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STUDY BY THE STAFF OF THE U.S.

General Accounting Office

Housing And Community Development: National Problems

This study on major issues concerning Federal involvement in the housing and community development area, covers a broad range of topics, including housing strategies and assistance programs, mortgage credit and finance, community and economic development, aid to small businesses and farmers, and disaster assistance programs. For each topic, GAO describes its reasons for emphasizing the areas, the objectives of the planned work, and the ongoing and completed studies.

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FOREWORD

Long-term economic and demographic trends have caused the 1980's to be characterized as the decade of crisis for housing in this country. The economic uncertainty characterized by high interest rates and unemployment is frustrating both consumers and providers of housing in their attempt to finance the Nation's housing needs. These factors also make it more and more difficult for distressed communities to finance their urgent redevelopment needs and to replace their aging infrastructure, for growing communities to fund capital improvements, and for the small businesses that these communities depend upon to form, grow and prosper.

This study presents our perspective on the major housing and community development issues facing this country and outlines our plan for addressing these issues during the next year. Chapter 1 provides an overview of the area which covers housing, community development, business assistance and disaster assistance. Chapters 2 through 8 describe the major areas of emphasis in our plan, including the strategy for selecting these areas, the objectives of our planned work, and a listing of ongoing and completed studies in each area.

Questions regarding the content of this study or GAO's specific plans for future work should be directed to William J. Gainer, Issue Area Planning Director for Housing and Community Development on (202) 426-1780.

Henry Eschwege

Director, Community and Economic Development Division

Contents

ABBREVIATIONS

CDBG	Community Development Block Grant
DOD	Department of Defense
EDA	Economic Development Administration
FEMA	Federal Emergency Management Agency
FHA	Federal Housing Administration
FIA	Federal Insurance Administration
FmHA	Farmers Home Administration
GAO	General Accounting Office
GNMA	Government National Mortgage Association
HUD	Department of Housing and Urban Development
MBDA	Minority Business Development Agency
NFIP	National Flood Insurance Program
PHA	public housing authority
SBA	Small Business Administration
UDAG	Urban Development Action Grant
VA	Veterans Administration

CHAPTER 1

OVERVIEW OF HOUSING AND COMMUNITY DEVELOPMENT

The domestic housing and community development issue area deals with the Government's role in four distinct yet highly related topics which are crucial to building and maintaining the economic infrastructure that our society depends upon--housing, communities, businesses, and disaster recovery. Housing plays a role in our lives second only to food and clothing. In this society it represents not only shelter, but status and long-term investment. Since our society has been very mobile and few people build their own homes, housing is a commodity constantly in demand and an industry employing millions. Since we value it highly, demand high quality, and regulate its production, it is a commodity not readily available to the poor. And since we encourage its consumption while making it relatively scarce, it has become closely entwined in the political as well as the economic fabric of the country. Our communities determine the nature of the housing we live in, the quality of our lives, where and how we work, and to a great extent how we view our existence. Like housing, businesses and farms are vital to the well-being of communities. They provide jobs, economic stability, and a host of products and services.

Long-term economic and demographic trends have caused the 1980's to be characterized as the decade of crisis for housing in this country. Recent economic trends, Federal program funding cuts, and continuing shifts toward greater local responsibility heighten the perception and the reality of the crisis and threaten to extend it to community development efforts, which have experienced phenomenal growth during the last decade. Meanwhile, the monumental drain on capital markets caused by a Nation bent on reindustrialization, solving the energy crisis, modernizing its defense, and riding out economic uncertainty in a period of high inflation, high interest rates, high unemployment, and continuing strong consumer demand is frustrating both consumers and providers of housing in their attempts to finance the Nation's housing needs.

These same factors are making it more and more difficult for distressed communities to finance their urgent redevelopment needs and replace aging infrastructure, for growing communities to fund capital improvements, and for the small businesses that both kinds of communities depend upon to form, grow, and prosper. Likewise, small businesses, including farms, are having serious problems, particularly in the capital markets.

HOUSING

Housing comprises a vital segment of the U.S. economy, a segment that entails much more than shelter. Over 25 percent of total U.S. capital is invested in housing, which means that it attracts more capital than any other nonfinancial sector of the

U.S. economy. Federal borrowing, by comparison, attracted only 15 percent of total U.S. capital during the 1970's. Equity in homes outstrips savings by about 50 percent. New housing in the 1970's made up almost 5 percent of the gross national product (GNP) each year. Outstanding mortgage debt is estimated at about $1.2 trillion with new mortgage lending each year approaching $200 billion. The value of the housing stock of 88 million units is probably in excess of $5 trillion dollars, and new investment in housing during the 1980's needed to meet projected demand could run to $1.5 trillion while total expenditures for shelter during the decade will likely exceed $4 trillion.

COMMUNITY DEVELOPMENT

The vast majority of the American population lives in cities, towns, or other urban areas. Most of these suffer either from aging infrastructure, rapid growth, or economic stagnation. Much of the public investment in America's cities was made more than 40 years ago, and migration, economic changes, and other factors have resulted in lower tax revenues which rarely meet the development or redevelopment needs of most communities. The need for capital improvement far outstrips both the Federal or local ability to pay for it, and borrowing against the future no longer seems workable.

For decades urban areas grew while rural areas declined. Since 1970, however, the migration trend from rural to urban areas has been reversed. Rural employment is now growing, but this growth has created new demands and new problems as well as new opportunities. But not all rural areas are growing. About 500 counties, heavily agricultural, continue to lose population because the exodus of workers from agriculture exceeds non-farm-job creation. Also, rural communities still have proportionately greater unmet basic needs--housing, water and sewer, health, education, income maintenance, and transportation--than do other parts of the Nation.

BUSINESS ASSISTANCE

There are 14 million small firms in the United States which employ more than 100 million people and account for 40 percent of the gross national product. These firms have provided 86 percent of the Nation's new private sector jobs in recent years, and more than half of the major innovations in contemporary life are developed by individuals and small firms. These small firms are deeply rooted in their neighborhoods and are the most vital ingredient in local economies. Farming is a business, and for many rural areas farming makes up a very significant part of the area's economy. The high cost and unavailability of credit may be the most crucial problems facing farmers today. Partly as a result of Federal initiatives, farmers have had access to plentiful loan funds. Farm sector debts increased thirteenfold, from $12 billion in 1950 to about $158 billion in January 1980. By the end of the decade, debt could total as much as $600 billion. About half of this debt will finance land transfers and will add little to productive capacity.

DISASTER ASSISTANCE

Federal disaster relief during fiscal years 1980 and 1979 was $1.5 billion and $1.3 billion, respectively. Over 25 Federal agencies provide disaster relief in various forms, such as temporary housing, loans and grants to individuals or families, loans to businesses and farmers, and grants to States and local governments for the repair or replacement of public facilities.

AREAS OF CONCERN

We have retained the majority of the areas of concern and lines of effort from our 1980 plan but have reoriented and shifted emphasis among them.

Effectiveness of the Nation's efforts to house lower income families

Despite 20 years of significant growth in Federal housing production and rental assistance, substantial need still exists. Since housing programs are being scaled back, cost effectiveness, better targeting, and avoiding the pitfalls of the past have become very important for both existing and new housing programs. (See ch. 2.)

Federal efforts to preserve the physical and financial integrity of assisted housing

The current investment in subsidized housing is staggering. The replacement value of the public housing stock alone is conservatively estimated at more than $50 billion, yet financial and physical problems threaten a huge proportion of the millions of units developed and maintained with Federal subsidies. Funding cutbacks could hasten the decline of this housing while the private sector may continue to be squeezed by demographic and economic forces. (See ch. 3.)

Improving national strategies for housing

In the long run, U.S. housing policy has been extremely successful in providing nearly 90 million units, but long-term economic trends could reverse much of the progress and exacerbate the plight of poor households. During the administration's reassessment and redirection of housing policy, it is crucial that the Congress get the kind of information needed to build a new housing strategy for both homeowners and renters--a strategy which matches Government involvement and resources to actual needs. (See ch. 4.)

Effectiveness of Federal efforts to provide mortgage credit and stabilize financing to maintain a viable housing industry

The credit markets are in disarray and the mortgage lending industry is being reformed in the midst of a revolution in mortgage financing. The ailing savings and loan institutions have $503 billion in outstanding mortgage loans, the majority of which yield interest at less than 10 percent while only 5 percent or less of U.S. households could afford a mortgage on a new home. Significant financing issues are facing the Nation amid great uncertainty, and the Congress is likely to continue to seek legislative solutions. (See ch. 5.)

Strengthening the effectiveness of Federal programs to preserve and upgrade urban and rural communities

Most Americans still live in cities which face major financial crises during the next few years. Shrinking Federal budgets put great stress on those remaining programs for community development at a time when older cities' physical plants are in need of major repairs and growing areas need to fund new services. Meanwhile, much of the responsibility may be turned back to the States and localities just as their revenue-raising abilities are diminishing. (See ch. 6.)

Enhancing community development through appropriate assistance to small businesses and farmers

Reviving distressed communities and building new ones is synonymous with creating jobs. Businesses and farmers, along with housing and transportation, are absolutely crucial to the survival or growth of any community, but funds to build and expand small firms and support farm production are becoming extremely costly. (See ch. 7.)

Reducing Federal costs of providing disaster assistance to communities and individuals

Recovering from and mitigating the effects of disasters continue to be of grave concern to thousands of communities across the Nation every year. Congressional interest in the more tragic and spectacular of those disasters will likely remain strong, yet the costs of recovery grow geometrically while mitigation is a relatively untapped source of potential savings. (See ch. 8.)

FUTURE TRENDS

The next few years may be a watershed for both the private housing market and Federal, State, and local government programs for housing and community development. Two decades of increases in real disposable income have recently turned into decreases for most households. For the first time since about 1970, real interest rates on mortgages (after adjustment for tax rates and inflation) are well above zero, heralding the end of cheap money. Appreciation rates for property have moderated, meaning that it costs more to borrow money on homes or business property which appreciate more slowly. Changes in the tax laws will also make housing investment less attractive, and cuts in the personal income tax rates offset by other tax increases will cloud many individual housing and business investment decisions.

Local governments are facing reduced Federal funding for a large number of activities at the same time that taxpayers' revolts have made it more difficult to raise revenue. Interest rate increases and the demand for public financing have made it all but impossible for local governments to rely on tax-exempt borrowing, which has for years been a steadily growing source of local capital. All these factors are complicated by major policy shifts at the Federal level which may greatly alter the way we provide assistance to the poor and the way communities are developed and preserved.

Small business in the 1980's will have to take over more and more of the responsibility for creating new employment in the U.S. economy, as growth among medium-sized and large companies is projected to become more stagnant and government struggles to slow its own expansion. Small business is already producing the lion's share of new jobs. Government's contribution to new employment in the United States climbed as high as 35.2 percent in the early 1970's but since 1975 has dropped to about 9 percent as Government's growth has slowed. As for the private sector, data from Fortune Magazine shows that the Nation's 1,000 largest corporations contributed only half of 1 percent of the new jobs created from 1969 to 1976.

If we are to achieve anything approaching a healthy level of employment for Americans in the 1980's, the leverage for public policy lies in spurring entrepreneurship and assisting existing small companies. In this regard, small businesses need primarily four things. One is the capital to create more and more new businesses. Another is greater retained earnings for existing small companies so that they can reinvest and grow. The third is management training to reduce the number of business failures. The fourth is relief from burdensome Government regulations.

<u>Housing demand and preference</u>

The 1980's are already being referred to by many housing experts as "the decade of the housing crisis." Homeownership cost increases have priced 93 percent of American families out of the home buyers' market. At the same time, the Nation's existing rental housing stock has the lowest vacancy rate in decades with little prospect for any new private construction.

The World War II baby boom generation is now stepping forward to purchase its own homes. During the 1980's the age group of 25- to 64-year-olds will increase substantially. By 1989, the 25- to 34-year-olds will gain over 5 million persons (14 percent increase) and the 35- to 64-year-olds will increase about 12 million persons (16 percent). Since the majority of the home buyers are within these two age groups, the housing demand for single-family homes will increase. An estimated 2 million new units each year are needed to meet the increase.

Current trends in consumer preference by housing type began in the late 1970's and will continue into the 1980's due primarily to two factors--energy and housing costs and lifestyle changes. Because of increasing energy costs, coupled with smaller family size and lifestyle changes, consumers will be searching for smaller, more energy-efficient homes. Condominium ownership may become the dominant ownership form in the near future. Manufactured housing will start to make major inroads in many local markets in the next few years and may become the logical choice for site-built housing for all but the rich by the decade's end. Co-ops, which were long in disfavor with home buyers, are now experiencing a resurgence for the same reasons as condominiums. In addition, to meet the shifting demands for military family housing and reduce the cost to operate and maintain its housing units, the Department of Defense (DOD), rather than building costly new units on-base, may need to place more emphasis on the DOD/Department of Housing and Urban Development (HUD) program to stimulate off-base housing.

Energy costs

The cost of heating and cooling buildings in an age of increased energy prices should encourage high-rise construction over townhouses and single-family detached houses, at least up to a point. Test results have shown increased thermal efficiency in buildings up to 10 stories, compared to single-family detached houses. As buildings become taller the increased energy necessary for general services (such as elevators) overcomes energy cost savings (at a height of 50 or more stories). Passive solar design and a variety of innovative design and buildings configurations are likely to be accepted during the next 10 years.

Interest rates

Traditional single-family home mortgages have been long term with fixed interest rates and equal monthly payments. These worked satisfactorily until the late 1960's when the United States started experiencing high inflation rates and slow growth in real personal incomes. With interest rates at an alltime high, a whole variety of innovative mortgage instruments are now being introduced. With the rapid deregulation of the thrift and banking industry, more changes which will work against housing are probably on the way.

High interest rates are also having a detrimental impact on the Nation's small businesses. The gap between planned and actual capital investment by small businesses is large and increasing primarily because they cannot afford to pay 20 percent interest for long-term borrowing. Not only are existing small businesses being affected, but new businesses and particularly minority firms are finding it more and more difficult to enter the marketplace. Farm debt is expected to grow exponentially during the decade in order to finance the transfer of land without adding to productive capacity. Higher interest rates almost assuredly will mean higher food prices.

Migration

Population redistribution is one of the most important forces affecting community development. In a mobile society like America, it is not suprising that 3 out of every 10 adult Americans say that they will move to a new residence in the next few years. The clear population losers in this relocation process are America's large cities. If the potential for migration is realized, the flow out of the city and toward suburbs and rural areas will continue, thus heightening the need for rural community development.

America may be slowly thinning out with greater population increases in the South, in the West, and in rural areas throughout the country. Until recently, mobility due to preference for climate and better employment were accelerating. But high mortgage, housing, and relocation expenses are causing more and more employers to offer low-interest loans, relocation allowances, and even company-owned or company-developed housing to employees at reduced rents or purchase prices.

Resource scarcity

Relative resource scarcity is replacing resource abundance as a dominant factor in the American economy. One implication of this trend for communities is that the value of existing infrastructures is increasing. As growing scarcities drive up the cost of resources needed to develop new communities, the value of much of the existing capital stock in cities will increase.

Energy price increases should lead toward more compact, less sprawling settlements. As the cost of transportation rises, we should begin to observe a movement toward increased proximity of dwelling, working, shopping, and leisure time places as a reaction against the increased cost of traveling between these locations under today's relatively spreadout arrangements. Another effect of the energy crisis coud be the encouragement of the existing movement toward smaller cities. Since longer trips are necessary in large metropolitan areas, cost savings could be realized by moving to a smaller city.

Urban communities will continue to be confronted with the need to satisfy rapidly growing expenditure requirements arising from the higher percentage of remaining "high cost" citizens--the poor and the elderly. On the other hand, their tax resources are either declining or are increasing at a decreasing rate, reflecting the exodus of industry and middle- and high-income families to the suburbs or rural areas.

CHAPTER 2

EFFECTIVENESS OF THE NATION'S

EFFORTS TO HOUSE LOWER INCOME FAMILIES

Significant growth in Federal housing assistance has occurred during the last two decades, and a very successful group of homeownership, rental, and rehabilitation programs buttressed by tax incentives and financing assistance has developed over a period of 40 years. Nevertheless, the national goal of "a decent home and suitable living environment for every American family" remains elusive. The demand for housing is expected to remain strong throughout the 1980's with estimates of need ranging from 20 to 26 million units by 1990. The strong demand for homeownership, the expectation of continued though modest population growth, demographic and lifestyle changes, continued southward and westward migration, and immigration all signal a continued strong housing demand. At the same time, however, the drop in overall production rates, the low rate of investment in new rental housing, the scarcity of land in some areas, the demand for condominiums, declining real incomes, and increases in operating costs all conspire against lower income renter households, which have been the major recipients of subsidized programs.

These opposing forces are converging at a point when (1) high interest rates have all but eliminated the production of new rental housing, (2) the unavailability of funds to refinance or refurbish present multifamily housing projects virtually assures condominium conversion of many existing buildings, and (3) rapidly rising property values on multifamily housing built in the 1950's and 1960's, combined with low rents and nonexistent tax shelters, make it irresistible for owners to dispose of rental investment property.

It is against this backdrop that subsidized housing production programs, plagued by years of inflationary cost growth, are being considered for elimination or significant alteration. Current thinking in the administration leans toward a housing block grant or housing voucher program, or some variant or combination of these ideas, as a replacement for the prolific and costly section 8 program.

Thus, the major issues we see in the area of subsidized housing production concern the role of production in any new housing initiatives introduced in the next 2 years, the continued improvement in program benefit targeting, and the cost effectiveness of those programs which continue.

STRATEGY FOR SELECTING LINES OF EFFORT

This area of concern has been and will continue to be our most important housing-related product line, and we have selected two lines of effort and related jobs which we feel will produce work of maximum value to the Congress during fiscal years 1982 and 1983. The first line of effort continues from the last plan and deals with the costs and effectiveness of the Government's programs for initiating housing subsidies with an emphasis on rental housing production, but which also include tenant rent subsidies.

These programs have been the mainstay of public housing strategies for more than four decades. Although section 8 may be eliminated or drastically changed in fiscal year 1983, we expect certain production programs to survive and perhaps grow in the next few years. Our second line of effort will be used to anticipate, analyze, and monitor the implementation of housing initiatives as we did when section 8 was established. That early section 8 work was instrumental in the changes the Nixon administration made to implement a then-faltering section 8 program.

We believe that these lines and work in other areas of concern will put us in a position to offer concrete advice on:

1. Cost-saving opportunities and improvements for programs such as public housing, Farmers Home Administration (FmHA) programs, and HUD programs which utilize existing units through cash subsidies or rehabilitation. Most of these results will be available early in 1983.

2. Specific new initiatives or proposals regarding housing production or tenant rent subsidies during the second half of 1982.

<u>How Efficiently and Economically Are Present Housing Production Programs Being Administered?</u>

This line of effort is being continued from the previous plan. The objective of our work in this line of effort will be to look at ways to reduce the cost of producing and delivering subsidized housing. Until the Reagan administration's contemplated changes in the section 8 program become more finalized, the bulk of our work in this line of effort will be directed at the public housing and rural housing programs which are very likely to pick up any subsidized housing production retained from section 8.

The need to produce subsidized housing more cost effectively has never been greater. Subsidized housing assistance under the two largest programs (section 8 and public housing) will result in, at most, 150,000 assisted units in 1982. According to an April 1981 National Housing Conference report, 5 million households live in physically inadequate or overcrowded housing and far more are in financial need. This huge shortfall demonstrates that Government must (1) eliminate all nonessential spending in its efforts to produce and deliver subsidized housing, (2) come up with new mechanisms for providing as much housing as possible at existing budget levels, and (3) direct the programs to the most needy. These also seem to be the goals of the new majority in the Senate and of the administration.

Critics of subsidized housing continue to stress that subsidized housing is not managed efficiently, that per-unit costs are exorbitant, and that some units are extravagant. There is also much debate over who should benefit from the housing assistance programs and how much assistance one household should receive.

The major problems facing rural housing are not unlike those facing the larger society--increasing housing costs and inequitable distribution of assistance. While rural housing problems today are most acute in remote areas, these areas do not receive an equitable distribution of the assistance compared to urban areas. For an increasing number of rural families, many rural programs are no longer workable, even with subsidized interest. Unless ways are found to provide lower cost housing through increased efficiency or reduced property standards, this trend will continue.

During the last 36 months we have performed a large number of significant jobs on the production aspects of the section 8 program, and we believe we have, to a large extent, exhausted the need for further work in that area. During this period we did much less work on (1) public housing, (2) other multifamily programs, such as the section 202 direct loan subsidy program for the elderly and handicapped, and (3) FmHA subsidy programs for rural areas. These programs were deemphasized for years but will very likely remain in the Government housing picture and are likely to come up for significant scrutiny during the next few years. We expect to emphasize work on these programs, which are likely to replace the section 8 production mechanisms. Also of great importance will be the role of existing housing in any new administration initiatives, and we will monitor these changes carefully for opportunities for important work. We expect continued strong congressional interest and will be prepared to adjust this line of effort where necessary. We will emphasize work on the following questions:

1. How can the costs of providing housing assistance be reduced?

2. How can obstacles to the efficient production of subsidized housing be dismantled?

3. How can the benefits of current subsidized housing programs be better targeted?

<u>What Program Changes Should the Congress Consider in Initiating New Housing Assistance Programs?</u>

This line of effort is being established to channel work dealing with specific new administration housing assistance proposals and to focus some effort on opportunities to generally improve the effectiveness of the Government's housing assistance programs regardless of the specific mechanisms chosen. Since major revisions in housing delivery mechanisms are expected, we hope to be able to provide the Congress with insights which may help avoid certain chronic problems of past programs. The specific proposals put forward by the administration, the President's Housing Commission, and the Congress may alter our plans during fiscal year 1982, but we expect certain themes to be of interest regardless of the specific proposals.

Although events will dictate our emphasis over the next year, we believe the following questions will be pertinent:

1. Will new housing assistance mechanisms be less costly in the long term than the past programs?

2. Will new initiatives avoid chronic problems of past programs?

3. Can new initiatives be better targeted to the intended beneficiaries than past programs?

CURRENT AND PAST GAO WORK

Following is a list of ongoing and completed studies in this area of concern.

Ongoing studies

--Survey of potential actions to reduce rental assistance subsidy costs and overpayments.

GAO reports

"Inquiry into the Farmers Home Administration's Selection of a Developer to Construct a Housing Project in New Hampshire" (CED-80-119, August 12, 1980)

"Letter Report on Ineligible Households in Assisted Housing" (August 21, 1980)

"More Improvements Can Be Made in HUD's Research and Technology Activities" (CED-80-134, August 29, 1980)

"HUD Not Fulfilling Responsibility To Eliminate Lead-Based Paint in Federal Housing (CED-81-31, December 16, 1980)

"How To House More People at Lower Costs Under the Section 8 New Construction Program" (CED-81-54, March 6, 1981)

"Lenient Rules Abet Occupancy of Low Income Housing by Ineligible Tenants" (CED-81-74, April 27, 1981)

"Weaknesses in the Planning and Utilization of Rental Housing for Persons in Wheelchairs" (CED-81-45, June 19, 1981)

"Inquiry into the Status of a Proposal to Construct 16 Single-Family Detached Homes for the Cuyahoga Metropolitan Housing Authority in Cleveland, Ohio" (CED-81-147, June 19, 1981)

"Review of the Navajo and Hopi Indian Relocation Commission's Program" (CED-81-139, July 2, 1981)

"Acquisition of the Coventry Site by the Fairfax County Redevelopment and Housing Authority Does Not Appear To Be Improper" (CED-82-20, December 16, 1981)

"Greater Use of Innovative Building Materials and Construction Techniques Could Reduce Housing Costs" (CED-82-35, February 18, 1982)

Letter report on the adequacy of procedures followed in selecting Section 8 developers, April 8, 1982

Bill comments on S. 2171, "Proposed Rental Housing Production and Rehabilitation Act of 1982," April 13, 1982

CHAPTER 3

FEDERAL EFFORTS TO PRESERVE THE PHYSICAL AND FINANCIAL INTEGRITY OF ASSISTED HOUSING

This area of concern covers those programs and activities within HUD, as well as the Veterans Administration (VA), Farmers Home Administration, and the Department of Defense, that provide funds to assist in the operation, maintenance, and rehabilitation of multifamily and single-family housing units. It also covers efforts to prevent federally insured projects from defaulting and becoming federally owned and managed.

The Housing Act of 1949 established a national goal of "a decent home and suitable living environment for every American family." To meet this goal many kinds of Federal assistance have been used--mortgage insurance programs for single-family and multifamily units, indirect subsidies through tax provisions to encourage the construction and purchase of housing, and direct subsidy programs to help low- and moderate-income families obtain housing. The direct subsidy programs aided by insurance and tax provisions have produced over 1.2 million public housing units with a replacement value estimated at over $50 billion and privately owned housing projects with about 2 million rental units, yet the national goal has proven difficult to meet. The supply of new units for low- and moderate-income families has not kept pace with the demand. Currently, about 6 million households are living in physically inadequate or overcrowded housing units and most of these are lower income households.

Because many of the Government's past housing programs were designed to provide a fixed amount of assistance which reduced the mortgage interest rate or paid the debt service, these programs were particularly vulnerable to increasing maintenance, utilities, and other operating costs. The drastic rise in these costs has caused a continuous financial crisis for these projects for nearly 10 years. Project owners, HUD, and FmHA, who had invested on the premise that incomes would rise at the same rate as costs and therefore strengthen their projects' financial integrity over time, have all sustained losses. Necessary rent increases granted to meet rising operating costs and taxes have often far outstripped increases in tenant income. Solutions to financial insolvencies involving substantial rent increases displaced many needy families and defeated the original purpose of providing projects. Furthermore, the tenants who replaced those who left were necessarily only slightly better off so that the solution was shortlived in the face of continuing inflation.

For privately owned Government-insured projects, owners who were generally unwilling (or organizationally incapable of agreeing) to put up additional funds to sustain seemingly unending losses were initially sheltered by tax incentives. Eventually these tax advantages were inadequate; losses amassed to the point of insolvency and many projects failed. The result of this combination of no-win situations and HUD's often inconsistent and ineffectual efforts to reform these programs or rescue those projects contributed to financial failures of various severity, requiring the Government to pay insurance claims of $3.7 billion. These claims are expected to continue to mount to $5 billion and involve a total of 342,000 units by 1982.

In the past, HUD's and FmHA's main objectives were to sell private acquired properties as quickly as possible in order to ensure an immediate dollar return on their investments. In recent years HUD has been placing more emphasis on preserving the assisted housing stock, but because of inadequate management information systems, HUD was unable to identify which projects were operating at a loss. HUD's general and special mortgage insurance funds absorbed all operating losses of acquired or assigned projects, and the use of section 8 funds to bail out projects provided a good source of funds but no incentive to control cost. Projects have been sold at sizable losses and insured with even more lucrative subsidies to new owners whose main objective was again the tax advantages accruing to such an investment. Many such projects are already in trouble again.

Low-income families also significantly depend on the Nation's 2,700 public housing authorities (PHA's) to help meet their housing needs. Currently, PHA's provide shelter to about 3.4 million low-income and elderly persons in abut 10,000 projects across the country. In particular, rapid escalation of costs due to inflation, growing physical plant obsolescence, and increased project deterioration have been major problems to PHA's. The condition of public housing is a serious concern. Some of the projects have experienced physical deterioration to the point that a high percentage of units are uninhabitable. PHA management in many cases must share the blame. To assist in meeting these problems HUD provides various forms of financial assistance, including funds to (1) cover the debt service for the construction of its projects, (2) assist in operating the projects, and (3) upgrade living conditions and correct serious physical deficiencies. However, despite HUD efforts to assist in saving and upgrading the public housing stock, many PHA's, particularly those in large urban areas, have been unable to adequately deal with their problems.

Indications are that the Reagan administration is placing priorities on preserving the physical and financial integrity of the federally assisted housing stock, particularly since subsidized housing production is being cut substantially, and HUD will naturally focus more attention on its existing inventory. Although the Omnibus Budget Reconciliation Act of 1981 reduced public housing modernization from $2 billion (requested) to $1.5 billion for fiscal year 1982, the amount signals a new modernization initiative expected to require more than $5 billion during the next 5 years as compared to $2.8 billion since 1968. Strong interest in the Congress in preserving subsidized stock is evident in the repeated contacts we have had regarding this subject.

STRATEGY FOR SELECTING LINES OF EFFORT

Based on our past work and congressional concern over certain issues needing review prior to upcoming program and funding decisions, we have selected three lines of effort for emphasis.

Our first line of effort focuses on the responsibilities and incentives to control operating, maintenance, and repair costs in federally assisted multifamily housing projects. Our past work made it evident that while changes aimed at controlling particular elements of costs can be effective in reducing operating costs, this approach does not address the root causes for high operating costs, poor maintenance, and high financial failure rates. For this reason, and the likelihood of a number of housing program changes, we will focus our efforts on the roles, responsibilities, and incentives of the owners, tenants, private and public lenders, and the Federal Government in the management of federally assisted multifamily projects.

The second line of effort concerns how mortgage servicing of federally assisted housing and the management and disposition of federally aquired housing can be improved to help preserve the Nation's housing stock. This line of effort was selected because the continued viability of the assisted housing stock is of utmost importance if the Nation's low- and moderate-income families are to be housed under decent, safe, and sanitary conditions. Also, the Reagan administration and the Congress are expected to place more emphasis, as well as Federal dollars, on utilizing, improving, and preserving the current assisted housing stock rather than replacing run-down units with new and more costly ones.

The third line of effort relates to the cost of operating and maintaining housing for military personnel both domestically and overseas. This is a new line of effort and it was selected because of increasing congressional concern over the rapidly increasing costs to operate and maintain DOD's inventory of family housing units and indications from recent GAO work that DOD has not effectively controlled costs in this area.

Are the Responsibilities and Incentives to Control Operating, Maintenance, and Repair Costs in Federally Assisted Multifamily Housing Projects Sufficient to Prevent Decay, Ensure Financial Integrity, and Preclude Default?

During the past 20 years, the costs of operating, maintaining, and repairing federally assisted multifamily housing units have surged, with the Government rapidly becoming the primary source for needed funds. During fiscal year 1980, Federal payments of $4.4 billion were made by HUD primarily to assist in the operation of multifamily housing projects. HUD outlay estimates for fiscal years 1981 and 1982 anticipate progressive increases to $5.4 billion and $6.5 billion, respectively. Additionally, the Government has spent and is planning to spend millions of dollars to modernize and correct deteriorated public housing, and to preclude default of certain financially troubled projects insured under Federal programs.

The factors leading to the rapid Federal involvement in the financial operation of multifamily rental programs are complex. In very basic terms, however, it has been the Government's approach to counterbalance the increasing differential between operating, maintenance, and repair costs and insufficient rental income through increased subsidies. This condition has been caused, in part, by

--increases in operating, maintenance, and repair costs due to inflation and the provisions for new services and

--the enactment of Federal legislation that limited the amount of rents charged to tenants (Brooke amendments).

For example, the public housing program, which encompasses 2,700 local public housing authorities and over 1.2 million housing units, has been the primary mechanism by which the Government has provided subsidized housing to low-income families. Until 1968 HUD contributed sufficient funds to cover only the debt service on PHA projects. In 1968, however, in order to assure the continued operation of PHA's, HUD began to provide funds to subsidize their operating and maintenance costs. Total PHA operating subsidies, which are allocated through HUD's Performance Funding System, have increased from about $475 million in 1975 to almost $1 billion for fiscal year 1981, and $1.2 billion has been requested by HUD for fiscal year 1982. PHA's have come to rely on HUD to advance these operating subsidies to keep their operations solvent.

Since PHA operating costs have substantially increased and inefficiencies have gone virtually unchecked, inadequate funds have been left over to pay maintenance costs. As a result, maintenance has been deferred and many PHA projects suffer from physical decay. Beginning in fiscal year 1981, a new and comprehensive public housing modernization program was to (1) upgrade living conditions in older PHA projects to present-day standards, (2) correct physical conditions which threaten the health and safety of tenants, and (3) achieve operating efficiency and economy. However, the Reagan administration has substantially reduced the funding for this program on the basis that the original funding was so ambitious that it is questionable whether the money could be used effectively.

In debating future operating subsidies and modernization needs, the Congress will need to know what are the responsibilities and interrelationships of the parties involved in multifamily housing matters, whether all concerned work in harmony to promote effective and efficient operations, and if existing policy and implementing regulations act as a disincentive for efficient operations. The Congress has delineated HUD as the authority to assert a leadership role in addressing the entire housing issue, but this leadership cannot be effective unless all parties involved--the mortgage banker, owner, manager, and tenant--work in concert to protect the financial and physical integrity of multifamily projects. Past and increasing Federal financial assistance may parlay all parties involved in multifamily projects into a passive role on issues and matters dealing with efficient and effective operations of multifamily projects.

Based on the work performed under the last plan, it became evident that while making changes to control particular elements of costs can be effective in reducing operating costs, this approach does not address the root causes of high operating costs, poor maintenance, and high rate of default. It is for this reason that under this program plan, our efforts are focused on what we believe to be the basic causes for these problems--the lack of responsibilities and incentives to promote efficient management on the part of owners, tenants, and lenders, as well as the Federal Government.

Accordingly, we are directing future work to address the following questions:

1. What should be the role of HUD and other responsible Government agencies in promoting efficient and effective federally assisted housing operations?

2. Can HUD's role be reduced or minimized by shifting greater responsibility to owners, managers, mortgage bankers, and tenants involved in multifamily housing matters?

3. What incentives are necessary to promote more efficient and effective operations?

4. Are information and management systems adequate to control and stem the trend toward spiraling operation and maintenance costs?

5. Are current modernization programs adequately planned and designed to produce effective results at the least Federal cost?

<u>How Can the Servicing of Federally Assisted Housing and the Management and Disposition of Federally Acquired Housing Be Improved to Preserve the Nation's Housing Stock?</u>

The continued viability of much of the Nation's housing stock built through various Federal programs is being threatened by severe economic, social, and financial pressures. The success of Federal efforts in addressing these pressures and for finding solutions to them are critical if we are to fulfill our Nation's housing goal, particularly for low- and moderate-income persons.

Federal agencies' efforts to prevent defaults through effective monitoring of private lenders and improved supplemental servicing practices have been ineffective. Several studies have indicated, for example, that HUD does not have sufficient staff, legal flexibility, and other resources needed to manage its current inventory of insured loans. Problems cited include lack of staff skills, inadequate management structure, and insufficient systems support to service the housing portfolio. The VA and FmHA also need to place more emphasis on preventing defaults.

HUD, VA, and FmHA administer loan insurance, loan guarantees, or direct loan programs designed to assist persons in purchasing single-family homes and for attracting investors in providing rental housing for low- and moderate-income persons. HUD, as the largest Federal insurer of housing loans, currently has insurance in-force on about 4.9 million single-family units and about 1.6 million multifamily units. The FmHA as of June 30, 1981, had direct loans outstanding covering about 974,000 single-family homes and 187,000 multifamily units, while VA had guaranteed loans covering about 4 million single-family homes.

Recent studies and statistics show a trend toward increasing defaults of both single-family and multifamily insured loans, followed by subsequent insurance claims and assignment of the mortgages to the Federal Government. This trend has put a tremendous financial burden on the Federal budget and has had an equally serious impact on homeowners, tenants, neighborhoods, and local governments. The increasing number of defaults resulted from several factors, such as high interest rates, unemployment, and inflation; rising operation costs; and poor financial planning and management. As of April 30, 1981, HUD had an inventory of over 15,000 single-family homes and 2,022 multifamily projects containing 269,000 units in its assigned inventory. The multifamily mortgages alone had an unpaid balance of almost $4 billion. Inefficient onsite management and the lack of Federal agency oversight and mortgage servicing of assigned projects often result in foreclosures. As of April 30, 1981, about 351 HUD-assigned projects containing 41,579 units were in the foreclosure process, with a strong likelihood that a substantial number of the remaining assigned projects will also face foreclosure.

Once foreclosure takes place the question of repair, management, and disposition of the property must be addressed. HUD, in particular, has been criticized for the management of its inventory of acquired projects. As of April 30, 1981, HUD owned about 31,300 multifamily units. A 1978 HUD study found that the cost to repair a project increases substantially during the period from default through foreclosure--from an average of $53,000 to $611,000. Also, when HUD disposes of its projects it attaches section 8 subsidies to a specific number of units. Since 1977 HUD has committed over $1 billion in section 8 for this purpose.

The acquisition and disposal of single-family housing units pose a different set of problems to the Federal Government. In fiscal year 1980, over 32,000 single-family homeowners with HUD-, VA-, and FmHA-insured mortgages lost their homes due to foreclosure. These agencies paid lenders over $700 million for the unpaid mortgages on these properties. It is anticipated that single-family foreclosures will continue to increase in the near future and that the disposition of federally owned single-family houses will become an increasingly difficult task. Abandonment of these properties also can have a devastating impact on a neighborhood. HUD has attempted to transfer many of its abandoned houses to cities and families for amounts as little as $1. However, claims of mismanagement have developed in certain parts of the country, along with claims that the houses are not being transferred to the most needy and that the programs are subject to fraud and abuse.

Federal efforts to preserve the Nation's existing housing stock for low- and moderate-income families is of utmost importance to the Congress and the administration, particularly in view of the administration's plans to deemphasize the construction of new rental units for low- and moderate-income families in favor of upgrading and preserving existing units. To help accomplish this the administration is placing a great deal of emphasis on participation by the private sector and has created a Housing Commission to study alternatives to current housing programs. It is becoming more important that Federal housing agencies take the steps necessary to ensure that federally sponsored and insured projects remain viable and in the hands of private investors. Once multifamily projects become troubled, are assigned to HUD, and are acquired, the costs to operate, maintain, repair, and dispose of the projects rise dramatically.

Although our primary focus under this line of effort will be on multifamily projects insured by HUD--particularly those that are subsidized--attention will also be focused on single-family programs administered by HUD, VA, and FmHA.

Our strategy will be two pronged. First, we will concentrate on improving Federal efforts to prevent failures among troubled projects. Second, for properties where the Federal Government holds the loan, we will concentrate on methods for putting units "back on their feet" prior to foreclosure, and on how effectively acquired units are managed and returned to private ownership. Accordingly we are directing our work to the following questions:

1. What progress has the Federal Government made in improving its servicing of insured housing loans and what problems remain?

2. How can the Federal Government be more effective and economical in monitoring the performance of mortgagors for assigned loans or in operating acquired properties?

3. How can Federal costs to acquire and dispose of acquired properties be reduced?

<u>How Can the Department of Defense Effectively Reduce the Cost to Operate and Maintain Its Family Housing Units?</u>

The Department of Defense views family housing as a major influence on the morale and performance of its personnel and adequate living conditions as an enhancement of the overall effectiveness of the military forces. It is DOD's objective to ensure that all members of the Armed Forces, particularly married members with dependents, have access to suitable housing. DOD relies on private housing for military families to the extent that it is available in communities near military installations. However, when adequate private housing is not available and cannot be accommodated by a combination of additional community construction or on-base housing assets, DOD may construct housing necessary to meet the shortage. In 1980 about 75 percent of all military families were living in private housing. The remainder lived in about 400,000 Government-owned housing units worldwide.

The age and condition of DOD's family housing units vary significantly. Some of the older units, as well as the recently constructed units, are in good condition. The average age of DOD's housing units is approximately 25 years. The operations and maintenance (O&M) costs associated with DOD's family housing programs have increased rapidly over the past 10 years. In fiscal year 1971 O&M costs were about $400 million. By fiscal year 1980, however, these costs had exceeded $1.4 billion--$1.6 billion was appropriated in fiscal year 1981. The total cost for DOD's family housing program, which includes, among other things, O&M, new construction, and leased housing, exceeds $2 billion.

The Congress has expressed continued concern over the rapid increase in costs associated with operating and maintaining DOD's housing units. The appropriations committees have stated that DOD was not doing an adequate job of either managing or justifying the program. They believe that military family housing is an area of great importance to the stability of our Armed Forces and deserves additional attention by the Department.

Of particular concern to the House Committee on Appropriations has been the wide variance between the various military services in the cost of operating and maintaining housing units. For example, in 1980 the Navy reported that it spent $4,500 per year to operate and maintain each of its family housing units as compared to $3,800 for the Army and $3,200 for the Air Force. In fiscal year 1981 DOD requested a 30-percent increase in its family housing appropriation--one of the largest percentage increases in the President's budget and a rate much higher than annual inflation. The appropriations committees have continued to express concern over the rapid rate of increase in O&M costs that have occurred even though the number of housing units has remained relatively stable over the past several years.

Concern has also been expressed over the DOD/HUD program to stimulate off-base housing for military personnel. Both Departments have claimed progress in the area, but the House Appropriations Committee has stated that it appears that both agencies are operating under a false assumption that progress is being made. DOD had proposed more than $20 million in new on-base construction at two of the three areas designated for stimulating off-base housing. The committee felt that DOD and HUD should devote the resources necessary to develop a workable program.

In light of the rapid increase in O&M costs and the recent work we have performed in this area, it appears that DOD has not made a concerted effort to effectively control and monitor the cost of operating and maintaining its housing units. In considering future DOD budget requests for military family housing, the Congress will need information on the effectiveness and efficiency of the program, if service families are being adequately housed, and where improvements can be made to cut costs and reduce the budget.

Our objectives under this line of effort will be to report to the Congress on DOD's effectiveness in controlling and reporting the costs to operate and maintain family housing units, and whether such housing is maintained at a level adequate and satisfactory to the families that are housed. Our work will be designed to answer the following questions:

1. How can the costs to operate and maintain military family housing be effectively reduced?

2. Are the responsibilities for controlling costs and maintenance needs adequate and properly placed?

CURRENT AND PAST GAO WORK

Following is a list of ongoing and completed studies in this area of concern.

Ongoing studies

--HUD controls over the Public Housing Modernization Program.

--Evaluation of selected operations of the Chicago Housing Authority.

--Effectiveness of Federal efforts in promoting effective and efficient operation and maintenance of federally assisted housing operations and in shifting greater responsibility to the private sector.

--Review of the effectiveness of the use of subsidies to sell acquired multifamily projects.

--Evaluation of the potential for greater economy and efficiency in the management of delinquent FHA-insured mortgages on multifamily projects.

--Evaluation of Federal efforts to prevent administrative and programmatic problems leading to defaults of insured housing loans.

GAO reports

"Administrative Procedures and Controls Need Strengthening To Reduce Losses to HUD's Mortgage Insurance Fund" (CED-81-29, December 18, 1980)

"Actions Being Taken To Collect Overbillings and Improve Contracting Procedures at HUD's Columbus Area and Cincinnati Service Offices" (CED-81-67, February 19, 1981)

"Differences in the Services' Military Family Housing Programs Hinder Good Management" (CED-81-71, March 5, 1981)

"Potential Savings from Eliminating Unnecessary Central Air-Conditioning in Military Family Housing in Oahu, Hawaii" (CED-81-91, April 20, 1981)

"Analysis of HUD's May 4, 1981, Response Concerning Its Efforts To Alleviate Housing Abandonment" (CED-81-130, June 25, 1981)

"HUD Single-Family Property Disposal Practices for Properties Transferred to Cities at Less-Than-Market Values or Small Dollar Amounts" (CED-82-16, November 30, 1981)

"Contributing Causes of Financial and Management Problems in Public Housing Projects" (CED-82-31, January 8, 1982)

"Duplicative and Unnecessary Renovations Made in the HUD-Subsidized Concord Commons Apartments in Rockford, Illinois" (CED-82-67, April 15, 1982)

CHAPTER 4

IMPROVING NATIONAL STRATEGIES FOR HOUSING

Federal legislative and administrative actions have set forth a variety of housing goals over the years. Some of these goals are promoting homeownership, improving housing for the poor, improving neighborhoods, promoting racial and economic integration, promoting housing credit liquidity, and promoting housing construction viability.

To meet these goals, a variety of policies and programs have been employed, which include favorable tax treatment, direct subsidies, mortgage insurance, loans, and grants. Grouped together as a mix of programs or individually as a policy, these policies and programs represent "strategies" for solving a particular set of problems. For example, reliance on subsidized new construction as opposed to improved use of the existing housing stock through rehabilitation, conservation, and direct tenant payments is one Federal strategy that is increasingly being scrutinized by many experts. The range of policies and strategies for achieving major housing objectives is extensive and is testimony to the ingenuity of Government managers in finding ways to exert influence in both the production and consumption of housing services--an influence that is already substantial but heading for certain change in the coming years.

Past Federal strategies have not always been successful in meeting intended objectives and, in fact, opposite or conflicting effects have been achieved. One reason for past failures was the inadequate consideration given to how the mix of programs comprising a strategy addressed specific, measurable needs. For example, Federal strategies to achieve a greater economic mix of families in subsidized housing lessened the number of housing units available for those families in greatest need of assistance.

We believe Federal strategies can be better formulated by a more thorough understanding of housing needs. To achieve this, a rational, systematic process for assessing and reassessing true housing needs is necessary. Once needs are accurately articulated, strategies can be formulated and final determinations made regarding achievements of objectives. Such a process is currently lacking in the Federal sector.

Among the many housing goals embodied in legislative and administrative action, confusing and conflicting objectives exist which blunt attempts to properly address real housing needs. For example, Federal goals which target resources to the needy may conflict with another goal to increasingly rely on private enterprise and local control. A more apparent conflict exists between a need for consumer protection (via building codes, environmental quality, and consumer warranties) and the need to maximize housing production while controlling costs.

Directing more issue area resources into strategies evaluation reflects our response to mounting concern over the rapid rise of Federal programs in general and housing in particular. Attesting to this concern is the President's Commission on Housing, which is considering a number of alternative strategies in subsidized and unsubsidized housing. The Commission's work is likely to become the key focus of congressional housing debate throughout the 1983 budget year. The direction of our work in this area of concern may change over time in response to changing housing policy.

STRATEGY FOR SELECTING LINES OF EFFORT

In this area of concern, we will focus attention on groups of programs and policies that make up a strategy to achieve one or more goals. As opposed to evaluating specific programs for results or economy and efficiency, our aim is to identify and evaluate the effectiveness of Government strategies (its mix of programs and policies) for addressing needs and objectives. Individual program evaluations would generally be carried out under other areas of concern.

For this planning period, we will employ three priority lines of effort. Priority attention will be placed on analyzing Federal strategies in terms of how well housing needs of low-income persons are met, given the current environment of increasingly severe physical and economic constraints. Priority attention is also given to an area identified by the administration as top priority: encouragement of homeownership. In this line of effort, reviews will center on Federal strategies used to utilize and encourage homeownership as a national housing strategy. In addition, we will follow up on previous work in the rental housing area by adding a third line of effort on rental housing within the overall Government strategy. This line of effort is being added at this time because we believe that condominium conversions, refinancing, removals, cooperatives, and other factors will continue to shrink the rental housing supply in the future and that it will reach epidemic proportions at mid-decade.

Do Today's Subsidized Housing Strategies Adequately Recognize Needs and Constraints?

The Federal Government's involvement in administering to the housing needs of the poor spans 40 years of experience and several major programs. Subsidized housing strategies employed over the years have ranged from programs providing direct cash subsidies to the poor for easing rent burdens to programs for constructing massive new multifamily housing developments. The results of these programs have been mixed and controversial. New strategies for housing the poor will likely be advanced in the near future as the administration and the Congress grapple over fundamental housing needs and the most cost-effective ways to meet those needs.

Defining housing "need" is a fundamental step in the policy-formulating process, yet too little attention is given to proper assessment and reassessment of people's needs that can be treated by subsidy programs. Historically, need has been defined in terms of physical inadequacies, degree of overcrowding, and more recently, cost burden. In addition, policy workers have, from time to time, outlined special groups in need of Federal assistance. Such special groups include the elderly, the handicapped, rural residents, and various cultural-ethnic groups such as Native Americans. The President's Commission on Housing has established its own set of priority needs to which programs and policies will be targeted. Its "needs" are the "truly" needy, low- and moderate-income persons, "special" groups (elderly and handicapped), and first-time home buyers. Transforming such imprecise need groupings into numbers would yield a very large segment of the population--probably nearly half of all Americans--in need of help. Such a large number "in need" cannot possibly be fully addressed by any feasible range of strategies if they are to be cost effective. A further complication is that within any need grouping, significant intensity differences exist. The "poorest of the poor" may require vastly different subsidy solutions than the "less poor." Thus, key issues are:

--What are the Nation's true housing needs?

--How can these needs be measured and defined in a management context?

--How well do current and alternative strategies satisfy these needs?

Strategies chosen to address needs must also be developed in recognition of constraints, which serve to limit the range of alternatives that can be adopted. The most serious constraint is probably economic as the era of budgetary restrictions is likely to continue for some time. Other constraints include the capacity of State and local governments to implement programs; interest rates, which invariably alter the incentive structure within many subsidy programs; and degree of managerial complexity, which is increasingly important since overly complex policies and programs can lead to poor monitoring, burdensome regulations, and procedures resulting in obscured objectives.

In sum, Federal housing policy lacks a systematic process for identifying and matching realistic, addressable needs to strategies which in turn can be realistically implemented. As national priorities change in response to social-economic change, so do needs and strategies. We expect work in this area to provide a baseline for future work within the entire housing area and also to draw attention to the need for better formulated housing subsidy strategies.

We expect interest in Federal housing strategies and alternative courses of action to receive intense public and congressional interest for the next 2 to 3 years. As the administration charts a new course for Federal housing policy, addressing strategies will become a prime focus in this program plan. Administration changes are expected to be significant and are likely to reflect a different set of assumptions regarding housing needs and strategies to address those needs.

We will closely monitor administration action and policy changes as they evolve. We anticipate initiating work in the future in direct response to administration action. Congressional requests are quite likely in this area. For example, our work on housing block grants was initiated in expectation of congressional requests.

Future work in this area will focus on these questions:

1. Are housing "needs" accurately and systematically assessed and reassessed?

2. How can the Government better target its overall housing policies to those in greatest need?

3. What alternative strategies exist that are less costly but more effective?

How Effective Is the Government's Strategy to Encourage Homeownership?

Encouraging homeownership opportunities has been a primary concern of the Federal Government. Since 1930, more than 50 Federal programs have directly or indirectly affected the ability of families to own homes. These programs, administered by a variety of Federal and quasi-Federal agencies, greatly contributed to increased homeownership so that today, two-thirds of American families own their own homes.

Despite the success of past programs, several issues exist which signal the need for a reevaluation of the Federal homeownership strategy. For example:

--Homeownership subsidies are costly and expanding sharply. Tax deductions for real estate, mortgage interest, and capital gains now cost the Federal Treasury over $24 billion annually in lost tax revenues. The cost in 1986 will climb to an estimated $57 billion. A recent Congressional Budget Office study has documented these costs and has recommended alternative actions to alter tax breaks given homeowners. Despite the political sensitivity of these issues, the Congress may be increasingly interested in considering whether homeownership programs are excessively costly.

--Although residential construction has been a declining percentage of GNP for over 20 years (now less than 4 percent), housing is absorbing a substantially increasing volume of capital--causing concern among some economists about the potential overinvestment of U.S. capital in housing.

--Despite the high subsidy cost of homeownership and the success of past programs, pressure continues to mount for ways of assisting the first-time home buyer, who is increasingly unable to afford a home.

--The popularity of condominium conversion in part reflects the attractiveness of housing as an investment, yet a high rate of conversion reduces the already tight supply of rental housing and creates displacement problems.

--The high cost of rental assistance programs has focused attention on ways of reducing the costs of low-income subsidy programs. Subsidized homeownership for low-income households may be a less costly alternative in the long run.

The Federal Government is changing its strategies to deal with some of these problems. For example, innovative financing techniques have been introduced to cope with high interest costs. HUD's graduated mortgage payment plan provides lower monthly payments in the early years, rising with the anticipated expansion of a family's income and leveling off in later years. The administration and the Congress are currently considering other new financing programs, such as variable rate mortgages and a VA graduated mortgage payment plan. Adjustments to secondary mortgage market institutions have also been made to accommodate graduated payment and variable rate mortgages, and some all-inclusive trust deeds.

The Federal homeownership strategy will be further changed in the near term. The House Democratic Caucus, for example, established a special task force in 1981 to come up with proposals for solving housing problems. The Reagan administration policy on homeownership will apparently place new emphasis on expanding homeownership without subsidy, especially for first-time buyers. The President's Commission on Housing is evaluating homeownership issues, including factors pushing up housing costs, alternative mortgage financing systems which can be used to expand homeowernship, private alternatives to Federal credit programs, the potential for increased pension fund investment in housing, the relationship between regulated and unregulated financial institutions, and the impact of financial institution deregulation. The Commission will also address the extent to which the Federal Government wants to preserve mortgage credit institutions and Federal credit agencies and whether homeowner tax breaks should be altered. The Community and Economic Development (CED) Division's recent symposiums on rural housing and the role of the Federal Housing Administration (FHA) highlighted homeownership opportunities as a key issue in the current housing policy debate. Preserving homeownership opportunities has been consistently advanced as a high priority by HUD and the administration.

Providing and preserving homeownership opportunities will likely remain a national priority. We plan to increase our knowledge and analytical capabilities in order to respond to and advise the Congress on homeownership issues. For example, our plan to analyze subsidized homeownership as a strategy for housing lower income people responds to the concern about the high cost of rental assistance programs and a variety of indications that interest in this kind of alternative is growing.

As the Congress and the administration debate and make decisions on the Federal homeownership role, we can meet their needs for information and analyses. For example, our future assessment of homeownership strategies will be guided by the proposals that are currently being studied by HUD, the administration, and the Housing Commission.

Our work in this line of effort will address the following questions:

1. How can Federal homeownership policies be changed to better meet household needs and Federal objectives?

2. Are Federal homeownership strategies cost effective?

Effectiveness of Strategies for Increasing and Preserving the Nation's Stock of Rental Housing

Providing adequate shelter for households has been and continues to be a longstanding national goal. For many households, rental housing is the only shelter available, yet evidence suggests that a rental crisis--in the form of a shortage of affordable rental units--is close to being a reality. As inflation continues to undermine chances for homeownership for all but a few, pressure will mount to stimulate rental housing. A significant rethinking of Federal strategies toward multifamily rental housing is clearly warranted.

Although experts disagree on the precise nature of the rental housing problem, few disagree that a crisis is fast approaching. For example:

--Rent increases pose a significant and increasing burden on poor people.

--Although rents have increased sharply over the years, they still do not cover rising operating costs, especially energy, which now threaten the solvency of many existing landlords and pose a significant barrier to new investment.

--As the rental stock continues to age, operating costs will surely increase, further exacerbating the landlords' cost problems.

--High home prices continue to lock moderate-income persons into rental markets, further squeezing supply.

The results of these and other factors is that few new, unsubsidized rental structures are being built, while at the same time the existing stock is being reduced by demolition, deterioration, abandonment, and conversion. Subsidized housing production is virtually stagnant and has been in disfavor as a Federal strategy since the early 1970's. Options for improving the rental situation frequently include the following:

--Restrict rents to ease the burden on the poor.

--Encourage new construction of rental dwellings.

--Subsidize the renovation of existing rental dwellings.

--Alter favorable tax treatment afforded homeowners to encourage builders to return to rental construction.

The United States has had rental housing programs since the 1930's. Federal strategy throughout the 1950's and 1960's had a well-defined emphasis on assisting low-income households while also boosting housing production. Major subsidized rental programs were abruptly halted in the early 1970's, giving way to rental assistance programs as the Government's dominant strategy for assisting renters. This sharp departure in rental housing strategy--a strategy which still exists--has as its focus subsidizing households rather than housing units. The new construction component of section 8 is growing smaller and is used only where it can be demonstrated that existing housing is inadequate. Other elements of the current Federal rental strategy include providing operating subsidies for maintaining public housing and funding rehabilitation of existing stock for stimulating new production. The United States relies on incentive programs to encourage private development of rental housing--primarily through tax subsidies and loan insurance (as opposed to direct Federal financing).

With the expected "crunch" in rental housing peaking within the next few years, now is the time to evaluate old and potential new strategies for addressing rental housing issues. We expect the administration to advance policy and program proposals affecting low- and moderate-income housing needs early in 1982. These proposals will be debated over the next budget year, but a concensus on any novel initiatives will probably build more slowly. We expect work in this line of effort to provide the Congress with information on several basic issues which will underlie what we envision as a major legislative decision facing the Congress in fiscal year 1983.

Our specific objectives are to address the following questions:

1. How effective is the mix of current policies and programs and what are the effects of proposed changes in meeting overall rental housing supply needs?

2. Are the needs of low- and moderate-income renter households adequately addressed by the mix of current and expected programs?

3. How balanced is Federal policy toward rental housing needs compared to homeowner needs?

CURRENT GAO WORK

Following is a list of ongoing studies in this area of concern:

--Use of housing grants as an alternative for housing low-income families.

--Assessment of subsidized homeownership as a strategy for housing lower income persons.

GAO reports

"October 1981 Recommendations of the President's Commission on Housing: Issues for Congressional Consideration" (CED-82-42, February 25, 1982)

"Housing Block Grant Activity in Pittsburgh: A Case Study" (CED-82-52, March 24, 1982)

"Housing Block Grant Activity in Seattle: A Case Study" (CED-82-60, March 30, 1982)

"Housing Block Grant Activity in Dallas: A Case Study" (CED-82-75, April 30, 1982)

CHAPTER 5

EFFECTIVENESS OF FEDERAL EFFORTS

TO PROVIDE MORTGAGE CREDIT AND STABILIZE FINANCING

TO MAINTAIN A VIABLE HOUSING INDUSTRY

The lack of an adequate supply of mortgage credit at reasonable terms and the escalating costs of housing have created serious problems for home purchasers and builders. At the same time, the construction of private rental housing has slumped and the vacancy rate in rental housing is at its lowest level in many years.

The availability and cost of mortgage funds have been extremely volatile. The housing industry has seen no less than seven short-term periods of cyclical instability since 1948. During these periods, housing production fell an average of 40 percent from the high to the low production point. Moreover, the availability of mortgage money for certain individuals and locations in the Nation has varied. Currently, the housing industry is plagued by the Federal Reserve Board's tight money policy and high interest rates.

Because housing is a major purchase that can be deferred when mortgage funds are difficult to obtain or when interest rates are too high, demand for housing is sensitive to credit availability and interest costs. Weaknesses in the flow of mortgage funds coupled with high interest rates have caused problems for home buyers, builders, and lenders.

Housing starts fell in September 1981 to a seasonally adjusted annual rate of 0.9 million units, 31 percent below the weak 1.3 million starts recorded in 1980, and were expected to drop even lower in the last quarter of the year. Also during 1981, mortgage rates rose above the 18-percent level (the FHA/VA interest ceiling was raised to a record 17-1/2 percent) and record outflows of funds from thrift institutions primarily into money market mutual funds continued to occur. Economists were predicting that the housing market will show few signs of improvement until mid-1982 when deposit flows are expected to improve, interest rates begin coming down, and the economy regains its momentum. A slow recovery of the housing market in 1982 is forecast with a modest 1.3 to 1.4 million housing starts predicted during the year.

The Nation's rental housing supply has declined in recent years until the vacancy rate--4.9 percent--is at the lowest level in 30 years. The increasing demand for the available units has pushed rental rates up. Factors responsible for the crisis in the supply of rental housing are (1) low levels of private construction, (2) losses of existing units through abandonments and conversions to uses such as cooperatives, condominiums, and office buildings, (3) increasing age of the existing rental stock, and (4) rapidly escalating operating costs.

Realizing that the condition of the housing sector so directly affects the condition of the Nation's economy as a whole and the quality of life of its citizens, the Congress has for many years assigned priority to those programs designed to make new and existing housing available and affordable to more families. The administration, in June 1981, expressed its commitment to solve the problems currently facing the housing sector by establishing a Presidential Commission on Housing. The Commission, composed of members representing both the private and public sectors, has been charged with reviewing all existing Federal housing policies and programs and advising the President on options for development of a national housing policy.

Currently, the mortgage insurance and loan guarantee programs of HUD, VA, and FmHA; the direct loan programs of FmHA and HUD; and the loan programs of the Federal land bank system embody the Federal initiatives which can have a positive effect in making homeownership and rental units more readily available to Americans. In addition, the secondary mortgage market activities of the Government National Mortgage Association (GNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) and the recent decisions by the Federal Home Loan Bank Board and the Office of the Comptroller of the Currency to allow lenders to offer inflation-indexed, floating-rate mortgages, are Federal initiatives designed to faciliate the flow of capital into the housing sector.

Some of the major issues that are emerging in connection with the availability and cost of mortgage funds include:

--Improving Federal efforts to promote homeownership, particularly for young, first-time home buyers.

--Encouraging through Federal efforts the production of a sufficient number of multifamily rental units.

--Using mortgage instruments that feature scheduled or unscheduled fluctuating monthly mortgage payments.

--Exempting from Federal income tax interest on savings accounts to assist families in accumulating funds for a downpayment on a house.

--Imposing congressional limitations on the amount of Federal credit for housing insurance and guarantee programs. This action is designed to reduce the Federal Government's direct role in providing home mortgage insurance and guarantees in favor of increased involvement by the private sector.

STRATEGY FOR SELECTING LINES OF EFFORT

In this area of concern, we will cover those programs within the Department of Housing and Urban Development and related agencies which deal with the effectiveness of Federal efforts to provide mortgage credit and stabilize financing to maintain a viable housing industry. Our strategy is to provide the Congress and agency officials with more efficient and economical ways of improving administration and operation of the housing credit programs. We expect this strategy to result in agency and congressional actions to improve the operations of insurance programs, strengthen efforts which seek to implement innovative financing techniques, and provide insight into the consequences of limiting the amount of Federal mortgage insurance and guarantee loans.

For this planning period, we have selected two lines of effort. The first focuses on the effectiveness of Federal efforts to provide mortgage credit at reasonable costs. Because of the current high interest rates which greatly contribute to the exceedingly high cost of housing, we plan to direct most of our work in this area of concern to this line of effort. Our remaining line of effort focuses on the effectiveness of Federal efforts aimed at moderating cyclical instability in the housing industry.

The lines of effort on making mortgage financing available in all locations and for low-income families at reasonable costs and on the organization of Federal housing credit agencies, which were included in our prior plan, are being dropped. The objectives under the first line of effort were largely satisfied through prior work--issuance of a major report entitled "Ways of Providing a Fairer Share of Federal Housing Support to Rural Areas" (CED-80-1, Mar. 28, 1980). Other priority work precludes us from performing work in the second line of effort during this planning period.

How Can Federal Efforts to Provide Mortgage Credit Be Made More Effective and Less Costly?

High interest rates, increasing home prices, restricted availability of mortgage credit, and weak income gains have led to reduced housing activity beginning in late 1979. These factors have created serious problems for potential home buyers, renters, lenders, and builders.

In August 1981, the median sales price of new single-family homes was $73,900 with the average sale price for such homes reaching $88,400. These figures represent increases of $10,700 and $11,900, respectively, from those recorded a year earlier. Using the record interest rate levels of mid-1981, home buyers purchasing an average new home today, after making a 5-percent downpayment and paying any points necessary, are facing monthly payments of approximately $1,300 for a 30-year mortgage, not counting monthly expenses for mortgage insurance premiums, taxes, property insurance, or utilities.

Continued deposit losses by the Nation's thrift institutions have forced these institutions to reduce their mortgage commitment and lending activity. In the first 6 months of 1981, withdrawals from federally insured savings and loan associations exceeded new deposits by $10.98 billion while mutual savings banks had a net savings drain of $6.22 billion during the same period. These deposit drains are primarily the result of stiff competition for household savings from the popular money market mutual funds. Adding to the industry's problems has been a severe earnings squeeze resulting from a combination of high interest rates on deposits and extensive portfolios of low-yield mortgage loans.

Numerous Federal policies and programs aimed at stimulating the housing sector have recently been implemented or are being considered. The Depository Institutions Deregulation and Monetary Control Act, enacted in March 1980, is expected to significantly increase the flow of funds for home mortgages by increasing the institutions' ability to compete for funds and reducing the restrictions on their activities. Recent decisions by the Federal Home Loan Bank Board and the Comptroller of the Currency regarding adjustable rate mortgages are expected to influence mortgage lending by providing income protection safeguards for the lenders. Another stimulus for the housing sector is expected to be provided by the tax cut legislation recently approved. The legislation includes a number of provisions to assist the housing sector, including the creation of a tax-exempt savings certificate designed to provide funds for housing and lower the cost of money for depository institutions.

HUD, too, has implemented or is considering implementing policies or programs designed to cope with the high cost of housing and the restricted availability of mortgage credit. The Department has developed the section 245 graduated mortgage payment plans aimed at young, first-time home buyers and is considering incorporating an adjustable rate feature into them. It is also considering seeking authority to insure adjustable rate and shared appreciation mortgages and including due-on-sale clauses in future loan contracts. HUD has increased mortgage limits on insured loans; is implementing programs for negotiated rates, co-insurance, and delegated processing; and is studying ways to reduce the cost of housing, including through reduced regulatory requirements. Further, programs have been designed to increase the availability of multifamily rental units, both new construction as well as refinancing/rehabilitation of existing units.

We believe that this line of effort deserves priority attention in that inflation and the general unavailability of credit have caused serious problems for the housing industry and many American households. Federal efforts to promote housing availability and affordability have not been sufficient to enable many families to purchase or rent suitable housing.

The Congress has shown considerable interest in Federal efforts to provide mortgage credit at reasonable costs. The Subcommittee on Housing and Urban Affairs, Senate Committee on Banking, Housing and Urban Affairs, has expressed specific interest in (1) the role of FHA as compared to private mortgage insurers (PMIs) and (2) the possibility of terminating or consolidating existing FHA programs. Similar interests were expressed by various housing experts during our planning symposium on FHA issues. Our objectives in this line of effort will be to provide the Congress with relevant information regarding several key policy issues which we believe will be debated heavily during the next 2 years. To do so we will address the following questions:

1. How can Federal credit agencies provide mortgage credit to crucial sectors of the housing market?

2. Have the Federal credit agencies been aggressive in seeking innovative financing techniques to increase housing construction and/or to assure the continued availability of funds for existing housing?

3. What are the consequences of imposing limits on the amount of Federal mortgage insurance and guaranteed loans made?

Are Federal Efforts Aimed at Moderating Cyclical Instability in the Housing Industry Efficient and Effective?

Cyclical instability has been a major characteristic of the housing industry since 1948. For example, from a peak annual rate of 2.5 million housing unit starts in the first quarter of 1972, residential construction declined to an annual rate of 904 thousand units in the first quarter of 1975. More recently, housing starts fell from a 1979 level of 1.8 million units to a seasonably adjusted annual rate of 918,000 units in September 1981.

In response to cyclical declines in housing, the Congress in the past has enacted legislation aimed at stimulating the construction and sale of new homes. One such program was established by the Emergency Home Purchase Assistance Act of 1974 which, as amended, authorized nearly $18 billion for the purchase of mortgage loans--both single-family and multifamily. In addition, GNMA programs have become increasingly important in countering cyclical declines in the housing areas.

The issue concerning the cyclical instability of the housing industry is again becoming critically important. High interest rates, tight money, and deteriorating conditions of the Nation's financial institutions have contributed to a rapidly deteriorating housing industry with housing starts at their lowest levels since the early 1940's. A major tool used to support the building and lending industries is the secondary market operation of GNMA through its Mortgage Backed Securities (MBS) Program.

Our objective during this period will be to examine the overall effectiveness of the administration of MBS and related activities. This should allow us to advise the Congress during early 1983 when we anticipate significant administration proposals to alter GNMA operations.

CURRENT AND PAST GAO WORK

Following is a list of ongoing and completed studies in this area of concern.

Ongoing studies

--Analysis of HUD's section 223(f) mortgage refinancing program.

GAO reports

Letter report--HUD's Payment of Distributive Shares From the Mutual Mortgage Insurance Fund (CED-81-44, February 9, 1981)

"New Home Buyers and Federal Agencies Benefit from Improved Warranty Protection" (CED-81-40, May 26, 1981)

"HUD Should Strengthen Mortgagee Monitoring To Reduce Losses" (CED-81-108, June 9, 1981)

"New Mortgages for Financing Homes Need Uniform and Comprehensive Consumer Safeguards" (CED-81-53, July 2, 1981)

CHAPTER 6

STRENGTHENING THE EFFECTIVENESS OF FEDERAL PROGRAMS TO PRESERVE AND UPGRADE URBAN AND RURAL COMMUNITIES

Cities range in size from the smallest incorporated rural communities to the metropolitan giants like New York, Chicago, and Los Angeles. As diverse as they are, they have common elements--they house people and serve as centers of jobs, learning, recreation, communication, and commerce. It is not presumptuous to say that the vitality of American cities is crucial to the Nation's economic strength and quality of life.

Another common thread binding many of our small communities and our aging cities is that they are in distress. The need to face escalating costs of county and city governments as a result of double-digit inflation, the need to provide services for large numbers of often unemployed poor people, and the need to maintain aging infrastructures more than ever threaten to overtax the financial resources of even our most prosperous communities.

The movement to preserve and improve the quality of life in urban and rural communities gained increasing prominence in recent years. Federal policy statements recognized that several program authorities had been enacted over the past two or three decades to deal with the problems in urban and rural areas but pointed out that no institutional capacity exists at the Federal level for coordinating and focusing these programs in a coherent and effective way. Also, the Rural Development Policy Act of 1980 requires the Government to prepare a comprehensive rural development strategy to coordinate and focus Federal programs on rural issues and needs. Additionally, HUD's newly appointed Secretary has said that the Reagan administration will not turn its back on the problems of cities.

The continuing problems which plague our Nation's communities include

--housing deficiencies--lack of quality and quantity;

--crime;

--increasing fiscal and political fragmentation resulting in an aggravating mismatch of needs and resources;

--high unemployment and low family income;

--citizen alienation and/or apathy in the face of ineffective or poorly coordinated governmental action;

--transportation problems in communities--private automobiles are crowding city streets and main access roads, and mass transit is in serious financial trouble;

--deterioration of physical infrastructure, including systems for water supply and distribution, streets, and bridges;

--educational problems, with urban and rural school systems struggling to attain national standards; and

--the lag in development of community facilities in rural areas.

An array of Federal programs, administered by several agencies, provides financial support for community preservation and improvement activities in urban and rural communities. This support is provided through grants, direct loans, loan guarantees, and technical assistance to States and localities. In fiscal year 1982, the Government will spend about $8 billion for community and regional development.

The major programs for improving and preserving the quality of life in urban and rural communities include:

--The Community Development Block Grant (CDBG) Program, administered by HUD. This program provides grants, totaling about $4 billion annually, to some 1,900 communities. These grants can be used to support a wide range of eligible activities based on local priorities.

--The Urban Development Action Grant (UDAG) Program, administered by HUD. This is a $500 million program which assists severely distressed cities and urban counties, primarily through stimulation of commercial and industrial development.

--A wide range of grant and loan programs administered by the Economic Development Administration (EDA) to promote the long-term recovery of economically distressed communities.

--A variety of programs in the Department of Agriculture for water and sewer systems, community facilities, and planning assistance. These programs provide grants, direct loans, and loan guarantees to principally rural communities.

--Various other Federal programs relating to transportation, schools, public health, and employment opportunities.

Additionally, a recent important development in the Federal Government's strategy to aid economically distressed cities has been the "enterprise zone" concept. Under this approach the Government would provide a varity of financial incentives for businesses to locate in and create jobs for lower income persons in severely distressed portions of cities. The enterprise zone concept is a major feature in several bills before the Congress, but details on how such a concept would be implemented have not been developed.

STRATEGY FOR SELECTING LINES OF EFFORT

We are selecting four lines of effort during the upcoming planning period. The first stems largely from the previous plan and encompasses the effectiveness of HUD's $4 billion Community Development Block Grant Program--by far the largest single Federal program to preserve and revitalize our Nation's cities and counties. Our second line of effort is new. It concerns the economy and efficiency of the CDBG Program. This line of effort addresses such issues as grantee compliance with Federal financial management requirements; program financial controls; HUD and grantee procedures to stem waste, fraud, and abuse; and the usefulness of independent public accountant audits of the 1,900 block grant recipients.

Our third line of effort concerns Federal efforts to assist economically distressed communities. This was downgraded from a separate area of concern in the prior plan because the current administration has reduced the Federal resources earmarked for special programs such as UDAG and EDA grants targeted to severely distressed communities. Nevertheless, the Government will spend over a billion dollars in fiscal year 1982 to aid these communities, and therefore we will continue to perform work in this area. We will focus on ways to improve the economy, efficiency, and effectiveness of Federal dollars directed specifically toward the economic needs of severely distressed communities and how to target those dollars to areas, neighborhoods, and people with the greatest needs.

Our fourth line of effort addresses the growing awareness by the Congress and the Nation of the need to preserve and improve the quality of life in both our urban and rural environments to provide all Americans with viable choices as to where they wish to live and work. The importance of doing this for rural areas is widened by the recent enactment of the Rural Development Policy Act of 1980. In addition, recent and potential future budget cuts in urban and rural programs will make it increasingly important to get the most from the limited resources that are made available. Thus, we are continuing our line of effort on the Nation's comprehensive rural development policy. However, we are expanding the objectives of this line of effort to better focus on the policy issues affecting the quality of rural life.

How Effective Are Federal Efforts to Preserve and Revitalize Cities and Counties?

HUD's Community Development Block Grant Program is a $4 billion a year program, created in 1974 to provide decent housing, a suitable living environment, and expanded economic opportunities, principally for persons of low and moderate income. Most of the money--about $2.8 billion in fiscal year 1981--goes to approximately 550 metropolitan cities and 84 large counties which, because of their size and financial and physical condition, are entitled by law to receive CDBG's. About 25 percent of the program's funds--or about $1 billion in fiscal year 1981--was awarded competitively to about 1,300 small cities out of the approximately 3,700 units of local government potentially eligible to compete for the "small city" portion of the CDBG Program.

Grantees can use CDBG funds for a wide range of eligible activities, including

--acquiring real property,

--rehabilitating single-family or multifamily homes,

--demolishing or clearing blighted areas,

--providing public services to the community,

--paying for persons displaced by Federal projects,

--developing strategies to conserve energy, and

--repairing streets and sewer lines.

Recent emphasis by both the Reagan administration and the Congress has been to decrease the Government's involvement in the day-to-day operations of the program and to give local governments more flexibility in deciding how to spend program funds. For example, as a result of the 1981 amendments to the program's enabling legislation, entitlement grantees no longer have to submit detailed application packages for HUD approval describing, on a project-by-project basis, how the city will spend its grant. The amendments took HUD out of the preaward approval business. HUD's oversight now consists exclusively of postaward monitoring and audit.

Concerning the eligibility of activities, the 1981 amendments now allow cities to use CDBG money for direct assistance to "for-profit" firms. HUD's Assistant Secretary in charge of the CDBG Program has recently stated that this change means that, more than in the past, block grant funds can be used to spur economic development and that leveraging (with private funds) can be an important vehicle to accomplish this objective.

Perhaps the most significant program change as a result of the 1981 amendments is in the small cities portion of the CDBG Program. The amendments allow for an optional takeover of that portion of the program by individual States starting in fiscal year 1982.

How well HUD manages the block grant program and the extent to which the program complies with legislative objectives and achieves measurable improvements in community development are the major issues addressed by this line of effort.

While the 1981 amendments give cities more flexibility in carrying out their block grant activities, HUD retains the important accountability function of determining "after the fact" whether grantees actually spent their funds on the program's three main legislative objectives: (1) principally benefiting low- and moderate-income persons, (2) preventing or eliminating slums and blight, or (3) meeting community development needs having a particular urgency. HUD's Secretary has statutory authority to reduce the amount of a recipient's future block grant if the Secretary finds that a recipient is, among other things, not complying with the program's main objectives. (The 1981 amendments did not alter this authority.) We plan to assess HUD's efforts in these areas.

We will also look at how well HUD is implementing its recent legislative mandate to transfer to the States responsibility for administering the $1 billion small cities portion of the CDBG Program. Finally, we plan to monitor HUD's response to the reporting requirement in the 1981 amendments concerning our conclusions regarding major issues to be addressed in restructuring the block grant program.

We expect our work to focus on the following questions:

1. Are HUD's monitoring and oversight of the block grant program adequate to determine whether grantees comply with the program's continuing legislative objectives?

2. How effectively is HUD transferring administration of the small cities portion of the block grant program to the States?

Is the Community Development Program Being Operated Efficiently and Economically?

Financial accountability for the $4 billion CDBG Program is shared between HUD and the 1,900 cities and counties (and starting in fiscal year 1982, the States) that receive grants. HUD has overall responsibility for assuring that grantees follow Federal requirements dealing with financial management, allowability and eligibility of costs, and requirements that grantees be audited at least biannually by independent public accountants (IPA's).

Grantees, on the other hand, have first-line responsibility to operate community development programs that are economical; well managed; and have sufficient safeguards to detect and prevent waste, fraud, and abuse.

The main objective of this new line of effort is to evaluate the adequacy of HUD and grantee performance in the area of financial management and their capacity to detect, prevent, and eliminate waste, fraud, and abuse. Our strategy will be to perform top-to-bottom reviews of several large grantees to identify and evaluate Federal and local policies and procedures for managing the financial aspects of CDBG's and for preventing and eliminating waste, fraud, and abuse. This should put us in a good position to identify financial management and control issues warranting nationwide review.

Our primary focus will be directed at determining whether grantees are complying with legislative requirements (those unaffected by the 1981 Omnibus Budget Reconciliation Act), including HUD and Office of Management and Budget implementing regulations dealing with grant administration and financial management. Some of the issues we plan to look at include Federal requirements concerning grantees' reprograming of funds between projects; management of cash receipts and use of letters of credit; compliance with a 20-percent legislative cap on administrative costs; and use of independent public accountant and HUD Inspector General audit reports as a management tool for identifying, reporting, and taking corrective action on cases of mismanagement, fraud, abuse, and waste. Specifically, we will address the following question:

--Are CDBG grantees complying with Federal (and local) requirements dealing with managing, safeguarding, and efficiently using program funds?

<u>How Effective and Economical Are Federal Efforts in Assisting Economically Distressed Communities</u>?

Economically distressed communities, both large and small, are located in every region of America. Burdened with too few jobs and too little income, these communities have a wide variety of severe economic problems. Although these problems cannot be treated alike, distressed communities share the following common characteristics:

--Their residents suffer from high unemployment and low family income.

--Their population growth is often below average, sometimes even declining.

--Their young people leave for greater opportunity, stripping the area of badly needed skills and energy.

--They find it increasingly difficult to support schools, hospitals, and other public facilities.

--They are often too poor to provide and/or protect public structures needed to attract new businesses and new jobs.

Federal programs directed specifically toward the economic needs of distressed communities are administered by EDA and HUD. EDA, which has been at the forefront of the Federal Government's efforts in this area, uses planning and technical assistance grants, public work grants, and direct and guaranteed loans to promote the long-term recovery of economically distressed areas by reducing unemployment and underemployment, increasing family incomes, strengthening tax bases of local communities, and assisting the construction of facilities providing essential services to low-income groups. HUD also plays a major role in this area through its Urban Development Action Grant and CDBG Programs. UDAG provides grant assistance to communities to help alleviate physical and economic deterioration through the stimulation of commercial and industrial development and the reclamation of deteriorating neighborhoods. Also, a significant part of the CDBG Program (about $400 million in fiscal year 1981) is spent on economic development projects.

The Reagan administration recommended abolishing EDA because it was originally established to provide special financial assistance to the 10 to 12 percent of the country which had been bypassed by general economic prosperity, but the program had evolved to the point where 80 percent of the country qualified for assistance. Reportedly, the funds have been spread too thin and not used effectively. The administration's economic policy is geared toward stimulating capital investments and creating jobs through the private sector by reducing interest rates, inflation, taxes, and Federal spending and removing unnecessary and burdensome Federal regulations. In addition, the administration supports the enterprise zone concept and is studying ways to set up enterprise zones in distressed communities--both urban and rural. The Congress voted to fund EDA for fiscal year 1982, but only at about 45 percent of its 1981 level.

Similarly, the administration initially proposed folding the $600 million UDAG Program into the larger Community Development Block Grant Program. However, strong congressional and local government opposition to such a consolidation resulted in the administration's softening its position on UDAG. Indeed, the recently enacted 1981 housing amendments authorize UDAG at $500 million annually through fiscal year 1983. HUD is currently performing a comprehensive evaluation of the program to decide whether the program needs to be restructured or even terminated after fiscal year 1983.

While the Government's approach to assisting and stimulating economic development has undergone major changes, the Federal role for helping to stimulate economic growth in the more distressed communities continues to be of interest to the Congress. We expect our work to focus on the following questions:

1. Should resources be better focused to reach areas, neighborhoods, and people with the greatest needs?

2. How can the Federal Government assure the economical and efficient use of its economic development dollars?

3. To what extent will enterprise zones contribute to curing the economic ills of distressed communities?

Our strategy in this line of effort is to help improve the economy, efficiency, and effectiveness of Federal dollars directed specifically toward the economic needs of distressed communities and to better target those dollars to areas, neighborhoods, and people with the greatest needs.

How Effective Is the Nation's Rural Development Policy?

For decades urban areas grew while rural areas declined. Since 1970, however, the migration trend from rural to urban areas has been reversed. Rural employment is now growing and diversifying, but this growth has created new demands and new problems as well as new opportunities. Some of the problems are readily apparent. Property values and taxes are rapidly escalating. Prime agricultural land is being lost to development, and the influx of new residents is increasing the demands on local governments for essential public facilities and services.

But not all rural areas are growing. About 500 counties, heavily agricultural, continue to lose population because the exodus of workers from agriculture exceeds the number of nonfarm jobs. Also, rural people and communities still have proportionately greater unmet basic needs--housing, water and sewerage, health, education, income maintenance, transportation, and social and legal services--than do other parts of the Nation. Meeting these needs is essential to foster and accommodate the growth and development of rural areas.

However, many small towns and rural communities do not have the capacity or resources to respond to their problems. Many also lack the "grantsmanship" required to compete successfully for limited Federal and State assistance. Further, many Federal programs were formulated with big cities in mind and thus contain eligibility and other criteria that hinder access by small communities. Even when assistance can be obtained, many small communities lack the fiscal resources to match Federal grants or repay loans.

A multitude of Federal agencies and programs are available to provide small towns and rural areas with the tools and resources they need to respond to their problems. Overall, there are over 200 Federal programs, currently included in 15 GAO-approved issue areas, that can be used to address rural problems. One of the most important agencies to rural development is the Farmers Home Administration. This agency operates a wide range of credit assistance and grant programs for farmers, rural residents, communities, and businesses to help improve the quality of rural living.

The responsibility for coordinating Federal rural development activities was given to the Secretary of Agriculture in 1972. In December 1979, this coordination role became the cornerstone of the Carter administration's small community and rural development policy. This policy included a number of goals and principles which were incorporated into the Rural Development Policy Act of 1980.

The Rural Development Policy Act of 1980 requires the new administration, specifically the Secretary of Agriculture, to prepare a rural development strategy and to update this strategy annually. The act requires that this strategy be based on the needs, goals, objectives, plans, and recommendations of local communities, substate areas, States, and multistate regions. The strategy is to be designed in part to

--improve the effectiveness, responsiveness, and delivery of Federal programs;

--increase the coordination of Federal programs:

--achieve the most effective combination of Federal, State, and local resources; and

--improve State and local government management capabilities, institutions, and programs.

In implementing this strategy, the Secretary is to

--improve communication and encourage cooperation among Federal departments and agencies;

--eliminate conflicts, duplication, and gaps in program coverage;

--facilitate and expedite joint financing of rural projects;

--correct administrative problems that delay or hinder the effective delivery of Federal services and assistance; and

--simplify, standardize, and reduce the complexity of applications, reports, and other forms.

How well Federal programs, activities, and resources are managed and coordinated will determine the extent to which rural problems will be resolved and the quality of rural life will be improved. Thus, in determining the effectiveness of the Nation's rural development policy, our line of effort will address this major issue.

The extent to which rural problems will be resolved and the quality of rural life improved depends in part on how well Federal programs, activities, and resources are managed and coordinated. The objectives provided for in the Rural Development Policy Act now provide a consistent basis to evaluate the effectiveness of the Nation's rural development efforts. But present and future budget reductions in Federal programs, including many that benefit rural areas, also make it increasingly important that rural development activities be properly and economically managed to assure that rural areas get the most out of the limited resources available. Emphasis will be given to the leadership responsibilities of the Secretary of Agriculture in developing a rural strategy and coordinating and monitoring its implementation. Specifically, our objective in this line of effort will be to provide partial answers to the following questions:

1. How effective is the Federal Government in improving the ability of small communities to deal with their problems?

2. How can Federal loan programs be made more cost effective?

3. Are Federal rural development efforts responsive to regional, State, substate, and local needs, objectives, plans, and priorities?

CURRENT AND PAST GAO WORK

Following is a list of ongoing and completed work in this area of concern.

Ongoing studies

--Who benefits from the Community Development Block Grant Program?

--Evaluation of the economic and social impacts of enterprise zones as a means of revitalizing distressed urban areas.

--Analysis of HUD's evaluation of the Urban Development Action Grant Program.

--Review of interest rates used in financing and making loans in FmHA.

GAO reports

"HUD's Urban Development Action Grant for Parkway Shopping Mall, Pittsburgh, Pennsylvania" (CED-80-110, June 26, 1980)

Letter report--Status of Youngstown, Ohio, CDBG and UDAG (CED-80-121, July 25, 1980)

"Analysis of Community Development Block Grant Drawdown Rates" (CED-80-137, August 20, 1980)

"Financing Rural Electric Generating Facilities: A Large and Growing Activity" (CED-81-14, November 28, 1980)

"Summary of Major Deficiencies in the Farmers Home Administration's Business and Industrial Loan Program" (CED-81-56, January 31, 1981)

"Further Actions Needed To Improve Management of HUD Programs" (CED-81-41, February 26, 1981)

"The CDBG Program Can Be More Effective in Revitalizing the Nation's Cities" (CED-81-76, April 30, 1981)

"Limited-Resource Farmer Loans: More Can Be Done To Achieve Program Goals and Reduce Costs" (CED-81-144, August 31, 1981)

"More Can Be Done To Measure HUD's Success in Using Millions of Dollars for Rehabilitating Housing" (CED-81-98, July 14, 1981)

CHAPTER 7

ENHANCING COMMUNITY DEVELOPMENT THROUGH APPROPRIATE ASSISTANCE TO SMALL BUSINESSES AND FARMERS

The small business economy is so embedded in everyday existence that it is easily overlooked. There are about 14 million small firms in the United States comprising more than 98 percent of all American businesses. They provide livelihoods for more than 100 million Americans and account for roughly 40 percent of our gross national product. But statistics hardly do justice to the diverse ways that people depend on small concerns every day for goods and services.

Small businesses are deeply rooted in their communities, regions, and neighborhoods and are the most vital ingredient in local economies. Studies have shown that communities with large numbers of small businesses have higher income levels, more balanced and stable economic lives, and greater civic participation. Small business towns have more abundant retail facilities and goods; more homeownership, better housing, and fewer slums; plus greater expenditures for educational, recreational, cultural, and religious activities.

New and existing small firms in recent years have provided an astonishing 86 percent of the Nation's new jobs in the private sector. In addition, more than half of the major innovations in contemporary life have been developed by individuals and small organizations.

Despite the importance of a flourishing small business community to the well-being of our Nation, there are numerous obstacles and impediments to establishing and maintaining a small business. Among the more serious are inadequate equity and debt capital, burdensome Federal regulation and paperwork, and ineffective management capability on the part of business owners.

Over the years, there has been a growing recognition of the importance of small businesses as well as their problems and needs. One of the older initiatives to assist small businesses was the establishment in 1953 of the Small Business Administration (SBA). SBA has a number of programs directed at the financial and management assistance areas. Since 1953, programs benefiting small businesses have been established in other agencies such as the Minority Business Development Agency (MBDA), the Economic Development Administration within the Department of Commerce, and the Farmers Home Administration within the Department of Agriculture.

In the last several years, the recognition of small business issues and problems has greatly expanded. For example, a 4-day White House Conference on Small Business was held in January 1980. The Conference was attended by 1,682 delegates, and a number of legislative recommendations emerged from the Conference. In the Congress, the importance of small business issues has also been emphasized with the passage of legislation intended to create a more conducive environment for small businesses. One example of such legislation is the Regulatory Flexibility Act of 1980. The main objective of this law is to substantially reduce the number of regulations affecting small firms.

Congressional interest in small business issues is also being demonstrated in the 97th Congress. Well over 100 bills pertaining to small business have been introduced. These bills cover a wide range of small business problems including financing and interest rates, regulations, taxes, etc.

This increased interest in small business issues along with the administration's desire to shift more responsibility for small business assistance to the private sector will undoubtedly affect the direction of our work. In the past, the majority of our work was congressionally mandated and focused on individual Federal programs without assessing Federal/private sector linkages. Our reviews over the last 6 years covered virtually every major SBA program and many of that agency's smaller programs. In addition, we covered a number of business assistance programs administered by EDA, FmHA, and MBDA. Since our previous work did not assess how effective Federal programs are in leveraging private sector involvement, we see the need to consider future work in this context.

Farming is a business, and for many rural areas farming makes up a very significant part of the area's economy. Like other businesses, farmers need credit. There are three major public agencies that lend directly to farmers: the Commodity Credit Corporation, the Farmers Home Administration, and the Small Business Administration. FmHA is the largest of these and the most important in terms of reflecting Department of Agriculture credit policies and structural interests. In fiscal year 1981, FmHA insured or guaranteed about $8 billion in loans under its farmer programs. Traditionally, FmHA has been the lender of last resort providing credit to farmers unable to obtain credit from other sources.

Over the years, the Congress has been concerned with preserving the family farmer, assisting small and limited-resource farmers, and helping beginning farmers to overcome the difficulties of getting started. One of its highest concerns, and one that transcends all others, is the need to provide credit at a reasonable cost to the farmer. This concern is heightened at this time by many indications that farmers are plagued by high interest rates and a lack of resources to meet loan payments. Yet, the current administration's desire, and apparently that of the Congress, is to reduce Federal expenditures.

Our future reviews of small business assistance programs will be in the context of alternative approaches to addressing small business problems and how the Federal and private sectors interrelate in meeting the needs of the small business community. Our work will focus on the effective use of available resources within both the public and private sectors for dealing with these problems.

STRATEGY FOR SELECTING LINES OF EFFORT

We selected five lines of effort in this area of concern for attention during the upcoming planning period. Three of the lines of effort pertaining to financial assistance, management assistance, and Federal policies which adversely affect small businesses, are modifications to lines of effort in our previous plan. These modifications are consistent with our intent to address the relationships between Federal business assistance programs and private sector resources in meeting the needs and concerns of small entrepreneurs. A fourth and new line of effort addresses SBA programs from an economy and efficiency orientation. This was added in recognition of and response to current congressional and administration emphasis on budgetary reductions and cost savings. A fifth line of effort concerning Federal loan programs for farmers is being continued from the prior plan.

A sixth line of effort pertaining to Federal programs designed to develop viable firms owned by minority and other special groups is being dropped. We completed the six assignments identified in the previous plan under this line of effort and believe that additional work would be redundant. We are cognizant, however, of continued congressional interest in this area. Accordingly, whenever appropriate, we will address problems unique to minority and other special groups as a part of broader reviews in our other lines of effort.

Our basic legislative responsibility work during this planning period will focus on the five lines of effort mentioned above. Initially we will emphasize economy and efficiency reviews, reviews relating to capital needs of small businesses, and reviews of Federal farm credit programs. Also, depending on the level of congressional work undertaken, we plan to initiate a major review within the management assistance line of effort and another on the impact of Federal policies on small businesses.

How Can the Federal and Private Sectors Best Address the Financial Requirements of Small Business?

The nonavailability of capital continues to be one of the biggest problems confronting small businesses. Small companies, particularly new and expanding ones, often do not have enough earnings to support their growth. Inflation, which has driven up operating costs, has made it increasingly difficult for small businesses to generate capital through retained earnings.

Aside from difficulties in generating internal capital, financing from outside sources traditionally has been more difficult to obtain for small firms than for large ones. Recent higher interest rates have intensified this problem. The gap between planned and actual capital investment by small businesses is large and increasing primarily because they cannot afford to pay 20 percent interest for long-term borrowing. This problem was the subject of congressional hearings held on July 30, 1981.

Aside from inflation and high interest rates, other factors have also contributed to capital shortages for small firms. For example, commercial lenders often prefer larger loans over small ones because administrative costs are proportionally lower. Also, small businesses, particularly those just starting up, are generally considered more risky than larger, established companies. Finally, Government regulations associated with stock offerings can be very costly for the small entrepreneur attempting to raise equity capital.

For more than two decades, SBA has been at the forefront of Federal efforts designed to promote and supplement private capital in meeting the financial needs of small businesses. Since its establishment in 1953, SBA has approved over $40 billion in loans to small firms. In fiscal year 1980 alone, SBA made business loans totaling $3.4 billion. Although SBA makes primarily two types of loans--guaranteed and direct--the volume of guaranteed loans has exceeded direct by a ratio of about 20 to 1. In the case of a guaranteed loan, SBA guarantees up to 90 percent of a bank's loan to a small business.

Aside from providing short- and intermediate-term assistance through direct and guaranteed loans, SBA assists small businesses in obtaining long-term debt and equity capital. For example, under its Small Business Investment Company (SBIC) Program, SBA licenses privately owned and operated SBIC's for the purpose of providing long-term debt and equity capital to small firms. As a rule, SBIC's must be capitalized initially by private investors after which they are eligible to receive Federal guaranteed loans for investment in small firms. As of March 1981, SBA had $774 million in outstanding loans to 358 SBIC's.

In addition to SBA, two other Federal agencies have provided substantial assistance to small businesses. The Economic Development Administration, established in 1965, provides direct and guaranteed loans to businesses that are located in distressed areas and to businesses that are injured by imports. Since inception, EDA has provided over $1.5 billion in loan assistance to predominantly small businesses. Also, since 1972, the Farmers Home Administration has made over $5 billion in loans to businesses located in rural areas through its business and industrial loan program. As in the case of SBA, most of this assistance has been provided through guaranteed loans.

Despite the sizable dollar amount of credit assistance extended through the above programs, they have benefited only 2 to 5 percent of the small business community. This limited Federal role is by design since the Congress considers the Government a lender of last resort. However, this role should not be minimized since in a typical year as many as 40,000 small businesses are assisted through Federal direct or guaranteed loans.

In the last several years, a movement has been afoot to get more of the loanmaking responsibility out of the Federal Government and into the banking institutions. For example, in February 1979, SBA instituted its Bank Certification Program. Under this program, SBA relies on selected banks to assess prospective borrowers' creditworthiness with the objective of expediting loan approvals.

In addition to this shift toward private banks, some Government programs are attempting to leverage the Federal dollar in the private sector. For example, SBA and FmHA permit banks to sell the guaranteed portions of their loans in the secondary markets. The Government anticipates that the proceeds generated from the secondary markets will be loaned to other small businesses.

Since its inception in 1978 through March 31, 1981, the National Consumer Cooperative Bank has provided over $100 million in loans to open new co-ops and expand existing ones. In addition, the bank provides technical assistance to upgrade the business management skills of co-op directors and members. The bank was formed to help strengthen community life, control costs, upgrade services, and stimulate economic development. Under the act that created the bank, 35 percent of the bank's outstanding loans must be to co-ops serving low-income persons.

Under recent changes in the law, the bank is to become a totally private entity during fiscal year 1982. Despite this change, GAO will continue to have audit responsibility for the bank. To date, GAO has made only a financial audit of the bank.

Our primary objective under this line of effort will be to assess whether Federal financial assistance activities are meeting the needs of small businesses. Because Federal activities are linked directly to private capital institutions, our focus will be oriented toward evaluating the responsiveness of this public/private sector relationship in meeting the capital requirements of small businesses. This relationship will also be assessed in terms of its responsiveness to minorities and other special groups. Our work under this line of effort will be closely coordinated with the Program Analysis Division, which has issued several reports 1/ related to methodologies for studying Federal credit assistance programs.

Discussions with small business associations and staffs of both the Senate Select and House Small Business Committees have confirmed that the availability of credit to small businesses will continue to be of concern and interest both to the small business community and the Congress. Committee staffs have expressed specific interest in each of the jobs cited below. Accordingly, a broad line of effort recognizing this interest is most appropriate.

As small business assistance shifts increasingly from the public to the private sector, our objectives in this line of effort will continue to focus on the recognized goals of servicing small business needs. We will attempt to ensure that these needs continue to be met by providing the Congress with answers to the following questions which define our objectives more explicitly:

1. Are Federal financial assistance programs achieving their objectives at the lowest cost and with the least adverse impact on private lending institutions?

2. Are Federal financial assistance programs maximizing the use of private sector capital?

3. What factors affect a bank's decision to participate or not participate in SBA's guaranteed loan program?

4. Should banking institutions assume more of the loan-making responsibility from SBA?

5. Is the National Consumer Cooperative Bank carrying out its legislative responsibilities in an efficient and effective manner?

<u>How Efficiently and Economically Are Small Business Administration Programs Being Administered?</u>

The current national economic and political climate dictates that Federal programs be run as economically and efficiently as possible in order to minimize waste. In this connection it is also important that the Federal Government ensure the timely collection of debts and fees associated with its programs.

1/"Federal Credit Assistance--An Approach to Program Design and Analysis" (PAD-78-31, May 31, 1978); "A Methodology for Estimating Costs and Subsidies from Federal Credit Assistance Programs" (PAD-79-5, July 17, 1979); and "An Analytical Framework for Federal Policies and Programs Influencing Capital Formation in the United States" (PAD-80-24, Sept. 23, 1980).

SBA has recently experienced a marked increase in loan delinquencies and liquidations. To address this problem, SBA has utilized a number of methods that affect collections, including extensive deferments of payments, loan refinancings, and charge-offs of loan balances.

Also, SBA operates several major programs which have fees associated with them. For example, SBA charges banks a 1-percent fee on all SBA-guaranteed loans. Also, under its Surety Bond Guarantee Program SBA charges contractors a 0.2-percent fee and requires surety companies to remit 20 percent of their premiums on guaranteed bonds. In fiscal year 1980 alone SBA charged about $40 million in fees on its various programs.

In addition to the importance of managing its debts and making timely collection on the revenue side of programs, it is equally important for SBA to minimize expenses under its programs. Most SBA programs require the outlay of funds, including payments on defaulted loans and surety bonds. SBA is also expending funds on a lease guarantee program which it has been phasing out since fiscal year 1977. Under this program, SBA helped small businesses obtain leased space by guaranteeing rent payments to landlords. Although the program was terminated in 1977, the agency continues to pay about $4 million a year on defaulted leases.

Both the administration and the Congress have placed an increased emphasis on economy and efficiency in Government. We believe the increased interest in this aspect of Federal programs warrants this new line of effort. Our primary objective will be to provide SBA and the Congress with recommendations on how to improve the economy and efficiency of Federal small business programs. We expect our work to result in significant improvement in SBA operations.

Our work will address the following questions:

1. Is SBA exercising adequate controls to effectively manage its loan portfolio and meet its debt collection responsibility?

2. Is SBA exercising proper management controls over fee and premium collections and are these fees and premiums adequate?

3. Has SBA minimized costs associated with its small business assistance programs?

Is the Impact of Federal Policies on Small Businesses Being Adequately Considered?

A number of factors tend to obstruct the development of a flourishing small business economy. One of these major factors has been Federal regulations and the overwhelming, often incomprehensible reporting requirements that go with them. During the past decade, the growth of Government regulations has been explosive, particularly in such areas as affirmative-action hiring, energy conservation, and protection for consumers, workers, and the environment. Currently, about 90 agencies issue thousands of new rules each year.

While everyone recognizes the need for a certain amount of regulation to maintain an orderly society, a large number of Government regulations have had a disproportionate adverse effect on small businesses. Small firms do not have the same financial ability as large firms to meet regulatory requirements. Also, they do not have the same ability to absorb the costs by raising prices. The large firm with large production quantities and less than proportional regulatory costs can pass along its increased costs with a small increase in unit pricing. This situation translates directly into increased economic concentration. Reports by both Houses of Congress cite disproportionate economic burdens on small business as key contributors to declines in productivity, competition, innovation, and the relative market shares of small business.

The executive and legislative branches have taken certain actions in recent years which are intended to ease the regulatory burden on small businesses. In November 1979 President Carter issued a memorandum requesting agencies to tailor requirements to fit the size and nature of the businesses subject to them. A followup memo later that month called for a reduction in the paperwork that the Government requires of small companies. Several Federal agencies have taken actions along these lines. For example, the Securities and Exchange Commission imposes less stringent disclosure and auditing standards on stock offerings of less than $5 million.

While these actions demonstrate a recognition of the problem, the most significant step toward minimizing the regulatory burden on small business was passage of the Regulatory Flexibility Act in 1980. Under this act, Federal agencies have to periodically publish lists of rules which they expect to print in the Federal Register and which would more than likely have a significant economic impact on a substantial number of small entities. When these proposed rules are actually published in the Federal Register, the agency must also publish a regulatory flexibility analysis which must include such items as:

--An estimate of the number of small businesses that will be affected.

--A detailed estimate and description of the reporting, recordkeeping, and compliance requirements anticipated.

--A specific discussion of alternatives to the rule which could accomplish the same objectives, such as different standards for large and small entities or exemption of small entities.

Agencies also have to ensure participation of small affected parties in developing rules through a number of techniques identified in the act. Finally, the act requires Federal agencies to systematically review all their existing rules pertaining to small entities over the next 10 years. In reviewing a rule, an agency must take into consideration the continued need for the rule, public complaints regarding the rule, its complexity, and the extent to which it overlaps, duplicates, or conflicts with other Federal or State rules.

The overall responsibility for policing all of these activities lies with SBA's Chief Counsel for Advocacy. The Chief Counsel is required to submit annual reports to the President and the small business committees of both Houses.

Although a number of outside factors impede the development and growth of small businesses, Federal regulation has been cited as one of the most important problems. It is also a problem which can be controlled to a certain degree. Therefore, our work under this line of effort during this period will concentrate on the regulatory issue as it pertains to small businesses.

Congressional recognition of the importance of small businesses to our national well-being has increased in recent years. Of particular concern are the impediments to the development and growth of small businesses. As a result, we believe this line of effort warrants greater emphasis. Our objective will be to provide the Congress with information on how to best minimize impediments to small business development and growth. We expect our work to result in improved implementation of the Regulatory Flexibility Act, and increased effectiveness of SBA's Office of Advocacy in overseeing its implementation.

Our future work will address the following questions:

1. Have recent Federal initiatives to minimize the impact of paperwork and regulation on small businesses been effectively implemented?

2. Is SBA's Office of Advocacy effectively carrying out its legislative mandates?

What Should Be the Strategies for Addressing the Management Problems of Small Businesses?

Many individuals who go into business are initially inexperienced about business principles and practices. According to Dun & Bradstreet, the majority of business failures are due to management deficiencies such as lack of planning, inadequate controls, poor accounting, and an inability to read and understand financial statements. Also, other businesses often stagnate because of limitations in management and technical skills.

Both the Federal Government and the private sector operate a variety of programs intended to address the management needs of small businesses. At the forefront of the Federal effort has been the Small Business Administration. Through its five primary management assistance programs, SBA reportedly provides counseling and training to over 300,000 small businesses annually. Aside from SBA, the Minority Business Development Agency within the Department of Commerce has a $57 million budget to provide management assistance to medium-sized minority-owned businesses.

Both SBA and MBDA rely heavily on the private sector to deliver much of their management assistance. For instance, SBA finances universities under its Small Business Institute Program to send out graduate students in management to help small companies. Also, under its call-contracting program, SBA contracts with private management consultants who are on call for troubleshooting assignments to help small firms with specific problems. Similarly, MBDA is placing increased reliance on the private sector. In fiscal year 1980, MBDA began using grants to fund a nationwide delivery system of private management and technical assistance organizations.

Aside from efforts undertaken in connection with Federal programs, the private sector also offers numerous management and technical assistance services to both established and potential small business owners. For example, an increasing number of colleges and universities offer curriculums for students contemplating going into business. Also, numerous private firms provide management training services; however, many are geared to developing corporate executives rather than to resolving problems of the small entrepreneur.

The central theme in the management area which came out of the White House Conference on Small Business was the need to foster a partnership among Government, educational institutions, and private management consulting firms. The purpose of this partnership would be to foster an integrated approach to providing management and technical assistance to small businesses. The Conference envisioned the Government's principal partnership role as a policy coordinator. In this regard, it saw the Government as a supplier of seed money to businesses and universities, which in turn would develop specific approaches to entrepreneurial training and management assistance.

As indicated, this line of effort has been revised to focus on the interrelationship between Federal and private sector management assistance services. Our objective is to stimulate effectiveness, efficiency, and cost improvements in management assistance to small firms. We plan to use the results of our prior and ongoing reviews as a basis for a broader review of Federal/private sector managment assistance activities. In doing so, we will address the following questions:

1. How well coordinated are Federal management assistance activities?

2. Are Federal management assistance services effectively integrated with private sector services?

3. To what extent are the Federal and private sectors meeting the management needs of small businesses?

Initiation of future assignments in this area will depend upon the level of congressional request work. Our work should result in improvements in the quality of management assistance to small firms.

How Economical and Effective Are Federal Loan Programs for Farmers?

Since the second decade of this century, agricultural policy has been to assure farmers access to loan funds at favorable rates and terms. This policy has been pursued by reducing risks in agriculture to make farm loans more attractive to private lenders, improving the workings of money markets and lending institutions, and intervening directly in the credit market with programs of direct and insured loans and loan guarantees.

Partly as a result of Federal initiatives, farmers generally have had access to plentiful supplies of loan funds at competitive costs. Many farmers even obtained credit at lower costs than their counterparts in other sectors of the economy thanks to the farm credit system banks, subsidized loans from public agencies, and the isolation of some rural money markets. In turn, farmers have greatly increased their use of and reliance on borrowed funds, invested heavily in capital-intensive technology, and increased their use of purchased production supplies (operating expenses) to replace farm-produced inputs.

Farm-sector debts have increased thirteenfold, from $12 billion in 1950 to about $158 billion on January 1, 1980. By the end of the eighties, farm-sector debt could total as much as $600 billion. Nearly 80 percent of this debt will be owed by farms having annual sales of $40,000 and more. Farms with sales of $100,000 or more will owe about one-half of all farm debt. About half of the borrowed funds will be used to finance transfers of landownership and thus will add little to the productive capacity of the farm sector.

Farms with over $40,000 in sales, and especially those with more than $100,000 in sales, should earn sufficient income to compete for funds on an equal footing with other firms. However, some are highly debt-leveraged and of late have encountered repayment difficulties. Small farms--those with sales between $5,000 and $40,000 a year--are generally not as heavily debt-leveraged and thus have some resiliency to fluctuations in cash flows. But those that rely primarily on farming for a living and must incur substantial debt for operating expenses or acquiring additional resources will be quite sensitive to changes in interest rates in tight-money periods.

The Department of Agriculture in a January 1981 report entitled "A Time to Choose: Summary Report on the Structure of Agriculture," suggested that FmHA should serve

--small farms with sales under $5,000 a year operated by those who are poor and have few off-farm employment opportunities;

--small and medium-sized farms, generally those with sales under $100,000 a year, operated primarily by farmers who have limited resources; and

--beginning farmers to slow the increasing concentration of land in the hands of those already wealthy or controlling land resources.

This report indicated that FmHA had a legitimate role to play in promoting an efficient agriculture and in slowing the trend toward concentration of economic power in large farms. To better fulfill this role, the report stated that the following adjustments in FmHA would be required:

--Substantial redirection of staff toward providing supervised credit to limited-resource farms.

--Shifting more credit to loan guarantees and eliminating interest-rate subsidies wherever possible.

--Providing no funds for farms larger than the size necessary to be reasonably efficient--most farms with sales over $100,000.

--Elimination of subsidized emergency credit.

--Limiting credit for beginning farmers to those seeking to finance operations no larger than necessary to be viable and efficient, pursued by vigorous graduation to private credit.

--Improving the vigor and credibility of procedures for verifying that potential borrowers could not obtain credit elsewhere.

FmHA's farmer loan programs also provide financing important to the growth and development of agriculture, which is still the backbone of the economies of many rural communities. Thus, farmer assistance programs have been considered an important part of our work in enhancing community development.

This line of effort will focus on the economy and effectiveness of Federal loan programs for farmers. This issue is broad enough to cover the Congress' basic concerns and emerging issues relative to the availability and cost of credit and the structure of agriculture.

Our primary objective is to provide the Congress with the information needed to deal with the following important issues:

1. How can Federal farm loan programs be modified to reduce cost?

2. Do Federal farm lending programs assist farmers with the greatest need?

3. Do Federal farm lending programs help farmers to improve their financial profiles and reduce their dependence on credit financing?

We expect our work to result in improved economy in farm credit programs through better targeting of farm loans and more flexible repayment mechanisms.

CURRENT AND PAST GAO WORK

Following is a list of ongoing and completed studies in this area of concern.

Ongoing studies

--Evaluation of the impact on small businesses of sales of SBA-guaranteed loans in the secondary market.

--Control of the loan guarantee credit policy.

--Survey of SBA's efforts to minimize lease guarantee losses.

--Review of the effectiveness of SBA's Certified Lenders Program.

--Evaluation of FmHA efforts to help farmers repay their loans.

--Evaluation of MBDA's role in providing management services to medium-sized minority businesses.

GAO Reports

Status Report on Small Business Minority and Subcontracting and Waiver of Surety Bonding for 8(a) Firms (required by Sec. 7(j)(8) of Small Business Act as amended by Public Law 95-507) (CED-80-130, August 20, 1980)

"Procurement Assistance on Certificate of Competency Program" (November 24, 1980)

"Economic Development Administration: More Can Be Done To Ensure That Industrial Parks Create New Jobs" (CED-81-7, December 2, 1980)

"Most Borrowers of Economic Opportunities Loans Have Not Succeeded in Business" (CED-81-3, December 8, 1980)

"Similar Business Assistance Programs of Two Federal Agencies Have Potential for Duplication" (CED-81-26, December 31, 1980)

"The 8(a) Pilot Program for Disadvantaged Small Business Has Not Been Effective" (CED-81-22, January 23, 1981)

"SBA's Pilot Programs To Improve Guaranty Loan Procedures Need Further Development" (CED-81-25, February 2, 1981)

"The SBA 8(a) Procurement Program--A Promise Unfulfilled" (CED-81-55, April 8, 1981)

"Need To Determine Whether Existing Federal Programs Can Meet the Needs of Women Entrepreneurs" (CED-81-90, April 30, 1981)

Letter report to SBA's Acting Associate Administrator for financing assistance on loan servicing practices (June 9, 1981)

"Better Management of Collateral Can Reduce Losses in SBA's Major Loan Program" (CED-81-123, July 17, 1981)

"SBA's Progress in Implementing the Public Law 95-507 Subcontracting and Surety Bond Waiver Provisions Has Been Limited" (CED-81-151, September 18, 1981)

"SBA's 7(j) Management Assistance Program: Changes Needed To Improve Efficiency and Effectiveness" (CED-81-149, September 29, 1981)

"Management of Trade Adjustment Program Shows Progress" (CED-82-58, April 2, 1982)

CHAPTER 8

REDUCING FEDERAL COSTS OF PROVIDING DISASTER

ASSISTANCE TO COMMUNITIES AND INDIVIDUALS

The Congress has become increasingly concerned about the growing cost of Federal disaster relief. The Federal Emergency Management Agency (FEMA) estimates that Federal disaster relief during fiscal years 1980 and 1979 was $1.5 billion and $1.3 billion, respectively. Over 25 Federal agencies provide disaster relief in various forms, such as temporary housing, loans and grants to individuals or families, loans to businesses and farmers, and grants to States and local governments for the repair or replacement of public facilities. The principal programs covered include the Small Business Administration's Disaster Loan Program and the Farmers Home Administration's Emergency Loan Program.

During 1979, FEMA was established as an independent agency to consolidate Federal emergency management activities, including civil defense programs as well as disaster relief activities. Other Federal emergency activities transferred to FEMA include earthquake and dam safety programs, the Emergency Broadcast System, coordination of emergency warning, and Federal response to terrorist incidents. Also transferred to FEMA were (1) the functions of the Federal Insurance Administration (FIA), including the National Flood Insurance Program (NFIP), the Federal Riot Reinsurance Program, and the Federal Crime Insurance Program, (2) the functions of the U.S. Fire Administration, and (3) the President's disaster fund.

A recent FEMA analysis shows that a single expected catastrophic earthquake of the type likely to occur in California could easily cause over $20 billion in property damage and over 10,000 deaths. Such losses are larger by far than any disaster to have affected the United States historically. Each year flood losses reach $4 billion and 100 deaths. Losses from natural hazards are large, are increasing, and are likely to become an issue of substantial national interest in the coming years. Also increasing are "man-made" disasters such as the Love Canal chemical contamination and the Cuban refugee influx. Each year there are over 2,000 spills of hazardous materials. As the following chart shows, most Americans are exposed to some type of natural hazard.

Type of hazard	Percentage of population exposed
Tornado	89
Earthquake	70
Expansive soils	48
Landslides	41
Hurricane wind	31
Riverine flood	12
Storm surge	5

Emergency/disaster-related activities are recognized to occur in four phases that are related by time and function to all types of disasters. These phases are mitigation, preparedness, response, and recovery. Mitigation includes any activity that actually eliminates or reduces the probability of an occurrence of a disaster, such as exercising control over the transportation of hazardous waste or long-term activities designed to reduce the effects of unavoidable disasters such as land-use management in flood-prone areas. Preparedness activities, such as the development of emergency plans and the completion of training exercises, are needed to the extent that mitigation measures have not prevented or cannot prevent disasters. Response activities follow an emergency or disaster and are generally emergency-type assistance for casualties, such as search and rescue, mass feeding, emergency shelters, and medical care. Recovery activities are those related to longer term steps to return a disaster area back to normal, such as temporary housing and redevelopment loans.

STRATEGY FOR SELECTING LINES OF EFFORT

In this area of concern, we cover all the emergency management activities of FEMA except for its civil preparedness (war-time mobilization/stockpiling) activities.

For this planning period, we have selected two lines of effort for attention. From the prior plan we are retaining one line of effort, "How effective are Federal programs in assisting communities to respond to and recover from catastrophes?" and establishing a new line of effort, "Reducing Federal cost by mitigating future disaster losses." We are now completing work under the first line of effort and can expect to receive several congressional requests during the planning period. We plan to initiate no new basic legislative assignments in this line of effort.

During the program period we plan to focus our work in new assignments under the line of effort, "Reducing Federal costs by mitigating future disaster losses." This new line of effort places attention on reducing Federal costs in disaster assistance. It incorporates most of the ideas from the third line of effort in the prior plan, "How effective are FEMA's programs in minimizing the adverse effects of catastrophes?"

Reducing Federal Costs by Mitigating Future Disaster Losses

Mitigation activities are those that eliminate or reduce the probability of the occurrence of a hazard event, or those that reduce the impact of a hazard occurrence. Mitigation may be pursued through a variety of approaches, taken alone or in combination. About 90 percent of all Presidentially declared major disasters or emergencies involve flooding. Therefore, our mitigation examples discussed below will concentrate on flooding.

Mitigation approaches can be classified in three general categories: those reducing the risk, those modifying the hazard, and those moderating the impact. Approaches that reduce the risk are those that reduce the hazardous uses of hazard-prone areas through land-use management. For example, flood damages can be greatly reduced if human activities on flood plains could be made more compatible with natural processes and systems. Undeveloped flood plains suffer little economic damage from floods, and wise government policy will discourage damageable properties from locating on them. Approaches that modify the hazard do so by physical means through the construction of dams or levees, modification of a channel, etc. In moderating the impacts, there are a number of approaches including insurance, various flood-proofing techniques, and relief and rehabilitation activities.

Floodproofing provides a means to utilize land susceptible to occasional flooding by protecting existing structures when it is not practical or appropriate to control flooding. Floodproofing includes elevating structures, building walls and levees, and installing water-tight closures for openings on structures.

The relief and rehabilitation process begins with the evacuation of victims and continues until they return home or to permanent, alternative living arrangements and are able to resume normal living. Help includes emergency shelters, medical assistance, temporary housing, and grants and low-interest loans for repair/replacement of homes and personal property.

The National Flood Insurance Program was an important element in reducing the Nation's flood losses by bringing into play four nonstructural mitigation approaches: insurance, flood plain (land-use) regulations, floodproofing, and land acquisition. Under NFIP, communities must adopt flood plain regulations before homeowners/businesses become eligible for flood insurance. Without flood insurance, certain Federal or federally related financial assistance cannot be provided for land acquisition or construction in the flood hazard area.

We issued a report (CED-79-58) to the Secretary of HUD (FIA was part of HUD prior to its transfer to FEMA) on March 27, 1979. In that report, we noted that FIA has not sufficiently stressed the flood plain management aspects of the program beyond those activities associated with eligibility for participation in the insurance program. We also noted that FIA was making relatively few visits to communities to evaluate their compliance with flood plain management requirements. We stated in the report that, although FIA is required to guide development away from flood hazard areas, development of the Nation's flood plains continued and, in certain coastal areas, the availability of flood insurance has actually enhanced development in high hazard zones. We also observed that FIA had not implemented section 1362 of the act, which authorizes FIA to acquire substantially damaged properties to prevent rebuilding in high hazard areas.

Although FIA has taken a number of steps to redirect the program to improving flood plain management, there is still concern that the program is continuing to encourage development in our coastal areas. Part of the problem may be FIA's continual lack of adequate monitoring of communities' flood plain management activities.

Insurance rates for existing structures in flood hazard areas in communities joining the program are highly subsidized. In 1979 the program sustained losses of over $427 million. Although FIA has not raised rates recently, there is some question as to whether the Federal Government should continue to subsidize homes and businesses that exist in these hazardous areas. Should a greater portion of the cost be borne by the individuals who choose to live in such areas rather than by the taxpayers?

Another federally subsidized program administered by FIA is the Federal Crime Insurance Program. This program provides individuals and business owners low-cost protection against burglary and robbery losses in areas where crime insurance is not fully available at affordable rates. Because of the small number of policies outstanding nationwide, the availability of private crime insurance, and the $55 million in program losses, we question whether the Federal program is still needed. Also, questions exist as to whether the program is operating as the Congress intended.

Our objective under this line of effort is to identify a variety of potential agency and congressional actions which will reduce the long-term costs of Federal disaster assistance. Specifically, we will perform work to answer the following questions:

1. How can Federal costs and subsidies be reduced?

2. How effective are Federal programs and activities in reducing future losses from catastrophes?

3. Are Federal disaster assistance programs meeting the intent of the legislation and are the programs still needed?

<u>How Effective Are Federal Programs in Assisting Communities to Respond to and Recover From Catastrophes?</u>

When a disaster occurs, local governments are responsible for taking immediate steps to warn and evacuate citizens, alleviate suffering, and protect life and property. If additional help is needed, the Governor may, under State law, declare the area a disaster area and direct execution of the State's emergency plan, committing various State resources as the situation demands.

Federal disaster relief programs are designed to supplement the efforts and available resources of State and local governments when a disaster situation is beyond their capabilities. In such situations, the Governor must request the President to declare a "major disaster" or an "emergency" under the Disaster Relief Act of 1974. As defined by the act, a major disaster is any hurricane, tornado, storm, etc., which, in the determination of the President, causes damage of sufficient severity and magnitude to warrant major disaster assistance above and beyond emergency services of the Federal Government. An "emergency" declaration may be made by the President for the same types of disasters but requires Federal emergency assistance only to supplement State and local efforts to save lives and protect property and public health and safety or to avert or lessen the threat of a disaster.

In addition, certain Federal agencies have authority under their own legislation to declare a disaster area and provide disaster assistance in that area. For example, the Administrator of the Small Business Administration and the Secretary of Agriculture can make declarations and provide disaster loans to eligible individuals, businesses, and farmers in the declared areas.

Substantial amounts of Federal funds (grants and loans) are provided to individuals, businesses, and farmers to assist them in recovering from disasters. A significant portion of FEMA's assistance is also provided to State and local communities for their recovery after a disaster. For disasters declared in fiscal year 1980, FEMA estimated that grant funds to individuals and to States and local communities will total $533 million.

Members of Congress and State officials have expressed concern over how the President and the Federal Emergency Management Agency determine that an area is or is not in need of assistance. Also of concern is whether FEMA uses uniform criteria in declaring an area eligible for Federal disaster assistance and in determining costs eligible for Federal reimbursement.

We will complete our two ongoing assignments and do not plan to initiate any new work. However, due to high congressional interest, we expect to receive several congressional requests.

Our approach will be to respond to continuing congressional concern for improving the delivery of Federal disaster assistance and to monitor legislative and regulatory changes as they are considered and made. We will continue to follow up on our previous recommendations and attempt to incorporate the objectives listed above in any congressional request work.

CURRENT AND PAST GAO WORK

Following is a list of ongoing and completed studies in this area of concern.

Ongoing studies

--Federal Flood Insurance Program: Is it working as intended?

--Review of Federal disaster assistance to States and local communities.

--Review of Federal relief assistance provided in response to the Mount St. Helen's disaster.

--Feasibility of the National Flood Insurance Program operating without subsidies.

--FEMA's role under the Earthquake Hazard Reduction Act.

GAO reports

"Federal Disaster Assistance: What Should the Policy Be?" (PAD-80-39, June 16, 1980)

"Poor Controls Over Federal Aid in Massachusetts After the 1978 Blizzard Caused Questionable Benefit Payments" (CED-81-4, January 26, 1981)

"Termination of Map Information Facility Contract by FEMA" (CED-81-99, May 12, 1981)

"Improvements Should Be Made in Evaluating Requests for Federal Disaster Assistance" (CED-82-4, December 7, 1981)

"The Federal Crime Insurance Program: An Overview" (CED-82-68, April 15, 1982)

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