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The History and Overview of the Performance Funding System

Evaluation of the Performance Funding System

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ABSTRACT

This report presents an overview of the Performance Funding System and the factors that led to its creation. First, the report summarizes the history of public housing and legislation affecting it. The report then focuses on the financial problems of public housing agencies in the late 1960s. Finally, the report describes the Performance Funding System itself and how it was developed.

CHAPTER 2

AN HISTORICAL PROFILE OF PUBLIC HOUSING POLICY AND LEGISLATIVE INITIATIVES

To understand why the Performance Funding System was needed, it is first important to examine the housing policy context within which it developed. This chapter explores the housing initiatives of the federal government during the twentieth century. As this brief chronology shows, significant involvement by the federal government in housing programs is a relatively recent phenomenon. No permanent role for government in housing was envisioned before 1937. By 1949 a limited role was defined, but it was not until the mid 1960s that this role grew to substantial size. Thus, when public housing authorities (PHAs) began to encounter financial difficulties during that decade, the federal government with its ever growing responsibility to address the housing needs of low-income persons, had to search for solutions.

2.1 POLICY INITIATIVES PRIOR TO 1937

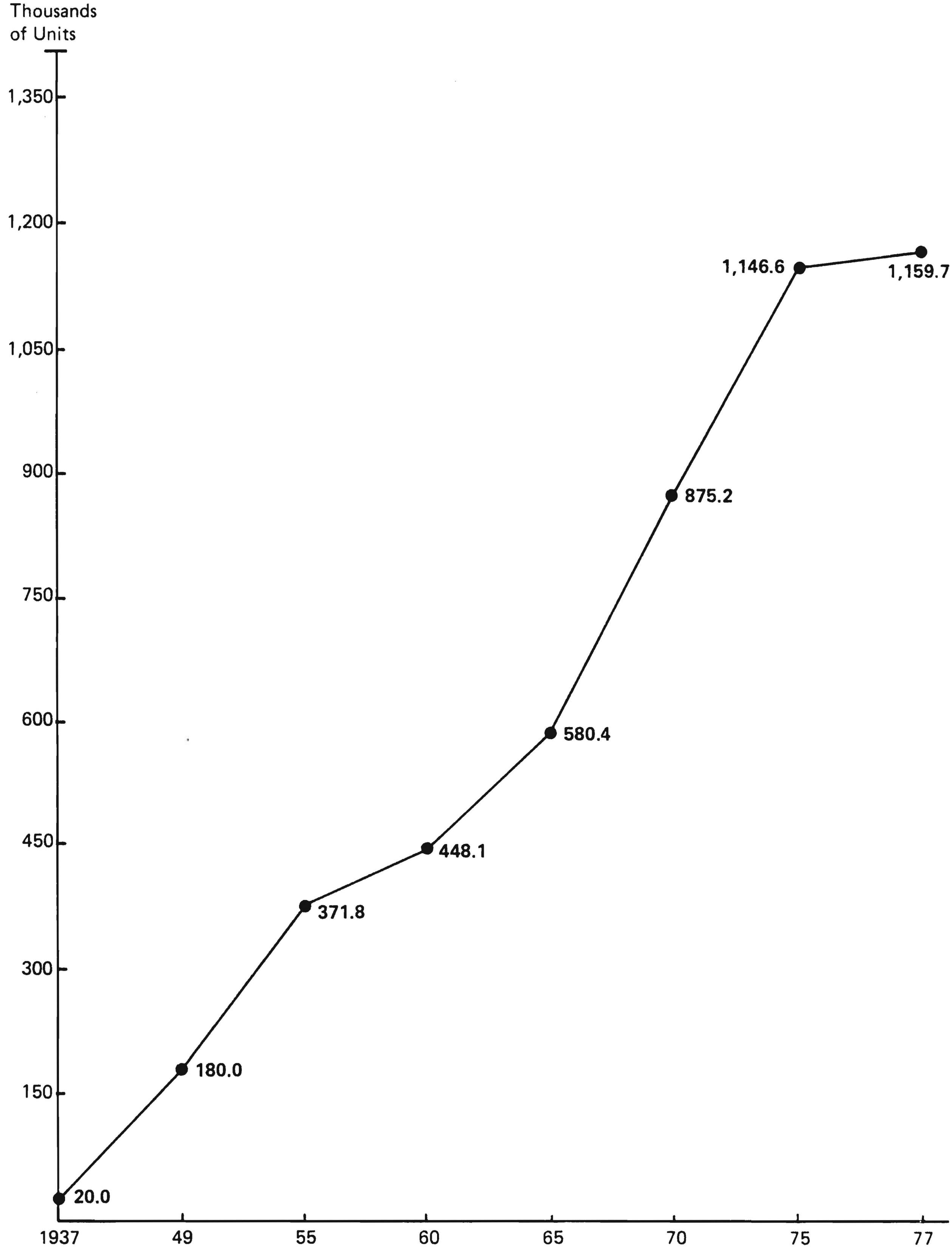
One of the earliest federal government initiatives in the housing field came in the form of a Presidential Commission appointed in 1908 by President Theodore Roosevelt to evaluate slum conditions in the nation's capitol. The Commission recommended a government slum clearance effort involving acquisition of "all unsightly and unsanitary property" and the construction of "healthful habitations," for slum dwellers in the District of Columbia. No actions were taken as a result of the Commission's recommendations.

Approximately ten years later, faced with a need to house defense workers, Congress approved the first national housing program. But, after World War I ended, all housing produced by the federal government for this purpose was either sold or demolished. Through the 1920s, the federal government left the housing area to the private sector. However, after the stock market crash of 1929 and the ensuing Depression, the federal government re-entered the housing arena.[1]

President Hoover, in December 1931, spurred by the alarming rate of mortgage foreclosures in single-family homes and the deeply recession-entrenched home building industry, called a President's Conference on Home Building and Home Ownership. The Conference and its subsequent reports recognized two points

Figure 2-1

TOTAL NUMBER OF LOW RENT PUBLIC HOUSING UNITS AVAILABLE FOR OCCUPANCY 1937-1977



Source: U.S. Department of Housing and Urban Development, *Statistical Yearbook,* Washington, D.C., 1977, pp. 223 and 224.

units than had been constructed in the whole period between 1933 and 1949. As Figure 2-2 shows, the number of new public housing units made available for occupancy increased between 1950 and 1953 and then fell off until 1957.

The Elderly Housing Program of 1956

In 1956, the federal government broadened its commitment to the housing needs of the poor. For the first time, single-person elderly households were eligible for admission into public housing designed for families. In addition, the Public Housing Administration was authorized to finance construction of new housing or remodeling of existing low rent public housing so that it would be suitably designed for the needs of elderly tenants.

This program was utilized heavily. PHAs encountered less community resistance to the idea of constructing units for older persons than for families. In addition, they received more federal reimbursement for construction costs of these developments. By 1964, 48 percent of all public housing starts were units for the elderly. By 1967, the percentage increased to 57 percent.[6]

2.3 HOUSING POLICY OF THE 1960s

During the 1960s, the federal government became more deeply involved in the provision of low rent housing than ever before. New programs proliferated as the Congress expressed a deepening commitment to the provision of decent housing for all Americans.

Construction of public housing increased dramatically. In 1968, the number of units completed was almost double that of the year before (see Figure 2-2).

In addition, new ways to address the housing needs of the poor were tried. Many of these attempted to increase the role of the private sector in the provision of subsidized housing. In 1961, the Section 221 mortgage insurance program was amended so that private developers could secure low interest loans from the federal government. In this way, rents could be lowered and brought within reach of low-income families. In 1965, the Rent Supplement program was introduced. It provided for payments to lower rents in privately owned housing. When used in conjunction with the 221 program, it lowered the rents of those units even further. The payments were used to reduce the rents of eligible families to 25 percent of income. A similar program (Section 23) was begun in 1965. PHAs leased units from private landlords and used the subsidies to reduce rents for eligible families.

In 1967, another initiative was made when the Turnkey Construction program began. Private developers signed contracts with local housing authorities to complete housing complexes and then sell them to PHAs. In 1968, the Section 235 Homeownership and Section 236 Rent Subsidy Programs were added. They provided for subsidies of mortgage interest rates. Under the Section 235 program, prospective homebuyers with low incomes could qualify for low-interest mortgages. The Section 236 program subsidized mortgages for developers of rental housing so that rents could be reduced to 25 percent of household income.[7]

2.4 SUMMARY

Early in the twentieth century, the federal government began to show concern about the spread of urban slum housing and related problems of poverty. But, initial government intervention in the housing market was limited to producing a few thousand units of housing during World War I and to a series of temporary measures in the early 1930s. The efforts during '30s were designed to provide employment and to stimulate private mortgage lending and homebuilding which had been restricted by the collapse of the economy.

Direct housing production by the government was undertaken by the Public Works Administration pursuant to the National Industrial Recovery Act of 1933. Eventually, direct federal production of public housing under the old PWA was replaced by local development, with federal financial assistance pursuant to the 1937 Housing Act. The public housing program was conceived as an extension of the public works approach to stimulate increased employment and as a slum clearance program. Housing subsidization was somewhat secondary.

In fact, Congress made no clear expression of a national commitment to provide decent housing for all Americans until the 1949 Housing Act. After that time, construction of low-rent housing units increased dramatically although not to the levels envisioned by the architects of the legislation. In 1956, the scope of the program expanded again when single elderly individuals became eligible for admission. The 1960s saw the creation of many new strategies which were designed to supplement the growing public housing program. By that time, the federal government was deeply involved in the provision of housing assistance to low-income citizens. Thus, when PHAs began to have

FOOTNOTES

1. U.S. Department of Housing and Urban Development, Housing in the Seventies, op. cit., pp. 1-14 to 1-15.

2. Nathaniel, Keith, Politics and the Housing Crisis, New York, Universe Books, 1973, p. 17.

3. U.S. Department of Housing and Urban Development, Statistical Yearbook, Washington, D.C., 1977, p. 223.

4. Ibid.

5. The Preamble of the Housing Act of 1949, 42 U.S.C. §1441 (1964).

6. National Commission on Urban Problems, Building the American City, Washington, D.C., 1968, p. 115.

7. U.S. Department of Housing and Urban Development, Housing in the Seventies, op. cit., pp. 1-19 to 1-24.

CHAPTER 3

GROWING FINANCIAL INSOLVENCY OF LOCAL HOUSING AUTHORITIES

This chapter describes the growing financial problems of public housing agencies during the late 1960s. It identifies the factors which contributed to rapidly increasing operating costs and declining rental receipts.

3.1 DEVELOPMENT OF FISCAL INSOLVENCY

As initially formulated and implemented for over 20 years, the federal financial support structure for public housing programs was reasonably straightforward. The federal government subsidized the full cost of development and the initial capital costs to the extent necessary, while the public agency was responsible for all costs associated with maintenance and management, tenant services, and other costs of administration. The clear intent of the 1937 federal legislation was to provide a debt subsidy, and that only. For all activities of an operating program, it was assumed that local housing authorities would function as other businesses might, bringing in revenues that were at least sufficient to cover costs.

In fact, for a number of years, this was the case. Public housing agencies (PHAs) were generating sufficient cash receipts so that all operating expenditures were fully paid, an operating reserve account equal to 50 percent of routine operating expenses were maintained, and a capital reserve account was maintained. In addition, excess receipts (referred to as "residual receipts") were returned to the federal government; thus, in 1949, the government only had to pay slightly less than 16 percent of the amount obligated under the annual contributions contracts, covering the roughly quarter million public housing units then under management.[1] But this was a passing phenomenon.

As Figure 3-1 illustrates, by 1969 operating costs for PHAs across the country began to outstrip rental receipts, and the gap widened dramatically after 1971. The fiscal problems of the largest PHAs occurred even earlier. By 1968, all of the 80 largest PHAs were unprofitable; half had only moderate deficits; 15 were near bankruptcy.[2] By 1975, every PHA categorized as large (1,250 dwelling units or more) was operating at a deficit.[3] Concurrently, federal subsidies for operating expenses went from $4.8 million in 1968 to $661.6 million in 1978.[4] One study found that costs varied according to the geographic location of PHAs. Thus, PHAs located in the Northeast part of the country had the highest operating costs. PHAs within Standard Metropolitan Statistical Areas (SMSAs) but outside of center cities had lower operating costs than did their center city neighbors, while PHAs outside of SMSAs had even lower operating costs.[5] Clearly, although the relative deterioration of fiscal solvency suggests that the effect impacted broadly across the entire program, a more detailed look at the programs shows that the most pronounced effects were experienced in large, center city PHAs, especially those located in the Northeast.[6]

One case study conducted in St. Louis suggests that the federally established subsidy arrangement had always been inadequate and financial insolvency was unavoidable.[7] The St. Louis study postulates that there is an economic relationship between the type of investment, the size of the investment, and the level of resources which will be necessary to sustain it over time. A rule of thumb used to evaluate commercial apartments' economic feasibility is that gross annual income must be equal to one sixth of 16 percent of total investment; 50 percent of gross annual income or 8 percent of investment is required for maintenance and operations and the balance for debt service, taxes, profits, and reserves.[8]

While there are acknowledged differences between private commercial properties and public housing*, the St. Louis study attempted to apply the 8 percent feasibility test to St. Louis public housing projects. The logic was that since HUD paid most of annual costs (the debt service costs), annual gross receipts would have to equal only 50 percent of that on commercial properties. A detailed analysis of St. Louis operating budgets for individual project expenses and income showed that only two projects ever produced the desired level of earnings as a percent of development costs; those two did so only briefly, and in part

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*Unlike private real estate owners, PHAs are exempt from real estate taxes and pay smaller payments-in-lieu-of taxes. However, PHAs typically pay more utility costs than private owners, who generally provide either only heat and hot water or had tenants pay all utility expenses. Another difference is in the use of reserve accounts. Private owners usually maintain reserves to cover property taxes, capital replacement costs and other contingencies. PHAs, on the other hand, were expected to pay for capital improvements out of operating expenses until the 1968 modernization program provided additional funds for this purpose.

costs up markedly faster than rental income, thus exacerbating the deficit position of most PHAs.

Figure 3-2 illustrates this problem. Between 1961 and 1967, the national Consumer Price Index (CPI) and the average per unit monthly rent for PHAs increased at about the same rate. In 1968, the CPI began to increase at a faster rate, and average monthly rentals declined in the early 1970s. An Urban Institute study explored this issue in more detail.[9] Its central finding was that price and wage inflation had been the major cause of rising PHA costs in 23 large PHAs. They accounted for approximately 80 percent of the operating cost increases of the PHAs studied between 1965 and 1968. The same study found that the PHA rental charges to tenants were most strongly influenced by costs per unit. However, rent increases were only offsetting about 75 percent of the cost increases experienced. This problem was most severe in Northeast cities where prices increased more rapidly than in other parts of the country.

3.3 SOCIAL SERVICES AND PHA/TENANT RELATIONSHIPS

Still another change in operating condition that many PHAs experienced was an increase in the amount of services provided to tenants. In the early years of the program, most housing authorities operated much like any private landlord, and there was not much demand for special services. During the 1960s PHAs began to provide new, and often costly, tenant services. This occurred because PHAs felt that they had to respond to the needs of a tenant group that was increasingly made up of broken families and large households with several children. In 1950, 19 percent of all tenant families were broken; by 1969, that percentage had increased to 46 percent.[10] Large families were particularly prevalent among nonwhite tenant households. In 1969, the mean number of minors in a nonwhite family was 2.33 compared to 1.36 for white families. In that year, 38 percent of nonwhite tenant families had three or more minors in the family compared to 23 percent of white families.[11]

As the years went by, housing authorities felt that they were faced with more problems that they associated with "problem" families. They perceived that special services were needed to deal with unruly children, growing vandalism, and crime. As the Boston Housing Authority reported in 1966:

> In the past, housing authorities tended to limit their function to providing physical housing, leaving it to outside public agencies to provide all social services. But the realization is growing that mere housing is not enough, and that good housing by itself cures few of the ills experienced by people disadvantaged from birth....[12]

This PHA and others in the country developed comprehensive networks of costly social programs in response to the problems they perceived to be brought on by the characteristics of its tenant population. All of the programs were aimed at identification and rehabilitation of problem families through various combinations of casework, education, child care, training in home economics, and recreational activities.[13] Also, PHAs developed more protective services for their tenants. Security was tightened and special guards were hired at numerous housing developments.[14]

These services were costly and added new expenses to already strained PHA budgets. There were some special funds available from agencies such as the Office of Economic Opportunity and the Department of Health, Education and Welfare, but they rarely covered all of the costs. In addition, grants were often short-term and limited in scope. Therefore, PHAs had to absorb some of the costs themselves.

Some housing professionals and PHA directors argued that it was not the responsibility of public housing agencies to meet the complex needs of "problem" families. They felt that public housing should select for admission only those families who would meet certain standards of behavior.[15] This practice was used until 1968, when a new tenant assignment policy prohibited tenant selection by income or other social characteristics. Therefore, such screening was no longer permitted, and pressures for services from PHAs increased.

In 1971, HUD issued several circulars which modified the nature of the relationships between PHA tenants and managers and increased PHA administrative responsibilities. Tenant rights were spelled out for the first time. Tenants could not be evicted without cause, and all were entitled to grievance hearings.[16] These procedures were important measures to ensure due process for tenants. However, they also cost PHAs additional staff time and money and slowed down efforts to evict nonpaying tenants and replace them with occupants who would keep up with their rental payments.

During the 1960s and early 1970s, the social and political climate of the

PHAs had difficulty keeping their dense, high-rise projects occupied. The buildings were unattractive and sometimes families would not live in them. Thus, PHAs lost revenue when they had to support buildings with large numbers of vacancies. Thirdly, unoccupied units invited destruction through vandalism and this had an additional impact on maintenance costs.

Several examples taken from studies of the St. Louis public housing programs illustrate convincingly the impact of construction and design on occupancy and, thus, on revenues. One study found that occupancy decreased in family projects as height above ground level increased, although the decrease was not smoothly patterned. Overall occupancy in medium-rise buildings (6 to 8 stories) apparently was better than in taller buildings.[20]

Comparisons between the Pruitt Igoe project and three more successful St. Louis projects (Vaughn, Carr Square, and Clinton Peabody) clearly showed the impact of design and construction differences. The arrangement of rooms, the size of rooms, the level of amenities, the number of units per acre, the quality of materials used, and the availability of elevators to each floor were drastically different. Pruitt Igoe was built for approximately 60 percent of the parallel costs of the other projects, but completely failed to attract occupants.[21]

3.5 CHANGES IN PUBLIC HOUSING TENANT POPULATION

In the early days of public housing, tenant families tended to be young, working class households with incomes at the upper end of the eligible income spectrum. This pattern occurred because of several factors. PHAs tended to select families who could pay higher rents, and single person households were not even eligible. In 1940, P.L. 671 was enacted by Congress. It authorized the construction of public housing to serve defense and war workers. This law had the effect of reinforcing the working class, middle income character of the tenant population.[22]

After 1950, the nature of the tenant group began to change. Larger proportions of very poor households began to comprise the tenant population, and more households were dependent on fixed incomes. Between 1950 and 1968, the median income of public housing tenants shrank from 64 percent to 41 percent of family median income nationally (see Figure 3-3). Over the same period, the proportion of tenant households receiving public assistance or other benefits increased from 29 percent to 64 percent.[23] Thus, as the requirements for rental subsidies grew, the capacity of the tenant population to meet any increases in rent prices became more severely limited. There was no real possibility that the solution for the financial crisis could be passed to the renter households.

Increasing Proportion of Elderly Tenants

Part of the change in the poverty characteristics of the tenant population is explained by the increased proportion of elderly tenants. That trend occurred because of the institution of the Elderly Housing Program in 1956 which opened eligibility to single person elderly households and authorized construction of developments designed for the elderly. In 1952, only 10 percent of public housing families had heads aged 65 and over. By 1969, the percentage had gone up to 36 percent and rose to 45 percent by 1977. (See Figure 3-4.)

These households tended to be extremely poor. In 1968, median income of elderly households in public housing was only 47 percent of the median income of nonelderly tenant households.[24] That year, 95 percent of elderly public housing tenants received public assistance, social security or some other public benefit.[25]

Increasing Nonwhite Population

Over the years between 1950 and 1977, the proportion of nonwhite and particularly black families in public housing increased also. As Figure 3-4 illustrates, the percentage of nonwhite families went from 38 percent in 1950 to 61 percent in 1977. Between 1950 and 1969, most of the increase was accounted for by increasing numbers of black families. After that time, the rising proportion of other minorities accounted for much of the change.

In recent years, a large proportion of nonwhite tenant families had heads of households aged under 65 years. In 1977, 73 percent of nonwhite tenant families were headed by nonelderly persons. At the same time, the majority of white households were elderly. In 1977, 68 percent of white households were elderly.

Contrary to popular opinion, nonwhite tenant families were not poorer than white families. In fact, both white and nonwhite families had extremely low incomes. In 1970*, nonwhite, nonelderly households had median incomes of

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*Data not available for 1977.

$3,425 and <u>white</u> nonelderly households had median incomes of $3,479.[26] Nevertheless, the rising proportion of nonwhite families in public housing changed the image of the program from one created for middle income white families to one utilized by poor black families.

Factors Affecting Changing Tenant Characteristics

As we have shown, the composition of the tenant body in public housing shifted from a predominantly working class, white group to one composed of more elderly persons, nonwhite families and very poor households. This shift is explained by a number of factors including:

> Changes in housing policy as specified in the Housing Act of 1949, and administrative regulations of the 1960s
>
> Increased construction of new public housing projects in low-income neighborhoods
>
> Migration of low-income blacks from rural to urban areas where they sought low-cost housing
>
> Exodus of middle-income families from public housing.

The Housing Act of 1949 had a number of provisions which led to changing admission policies of PHAs. First of all, it required that priority for tenant selection had to be given to eligible applicants who were displaced by urban renewal action. Since much of that work was done in deteriorating neighborhoods occupied by poor black families, those families had more opportunity for admission to public housing than ever before.

Another provision of the Act prohibited discrimination by PHAs against households who received public assistance benefits. PHAs devised other screening procedures to exclude those families who were not felt to be "desirable," but the impact of the Act was felt nevertheless.[27]

Administrative regulations issued in the 1960s also contributed to increased admissions and continued occupancy of low-income nonwhite households. Until that time, nonwhites were frequently admitted to public housing only on a segregated basis. PHAs often maintained racially segregated projects[28] and the 1949 PHA Low Rent Housing Manual had a specific requirement that "housing provided for all races shall be substantially the same quality...."[29]

However, in the early 1960s, these practices were required to change. Federal tenants can escape and the racial composition of the neighborhood."[34]

3.6 ADMINISTRATIVE REGULATIONS

Restrictions on income eligibility for tenants also contributed to the fiscal problems of PHAs. One of these, the gap requirement, was laid out in the 1949 Housing Act. It set the formula by which localities should calculate maximum income limits for eligible households. It stated that income limits for admission had to be set at a level at least 20 percent below what would enable the family to rent similar, decent, safe and sanitary housing in the community.

To illustrate this concept, assume that two-bedroom units are available in the unsubsidized market at $175 monthly gross rent. The "gap rent," at 20 percent less, would be $140. If a PHA assumes that families can afford 25 percent of their incomes for shelter, then maximum monthly income for families occupying two bedroom units would be $560. The rule was intended to reserve public housing for families who genuinely needed it and insure that the program would not compete with the private housing sector. In fact, it was hoped that private builders would develop units at rental ranges in the gap. However, the provision created numerous problems. New units at lower rents were not developed, and the process thus created a group of people who were deemed ineligible for public housing but who could not afford standard private units. They had to turn to inadequate housing or pay larger amounts of income for shelter.

Under the original provisions of the Act, any increase in income would lead to an automatic increase in rent, and once the tenant's income increases so that he or she could affort to pay rents of more than 80 percent of the amount at which private units were available, he or she had to leave public housing. Thus, in our example, if private units were available at $175 per month, the tenant would have to move if his/her income reached $560 per month. The rule thereby required housing authorities to evict families who could afford higher-than-average rents which could offset the very low rents of poorer tenants. A source of financial aid to marginally solvent LHAs was thus denied.[35]

In the 1960s, the continuing occupancy rules were softened to allow PHAs to retain tenants who could afford higher rents. In 1961, the Housing Act provided that tenants whose incomes had increased so that they could afford rents reached disastrous proportions, drawing national attention and requiring federal action.

18. Roger Mulvihill, "Problems in the Management of Public Housing," Temple Law Quarterly, vol. 35, 1961-62, p. 187, and William H. Ledbetter, "Public Housing - A Social Experiment Seeks Acceptance," *Law and Contemporary Problems*, vol. 32, 1967, pp. 497-498.

19. Lawrence M. Friedman, "Public Housing and the Poor: An Overview," *California Law Review*, vol. 54, 1966, pp. 649-651.

20. Meehan, *op. cit.*, p. 55, Table 4-3.

21. Meehan, *op. cit.*, 34 pp. For a full discussion of the relative merits of various building designs, site configurations, relationship of buildings to public space, and relationship of private, interior and privately controlled (by a single tenant) outdoor space to *commonly* used interior and exterior space, see Oscar Newman, *Defensible Space: Crime Prevention Through Urban Design*, Macmillan, Riverside, New Jersey, 1972.

22. Silverman, *op. cit.*, p. 590.

23. *Ibid.*, p. 592.

24. U.S. Department of Housing and Urban Development, *Statistical Yearbook*, Washington, D.C., 1968, pp. 268 and 274.

25. *Ibid.*

26. Henry Aaron, *Shelter and Subsidies*, Brookings Institution, Washington, D.C., 1972, p. 117.

27. Scobie, *op. cit.*, p. 3.

28. Friedman, *op. cit.*, pp. 648-652.

29. U.S. Public Housing Administration, *Low Rent Housing Manual*, Section 207, Washington, D.C., 1949.

30. 3 C.F.R. 261 (Supp. 1962), 42 U.S.C. §1982 (1964).

31. William H. Ledbetter, "Public Housing - A Social Experiment Seeks Acceptance," *Law and Contemporary Problems*, vol. 32, 1967, pp. 503-504, and Friedman, *op. cit.*, p. 650.

32. Friedman, *Ibid.*, p. 651.

33. Mulvihill, *op. cit.*, pp. 175-176.

34. *Ibid.*

35. The implications of the gap requirements are discussed in Douglas Commission, *op. cit.*, p. 110, Ledbetter, *op. cit.*, pp. 505-507.

36. §10(g)(3), 42 U.S.C. §1410(g)(3) (1964).

CHAPTER 4

THE SUBSIDY INITIATIVES OF THE 1960s AND EARLY 1970s

As the 1960s progressed, more and more PHAs found that they could not generate enough revenue to offset their expenses. At first, the major solution was for PHAs to raise rents. However, given the nature of the tenant population which was typically poor and dependent on fixed incomes, rent increases often meant that families were required to spend excessive proportions of their incomes for rent. In some cases, tenants were expected to pay as much as 80 percent of their incomes.[1] Inevitably, this solution was unacceptable. Rent delinquencies increased and housing managers had to dip into their limited cash reserves, curtail social services and/or postpone maintenance activities where possible.[2] Larger scale measures were clearly needed, and it became the responsibility of the federal government to develop those measures.* This chapter describes the federal subsidies for operating costs which were provided during the 1960s and 1970s. These subsidies were the precursors of the Performance Funding System.

4.1 THE HOUSING ACT OF 1961

The first operating subsidy payment came as a result of an authorization in the 1961 Housing Act which allowed the Housing and Finance Agency (HFA)--the immediate predecessor agency to HUD--to make payments of $10 per month for each elderly family, or $120 per year. Apparently, the $10 per month was a general recognition that elderly households were subsisting on pension and/or social security payments and could not afford a higher rent. Thus, in order to assist public housing agencies that housed many elderly, the subsidy payment was

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*State and local governments typically did not provide additional support to financially embattled PHAs. PHAs were semi-autonomous units of government which primarily received funding from the federal government and were primarily responsible to HUD and its predecessors. Thus, the role of state government was usually limited to passing enabling legislation. Generally, states had little role in the location or funding of housing projects or in the development of program policy. Local governments had limited resources which they felt could not be stretched to cover PHA deficits. In addition, they were already subsidizing PHA capital costs because property taxes were waived. PHAs did provide payments in lieu of taxes in amounts equal to 10 percent of shelter rents, but these payments rarely equaled full real estate taxes.

Amendments, so-called because their chief sponsor was Senator Edward Brooke of Massachusetts.

> The first Brooke Amendment, enacted in 1969 and known as Brooke I, placed a statutory ceiling on rental charges to tenants of 25 percent of income.
>
> Brooke II, enacted in 1970, applied a uniform definition to income of tenants for purposes of calculating rental charges and generally liberalized the schedule of deductions and exemptions; in turn, this procedure had the effect of further lowering aggregate rental charges to tenants.
>
> Brooke III, effective in 1971, made it clear that the 25 percent limitation applied to families receiving public assistance. Before the passage of this amendment, some state welfare departments were reducing welfare payments to recipients whose public housing rents had been cut. This, of course, had the effect of once again increasing their rent-income ratios above the 25 percent limit. Under Brooke III, such reductions in welfare benefits were prohibited.

Together, the Brooke Amendments caused significant reductions in housing authority rental income. In some instances, families were even charged zero rents because the schedule of deductions reduced their effective incomes so severely. Thus, under Brooke II, HUD was authorized to make payments, up to a statutory maximum, to cover the deficits resulting from the legislation. The effect was to rapidly expand the amount of subsidy payments from $12.6 million in 1969 up to $102.8 million in the first full year (1971) in which Brooke III was effective (see Figure 4-1). Also, in cases where the statutory maximum limited subsidy payments, a PHA could continue to receive the special family payments in excess of the maximum but, of course, only up to the level governed by the number of families eligible for these payments.

Since the subsidies paid under the Brooke regulations were only a reimbursement for the revenue effect of the amendments, and because the Special Family Subsidies program was administered without regard to overall financial condition, the potential for insufficient subsidization or inequitable allocations still existed.

4.4 THE BUDGET REVIEW PROCESS

Another key feature of the so-called "deficit-financing" period, 1966 to 1972, was the budget review process. Budget reviews conducted by HUD field staff were used to determine approved housing authority expense levels which, in turn, determined the total subsidy. Proponents of the budget review process cited its flexibility and its responsiveness to unique operating conditions. There were, however, no existing standards to guide housing authority or HUD field office staff in the budget review process. To some extent, previous practices in that housing authority might serve as a standard. In other cases, an authority might argue successfully that notwithstanding past practices, more subsidy was necessary to combat whatever circumstances they faced. Naturally, there was a potential for inconsistent treatment depending upon the grantsmanship of a particular PHA and the different standards which a particular field office or even a single budget review officer might use in reviewing budgets.[5] HUD officials were certainly aware of the potential for inequities under the deficit-financing system.[6]

Another problem was accurate estimation of total subsidy requirements, which made the federal budgeting process uncertain. Because of these difficulties, the Office of Management and Budget (OMB) urged HUD to develop some systematic method to distribute subsidies which would (1) limit the rise in subsidy outlays, and (2) allow more accurate forecasts of future subsidy requirements. In addition, OMB felt that under deficit financing, HUD could potentially fund inefficient management.[7]

The concerns about poor management were not confined to OMB. HUD had had misgivings for years about some PHA management practices and used their concerns to justify tight regulation of PHAs.[8] Moreover, even in Congress there had been open expressions of concern about and condemnations of poor management in public housing authorities. Often, management abuses were reported in national news publications.[9]

4.5 THE LAUNCHING OF THE INTERIM FUNDING FORMULA: 1972

Between 1971 and 1972, operating subsidies increased dramatically (see Figure 4-1) and those increases were expected to continue. Thus, the deficit-funding system, which lacked spending restraints, incentives for sound management, and a consistent method of relating costs, revenues and subsidies, was considered inadequate by the Office of Management and Budget. The result was that OMB imposed a ceiling on the permissable rate of increase in public housing authority expenditures. This approach, known as the Interim Funding Formula, lasted for three years until it was replaced by the Performance Funding System.

for Housing Management, Norman Watson, felt that the limited expense increases allowed by Interim Funding were punitive even to well-managed PHAs.[12] Undoubtedly, in many instances, the inflation in wages and other expenses exceeded the allowable percentage increase. Even worse, the system did not recognize regional differences in costs or inflation rates. The choice of 1971 as the base year had unknown implications, but presumably those housing authorities whose financial conditions were most strained during the 1960s were at a relative disadvantage. Thus, whatever funding insufficiencies or inequities among housing authorities existed prior to and during the deficit-financing period may have been exacerbated under Interim Funding. As discussed in the following chapter, this entire financial history was inherited by the Performance Funding System.

CHAPTER 5

THE DEVELOPMENT OF THE PERFORMANCE FUNDING SYSTEM AND OTHER HOUSING INITIATIVES OF THE 1970s

The Housing Act of 1974 directed the Secretary of HUD:

> "to establish standards for costs of operation and reasonable projections of income, taking into account the character and location of the project and characteristics of the families served, or the costs of providing comparable services as determined in accordance with criteria or a formula representing the operations of a prototype well-managed project."[1]

This directive formalized concerns which had been expressed by housing experts, legislators and OMB for several years. By 1972, a major effort had begun within HUD to develop a system for allocating operating subsidies to PHAs. The result, the Performance Funding System, was put into operation in April, 1975.

This chapter describes the development of the Performance Funding System, indicates how management performance was defined, describes the technical elements and decision rules under PFS, and indicates how PFS establishes subsidy levels. The major criticisms of PFS are summarized and, finally, the other major housing initiatives of the 1970s are described.

5.1 DEVELOPMENT OF THE PERFORMANCE FUNDING SYSTEM

When the Interim Formula was introduced in 1972 it was considered to be a temporary strategy for distributing subsidy, to be used until a more systematic method could be developed. The Office of Management and Budget was insistent that HUD develop standards for management performance for PHAs and refused to lift the Interim Formula until HUD initiated a process to establish such standards.[2] Essentially, OMB feared that the relatively unsystematic allocation of operating subsidies which then prevailed was an invitation to mismanagement.[3] Confronted with the compelling directive from OMB and under the pressure of the leverage OMB might exert by withholding additional subsidy payments, HUD initiated several efforts which ultimately led to development of the Performance Funding System.

At the request of HUD Assistant Secretary Norman Watson, Ardee Ames of HUD

In order to collect the information needed to assess which PHAs were relatively well-managed, the interview information which was to have been gathered for the HMIP was greatly expanded and the sample of PHAs was expanded to include small and medium as well as large PHAs. In spring 1973, the Urban Institute surveyed 120 PHAs (40 each of small, medium, and large PHAs) and conducted approximately 9,000 interviews with the tenants and management staff of these authorities in order to assess satisfaction and perceptions of operating condition. Thus, HUD accepted the Urban Institute's methodology for defining "well-managed" authorities using a relative rather than an absolute standards approach, and the Institute agreed to work with HUD in developing a prototype cost equation. The equation was to be based on the operating costs of well-managed PHAs and would become one part of the Performance Funding System.[8]

5.2 ELEMENTS OF THE PERFORMANCE FUNDING SYSTEM

It is important to understand that the overall Performance Funding System consists of a number of technical components and decision rules for their use. Together, the decision rules and technical components determine the allowable expense levels of public housing authorities and the treatment of tenant and other revenues. The technical components include the prototype cost equation, the inflation factor, the utilities expense calculation, the calculation of PHA income and occupancy rates, and the calculation of audits and other eligible costs. Two important decision rules determine the use of these cost and income calculations: the base year and the range test. The so-called "base year" rule set allowable expenses in the first year at a level equal to the PHA's approved budget if this budget was within an acceptable "range" (interval) around the expenses estimated using the prototype cost equation. The development of the prototype equation and the overall Performance Funding System was technically quite complex. Only a summary is provided here; the details of the development are summarized in Urban Institute documents.[9]

Division of the PHAs into High and Low Performance Groups

Only "high-performing" housing authorities were used to estimate the prototype equation, that is, to relate actual costs and the variables affecting costs.

trol of the PHA; therefore, variables which measured management structure or organization were excluded from consideration. Similarly, variables likely to have unintended management effects, such as the number of children per adult or the proportion of PHA employees belonging to a labor union were rejected. Finally, the variables had to be accessible on an annual basis and had to meet various statistical criteria in order to be retained in the cost equation.

The variables used in the initial (1975) equation described:

The age of the project buildings

The height of the buildings

The average number of bedrooms per unit

The differences in regional costs of operating PHAs, and

The size of the population of the area served by the PHA.

The prototype equation is reestimated each year based on the latest data available. In subsequent equations the variable list has changed somewhat; for example, the 1978 prototype equation includes an additional variable, the Fair Market Rent for existing housing, and has changed the population variable so that it represents the population of the SMSA if the PHA is in an SMSA. Nevertheless, the <u>independent</u> nature of these variables remains clear: these are variables over which the housing authority has little or no control.

<u>Operating Expenses Not Included in the Prototype: Utilities and Audits</u>

Utility costs are an increasingly important component of operating costs. Since both utility rates and utility consumption are subject to unanticipated changes, and since the factors affecting rates and usage are not necessarily closely related to the factors in the prototype, utility costs are treated separately. The level of utility expense used in computing operating subsidies is based on the PHA's actual past levels of consumption and on current utility rates. Also, the cost of independent audits and some minor categories of additional costs are treated separately under PFS.

the range, based on an approved appeal.

The Appeals Process

An appeals procedure was available for authorities whose approved budgets were not above range and who felt that their base year expenditure level had been unduly constrained by interim formula rules. Funds were set aside for changes in expense levels resulting from appeals; 130 PHAs appealed during 1975 and 1976.

The Dynamics of the Performance Funding System

The basic elements of the ongoing Performance Funding System expressed on a per unit month basis (PUM), are set forth in the following equation:

$$\text{Subsidy}_{(t)} = \left[\underbrace{(\,[\text{AEL}_{(t-1)} + (\text{"Delta"})\text{I}])\ \text{I} + \text{U}_t + \text{A}_t)}_{\text{Expected costs}} - \text{R}_t \right] \text{M}_t$$

where:

$\text{Subsidy}_{(t)}$	=	The operating subsidy payment to which the PHA will be entitled in fiscal year t.
$\text{AEL}_{(t-1)}$	=	The Allowable Expense Level of the previous year, t-1.
"Delta"	=	The Formula Expense Level in year t less the Formula Expense Level in year t-1 ($\text{FEL}_{(t)} - \text{FEL}_{(t-1)}$). The $\text{FEL}_{(t)}$ is derived from PHA characteristics in year (t) and the latest prototype equation. The $\text{FEL}_{(t-1)}$ is based on the same prototype equation (regression weights) used for $\text{FEL}_{(t)}$ but is derived using PHA characteristics for year t-1. In each case formula expenses are obtained by solving the prototype equation (that is, multiplying the regression weights times the PHA variables and summing these amounts).

At the present time, however, the prototype equation has little effect on subsidy level. Since the variables in the prototype equation are not likely to change in any major way, the extent to which "Delta" affects the AEL is limited. Secondly, few, if any, PHAs are currently above range, so the notion of the "cutting edge" as a cost constraint is no longer salient. Thus, for many authorities the inflation adjustment may be the only component of the system that affects their Allowable Expense Level.

5.3 CRITICISMS OF PFS

Since its inception PFS has been controversial and has met with severe criticism as well as with praise. It is possible that some of the controversies were fostered by misunderstanding: the technical aspects of the prototype equation, for example, are complex and the use of the prototype equation within PFS may not be understood.

Much of the criticism has centered around one major theme--the ability of any formula or equation to determine for a vastly different group of housing authorities, facing difficult and persistent problems, an equitable or appropriate amount of subsidy. Currently, the rapidly changing cost environment puts a severe strain on the viability of any funding mechanism, particularly the inflation adjustment, to keep pace in an equitable manner.

The Performance Funding System was designed to accomplish a broad range of objectives. The Introduction to this paper listed the following goals for the system:

> To establish a level of federal operating subsidy based on the costs of well-managed PHAs
>
> To allow HUD to provide operating subsidies to PHAs on an equitable basis that takes account of local differences affecting public housing expenses
>
> To give PHAs maximum flexibility in allocating their financial resources to changing operating conditions, and
>
> To afford greater certainty and ease of budget preparation for both HUD and PHAs.

The ability of PFS to realize the first two goals--the adequacy and equity of the subsidy--has been the subject of much debate.

constrained in their allowable expense level.

5.4 OTHER HOUSING INITIATIVES OF THE 1970s

The Performance Funding System was not the only measure instituted to address the financial difficulties of public housing authorities. Legislative modifications, and some special programs were also designed to address various aspects of the problems.

The Housing and Community Development Act of 1974 had several relevant provisions. It lifted the "gap requirement" and continued occupancy income limits. Instead, occupancy income limits and rents could be set at the discretion of each PHA. These provisions provided more leeway to PHAs to admit higher income households. The law also addressed one of the unforeseen implications of the Brooke Amendments, whose definitions of income and deductions had made it possible for some households to pay zero rents. Under the 1974 law, every tenant would be required to pay a minimum rent equal to the greater of 5 percent of his or her gross income or the amount of welfare payments earmarked for rent. Finally, the law required PHAs to establish tenant selection criteria which would assure an "income mix" in projects. In this way, the earlier practice of "first come, first served" tenant selection was abandoned and an effort was made to avoid admission of only low-income households to public housing.

Initially, the law did recognize that the housing needs of the poorest applicants still needed attention. It therefore mandated that at least 20 percent of public housing units had to be occupied by "very low-income families." Such families were ones having incomes less than 50 percent of the median income of the locality's residents. In addition, it specified that PHAs could not meet the income mix criterion by waiting for higher income households to apply and rejecting lower income applicants.

During the 1970s, HUD introduced two new programs designed to provide concentrated assistance to especially troubled PHAs. The Housing Management Improvement Program spent $25 million between 1972 and 1975 to develop cost-effective management techniques in the areas of maintenance, rent collection, management information and data processing. Its successor, the Target Projects Program, began in 1974. Through that program, more than 200 PHAs have received special operating subsidy money to pay for tenant education, employ-

FOOTNOTES

1. Department of Housing and Urban Development, Performance Funding System, HM 75-20 (PHA), Washington, D.C., 1975.

2. Interview with Norman Watson, Washington, D.C., November 27, 1978.

3. Interview with Robert Sadacca, Washington, D.C., November 10, 1978.

4. Interview with Ardee Ames, Washington, D.C., November 21, 1978.

5. Interviews with Robert Sadacca, November 10, 1978 and Ardee Ames, November 21, 1978.

6. Interviews with Norman Watson, Washington, D.C., November 27, 1978, and Mort Isler, The Urban Institute, November 10, 1978.

7. Frank deLeeuw and Eleanor Jarutis, op. cit.; Frank deLeeuw and Sue Marshal, op. cit.; Robert Sadacca and Morton Isler, "Management Performance in Multi-Family Housing Developments," Washington, D.C., The Urban Institute, 1972.

8. Interview with Robert Sadacca and Morton Isler of the Urban Institute, Washington, D.C., November 10, 1978.

9. Robert Sadacca, Morton Isler and Joan deWitt, The Development of a Prototype Equation for Public Housing Operating Expenses, The Urban Institute, Washington, D.C., 1975.

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   Joan deWitt and Robert Sadacca, Development of the 1978 Prototype Equation for Public Housing Operating Expenses, The Urban Institute, Washington, D.C., 1978.

10. Interview with NAHRO personnel, Washington, D.C., November 13, 1978.

11. Robert Schafer, Operating Subsidies for Public Housing, Citizens' Housing and Planning Association, Boston, Mass., Boston Housing Authority, 1975.

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