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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

RESOURCES, COMMUNITY, AND ECONOMIC DEVELOPMENT DIVISION

March 15, 1983

B-211061

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The Honorable Henry B. Gonzalez
Chairman, Subcommittee on Housing
and Community Development
Committee on Banking, Finance
and Urban Affairs
House of Representatives

Dear Mr. Chairman:

Subject: Interim Report on GAO's Review of the Urban Development Action Grant Program (GAO/RCED-83-126)

On February 10, 1983, we briefed your office on the preliminary results of our Urban Development Action Grant (UDAG) Program review. At the request of your office, we are providing an interim report on major issues included in our review, in order that it can be used during the program's reauthorization process.

The Housing and Community Development Act of 1977 authorized the Department of Housing and Urban Development (HUD) to assist severely distressed cities and urban counties in alleviating physical and economic deterioration. These local governments receive economic development assistance through grants which are to be used to stimulate additional private investment and, therefore, economic growth. The legislation provided that 25 percent of available UDAG funds would be for small cities under 50,000 population and not central to a standard metropolitan statistical area.

Our review focused in part on the UDAG Program's limited success in assisting most of the 10,161 eligible small cities. Overall, slightly less than 8 percent (783) of the eligible small cities have ever applied for a UDAG, while just over 4 percent (422) have been awarded one. These statistics are largely a reflection of the very low participation in UDAG by small cities with populations under 2,500. Within this population category are 80 percent (8,077) of the UDAG-eligible small cities. However, less than 1 percent (67) of these cities have been able to obtain UDAG financing. To find out why small city participation in UDAG has been low, we statistically sampled and conducted telephone interviews with the most distressed small cities of all population sizes. Among the reasons we found contributing to their low participation were lack of knowledge

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about UDAG and insufficient capacity within the city government either to plan and carry through a UDAG application or hire an outside concern for that purpose. Also, small cities had major difficulties in obtaining adequate private sector involvement. A detailed discussion of this issue, along with statistical tables, is found in enclosure I.

Since cities receiving UDAG funds often loan them to private developers, our review covered UDAG loan repayments by developers and the question of who should receive them--the city or the Federal Government. Specifically, we examined the issue of whether repayments should be used to reduce the Federal UDAG funds needed, if repayments are received while UDAG funds are still being spent on a project. This is what is required by the grant agreement. However, various exemptions have been made in grant agreements. As a result, some cities are able to use their UDAG repayments for other community and economic development activities, while others have been advised by HUD to place repayments in interest-bearing accounts until the issue is clarified. Although HUD officials have been aware of the need for a consistent policy for about a year, no policy has been established on when a city is entitled to UDAG repayments. We believe HUD needs to aggressively pursue its efforts to develop a clear policy on when cities can use UDAG repayments. Until such a policy is established, action to correct inconsistent requirements cannot be taken. Enclosure II is a more detailed discussion of this issue.

Our review was made in accordance with generally accepted government audit standards. The details of the objectives, scope, and methodology of our review are summarized in enclosure III.

As requested by your office, we did not obtain written agency comments. However, the issues in this report were discussed with agency program officials, and their comments were included in the report where appropriate. As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 5 days from its issue date. At that time, we will send copies to the Secretary of Housing and Urban Development and the Director, Office of Management and Budget, and make copies available to other interested parties.

Sincerely yours,

J. Dexter Peach
Director

Enclosures - 3

SMALL CITY PARTICIPATION IN THE UDAG PROGRAM IS A PROBLEM

Only a small percentage of the eligible small cities have succeeded in obtaining UDAG funds. A review of small city application and funding patterns shows that participation in UDAG is associated with city size, the smallest cities having the least involvement in the program. Many small cities have not applied for UDAG funds, and some of the most distressed cities have applied without any success.

APPLICATION AND FUNDING PATTERNS OF SMALL CITIES

At the end of fiscal year 1982, HUD's data on the 10,161 small cities potentially eligible 1/ for UDAG funds showed low levels of participation. Overall, slightly under 8 percent (783) of these cities had ever applied for a UDAG, while just over 4 percent (422) had been awarded one. To determine the reasons for this situation, we broke down HUD's overall participation statistics into various population strata to see if participation was associated with city size.

A stratification by population ranges of 10,000 shows that the low overall applicant and funding rates do not apply to cities over 10,000 population. Of the 536 cities over 10,000 population, 266 (50 percent) have applied for UDAG funding and 173 (32 percent) have received it. The eligible cities over 10,000 population, however, make up only 5 percent of all eligible small cities. Of the remaining 9,625 eligibles which are under 10,000 population, only 5 percent (517) have applied for a UDAG; 3 percent (249) have received funding. Table 1 illustrates this information in more detail.

1/Throughout this report, the term "eligibles" refers to cities that are potentially eligible for UDAG funding on the basis of meeting HUD's minimum standards for physical and economic distress. Potentially eligible cities must also demonstrate results in achieving certain equal opportunity goals before submitting their first application. The term "cities" includes urban counties, Indian tribes, Guam, and the Virgin Islands.

Table 1

SMALL CITIES' UDAG APPLICATION/FUNDING STATISTICS (note a)

Population range	Number of eligible cities	Applicant cities		Funded cities	
		Number	Percent of eligibles	Number	Percent of eligibles
40,000 - 49,999	19	13	68.4	13	68.4
30,000 - 39,999	56	36	64.3	20	35.7
20,000 - 29,999	98	53	54.1	37	37.8
10,000 - 19,999	363	164	45.2	103	28.4
under 10,000	9,625	517	5.4	249	2.6
Overall	10,161	783	7.7	422	4.2

a/Covers the period from initial UDAG applications and awards in 1978 until the end of fiscal year 1982 and applies to small cities listed by HUD's Office of Management in Sept. 1982 as meeting minimum standards for physical and economic distress.

The lowest degree of participation occurs among small cities under 2,500 population, where 80 percent (8,077) of the eligibles are found. A stratification by population ranges of 500 shows that only 2 percent (179) of these 8,077 eligible cities have applied for a UDAG; less than 1 percent (67) have received funding. As table 2 notes, at these population ranges not only are the percentages low, the numbers of funded cities in each range are also low--varying from 16 funded cities in the 2,000 to 2,499 population range to 7 in the under 500 population range.

Table 2

UDAG APPLICATION/FUNDING STATISTICS FOR CITIES

UNDER 2,500 POPULATION (note a)

Population range	Number of eligible cities	Applicant cities: Number	Applicant cities: Percent of eligibles	Funded cities: Number	Funded cities: Percent of eligibles
2,000 - 2,499	405	40	9.9	16	3.9
1,500 - 1,999	588	39	6.6	16	2.7
1,000 - 1,499	966	42	4.3	13	1.3
500 - 999	2,051	34	1.6	15	0.7
under 500	4,067	24	0.6	7	0.2
Overall	8,077	179	2.2	67	0.8

a/Covers the period from initial UDAG applications and awards in 1978 until the end of fiscal year 1982 and applies to small cities listed by HUD's Office of Management in Sept. 1982 as meeting minimum standards for physical and economic distress.

WHY HAVE SO MANY SMALL CITIES NOT APPLIED FOR A UDAG?

According to HUD records at the end of fiscal year 1982, 628 potentially eligible small cities with impaction scores 2/ of 25 or less (indicating severe levels of economic distress) have never applied for a UDAG. We randomly selected 106 of the 628 most distressed small cities to be interviewed by telephone. A structured questionnaire was used to obtain comparable city responses. Altogether we were able to complete 92 of the 106 interviews sought, which enables us to project our findings to 88 percent or 553 of the 628 most distressed small cities that have never applied for a UDAG. Essentially, we found that these cities had problems not only with UDAG requirements but also with learning about the program's existence.

Seventy-three percent of the 553 non-applicant small city officials in our sample universe had little or no awareness of the UDAG Program. The remaining officials had a great or moderate awareness of the UDAG Program. Table 3 points out that city officials in the larger small cities are more likely to be aware of the UDAG Program.

Table 3

Population range	Percent of most distressed small cities: Great awareness	Moderate awareness	Little or no awareness
	-----------------(percent)	-----------------	-----------------
25,000 to 49,999	50	50	-
2,500 to 24,999	31	29	40
less than 2,500	4	13	83

Of the officials (27 percent overall) who had a great or moderate awareness of the UDAG Program, more than half talked to HUD about applying for a UDAG. Virtually all of them thought HUD's explanation of the program was very adequate or adequate. None, however, went on to apply.

2/The impaction percentile measures relative economic distress based on the age of the city's housing stock, the degree of its poverty, and the lag in its population growth. The score ranges from less than 1 (the most distressed) to 100 (the least distressed).

City officials who knew about the UDAG Program mentioned the following program requirements as being problems:

--Locating interested developers (37 percent).

--Leveraging 3/ the required amount of private sector funds (76 percent).

--Getting firm financial commitments 4/ of private sector funding (63 percent).

Seventy percent of the cities having problems getting interested developers also had problems leveraging adequate private sector funds and getting firm financial commitments. Almost 80 percent of the cities that had problems leveraging private sector funds also had problems getting firm financial commitments.

When questioned about the capacities of their city governments, some of the officials who knew about the program stated that they lacked the necessary staff, technical expertise and money needed to plan a UDAG project. Table 4 presents the percentage of cities that cited these reasons for not applying for a UDAG.

Table 4

Problem	All small cities	Cities under 2,500 pop.
	(percent)	
Lack of staff to plan and carry through a UDAG project	32	33
Lack of city technical expertise to put together a UDAG project	19	33
Lack of city funds to pay for outside help to plan a UDAG project	57	78

3/The term "leveraging" is used to describe the concept of public funds being used to stimulate additional private investment and, therefore, economic growth. Leveraging occurs when the UDAG investment generates a greater amount of private investment and is expressed as a ratio of UDAG funds to private investment dollars.

4/Private sector parties to a UDAG project must demonstrate that they have the financial resources to carry out the project and must agree to commit these resources to the project.

Almost 90 percent of the cities with inadequate city staff also lacked city funds to pay for outside help; 100 percent of the cities lacking expertise also lacked city funds to pay for outside help.

Non-applicant city officials who knew about the program said they needed help in applying for UDAG funding. Table 5 indicates what they considered to be very great or great needs.

Table 5

Need	All small cities	Cities under 2,500 pop.
	(percent)	
More program information	29	44
Technical assistance	37	56
Streamlined application process	58	75

About 60 percent of the cities mentioning the first two items had not contacted HUD about applying for a UDAG, while about 25 percent of those who wanted a streamlined application process had not contacted HUD about applying.

Overall, 17 percent of the city officials who knew about the UDAG Program said that their cities definitely or probably would apply during 1983, while 34 percent said they definitely or probably would not. For those cities under 2,500, none of the officials said they definitely or probably would apply during 1983, while 67 percent said they definitely or probably would not apply.

WHY HAVE SOME SMALL CITIES APPLIED FOR, BUT NOT RECEIVED, UDAG FUNDS?

According to HUD records, 33 of the most distressed small cities, as measured by the age of the city's housing stock, the degree of its poverty, and the lag in its population growth, have applied for UDAG funding without any success. We selected all of them for telephone interviews to determine (1) how many UDAG applications they had submitted, (2) what problems they had encountered in obtaining UDAG funds, (3) what assistance they needed to apply successfully, and (4) whether they intended to reapply.

We contacted the 33 cities and found that they had submitted a total of 42 applications: 26 cities applied once; 6 applied twice; and one applied 4 times. Nearly all of these cities discussed their applications with HUD officials. Over 75 percent said that HUD's explanation of how the program works was very adequate or adequate.

Officials of these cities said that about two-thirds of the 42 applications submitted did not succeed because of problems in obtaining adequate financing. The other third involved a variety of circumstances that do not fall into significant patterns.

We asked these city officials what was needed to help their communities apply successfully for a UDAG. Their responses were as follows:

--30 percent had a very great or great need for more UDAG program information.

--42 percent had a very great or great need for technical assistance.

--74 percent had a very great or great need for a streamlined application process.

The responses for the first two items correspond closely to responses from the non-applicant cities, while the response favoring a streamlined application process is 16 percentage points higher than for non-applicant cities.

These city officials, who had already applied unsuccessfully, were asked if they would be reapplying during 1983. They responded as follows:

--46 percent will definitely or probably reapply.

--54 percent are uncertain or do not plan to reapply.

Of the 54 percent that are uncertain or do not plan to apply, 43 percent cited a very great or great need for technical assistance and 76 percent cited a very great or great need for a streamlined application process.

UDAG FUNDS HAVE BEEN AND WILL BE REPAID, BUT WHO SHOULD RECEIVE THE MONEY?

There is at this point no clear answer to the question. The need for an answer increases in importance yearly, as millions of UDAG dollars are expected to be repaid. Repayments have already been made for some projects.

Repayments arise when UDAG funds granted to a city are loaned to a private developer. If the developer starts making repayments before UDAG funds have been fully spent, then the program's governing regulations provide that the repayments should be used to reduce the amount of UDAG funds needed, unless the grant agreement provides otherwise. The grant agreement has similar standard provisions.

Various exemptions, however, have been made in grant agreements, resulting in inconsistent requirements. HUD UDAG officials are aware of this problem and intend to correct it once a decision has been made on when UDAG repayments should be considered city money. These officials, as well as city officials in New York and Michigan, would like the requirements clarified so that repayments would be considered city money regardless of when they are received.

UDAGS ARE OFTEN STRUCTURED TO BE REPAID; MILLIONS OF DOLLARS MAY BE REALIZED

The UDAG Program provides Federal funds to distressed cities for specific economic development projects. Recipient cities can in turn provide these funds as a grant to private developers, but often the cities provide developers with a loan and require them to repay the money.

There are no standard terms or conditions for UDAG repayments. UDAG repayments could arise from a loan carrying an interest rate of anywhere from 0 to market rates and terms of anywhere from 1 to 40 years. In addition, the project may be structured to permit the city to participate in the project's gross revenues or net cash flow. About 60 percent of approved UDAG applications have provided that a specific amount of UDAG funds be repaid and 30 percent have provided for city profit participation according to a September 9, 1982, HUD application approval listing.

Of those projects requiring a specific repayment amount, projects in New York and Michigan accounted for 25 percent of all UDAG dollars to be repaid. Michigan had 32 and New York had 137 approved applications with a specified amount of UDAG dollars to be repaid. Our review included 41 projects--12 in Michigan and 29 in New York.

The Michigan projects had a loan face value of $33 million and present value of $17 million. 5/ One Michigan loan significantly affected these totals, as it had a face value of $17.3 million that was reduced to a present value of $4.2 million due to interest-free terms over a 40-year repayment period. The New York projects had a loan face value of $73 million and a present value of $51 million. For these projects, the interest rates ranged from 0 to 15 percent.

At the time of our review, 17 of the 41 projects reviewed (7 in Michigan and 10 in New York) had begun to receive UDAG repayments, totaling about $1.7 million. Some repayments were received while additional Federal UDAG funds were being requested for the projects. For example, three of seven Michigan projects realized repayments while the cities continued to request additional UDAG funds for these projects. For one of the projects, the city received $354,849 from UDAG repayments by June 17, 1982, but later in the month used $266,640 in additional UDAG funds. Another city received $13,000 in repayments before using the last $20,000 in UDAG funds. For these and similar projects, not all of the UDAG funds may have been needed if UDAG repayments had been applied to the project.

CLEAR POLICY NEEDED TO DETERMINE WHEN UDAG REPAYMENTS BELONG TO CITIES

Although no clear policy exists on when repaid UDAG funds belong to cities, HUD program officials said they always intended that cities keep and use UDAG repayments for other economic development activities. The Director of HUD's Office of UDAG stated that this intent has been expressed at meetings with mayors and other government officials and in negotiations with cities and participating parties. However, HUD is now realizing that its intentions and understandings with cities cannot be fulfilled when UDAG repayments are received before UDAG-assisted activities are completed. This is because UDAG regulations provide that UDAG repayments are to be used instead of additional UDAG funds, if received before UDAG construction activities are completed. 6/ The regulations state that this

5/Throughout this report, present value refers to an order of magnitude rather than a precise point estimate. A discount rate of 10 percent per annum was used, which is the current approximate average yield for outstanding marketable U.S. Treasury obligations.

6/After activities are completed, repayments are considered city money available for community and economic development activities.

requirement applies unless the grant agreement states otherwise. UDAG grant agreements have standard provisions which provide that repayments be used for the project instead of additional UDAG funds, until all city activities have been completed.

Various exemptions, however, have been made to the standard grant agreement provisions, resulting in inconsistent UDAG repayment requirements. Of the 41 projects reviewed, 19 contained various exemptions. For example, one project's exemption stated that any repayments received by the city should not cause a reduction in the grant amount. Another exemption provided that loan repayments should be deposited in an interest-earning escrow account insured by the U.S. Government.

HUD UDAG and General Counsel officials are aware of the inconsistent requirements governing UDAG project repayments and are planning to make the requirements consistent. The issue has been under HUD review for about a year. A primary reason why it has not yet been resolved is that no decision has been reached on whether UDAG repayments should be used to reduce the grant funds needed for a project. The Director of the Office of UDAG said that once this decision is made, a technical amendment to the UDAG regulations would be issued. The Director also stated that other UDAG documents and procedures would be made consistent with the regulatory amendment.

HUD UDAG officials would prefer the requirements to be clarified so that UDAG repayments would be considered city money regardless of when received. City officials in New York and Michigan also would like the requirements clarified so that they keep all UDAG repayments. Generally, city officials said they planned on using the UDAG repayments for community and economic development activities. One city, for example, has already used UDAG repayments to acquire and clear a 21-acre site for an industrial park. Another city contributed a smaller portion of its repaid UDAG funds to a nonprofit charitable corporation responsible for building and operating a primary care medical clinic; its remaining funds were used to purchase a time certificate. A third city deposited a portion of its repayments into a development fund for public improvements in the city's downtown area.

Some cities, however, have been told by HUD officials to deposit UDAG repayments in escrow accounts until a policy is issued. For instance, one New York city had received $280,000 in repayments as of May 31, 1982. This city had reprogramed some of the money for eligible community development activities. However, HUD field officials stated that until headquarters clarified the repayment policy, the repayments should be held in an interest-bearing account.

OBJECTIVES, SCOPE, AND METHODOLOGY

Our primary review objectives were to determine:

--Why many potentially eligible, very distressed cities have not applied for UDAG funds and why some applicant cities have not been successful.

--To what extent UDAGs are to be repaid, who should receive the repayments, and how the funds are being used.

We reviewed applicable legislation; HUD regulations, policies and procedures; and UDAG research reports, evaluations, and audit reports. We also discussed UDAG issues with Federal and local government officials and private business officials.

To obtain information on why some potentially eligible small cities have not received UDAG funds, we statistically sampled small cities that (1) had never applied for a UDAG or (2) had applied without any success. We limited our sample to those cities that are shown to be most distressed by a UDAG standard referred to as the "impaction score." It represents the sum of the weighted standardized scores for population growth, poverty, and pre-1940 housing. The score ranges from less than 1 (the most distressed) to 100 (the least distressed). We considered the most distressed to be cities with a score of 25 or less. We believe that this group of small cities had the greatest need and incentive to apply for a UDAG. Also these cities were less likely to drift in and out of the eligible status from year to year as impaction data was updated. Towns and townships meeting the distress standard were not included in our review because their UDAG eligibility depends, among other things, on their performing functions comparable to those associated with cities. Also, we did not attempt to assess the attractiveness of the eligible small cities' investment climate. Distressed small cities could have disadvantages, such as poor roads and low levels of public service, which would discourage investment by private developers.

Based on information provided by HUD's Office of Management, we developed statistical information on small city eligibility and application patterns. From this information, we determined that 628 cities had impaction scores of 25 or less, and had never applied for UDAG funds. We randomly selected 106 to be interviewed by telephone, and were able to complete 92 of the interviews. This response enables us to project our findings to 88 percent or 553 of the 628 most distressed small cities that have never applied for UDAG funds. In addition, we determined a total of 33 small cities with impaction scores of 25 or less had applied without success. All of these were selected to be interviewed by telephone. During December 1982 and January 1983, we conducted our 33 interviews with unsuccessful applicants. The interviews with non-applicants were also performed during this time period.

There were only 67 funded cities among the 8,077 cities under 2,500, and of these only 3 had impaction scores of 25 or less. We did not, as a consequence, include a sample of successful applicants in our survey. The data obtained from such a small number would not be of use in characterizing success factors for cities under 2,500.

From a September 9, 1982, HUD listing of all UDAG approved projects, we identified projects where a specified amount 7/ of UDAG funds were scheduled to be repaid, and totaled the repayment amounts according to State and cumulatively. Thereafter, we selected New York and Michigan for review because 25 percent of all specified UDAG repayments were located in these States. Michigan had 32 approved UDAG projects with specific repayment amounts, but at the time of our review only 13 of the projects were ongoing with signed grant agreements finalizing repayment provisions. Since the file information for one of these projects was unavailable, 12 Michigan projects were reviewed. New York had 137 projects with a specified amount of UDAG dollars to be repaid. Five of these projects accounted for about 60 percent of specified UDAG repayments for all New York projects. These five and 30 randomly selected projects represented our initial selection. This selection, however, was reduced to 29 projects which were ongoing with signed grant agreements at the time of our review.

In summary, a total of 12 Michigan and 29 New York projects were reviewed to obtain UDAG repayment information. For each project, we (1) reviewed the application, grant agreement, and any amendments to it to determine the type and amount of repayment provided for, (2) discussed UDAG repayment issues with HUD and grantee (city) officials, and (3) reviewed grantees' use or planned use of UDAG repayments. We reviewed applicable legislation and HUD regulations, policies, and procedures to determine whether they were clear and consistent regarding recaptured UDAG dollars. Also, we calculated the present value of UDAG dollars to be repaid.

To calculate the present value of UDAG repayments, a discount rate of 10 percent per annum was used. That figure is the current approximate average yield rate for outstanding marketable U.S. Treasury obligations. Because we considered only

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7/UDAG project repayments based on profits to be generated were excluded since repayments are contingent on a future unknown profit level.

active UDAG projects, each of which has unique loan terms, we believe that the value of these projects cannot be extended to other projects in a statistically meaningful way. Our intention was to show an order of magnitude rather than precise estimates. We felt this was preferable due to the imprecise nature of an assumed discount rate as well as the use of incomplete data which required certain assumptions. For instance, we assumed that repayments would be in compliance with stated loan terms, and that these terms would take precedence over expected or actual payments (the impact of these were minimal). It is our judgment that the net impact of the assumptions will not materially affect the results obtained if they are considered as order of magnitude estimates, rather than precise estimates.