rare occurrence in real estate activity); the power of eminent domain has been restricted to taking land essential for public buildings, control of navigation, and the national defense.[4] The federal government is no longer important as a landholder, except in a few states; and the federal taxing power has limited application as a means of influencing realty investment. Credit, therefore, is the main avenue of federal influence and with the shift of emphasis from state to federal jurisdiction it has come to be the most direct means of governmental impact on the realty market.

Credit as an All-Purpose Instrument

The federal government has used its power to influence lending activity and to accomplish a number of objectives not all directly related to credit conditions. A number of examples may be given. First, the credit instrument has been used to grant privileges to special groups. Initially, privileges were extended only to borrowers in distress [5] but now, under the Bankhead-Jones Act and the Cooley Act (Farmers' Home Administration), they include loans for farm purchase and improvement by tenant farmers, sharecroppers, and owners of submarginal farms, as well as loans for the benefit of low-income urban families under the United States Housing Act. The same principle was used to provide for war workers and later for veterans, under amendments to the National Housing Act and through the Servicemen's Readjustment Act.

In extending credit to special groups two important principles are apparent: (1) credit is made available in accordance with a measure of need rather than a measure of risk; and (2) the terms of credit are such as to meet the need. The objective of protecting certain groups from the risks they have incurred has always been present in times of distress, but there is a tendency now to embody protective measures in the original credit instrument. For example, there is the ease with which debt obligations may, on the occasion

[4] The control over navigation (under the interstate commerce clause), as previously noted, has been sufficient to permit an extensive use of the power to effectuate general planning schemes. The right to exercise the power of eminent domain in the interests of national defense seems likely to expand further with the development of atomic energy. In the general field of real estate activity, however, the federal use of eminent domain is still negligible.

[5] Through the Home Owners' Loan Corporation and the Federal Farm Mortgage Corporation.

of distress, be modified under the Bankhead-Jones procedure and under the Servicemen's Readjustment Act for loans to veterans.[6]

Second, mortgage credit has been used to influence the type of tenure. Thus, special credit devices have been aimed at the encouragement of the family-operated farm. In cities they have been directed at the expansion of individual home ownership, and under some circumstances at the erection of rental housing.

Third, not only tenure but the character of the property has been subject to influence through the credit mechanism. Under Bankhead-Jones loans, the government maintains a measure of control over farm size and management, while under Federal Housing Administration procedure the mortgaged property is required to meet prescribed standards of location, planning, and construction. In many respects, FHA standards have provided a means of overcoming the inability of the federal government to exercise the police power directly. Land selection, land planning, building design, and construction of public housing projects are, of course, subject to almost complete control by the federal government through its loans and subsidies to public housing authorities, and a strong measure of such control will follow the loans and grants to cities for redevelopment purposes.

Fourth, the federal government influences real estate prices through FHA and Veterans' Administration appraisals and limitations on loan amount. It also controls the prices veteran borrowers are permitted to pay for their houses and the rents at which apartment properties subject to FHA-insured financing and public housing properties can be offered and assumes considerable jurisdiction over operating policies in respect to these properties. Through loans to cities for redevelopment purposes it has the final voice in setting the price at which the assembled lands are offered for re-use.

Fifth, credit devices have been used to influence many aspects of construction, such as the encouragement given to large merchant builders by the FHA system, the special appeal offered to the large contract builder by public housing, and the aid extended to manu-

6 The provision for veterans' loans referred to is in § 506 of the Servicemen's Readjustment Act, 59 Stat. 626 (1944). This permits the Administrator of Veterans' Affairs, on notification of default, to pay the holder of the obligation the unpaid balance of the loan plus accrued interest and to take an assignment of the loan and security, thus allowing the Administrator to make any modified arrangement for payment that he may deem advisable.

facturers of prefabricated housing by direct loans from the Reconstruction Finance Corporation. Federal Housing Administration standards influence the whole technology of the construction industry, while the greater means of control exercised over public housing contracts and other direct loan operations, such as loans to farmers, have a similar but even more far-reaching effect.

Finally, the extension of mortgage credit has been used as an instrument for increasing employment. Closely allied was the objective of establishing a "fair" wage. Thus, where public credit was used directly, as in public works and public housing, construction wages have been set at what the Secretary of Labor found to be the "prevailing wage" in the area. Where government operates more indirectly, as in FHA-insured financing of rental housing construction, the same procedure has been applied, and a recurring effort has been made to apply it to all FHA insurance activity.

These new objectives in the use of the credit power have carried it far from its original status. The increase in availability of mortgage funds is no longer the single end; indeed, it may be overshadowed by numerous other objectives. In its new function, credit plays an integral part in a general welfare program under which government assumes responsibility for better standards of income, health, and shelter.

Persistence of Conflict

The relationship between government and real estate finance has not developed in the direction of greater simplicity or uniformity. Starting with a legal system of great complexity and a multitude of jurisdictions (from the forty-eight states to the thousands of counties, municipalities, and taxing authorities), the number of agencies with which investors must deal, and the number of matters about which they must be concerned, have grown with the years. Amid the increasing diversity of governmental powers many old conflicts have persisted and new ones have appeared. Conflicts, of course, are inevitable as long as interests differ; and the making of working compromises between interests is the basis of all law. The conflicts, however, do not arise merely from differences among the interests in an otherwise private transaction but also in different sets of governmental jurisdictions, among contrary attitudes of the function of government, and among the very objectives that government undertakes to achieve. No resolution of these conflicts has yet been accomplished.

So far, the conflict between state and local law, on the one hand, and federal initiative, on the other, has found no solution except by the federal government's reaching over state jurisdiction by insuring and guaranteeing mortgage loans, chartering specialized lending institutions, and making direct loans and subsidies. These means have served not only to draw under federal influence a large part of farm and residential finance but also to give the federal government influence on matters of land development and building that otherwise would be subject only to the police power of the states.

The second realm of conflict—that between the concept of government as an arbiter in an economic system where activity springs mainly from private decisions and the concept of government as a prime mover and director of economic activity—has so far come even less near to a working compromise. Perhaps one reason for this failure is the fact that the character of the conflict itself has not even now been clearly defined.

In its relationships with mortgage credit, government has not been guided by any consciously stated principle; intervention has been largely a matter of expediency rather than principle. As often shown in the course of this study, it has come in response to a crisis; and the nature of the crisis, rather than some basic concept of the function of government, has determined the nature of the action taken.

In most early instances of intervention, the government's role was that of a salvaging or corrective agent, and not of a permanent directive force; and it tended to withdraw soon after the immediate danger was past. This was true, for instance, of state action in staying foreclosure proceedings during financial panics. In the federal sphere, it was true of the Home Owners' Loan Corporation and the Federal Farm Mortgage Corporation. However, many crisis-bred measures, such as the extension of redemption periods, the limiting of the deficiency judgment, and restrictions on the lending power of financial institutions, have continued to exemplify governmental policy after the immediate occasion for them had passed. Except where the original enactment has carried a definite expiration date, positive action to eliminate it has rarely been taken. Successive crises, therefore, have produced an accumulation of interventionary measures; and the attitude has generally been to continue a measure, once it has become familiar or in respect to which special interests have developed.

Beginning with the crisis in farm credit about the time of World War I, and continuing through the 1930's and 1940's, crises became the occasion not only for temporary supporting and protective measures but for a number of designedly permanent new governmental operations (from the Farm Loan Board to the Farmers' Home Administration and from the Federal Housing Administration to the Public Housing Administration). Even here, the ultimate scope of these new activities was rarely contemplated at their inception. In nearly every case, however, there has been a drift that has placed steadily more responsibility and directive power in the hands of government. Despite the extensive advances resulting from the state and federal legislation of 1949, there is still no indication of the extent to which governmental control will finally impinge upon or supersede the operation of market forces.

The final source of unresolved conflict lies in the diversity of the objectives that government attempts to pursue. Thus, during the period immediately after World War II, the immediate demand was for an increased number of new houses and for the easy credit, subsidies, or grants that might be helpful in getting them built quickly and in enabling families to acquire them when built. Yet longer range considerations required that demand be held back as much as possible while the risk of inflation was present, an objective that called for measures contrary to those invoked for the first purpose. Where long range objectives conflict with shorter run demands, political pressures are almost certain to tip the balance to the latter.

But even among concurrent purposes, conflicts in governmental policies are frequent. The purposes of the housing agencies, for example, have often been at variance with those of the supervisory agencies. The desire to encourage equity investment in income-producing property has been countered by the tax policy.

The problems raised by these unresolved conflicts in public policy are of immediate and inescapable concern to all participants in realty finance whether as lenders or borrowers, or as private persons, institutions, or government agencies. So far, there has been little reason to believe that a means for bringing consistency into the vast range of governmental impacts on real estate finance is likely to be brought about in the near future.