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REPORT BY THE

Comptroller General

OF THE UNITED STATES

Lenient Rules Abet The Occupancy Of Low Income Housing By Ineligible Tenants

The occupancy of section 8 housing by ineligible households is a significant and costly problem. Although program rules allow some leeway for owners to rent units under section 8 assistance contracts to households ineligible to receive assistance, the rules are too lenient and some owners ignore them. Although ineligible tenants receive no direct subsidies, they do benefit from large, indirect financing subsidies and displace needy households.

The Department of Housing and Urban Development has agreed to take a number of corrective actions suggested earlier by GAO, but some aspects of the problem remain. GAO is therefore recommending further actions by both the Congress and the Department.



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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-199105

The Honorable Jake Garn
Chairman, Committee on Banking,
Housing and Urban Affairs
United States Senate

The Honorable Fernand J. St Germain
Chairman, Committee on Banking,
Finance and Urban Affairs
House of Representatives

While reviewing the cost effectiveness of section 8 subsidized rental housing we observed that some section 8 project owners lease units for which section 8 assistance is available to tenants ineligible for rental assistance. Although limited leasing to ineligible or market-rate households is permissible when no eligible households are available and under certain other conditions, we believe the current policy and procedures related to including ineligible tenants in assisted housing could be strengthened.)

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The Department of Housing and Urban Development (HUD) recently took a number of positive steps when it (1) lowered to 10 percent (from 20 percent) the percentage of section 8 assisted units in any new project that can be rented to ineligible households without explicit HUD approval and (2) developed new sanctions for dealing with project owners who fail to comply with the limitation. We agreed with these changes but believed additional measures were needed, since all previously completed projects continue to be covered by the older regulations and because HUD's enforcement options were still limited. Although HUD has promised to make some further changes, the problem remains unsolved. Therefore, we recommend that the Secretary of Housing and Urban Development:

- 4
--Modify program regulations for new, fully assisted projects to further lower the percentage limitation, from 10 percent to 5 percent, on the number of units that can be occupied by ineligible households without HUD approval and allow no ineligible households in contracted units in partially assisted projects without HUD approval.

- Issue explicit enforcement guidelines for use by HUD regional and area offices in dealing with project owners who exceed the limitation on ineligible households or otherwise fail to comply with HUD's policies on occupancy by ineligible households.
- Amend section 8 regulations to explicitly state a project owner's responsibility to make every effort to rent all section 8 contracted units to eligible households before utilizing the exception for ineligible households.

In addition, we recommend that the Congress consider whether a more stringent limitation on ineligible households should be applied to previously completed section 8 projects. This limitation could be achieved by either

- enacting legislation to apply a 5-percent limitation to completed projects already under contract or
- directing the Department to change its regulations to have the same effect.

Finally, we recommend that the Congress enact legislation to

- clarify the program's original intent--that housing units for which section 8 subsidy contracts are signed be used to the maximum extent possible for eligible households.

Our data on all projects in HUD's Los Angeles, California; Detroit, Michigan; and Chicago, Illinois, area offices indicates that in many housing projects, the number of ineligible households exceeds the applicable limits on occupancy by ineligible households. This problem warrants prompt attention because (1) under present regulations the potential exists for greater occupancy by ineligible households in the future and (2) the incentives to house ineligible households and market forces that encourage it will increase as the cost of housing escalates and the scarcity of rental housing becomes more prevalent.

We brought this problem to HUD's attention in August 1/ at a time when the agency was making changes to section 8 regulations and contract forms. Although HUD promised to make several positive changes in occupancy and contract administration guidelines in response to our concerns, it argued against lowering further the administrative limitation on ineligible households and took the position that our suggestion to make such limitations retroactive to section 8 projects already in operation was legally impossible. We concluded that the retroactive change was possible and would probably cause no real detriment to owners but that litigation could result.)

Our analysis of HUD comments on our August letter is in appendix VI, and HUD's entire response is reproduced as appendix VII. HUD declined to comment on the draft of this report because it felt that its response to our August letter was still applicable and that it had nothing to add at this time. HUD also declined to comment on the congressional recommendations, which were not included in the August letter.

OBJECTIVE, SCOPE AND METHODOLOGY

In a previous review by us of section 8 housing, data gathered from HUD's Chicago area office suggested that there might be a problem with ineligible households occupying section 8 units. To determine the extent to which this problem existed in other areas, we selected the Chicago, Detroit, and Los Angeles area offices for data collection because of their large section 8 portfolios. We did not include Los Angeles in our final analysis for reasons discussed later. (See p. 5.) This review was performed primarily at HUD headquarters in Washington, D.C., with field data collection accomplished by telephone and mail.

Tenant occupancy data was collected from section 8 Reports on Program Utilization (HUD form 52684), which provided figures on the total number of units in a project, units under assistance contracts, units leased to assisted tenants, and the total number of units in a project. These

1/Letter to the Assistant Secretary for Housing - Federal Housing Commissioner, dated August 21, 1980.

statistics were compiled by HUD area offices at our request, and using these and other records, these offices also provided independent estimates of the number of ineligible (market-rate) households in section 8 contracted units. We used these estimates as the basis for our findings. These calculations provided our starting point for assessing how HUD's limitation on leasing assisted units to ineligible households affected the effectiveness of section 8 and for estimating the possible costs of various levels of the problem.

Cost estimates are based on a cost methodology developed in an earlier GAO report 1/ and recent data on loan discounts absorbed by the Government National Mortgage Association (GNMA). We examined pertinent HUD regulations, contract forms, and handbooks and discussed ineligible occupancy with HUD program officials in Washington and each of the area offices. We also did an extensive legislative and legal analysis that helped us in framing our recommendations.

We did not attempt to measure the nationwide problem; however, the magnitude of the problem in Chicago and Detroit, discussions with HUD officials in other area offices, and a preliminary review of data on tenant occupancy in several other area offices suggest that this abuse of section 8 contracted units exists elsewhere.

TWO OBJECTIONS TO THE POLICY OF LEASING TO INELIGIBLE HOUSEHOLDS

We have two objections to allowing ineligible households to occupy section 8 units. First, occupancy of section 8 contracted units by ineligible tenants probably frustrates the intent of the program by causing it to fall short of its planned assistance, even though the money to achieve more assistance has been made available by the Congress. Second, the cost effectiveness of the program is degraded since indirect subsidy costs which are incurred--regardless of who occupies the housing units--must logically be counted against a lower number of assisted households.

1/"Evaluation of Alternatives for Financing Low and Moderate Income Rental Housing" (PAD-80-13, Sept. 30, 1980).

THE IMPACT OF ALLOWING INELIGIBLE
HOUSEHOLDS TO OCCUPY SECTION 8 UNITS

To assess the impact of the policy allowing occupancy by ineligible households, we looked at occupancy data provided by three HUD area offices. Since two of these area offices showed significant numbers of ineligible households, we suspended further costly data collection.

In the Los Angeles area office, data taken from the Management Information System included a significant number of projects for which no data was recorded. We decided that information from that office was inconclusive. In the other two area offices (Chicago and Detroit), we estimated that at least 1,000 units and 400 units, respectively, were occupied by households ineligible for section 8.

In the Chicago area office, 86 percent of all section 8 units not insured by the Federal Housing Administration (FHA) (most projects in operation are uninsured) were housing eligible section 8 households. Allowing for the 3-percent vacancy factor that HUD gave us for Chicago area contracted units, we estimate that about 11 percent (or 950 units) of the roughly 8,900 new or substantially rehabilitated units for which section 8 assistance is available are leased to ineligible households. This overall statistic is made up of projects exhibiting a wide variation in the percentage of assisted units occupied by eligible households. One small project, which has had only one assisted household during several years of operation, presently houses no eligible tenants. Another project approved for occupancy by 164 assisted households has never exceeded 50 section 8-eligible households. Appendix I gives examples of Chicago area office projects showing the variation in the extent to which projects include ineligible households.

Several partially assisted projects in the Chicago area have consistently rented roughly half of the number of units planned for assisted households to market-rate households. One project that seemed to be limiting the number of assisted households to about half of those authorized had an extremely high overall vacancy rate of nearly 17 percent. These vacancies, for which HUD very likely continues to pay subsidies, could have been eliminated if all units under a Housing Assistance Payments (HAPs) contract were leased to assisted households. Several partially assisted projects

that are underusing the available section 8 assistance are in Chicago, which has one of the longest section 8 and public housing waiting lists in the Nation. (See appendix III.)

The limited number of FHA-insured section 8 projects in Chicago that are in operation are generally fully assisted and house only eligible tenants.

In the Detroit area office, we obtained data on uninsured projects only, since it was more readily available and we were told that the FHA-insured projects would generally follow the pattern noted in Chicago. Six percent of all uninsured units covered by section 8 assistance contracts monitored by the Detroit area office house ineligible households. At the end of June, 6,987 assisted units were under lease, 6,563 of which were leased to eligible households, leaving 424 units leased to market-rate households. (See app. II for examples of particular projects.) Although the 6 percent may not appear detrimental to the section 8 program, the loss of these contracted units to market-rate households is troublesome because we know that there is a great need for subsidized rental housing as evidenced by the long section 8 and public housing waiting lists.

In the Detroit and Chicago areas, a large number of units that could have served assisted households went to households that were never envisioned as section 8 recipients. Meanwhile, the funds to subsidize an equal number of needy households went unused.

PROGRAM INTENT AND THE ISSUE
OF ECONOMIC INTEGRATION

Our argument that the program's intent is frustrated by ineligible occupancy is not inconsistent with another stated program goal--economic integration. In fact, we believe ineligible occupancy also works against or fails to enhance economic integration in many instances. This is because the program was designed to assure economic integration by developing partially assisted projects, by providing broad eligibility requirements, and by favoring locations that provide a deconcentration of low-income households, not by renting section 8 units to higher income tenants. Once HAP contracts are signed, the number and location of assisted units should be fixed.

Economic integration among assisted units should be achieved by selecting tenants across the broad range of income-eligible households. The regulations allow for the inclusion of households whose incomes are initially low enough to qualify, but increase to the point where they would no longer qualify. This can further enhance economic integration. What we are arguing against is the use of units already earmarked for assisting lower income households to house middle-income households, without regard to the availability of assisted households. For example, if a partially assisted project with 20 percent of its total units designated as assisted (and 80 percent for market-rate tenants) fails to achieve the 20 percent assisted occupancy, the goal of economic integration is actually damaged since fewer assisted households than planned are housed in the integrated environment. It seems unlikely that this is the kind of economically integrated environment envisioned in the legislation.

Project owners wishing to develop an economically diverse tenant population by attracting a range of incomes among residents in a project can do so within the eligible section 8 population. Eligibility currently ranges up to 80 percent of area median income for a family. In actuality, the average income of section 8 households is quite low, with the bulk of tenant households nationwide falling below the poverty threshold.

THE COST OF THE POLICY

The potential cost of allowing ineligible households to occupy section 8 contracted units is quite large. This is because the indirect subsidy costs, such as HUD administrative costs, loan discounts absorbed by the Government (known as TANDEM), and tax expenditures (taxes foregone when tax-exempt bonds are used) for units rented to ineligible households are incurred without providing any benefit to eligible households.^{1/} These are, in effect, the hidden costs of providing assisted housing to eligible program recipients, and when they are added to the direct subsidies for assisted units, the total subsidy per assisted unit is substantially higher than if all assisted units serve eligible households.

^{1/}See the footnotes for appendix IV.

This higher cost is illustrated by the calculations in appendix IV, which show the possible consequences of leasing 10 and 20 percent of contracted units to ineligible households, which is now possible for projects already under contract. The calculations are based upon an FHA-financed project where GNMA purchases the mortgage and sells it at a discount. We estimate that the November 5 regulation change allowing 10 percent of such units to be leased to ineligible households could conceivably increase the subsidy to assisted households by \$820 per unit for 20 years of operation. If this additional expense was incurred to subsidize 100,000 households, the additional cost occasioned by allowing ineligible households to occupy section 8 units would be \$82 million.

Another way of viewing the potential cost of allowing a 10-percent exception for ineligible households to remain in force is that for every 100,000 units financed under the new regulations with FHA TANDEM loans, 10,000 units (10 percent) will receive large, per-unit TANDEM subsidies, yet may never benefit households in need of housing assistance. Using only the TANDEM subsidy cost figures shown in the footnotes to appendix IV, we calculated a potential expenditure of \$68,000,000, and none of these funds would provide housing to eligible households. This amount of money, if applied directly to the purchase of multifamily housing, could provide 2,000 dwelling units at \$34,000 per unit. Although these illustrations are based on FHA TANDEM financing, certain indirect costs would be incurred under any section 8 financing mechanism, and in those involving tax exempt mortgage bonds, the potential costs of misusing units are even greater since the indirect costs are much higher.

Both these cost calculations assume that all units subject to the exemption for ineligible households would actually house market-rate tenants. This assumption is probably unrealistic, yet with a tight rental market throughout most of the U.S. and no relief in sight, the pressure for an increase in market-rate tenant occupancy is probably quite strong. The cost estimates are also understated since they reflect only one of the major per-unit indirect subsidies (TANDEM) and are based upon unit development costs, which are much lower than those we can expect in the future.

THE PERCENTAGE OF ALLOWABLE INELIGIBLE
HOUSEHOLDS SHOULD BE REDUCED

We believe the exception for ineligible households should be further reduced from 10 percent to 5 percent for section 8 projects where all units are under assistance contracts and eliminated altogether for projects where fewer than half of the total units are under section 8 contracts. This change would result in greater availability of units to needy tenants while reducing the total subsidy cost per household assisted.

Our understanding of the 10-percent exception allowing some ineligible tenants is that it was set arbitrarily to avoid unnecessary administrative problems in granting case-by-case exceptions any time a unit is leased to an ineligible tenant for unavoidable reasons. For example, a tenant might, after a period of time, go over income yet wish to remain in the project, which the program allows. We believe a 5-percent limit ^{1/} would give sufficient leeway for even the smallest projects while ensuring that to exceed the limitation, the project owner would have to notify HUD and ask for permission. HUD takes the position that owners have the obligation to rent all contracted units to assisted households and the leeway to include market-rate households applies only when owners find it impossible to locate eligible tenants or when an eligible tenant goes over income. However, the actual wording of the limitation in the regulation makes it appear that owners can exceed the limitation for up to 6 months before HUD will take action to enforce owner compliance.

For partially assisted projects where the owner already has significant leeway in choosing market-rate versus assisted households each time a vacancy arises, we see no need for the exception. We noted in our data collection that for projects that had less than half of the units under section 8 assistance contracts and were therefore clearly

^{1/}Although we have no statistical basis for selecting 5 percent, we feel that if HUD does an adequate enforcement job, which it has promised to do, the 5-percent limit will essentially eliminate owner noncompliance and eliminate ineligible households except where ineligible occupancy is unavoidable for reasons already covered in HUD regulations.

partially assisted, there seemed to be a greater likelihood that market-rate tenants would occupy units for which assistance was available. HUD felt that this probably occurs because it is much easier to attract higher income tenants to projects that have fewer low income tenants.

HUD felt that the current 10-percent limitation had not been in effect long enough to judge its impact and suggested delaying any further changes. We see no reason for delaying the change and discuss our reasons in appendix VI.

Recommendation to lower the
exception for ineligible
households

To reduce the number of section 8 assisted units that can be leased to ineligible households, we recommend that

--the Secretary of Housing and Urban Development further lower the percentage limitation on ineligible households from 10 percent to 5 percent for new, fully assisted projects without HUD approval and allow no ineligible households to occupy contracted units in partially assisted projects without HUD approval.

ENFORCEMENT GUIDELINES ARE NEEDED

With the adoption of the new regulations, which were effective in November 1979, HUD now has several explicit sanctions for dealing with landlords who lease more than 10 percent of their assisted units to ineligible households. HUD may reduce or suspend assistance payments, sue for specific performance of contract terms, suspend or debar the owner from HUD programs or, as in the past, reduce the number of units under section 8 contracts. It would therefore seem to be an opportune time to issue clear guidelines to regional and area office personnel spelling out (1) acceptable limits within which they should expect project owners to comply, (2) time periods for coming into compliance, and (3) a set of procedures that should be followed to enforce compliance when necessary. To our knowledge, no such guidelines exist even though the past HAP contracts probably provided sufficient authority for HUD to take a variety of actions against noncomplying project owners, in addition to the reduction in contract units spelled out in the old regulations. Several field office personnel we spoke with felt that this reduction

in units was their only recourse and thus were reluctant to use this sanction and further hamper the achievement of the section 8 planned assistance goals. We agree with this view since reducing the contract units has the effect of making permanent the loss of subsidized units.

To make sure that this reluctance to enforce the limitation on ineligible households does not continue, we believe specific guidelines on enforcement for use by area offices are needed. Better enforcement would be particularly important if our limited research, which showed that a minority of projects accounted for much of the problem, proves true in other areas of the country.

HUD promised to take a number of steps aimed at better enforcement, which are discussed in detail in appendix VI.

Recommendation to issue
specific enforcement guidelines

To provide HUD regional and area office personnel with a set of guidelines for enforcing project owner compliance with limitations on ineligible household occupancy, we recommend that

--the Secretary of Housing and Urban Development issue explicit enforcement guidelines for use by HUD regional and area offices to deal with project owners who exceed the limitation on ineligible households or otherwise fail to comply with HUD's policies on ineligible occupancy.

SHOULD A MORE STRINGENT
LIMITATION BE APPLIED TO PAST
SECTION 8 CONTRACTS?

We believe that the Congress should consider whether a more stringent limitation on ineligible households should be applied to past section 8 developments already under assistance contracts.

HUD takes the position that it cannot retroactively and unilaterally raise what is in effect the enforcement level regarding ineligible households in existing section 8 contract units. Although project owners could argue that doing so would illegally impair their contractual rights,

we believe that since present law requires that assisted (contract) units be occupied by eligible families, owners cannot use the terms of their contracts to avoid the effect of statutory requirements. Making owners seek HUD approval when less than 95 percent (instead of 80 percent) of contracted units are occupied by eligible households could cause some added administrative burden but owners could be compensated for any additional costs. Such costs might easily be outweighed by the benefits of providing more housing units to needy households.

The 1,400 units we found in two areas seem adequate motivation for a change, but more importantly, by the end of fiscal year 1979, roughly 6,000 section 8 projects, with more than 450,000 assisted units, had been started under the new construction and substantial rehabilitation portions of the program. Most of these units are covered by the earlier regulations allowing up to 20 percent of all section 8 contracted units to be leased to ineligible tenants without asking HUD for explicit approval. Since all these units benefited from nonrecoverable indirect tax and financing related subsidies, the bulk of all section 8 projects have the potential of being only 80 percent effective but with much higher per-unit subsidy costs than anticipated.

We do not have the statistics to accurately estimate the current nationwide situation, since the section 8 occupancy data is of uncertain and varying quality and extensive field work would be necessary. We also cannot predict the extent to which section 8 owners will tend to admit ineligible (market-rate) households in the future. What is certain is that the incentives to do so, and the market forces that make it possible, will increase as the cost of housing grows and the scarcity of quality rental housing becomes more prevalent. If this problem develops to the point where many section 8 owners come to rely on ineligible households as a significant part of their tenancy, the political difficulty of making a retroactive change will increase proportionately.

A retroactive change such as we suggest is very likely possible ^{1/} and practical since it passes two sensible tests for a retroactive policy adjustment. First, it would buttress the original intent of the program by maximizing the service of the program to the intended beneficiaries. Second, it would not cause any undue hardship on section 8 project owners who, after all, contracted initially to house section 8 eligible households. The change would merely reinforce the Government's consistent position that assisted units should serve eligible households--that is, the change is reasonable given the purpose of the original assistance contract and the favorable financing terms afforded housing developers. Section 8 owners would still have the ability to serve a broad range of income-eligible households under current eligibility rules if their motivation in admitting ineligible households has been to provide economic integration. In the unlikely event that some financial damage is sustained by a project owner, the owner could seek compensation through the courts. If owners find it impossible to find eligible households, HUD could still allow owners to rent to market-rate households, but the path of least resistance would be for them to seek eligible households in most situations. Ineligible households already occupying section 8 units would be allowed to continue renting under existing provisions of the program regulations until they voluntarily terminated their tenancy.

Recommendation for a retroactive policy adjustment

To maximize service of the section 8 program to its intended beneficiaries, we recommend that the Congress should consider whether a more stringent limitation on ineligible households should be applied to section 8 projects already under contract. This could be achieved by either:

^{1/}There is precedent for the Congress to change the terms of contracts by legislation (Public Law 96-153, §503, later repealed). This is admittedly unusual and subject to challenge but could be sustained in the case of a more stringent limitation on ineligible households, we believe, since the impact on project owners is minimal.

--enacting legislation to apply a 5-percent limitation to completed projects already under contract or

--directing HUD to change its regulations to have the same effect.)

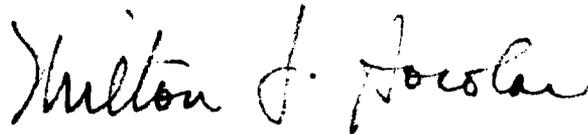
Recommendation that the Congress clarify program intent

Given the confusion regarding owners' responsibilities to rent only to eligible households, seemingly conflicting HUD regulations, the complex issue of economic integration, and other factors that tend to complicate the problem of ineligible occupancy, we believe a clear signal on program intent from the Congress would make it much easier to set and enforce HUD policy regarding section 8 occupancy. We therefore recommend that

the Congress enact legislation clarifying the section 8 program's original intent--that housing units, for which section 8 subsidy contracts exist, be used to the maximum extent possible for section 8-eligible households.)

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Copies of this report are being sent to the Secretary of Housing and Urban Development and the Assistant Secretary for Housing-Federal Housing Commissioner.



Acting Comptroller General
of the United States

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EXAMPLES (note a) OF PROJECTS FROM
THE CHICAGO AREA OFFICE
SHOWING THE RANGE
OF COMPLIANCE

	<u>Units under effective HAP contract</u>	<u>Units under lease</u>	<u>Units leased to eligible households</u>	<u>Percent leased to eligibles</u>
Project A	5	5	0	0
Project B	70	70	35	50
Project C	231	231	69	30
Project D	212	212	212	100
Project E	79	79	79	100
Project F	154	148	77	52
Project G	210	210	210	100
Project H	140	140	140	100

a/These are only a few of the projects examined that are included as an illustration of the range of project compliance and were not selected statistically.

EXAMPLES (note a) OF PROJECTSFROM THE DETROIT AREA OFFICESHOWING THE RANGEOF COMPLIANCE

	<u>Units under effective HAP contract</u>	<u>Units under lease</u>	<u>Units leased to eligible households</u>	<u>Percent leased to eligibles</u>
Project A	170	170	170	100
Project B	48	48	46	96
Project C	266	266	252	95
Project D	86	85	74	86
Project E	246	245	184	75
Project F	28	28	12	43
Project G	132	130	38	<u>b/29</u>

a/These are only a few of the projects examined that are included as an illustration of the range of project compliance and were not selected statistically.

b/This project is being constructed in stages and will eventually include 208 more units (200 for the elderly and 8 for families). As it is anticipated that most of the units for the elderly will be leased to Section 8-eligible tenants, the Detroit area office predicts that this percentage will increase to 70 percent.

ASSISTED HOUSING WAITING LISTS

(number of households)

<u>City</u>	<u>Public housing</u>	<u>Section 8</u>
Los Angeles	828	16,350
Houston	4,439	2,550
San Diego	--	8,019
San Francisco	8,000	3,000
Washington, D.C.	7,000	238
San Jose area	--	747
New Orleans area	8,000	980
Portland area	2,306	461
Seattle	2,504	1,453
Denver	936	1,004
Minneapolis-St. Paul area	2,048	1,948
Honolulu	2,023	2,201
Philadelphia area	12,933	6,425
Chicago	18,071	44,096
Oklahoma City area	1,097	275
Des Moines area	450	703
North Suburban, Ill.	1,557	2,300
Harrisburg area	912	610
Dallas	5,586	1,446
New York, New York	55,500	90,000
Milwaukee area	5,767	5,969
Pensacola	259	504

Source: Congressional Record, June 20, 1980, Volume 126,
Number 102, page S7626

ANNUAL SECTION 8 SUBSIDY COSTSPER ASSISTED HOUSEHOLD (note a)

(Family of four with gross annual income of \$5,000)

	100-percent occupancy by eligible <u>households</u>	90-percent occupancy by eligible <u>households</u>	80-percent occupancy by eligible <u>households</u>
Section 8 assistance (note b)	\$ 3,254	\$ 3,254	\$ 3,254
TANDEM discount (note c)	338	375	423
HUD administrative costs	<u>40</u>	<u>44</u>	<u>50</u>
Yearly subsidy	<u>3,632</u>	<u>3,673</u>	<u>3,727</u>
Twenty year total	<u>\$72,640</u>	<u>\$73,460</u>	<u>\$74,540</u>

	73,460	74,540	
	<u>-72,640</u>	<u>-72,640</u>	
Differences (note d)	820	1,900	

a/Based on FHA-insured financing. Shown here are the direct section 8 subsidy plus the TANDEM subsidy that GNMA pays when it buys the below-market interest rate loan from the original lender and resells it at a loss. There are also subsidy costs such as tax expenditures that are not estimated here for the sake of simplicity. State-financed and section 11(b)-produced units also incur large indirect subsidies due to the tax exemption for interest paid on lower income housing bonds.

b/The direct subsidy is based on the mortgage amount, interest rate, operating cost, and tenant income shown in appendix V. The data reflects an average nonelderly unit that went into construction in 1978 and was completed in January 1980.

c/TANDEM subsidy is based upon an actual sale by GNMA of 7.5 percent project mortgages in January 1980 when the market interest rate was between 11.5 and 12.5 percent. It is roughly equivalent to the yield obtained from a prepayment schedule of 40-year term mortgages prepaid at 20 years. Purchasers receive a yield of about 11.4 percent on the mortgages and GNMA receives 70.4 percent of the mortgage balance. The loss is figured by subtracting the GNMA fee and discount from the mortgage amount and calculating the difference between GNMA's net price of 95.5 percent and 70.4 percent, times the mortgage amount of \$27,000. This results in a one-time subsidy of \$6,777 or a per-year cost of \$338 based on 20 years of subsidized operation. This is based upon a GNMA auction that occurred in early 1980.

d/Although these potential cost differences of \$820 and \$1,900 per unit may not seem significant, they are when the large number of section 8 units covered by the earlier 20-percent exception for ineligible households and these units to be developed in the future under the 10-percent exception are considered. Extending those per-unit costs to half a million units (or roughly 5 years' production), the potential cost of underusing assisted units can be calculated at \$950 million and \$410 million, respectively, for 20 years of program operation. Since some projects that are already in operation will be sold or converted to private use before 20 years of use, the actual cost of assisting households will be even higher. By lowering the percentage of ineligible occupancies allowable to 5 percent and carefully enforcing this limitation, ineligible occupancy could probably be limited to perhaps 3 percent or even less, since many projects are currently occupied entirely by eligible households. The cost of having 3-percent ineligible occupancies for an assisted stock of 500,000 units and a 20-year period of operation would be roughly \$100 million, resulting in potential savings of \$850 million and \$310 million, respectively.

ANNUAL GROSS RENTTWO-BEDROOM APARTMENTFHA TANDEM

Total development cost	30,000
Mortgage amount	27,000
Interest rate	7.5%
Mortgage insurance premium	0.5%

Principal interest insurance premium	2,255
Operating and maintenance	1,354
Reserve for replacements	115
Property taxes	450
Cash return (6 percent of stated equity)	<u>180</u>
Gross rent	<u>4,354</u>

Annual Direct SubsidyFamily of Four with Gross Income of \$5,000

Gross rent	4,354
Tenant contribution	<u>1,100</u>
Direct subsidy	<u>3,254</u>

EVALUATION OF HUD'SCOMMENTS ON OUR AUGUST RECOMMENDATIONS

HUD's comments on our August 21, 1980, letter were divided into (1) general comments to stress their agreement with us in principal but to emphasize the need to have some flexibility for project owners in those circumstances when eligible households are not available and owners must rent to ineligible households and (2) a discussion of each of our recommendations in turn. Our response is in the same order.

HUD'S GENERAL
COMMENTS

First, HUD noted that admitting ineligible households could never result in direct subsidy payments to project owners. Second, they agreed with the concept of limiting unsubsidized tenants admitted to section 8 projects. However, it noted that project owners needed some leeway in choosing tenants because under certain circumstances a project may not be able to attract section 8-eligible tenants because of unit sizes or the particular market conditions. HUD argued that it was better in such circumstances to allow ineligible tenancy than to hold a unit vacant and pay the subsidy permitted for vacant units. In these situations, allowing the owner to make such a decision for a few units would save both HUD and project owners from an unnecessary and useless administrative workload in granting exceptions.

HUD asserted that the change from a 20-percent to a 10-percent exception was based on program experience and that this change had already accomplished much of the improvement we were suggesting.

GAO response

Regarding HUD's comment that owners cannot receive subsidies on behalf of ineligible households, we would like to clarify that in our report to HUD we did not suggest that ineligible households benefit from direct section 8 subsidies. We are unaware of any evidence that would determine whether direct subsidies were paid on behalf of ineligible households. What we did conclude was that indirect subsidies for financing through TANDEM discounts or tax exempt bonds accrue to all units regardless of who occupies them and that a decrease

in the percentage of eligible tenants housed by section 8 degrades the cost effectiveness of the program.

Regarding HUD's second point stressing the necessity for allowing owners sufficient leeway in selecting tenants, we accepted this principle in our letter to Mr. Simons. But, we questioned the cost of allowing a 10-percent exception without HUD permission when a 5-percent exception would likely allow sufficient latitude to those owners who try to comply. In actuality, most projects that we surveyed tended to comply completely, having all assisted units occupied by eligible households. HUD also mentioned the possibility of facing unnecessary vacancies if owners were not allowed some leeway, but we found instances where, on the contrary, owners of partially assisted projects who had significant vacancies were failing to fill them with section 8-eligible households in a market where thousands of families were on public housing and section 8 waiting lists. The explanation we were given for this practice was that project marketing plans agreed to by the owners and the contract administrator called for a higher percentage of market-rate households than shown in the HAP contract with HUD, and thus units were held vacant pending the location of market-rate households. 1/

HUD COMMENT ON
FURTHER LOWERING THE
LIMIT ON INELIGIBLE HOUSEHOLDS

HUD disagreed with our suggestion that the Secretary of Housing and Urban Development further lower the percentage limitation on ineligible households from 10 percent to 5 percent, with no exception for partially assisted projects. HUD stated that the recent change to 10 percent had not had time to take full effect and further experience was needed to observe its impact. No comment was made on our suggestion to eliminate the exception for partially assisted projects altogether.

1/This practice will result in much higher section 8 reserve accounts and might facilitate necessary rent increases throughout the term of the contract, whereas in general, section 8 reserves are expected to be inadequate.

HUD did promise to make a number of changes in procedures that we feel relate more directly to our second recommendation on better enforcement. We will, therefore, deal with these when we discuss enforcement.

GAO response

HUD's only argument for delaying a further reduction in the limitation on ineligible households to 5 percent before owners must ask for permission is that it has not had time to observe the impact of the 10-percent limitation.

We believe several arguments exist for making the change as soon as possible.

With historically low vacancy rates nationwide (and particularly in high-cost urban areas), with low production rates for both multifamily and single-family housing, and with continually high demand for housing, the likelihood of market-rate households opting to live in a section 8 project (particularly a partial project) can be expected to increase. The fact that it is already happening in several locations as documented in this report supports this argument. Section 8 should also become more attractive to market-rate households in a few years since rents usually become more and more competitive as buildings age.

Secondly, HUD takes the position that all assisted units should be rented to eligible households--that the exception is really only an administrative necessity. Lowering the percentage merely reinforces this position and at the same time lowers the threshold at which project owners must start to take corrective action on contracted units that are serving ineligible households or come to HUD for permission to lease contracted units to ineligible households. This would very likely have a greater deterrent effect in that those owners who could voluntarily comply would do so rather than create the documentation and justification necessary to avoid compliance.

Finally, lowering the percentage limitation now means fewer new projects would have the potential to opt for market-rate households. Lowering the percentage would also discourage developers who do not intend to fully utilize the section 8 subsidy since the limitation would reinforce

HUD's position that contracted units must serve assisted households.

HUD COMMENTS ON
BETTER ENFORCEMENT OF THE
LIMIT ON INELIGIBLE HOUSEHOLDS

Regarding enforcement of the limit on ineligible households, we suggested that the Secretary of Housing and Urban Development issue explicit enforcement guidelines for use by HUD regional and area offices in dealing with project owners who exceed the limitation on ineligible households.

HUD responded by detailing several procedural changes that it felt would clarify the responsibilities of project owners, improve monitoring procedures, and make explicit the enforcement options of HUD area office personnel seeking to bring owners into compliance with eligibility provisions or any other contract terms or applicable regulations.

These were

- changing the draft "Occupancy Administration Handbook for Subsidized Multifamily Housing Programs" to notify owners of their obligation to admit only eligible tenants to section 8 units unless ineligible admissions are clearly documented and justified. In no case would the number of such unsubsidized tenants exceed the applicable percentage limit.
- modifying the quarterly Management Information System occupancy report to show the percentage of market-rate tenants in each project, thus alerting HUD officials to problem projects. (The occupancy report may also take the form of a semiannual exception report.)
- augmenting the annual management review of subsidized projects and altering the detailed Management Review Form (9834B) used in these reviews to probe for owner noncompliance with the requirement to rent only to eligible households.
- including a discussion on limiting the admission of unsubsidized tenants and enforcement provisions relative to this limitation in a new section 8 contract administration handbook to be written by

HUD during fiscal year 1981 (perhaps in February or March).

- perhaps changing the section 8 regulations to more explicitly state the owner's obligation to rent to section 8-eligible tenants.

HUD also reiterated the fact that new section 8 regulations, effective November 5, 1979, and revised section 8 HAP contracts have expanded HUD's tools to enforce owner compliance with the limitation on market-rate tenants as follows:

- Reducing or suspending housing assistance payments to the owner.
- Denying owner/agent participation in HUD programs until compliance is achieved.
- Reducing the number of units under the contract.
- HUD's assuming control of project operations, including rent collection and payment of necessary expenses, by appointing a receiver or obtaining mortgagee-in-possession status.

HUD concluded that the most desirable of these enforcement options was reducing or suspending payments and that the least desirable was reducing the number of units, which we noted in our report to HUD.

GAO response

We believe the cumulative effect of all these changes will clearly result in a wider understanding of owners' responsibilities to rent exclusively to section 8-eligible households and of HUD field office enforcement options. These moves also indicate a strong HUD commitment to solving the problem of ineligible households in section 8. We do feel that certain of these changes are more likely than others to result in better enforcement. For example, the occupancy handbook is the document used by owners to determine eligibility. The language in this publication should clearly state the responsibility of owners to take all steps necessary to fill units with eligible households and to fully

justify and document decisions to substitute market-rate for eligible households.

Also of great importance will be the handbook on contract administration. Although this document is planned for completion in early 1981, work had not started as of November 1980. This handbook would be the best source for the clear, step-by-step enforcement procedure that we recommend. It should give explicit instructions as to the kind of notice project owners should be given, the length of time owners have to come into compliance, the procedure for implementing sanctions and the circumstances necessitating the various sanctions. It should also make clear that in no, or very rare, circumstances would HUD ever resort to reducing contract authority since this merely legitimizes the owners' noncompliance.

Finally, we feel that HUD's suggestion of a further regulation change to make explicit the owners' obligation to rent to section 8 eligible households is extremely worthwhile and have added this as a recommendation in this report, although it was not included in our August 21, 1980, letter to HUD.

We do not believe that these administrative changes, regardless of how well they are implemented, will in and of themselves solve the problem of ineligible households. The 10-percent exception that now applies to new projects and the 20-percent exception for projects in operation still create an enormous potential for decreased program effectiveness. Also, allowing the exception for partially assisted projects seems altogether unnecessary.

HUD COMMENT ON
RETROACTIVITY OF
LIMITATION ON INELIGIBLES

Our August 21, 1980, letter on ineligible households also suggested that the Secretary of Housing and Urban Development make the new percentage limitation on ineligible households applicable to completed projects for which the earlier 20-percent limitation is still in effect.

Although HUD had originally considered making the 10-percent limitation on ineligible households applicable to existing section 8 projects, it took the position in its response to our suggestion that such a retroactive change

was legally impossible. HUD reasoned that the limitation (on ineligible households) is a provision in each project owner's current HAP contract and that HUD cannot unilaterally change these contracts. It concluded that an owner could be obligated to adhere to any new limitation only if the owner agreed to amend the existent contract to so provide.

GAO response

We believe HUD's position on retroactivity is only partially correct. Although it concludes correctly that making a change in the percentage limitation would constitute a unilateral change in the contract, one cannot immediately conclude that this makes such a change impossible. The danger in a unilateral change is that it might be construed by project owners as a breach of contract. We believe that while such a retroactive change would modify the contract, project owners would not be adversely affected. The only real consequence would be to change the threshold percentage at which the owner had to notify HUD and ask for permission to rent to additional ineligible households. But, it would leave unaffected the owner's obligation to rent to eligible households since the earlier HAP contract to which HUD refers imposed the responsibility to do so and HUD has consistently taken this position. (See HUD response.) The owner must make every effort necessary to rent to eligible households before resorting to the exception for ineligible households. Thus, the owner's property rights are unaffected, and the owner may still rent to ineligible households if no eligible households are available. HUD will pay the rent on vacant contract units under section 8 and up to the full contract rent when the units are occupied by eligible households. Therefore, this slight change in the contract term would probably not cause any financial loss to the owner. Lowering the threshold might, however, have a significant impact on the owners' willingness to voluntarily comply with the requirement to rent only to eligible households, since doing so would become the path of least resistance.

Discussion with our Office of General Counsel and a review of HUD's position has persuaded us that HUD can probably make such a change administratively but that HUD would be on much firmer ground with a signal of congressional intent and support. We have, therefore, reoriented this suggestion on retroactivity to the Congress rather than HUD and have also suggested legislation clarifying the original

intent of section 8 to house only eligible households in contracted units. We also suggest that the Congress consider taking some action to make a 5-percent limitation on ineligible households retroactive to housing already under contract.



DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410

October 22, 1980

OFFICE OF THE ASSISTANT SECRETARY FOR
HOUSING - FEDERAL HOUSING COMMISSIONER

IN REPLY REFER TO:

Mr. Richard J. Woods
Associate Director
Community and Economic
Development Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Woods:

We appreciate the time and effort your staff has expended to produce for us the letter report of August 21, 1980 on ineligible (unsubsidized or market rate) tenants in Section 8 projects. In that report you recommended that the Department initiate regulatory changes and administrative actions to reduce the admission of unsubsidized tenants in Section 8 New Construction and Substantial Rehabilitation projects. We will respond to each of your three recommendations, but first we would like to make some general comments.

General Comments

First, we would like to point out that the admission of unsubsidized tenants into Section 8 projects can never result in subsidy payments to the owners for those tenants since such payments are made only for subsidized tenants.

Secondly, we agree with the concept of limiting the number of unsubsidized tenants admitted to Section 8 projects. Section 8 projects were built to house lower income tenants and lower income tenants should be the ones the owner seeks to attract to the project. Obviously, Section 8 projects are built because a need exists for Section 8 assistance in a particular area. However, we also believe it is important for owners to have some leeway to admit unsubsidized tenants. Occasionally, at a certain point in time, a project may not be able to attract Section 8-eligible tenants because of the unit sizes available or the particular market conditions. In this case, we believe it is better to lease to a market rate tenant rather than to leave the unit vacant and bill HUD for vacancy payments. Similarly, in a case of existing projects or units being converted to Section 8, an owner may be faced with a choice between housing eligible tenants or displacing Section 8-ineligible tenants currently living in the project. Owner discretion is necessary to allow the owner to house market rate tenants who may be displaced.

In these types of situations, an owner must have the ability to make decisions on a few units without having to come to HUD for individual waivers on each unit. HUD could not easily accommodate this potential workload, nor does a project owner/agent have the time to request individual waivers. As you know, we initially set this discretionary factor at 20 percent of the assisted units. Based on our experience with this program, we have now reduced the discretionary factor on admission of market rate tenants from 20 percent to 10 percent in an effort to use Section 8 more effectively while still leaving the owner and this Department some leeway. This reduction goes a long way toward answering your concerns on economic integration and hidden costs inherent in any potential financing, while holding down the costs associated with those waivers generated by a more restrictive policy.

Following are responses to your specific recommendations.

Recommendation No. 1: Further lower the percentage limitation on ineligible households to 5 percent, with no exception for partially assisted projects.

Response: Your work to date has consisted of an examination of the problem of admission of ineligible tenants in only two field offices. In addition, your survey on admission of ineligible tenants turned up problems in only a few of the projects under Contract in these offices. Since your report dealt with only two field offices and only a few projects in each of those offices, and since projects under the 10 percent limitation have not been in operation long enough for us to analyze the impact of the limitation, we feel it is improper at this time to make major program changes. Instead, in our Occupancy Administration handbook that will be in use by December of 1980, we propose to notify owners of their obligation to admit none other than Section 8-eligible tenants to the Section 8 units unless the owner clearly documents and justifies his admission of market rate tenants. Even with this documentation, the admission of these unsubsidized tenants would in no circumstances be permitted to exceed the 10 percent limitation. The owner will be required to document both tenant and project files to indicate why a market rate tenant was admitted in place of a Section 8 eligible tenant. The percentage of market rate tenants will be shown on the Section 8 Management Information System (MIS) quarterly occupancy reports. These figures will alert HUD field staff to closely examine, during the on-site reviews, the documentation of reasons for admission of unsubsidized tenants.

In addition to the new documentation requirements, we have several internal procedures the Department uses to monitor an owner's compliance with the limitation on leasing to market rate tenants. We are also developing other review procedures. Current reviews include on-site management and occupancy reviews and planned is a desk review of contract administration.

- ° Management and Occupancy Reviews: HUD, or the contract administrator, performs annual management reviews on HUD-insured and HUD-held projects, and annual occupancy reviews on non-insured projects. These reviews include both a desk review of the project by HUD personnel and an on-site visit to the project. During the desk review, HUD staff will examine project occupancy reports to determine if a significant number of units designated for assistance have been leased to unassisted tenants. If a problem appears, it can be pursued by the HUD staff during their on-site review. Per our above proposal, Part II of the Management Review Form will be revised to ensure a thorough examination of the owner's reasons for admitting any unsubsidized tenants and will include several questions on the admission of unsubsidized tenants. The questions in the management and occupancy reviews will be geared toward documenting the number of units leased to ineligible tenants; determining why an owner may have leased to market rate tenants; and a review of the efforts an owner may have taken to reach assisted tenants-i.e., whether the owner made good faith marketing efforts to locate assisted tenants, the number of vacancies at the project, the presence/absence of a waiting list of eligible tenants, etc.
- ° Contract Administration. During FY '81 we will produce a handbook on administration of Section 8 contracts. This handbook will include a discussion of the limitation on admission of unsubsidized tenants, why the limitation is required and when and how the limitation should be enforced. The MIS system will be used to produce a semi-annual exception report that will note those projects where more than the permitted number of units are leased to market rate tenants. This report will highlight those projects where HUD must make a careful review of tenant selection and admission policies.

Recommendation No. 2. Issue explicit guidelines for use by HUD area offices in dealing with project owners who exceed the limitation on ineligible households.

Response: The first step to be taken in securing owner compliance is to ask an owner for voluntary compliance with the applicable limitations. If either an on-site review or MIS data show a problem with leasing to unsubsidized tenants, HUD staff notifies the project owner of this problem and negotiates with the owner to achieve compliance with the limitation. If the owner fails to comply, HUD (or the contract administrator) has several enforcement options available.

These enforcement options are fairly explicit in both the Section 8 regulations and Contract. Step-by-step enforcement guidelines are also being built into the piece on contract administration. These guidelines will explain the regulatory and Contract provisions behind the admission of ineligible tenants and enforcement actions available if an owner abuses this discretion.

- ° Regulatory Provisions. Both the Section 8 New Construction and Substantial Rehabilitation regulations provide that the owner's failure to comply with the limitation on leasing assisted units to unsubsidized families "is a violation of the Contract and grounds for all available legal remedies, including specific performance of the Contract, suspension or debarment from HUD programs and reduction of the number of units under the Contract..." We are considering changing the Section 8 regulations to more explicitly state the owner's obligation to rent to Section 8-eligible tenants.
- ° Contract Provisions. The new Section 8 Housing Assistance Payments (HAP) Contract has expanded the tools HUD may use to enforce owner compliance with the limitation on admission of market rate tenants. The owner's failure to comply with this limitation is considered a default under the Contract. The options available to HUD (and the contract administrator) upon owner default include:
 - reduction or suspension of housing assistance payments to the owner;
 - denial of owner/agent participation in HUD programs until compliance is achieved, pursuant to the 2530 clearance process or temporary denial;
 - reduction of the number of units under the Contract; and
 - HUD assumption of control of project operations, including rent collection and payment of necessary expenses, through appointment of a receiver or obtainment of mortgagee-in-possession status.

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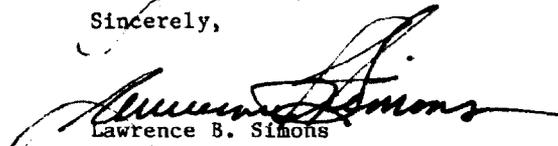
While all these remedies are available, the most effective seems to be the reduction or suspension of assistance payments until the owner complies with the terms of the Contract. HUD assumption of control would be used only in the most extreme cases, where an owner has consistently and deliberately violated the terms of the Contract. The least attractive remedy is reduction of the number of units under the Contract since this may be what an owner is trying to achieve. However, this may be a remedy of last resort.

Recommendation No. 3: Make the proposed 5 percent limitation on unsubsidized tenants applicable to completed projects for which the earlier 20 percent limitation is in effect.

Response: Our Office of General Counsel has advised us that it is legally impossible to make any new limitation we may establish retroactive to projects already under Contract. This limitation is a provision in each project's current Contract and HUD cannot unilaterally change any Contract. Any new limitation could be binding on the owner only if the owner agreed to amend the Contract to so provide.

We hope these comments and answers are satisfactory. Again, we appreciate your time in apprising us of this situation. If we can be of further assistance, please call.

Sincerely,



Lawrence B. Simons
Assistant Secretary

(382280)

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