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UNITED STATES GENERAL ACCOUNTING OFFICE

Washington, D.C. 20548

FOR RELEASE ON

WEDNESDAY, MARCH 9, 1983

STATEMENT FOR THE RECORD BY

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BEFORE THE

SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

ON

THE USE OF ENTITLEMENT BLOCK GRANT FUNDS FOR

RENTAL HOUSING REHABILITATION AND IMPLICATIONS

FOR A NEW RENTAL HOUSING BLOCK GRANT INITIATIVE

We appreciate the opportunity to provide information for use by the Subcommittee in its deliberations on legislation for a new rental housing block grant program being considered this session. This statement deals with (1) the results of a recently completed evaluation of housing activities under the Community Development Block Grant (CDBG) Program entitled "Block Grants for Housing: A Study of Local Experiences and

Attitudes," (GAO/RCED-83-21, December 13, 1982) and (2) preliminary results of a survey we are performing at the request of the Senate Banking Committee Chairman, dealing with rehabilitation costs, income targeting and other aspects of local rental rehabilitation programs funded in part by the CDBG program.

As requested by the Subcommittee, this statement will focus on three interrelated issues--rehabilitation and subsidy costs, program beneficiaries, and program accountability. Our major findings are that:

--Although nearly half of the CDBG program entitlement cities have undertaken some rental housing rehabilitation during the past six years, only about 8 percent had extensive recent experience in designing, implementing or evaluating rental rehabilitation programs.

--Excluding those cities with exceptionally high program costs, average rehabilitation costs per unit were less than $7,000 per unit but still greater than the $5,000 contemplated in the bill of the Subcommittee. This figure generally includes what the communities consider to be non-essential improvements, in addition to those needed to eliminate housing deficiencies, and could therefore be reduced.

--The majority of cities we surveyed said their programs controlled rents after rehabilitation. Nevertheless, local officials said that these controls allowed rent increases as great as 50 percent. Yet most reported having little or no data on which to base this conclusion. More importantly they said that the rents allowed would be beyond the means of the low- and moderate-income households targeted by their localities. This could result in widespread displacement of lower income households.

--Subsidies may be greater than necessary to induce landlord participation because most cities do not tailor the amount of subsidy to the particular situation, but rather use a standard subsidy formula such as providing loans with fixed below market interest rates.

--Communities generally do not know who occupies subsidized units after the rehabilitation is completed. Furthermore, landlords are not usually required to keep records on tenant incomes.

We believe these findings indicate that without adequate guidance, communities will devise rental rehabilitation programs directed primarily at the rehabilitation of housing units without adequate consideration of the benefits from such rehabilitation to lower income renter households.

As requested by the Subcommittee staff, we are providing a number of suggestions for strengthening the legislation under consideration which should enhance the cost effectiveness, targeting, and accountability of rental rehabilitation block grants. With better guidance, local governments would do a much better job in designing, implementing, and evaluating their rental rehabilitation programs.

OBJECTIVE, SCOPE AND METHODOLOGY

The Chairman, Senate Banking Committee asked that we survey communities using CDBG funds to finance investor-owned rental rehabilitation programs and identify (1) the per unit rehabilitation costs and (2) the beneficiaries of the programs and certain other related information.

In our December 1982 report, we compiled a wide variety of data on 424 CDBG entitlement communities using two statistically administered questionnaires. Using that data, we identified 136 communities which had assisted more than 100 renters during the first six years of the CDBG program. We contacted these 136 communities, by telephone, to determine if they had used CDBG funds to assist investor-owned rental rehabilitation during the last three program years.

The 87 communities which reported having such a program were asked to provide (1) eligibility criteria including program description, (2) number of rental units rehabilitated by type of structure, (3) total rehabilitation costs including CDBG funds, (4) type of financing, and (5) tenant demographics. Sixty-four communities provided the data and we visited 22 of the 64 communities to verify key data elements, and to obtain additional information on tenants, rent levels, recordkeeping procedures and to visit rehabilitated units. These 22 were selected judgementally to provide good geographic coverage.

Before we describe our findings and suggestions in detail, we would like to briefly provide some background which we believe is relevant to consideration of a rental rehabilitation program.

RENTAL HOUSING NEED

Rental housing is the source of shelter for more than 27 million households and the only source for most lower income households. About three fourths of this rental stock is located in standard metropolitan statistical areas and predominately inside central cities.

Renters generally have lower incomes than homeowners, are more likely to be members of minority groups and have fewer household members. The gap between renter and homeowner income has steadily increased over the last decade and about 48 percent of U.S. renters earn less than $10,000 annually.

WHY REHABILITATION SUBSIDIES MAY BE NEEDED

Private investors will spend money to rehabilitate rental property only if (1) the return on investment after rehabilitation justifies the additional investment (which implies higher rents) or (2) if a subsidy encourages rehabilitation.

Despite strong improvement in the quantity and quality of the rental housing stock over the last 20 years (much of it encouraged by government programs), growth in the rental housing stock seems to have waned and much of the moderately priced rental stock is now in need of repair. Unfortunately many low- and moderate-income households cannot easily afford their present rents, let alone those needed to provide adequate investment returns to support renovation of the housing they occupy. Rent levels are now rising more rapidly than in the past and recent tax law changes are encouraging additional investment in existing rental housing which is likely to add further upward pressure on rents.

Rental rehabilitation subsidies can take many forms, but, if they are not merely to substitute for private investment, they must somehow encourage investors to do what they would not otherwise have done--bring substandard rental housing to standard condition for the benefit of lower income households. In providing subsidies it is in a local community's best interest to minimize the subsidy required both from a political stand-point--avoiding windfalls to investors--and from a programmatic standpoint--"getting more bang for the buck".

LIMITED RECENT EXPERIENCE INDICATES A NEED FOR TECHNICAL ASSISTANCE

In our December report we found that roughly 50 percent of entitlement communities assisted some investor-owned housing rehabilitation during the first six years of the CDBG entitlement program.

In spite of this apparently wide use of rental rehabilitation programs our more recent work for the Banking Committee Chairman indicates that few communities have assisted the rehabilitation of more than 100 dwelling units during the past three years. Specifically, we estimate that only one third of those 87 cities with programs operative during the last three years assisted more than 100 units.

Applying this figure to the universe of approximately 650 entitlement cities yields the estimate that only about 8 percent of entitlement communities have significant recent experience.

Considering this limited recent experience and other information on these local programs leads us to conclude that local capabilities to design, implement, and evaluate rental rehab programs is quite limited. This probably indicates a need for Federal technical assistance during the early stages of implementation.

WHICH COMMUNITIES ARE FUNDING RENTAL REHABILITATION

We compared communities with and without block grant funded rental rehabilitation programs using information from our December report on 424 communities receiving block grant funds and found that:

--over 55 percent of the communities in the Northeast (53 of 95) and West (57 of 96) were helping finance rental rehabilitation. Less than 45 percent of the communities in the Northcentral (47 of 109) and Southern regions (52 of 117) were doing so.

--communities with older housing stocks were more likely to have rental programs. Almost two-thirds or 55 of the 85 communities with at least half of their housing stock more than 40 years old reported having rental rehabilitation programs.

--communities with declining populations were much more likely to have a rental rehabilitation program than those with increasing populations (105 of 208 versus 62 of 207).

WHAT DOES REHABILITATION COST?

The total cost of rental housing rehabilitation for units covered in our survey of 64 communities totaled over $100 million for 9,904 housing units and varied from less than $1,000 per unit in Boston, Massachusetts to over $26,000 per unit in Raleigh, North Carolina. Locally, Montgomery County spent $4,900 per unit and Arlington County $8,200 per unit. The average cost per unit, after excluding those cities with the highest per unit costs, was less than $7,000. Much of the variation from city to city can be explained by the extent to which cities limited individual per unit subsidies and the extent to which non-essential improvements were allowed. The highest costs were for substantial rehabilitation but even some of the lower per unit costs included expenditures beyond those necessary to eliminate code violations and bring units up to standard condition. It should be remembered that code violations can often be trivial in nature and vary from location to location.

The programs of most communities we surveyed allowed non-essential property improvements in conjunction with correcting code violations or major problems, but a few communities said they funded rehabilitation without the presence of some code violations or substandard housing condition.

To further explore the question of what level of rehabilitation expenditures are generally needed in a program of this kind without performing a very detailed and expensive field study, we asked the localities we visited what level of rehabilitation spending would be necessary to eliminate code violations in the majority of substandard rental units in their jurisdiction. Eleven of 22 said that the average cost would be $5,000 or less and another 7 said that $10,000 per unit would be sufficient and three localities declined to answer.

Because most communities are already running programs which could be continued under a reasonable cost ceiling and because these programs include non-essential improvements, we feel that if the Subcommittee and the Congress wish to do so, it would be possible to establish a firm ceiling on total rehabilitation costs (including investor contributions) of somewhere between $5,000 and $7,500 without unduly hampering the flexibility of local governments to operate an effective program. As in any program, exceptions could be granted by HUD on a case-by-case basis.

WHY CONTROL REHABILITATION COSTS?

There are two major reasons to limit rehabilitation costs under a rental rehabilitation program. These are:

--to maximize the number of households and units which can be assisted, and

--more importantly, to avoid pricing lower income households out of the rehabilitated housing units.

Higher rehabilitation costs imply higher rents unless rents are directly or indirectly constrained. When we asked a sample of 22 communities with rental rehabilitation all but one said that rents increased, but 9 of these communities had no specific knowledge of how much rents increased after rehabilitation was completed. Those who provided estimates of rent increases gave answers ranging from 5 to 50 percent.

In our larger sample of 64 communities having rental rehabilitation programs, nearly two-thirds (41 of 64) had some form of rent constraint. The most prevalent method was to limit after rehabilitation rents to HUD's fair market rents which are benchmarks set for wide local market areas, and which assume standard quality housing. Using these rents, however, does not mean that the rehabilitated housing is affordable by lower income households.

Since we believed that lower income households would not generally be able to afford such market rents, we asked representatives of the 22 communities we visited whether lower income households targeted by their programs could afford section 8 market rents without additional assistance. Over 80 percent (18 of 22) said that lower income households in their jurisdictions probably could not afford the local fair market rents without additional assistance.

Therefore, it is quite likely that rehabilitation costs are greater than necessary, that they are resulting in significant rent increases, and that the form of rent restraint being used is ineffective in making rehabilitated housing affordable by lower income households. Without some explicit agreement on the part of landlords, there is nothing to preclude them from increasing rents to recover the costs of improvements which were actually paid for with government subsidies.

To control costs and enhance income targeting under its rehabilitation block grant initiative, the Subcommittee could take several actions which would:

--place an overall dollar limit of $5,000 to $7,500 on the per unit rehabilitation costs performed in conjunction with the program (allowing HUD the flexibility to make exceptions),

--further limit rehabilitation expenditures to only those necessary to correct substandard conditions (make essential improvements) or repair major systems in danger of failure, and

--limit rent increases for some period of time to those necessary to cover increases in debt service or owner equity.

Displacement of lower income households

We attempted to discover whether rent increases after rehabilitation were adversely affecting the original tenants of assisted housing units, but the absense of adequate before and after rehabilitation data on tenant incomes made this impossible.

Only one community of 22 we visited was tracking how many tenants were displaced from their apartments after property rehabilitation. This city's data showed that the average rent went up 26 percent following rehabilitation with almost 60 percent of the affected tenants subsequently vacating their apartments. The community did not determine if the new tenants were economically better off than the tenants who moved.

To reduce the potential for displacement of low- and moderate-income households, we believe that two simple steps could be taken in addition to controlling costs by including project selection criteria to be used by local governments:

--prohibiting the selection of projects which would result in the displacement of low- and moderate-income households by middle- or upper-income households, and

--requiring that communities give priority in selecting rehabilitation projects to those with units in substandard condition which are already occupied by low- and moderate-income households.

WHAT SUBSIDY METHODS WERE USED?

Low interest loans were by far the most common subsidy mechanism and were used by 40 of the 64 communities. In fact, 30 of the 64 communities--47 percent--had 100 percent CDBG-financed loan programs to rehabilitate their rental housing. In contrast, only 18 communities were using grants and 9 communities were using interest subsidy payments. Several communities had more than one financing method.

Full loans provide a continuing source of funding for future rehabilitation work--as loans are repaid, the "recaptured" funds are loaned out again. Nevertheless, they have several disadvantages--fewer units can be rehabilitated in the short term, repaid funds are worth less, and private funds are not leveraged by the subsidies.

In analyzing the financing mechanisms used, we noted that average per unit rehabilitation costs were substantially higher when loans were used in contrast with grants and interest subsidy payments. Forty communities used loans which were fully or partially funded by the CDBG program to finance rehabilitation programs. The median cost per unit was about $10,600 and ranged from $1,867 to $26,657. In contrast, when grants and interest subsidy payments were used, the median cost was $7,600 and $5,264 per unit respectively.

Thus, it is possible that communities are asserting more control over rehabilitation costs when a grant-type subsidy is used because of the concern about community reaction to so-called give-away programs. In contrast, communities may believe they should have less control over costs when a loan program is used because the investor pays back the loan.

We also noted that program costs may often be greater than necessary to induce landlord participation because most of the localities we surveyed do not tailor the subsidy amount to the particular project being rehabilitated. Instead, they typically use a set subsidy formula or dollar amount which may be greater than necessary.

Without taking into consideration the project's economics, fixed subsidies may provide windfalls to investors and reduce the number of units rehabilitated. Only 11 of the 64 communities we surveyed were tailoring their subsidy payments to the individual rehabilitation project.

INCOME TARGETING

If rental rehabilitation is to result in greater housing opportunities for lower income households, some strategy for assuring this should be adopted. The typical solution in federal categorical programs has been income certification and strict enforcement of income eligibility standards. Although most communities we contacted said that their programs were targeted to lower income households, the majority of communities could not provide income data, since most make no attempt to collect such information.

Of the 64 communities we surveyed, 14 set income limits which were to be enforced by participating landlords and another 15 had programs which were tied to the existing section 8 programs which also enforces income eligibility. Nearly all communities said they targeted their programs to low- and moderate-income areas as a method of insuring lower income tenancy.

Only 23 of the 64 communities we surveyed were able to provide any statistics on the incomes of households occupying rehabilitated housing. Ten of the 23 that had income and other demographic data had programs tied to section 8 which explicitly requires landlords to certify income and collect demographic data. Only 13 of the 64 cities had income and demographic data independent of the section 8 program.

A few examples will help illustrate the difficulty of establishing how effective income targeting has been under these local programs.

--One community rehabilitated over 700 rental units and had no data on the tenants occupying these units. The local program administrator felt that keeping such data would create an administrative burden, that tenants and investors would not want to comply, and that location of projects in low- and moderate-income areas was a sufficient targeting mechanism. He admitted, however, that there were "pockets" of middle-income households in these neighborhoods.

--Two other communities which collected income and demographic data on tenants who occupied units prior to rehabilitation, targeted their programs to low- and moderate-income areas, but income data for their most recent program years showed that 56 and 69 percent of pre-rehabilitation tenants were middle income.

--Even when rental rehabilitation programs were tied to the section 8 program, which requires tenant income certification, several communities did not compile or maintain the available demographic statistics and did not see any reason to do so.

--Several communities explicitly required landlords to rent to low- and moderate-income tenants as a condition of receiving the subsidy, yet these communities still did not obtain tenant income data to verify contract compliance. For example, one community assisted the rehabilitation of 2,843 rental units with the stipulation that landlords rent at least 20 percent of their units to low- and moderate-income tenants. Tenant income data was not collected and the community representative could provide no rationale for not monitoring landlord compliance.

We believe that income certification is a necessary strategy for assuring that subsidized housing is being provided to lower income households. Landlords are a logical candidate for doing income certification since the landlord is receiving the subsidy. Nevertheless, several other alternatives exist--the local administrator for the section 8 existing program, the local housing authority, or local community groups could fulfill this need but additional costs would be incurred.

STRENGTHENING ACCOUNTABILITY

The issue of how scarce resources should be allocated is always important. Program evaluation is one of the key tools in making such allocations. Nevertheless, program evaluation has been relegated a minor role in these local rental rehabilitation programs. Program evaluation has to be an integral program component if Federal or local governments are to have information necessary to manage their programs and for Congress to exercise its oversight responsibilities.

Our past research has shown that when records are kept in varying formats and at varying levels of detail, it is extremely expensive and time consuming to aggregate and analyze the data on a national basis. Indeed, it may well be impossible to do so except through a separate study.

It is our view that program evaluation is a fundamental part of effective program administration and that the responsibility for evaluations should rest initially upon the resonsible local governments. If Congress wishes to have comparative data on how programs are working, it is necessary that they generally specify the most important information needed for national oversight and we would be glad to work with the Subcommittee if you so desire. To facilitate national oversight, the Subcommittee may wish to:

--Require the Department of Housing and Urban Development to report to the Congress on a periodic basis as to the overall progress of the program. Certain minimum reporting requirements should include (1) consolidated verified information from all local governments, and (2) information on costs, services delivered, and program beneficiaries.

--Require each participating local government to submit annual reports to the Department showing what they have accomplished during the fiscal year. This does not mean, however, that paperwork requirements should be excessive. Necessary recordkeeping by local governments would be spelled out in regulations provided by the Department.

--Either require project owners to provide verified income and other demographic information yearly to the local administering government on each household residing in assisted housing units or make some alternate provisions for collecting this information.

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Based upon our past work in this area and our current review of rental rehabilitation under the Community Development Block Grant Program, we believe that without specific congressional guidance regarding program objectives and approaches for any new rental rehabilitation block grant, that:

--local governments will tend to design programs targeted at housing units rather than needy renter households,

--costs will likely be higher than necessary to improve the housing conditions of lower income households, and

--evaluation information will be inadequate.

We believe that the suggestions we have provided in this statement could help minimize such problems. A more comprehensive report on this topic will be provided to the Chairman, Senate Banking Committee, in which we will include recommendations to HUD on the present CDBG program.