The Heritage Foundation Backgrounder

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TIME TO END WASTEFUL URBAN DEVELOPMENT GRANTS

INTRODUCTION

To the consternation of many state and city officials across the country, Ronald Reagan has called for the elimination of the popular $500 million Urban Development Action Grant (UDAG) program. The Senate Budget Committee has so far refused to accede to the President's request--an indication of the program's powerful interest group support. But if Congress is really serious about cutting spending, there could hardly be a better test of its determination than its treatment of UDAG.

The grant program was intended to foster economic improvement and job creation in distressed urban areas by stimulating private investment with federal funds. But UDAG does not create net new investment or jobs for the economy as a whole. It simply redistributes investment and jobs from one part of the economy to another. In the process, however, the program results in a net drain on the economy as a whole, and a loss in total jobs.

UDAG now serves as a sort of "urban slush fund," redistributing investment and jobs toward politically powerful and influential cities at great cost to other jurisdictions. Moreover, UDAG exemplifies the worst form of trickle-down economics. The program's funds go directly to aid wealthy developers and business operators with the poor supposedly benefiting indirectly from the projects the wealthy undertake with federal funds. In practice, however, substantial benefits to the poor are difficult to find. But the program has attracted grantsmen with sharp eyes for bureaucratic soft touches. On the other hand, genuine entrepreneurs with keen instincts for innovation and market opportunities have been less in evidence.

With the federal government running record deficits, it makes little sense for Washington to provide UDAG grants to the state and local sectors, which are enjoying current and projected surpluses. It makes even less sense now that local governments are starting to receive repayment of former UDAG loans, which eventually will amount to over $3.0 billion that in turn can be loaned out to new development projects.

Even if there were no federal deficit, however, direct investment assistance programs, such as UDAG, are not the way for government to create jobs. The evidence shows that the best way for governments to stimulate economic development is to establish and maintain free markets and a tax and regulatory climate conducive to risk taking. This approach provides the most effective help to the poor by creating true opportunities for economic advancement. Further necessary help to the poor is best provided through assistance given directly to them, not to developers. UDAG, however, means increased government interference, distortion in the economy, and welfare for the wealthy.

The Senate Budget Committee voted merely to trim outlays for this politically popular program. But if Congress is serious about cutting ineffective programs, it should eliminate UDAG as expeditiously as possible, as the Reagan Administration has proposed.

THE UDAG PROGRAM

The Urban Development Action Grant program was enacted in 1977 by the Carter Administration. Under the program, the Department of Housing and Urban Development (HUD) provides grants to economically distressed cities and urban counties for specific economic development projects proposed by private owners and developers. These projects may involve industrial plants and commercial or housing developments.

How Funds are Distributed

Recipient governments may use the grant funds to provide below-market rate loans, rehabilitation loans, or interest subsidies to private investors. The funds also can be used to subsidize land purchases or on-site project improvements or to finance complementary public infrastructure. Permissible expenditures also include relocation payments to individuals and businesses affected by project activities.

UDAG grants can be awarded only to cities or counties that have been declared eligible on the basis of criteria indicating economic distress. Cities or counties that do not meet these criteria, but have distressed "Pockets of Poverty" within them that do, also can receive UDAG grants for projects within such pockets. The UDAG criteria include rates of unemployment, growth of income, population, and jobs, the percentage of local population in poverty, and the age of the local housing stock.[1] About 13,000 cities, towns, and counties, encompassing 37 percent of the entire U.S. population, qualify for grants under these criteria.

A community seeking a UDAG grant presents an application to HUD describing a proposed project and the amount of UDAG funds requested. The applicant must demonstrate to the satisfaction of HUD officials that the project would not go ahead without the injection of the requested assistance. The project also must involve a minimum of 2.5 private dollars of investment for every UDAG dollar committed.

HUD is required to choose projects on a competitive basis, taking into account such factors as the degree of economic distress in the applicant community, the amount of private sector and state funds devoted to the project, and the likely job-creating impact of the project. Twenty-five percent of UDAG funds must be awarded to small communities, defined as those with a population of less than 50,000. Since the program's inception in FY 1978, UDAG grants totaling about $4 billion had been awarded to approximately 2,000 individual projects.

The budget authority for FY 1985 is $440 million, with $500 million in expected outlays. The Reagan Administration now has proposed eliminating further UDAG budget authority starting in FY 1986 and the phasing out of all UDAG outlays by FY 1990.

Why Jobs are Lost

UDAG was not intended to create any net new investment or new jobs for the economy as a whole, but to redistribute investment--and thus jobs--from one part of the economy to another. The projects made possible by UDAG grants draw upon national savings that would otherwise have been invested elsewhere in the economy, creating jobs in different enterprises. This relocation of jobs is most evident when UDAG subsidizes explicit business relocations or when the program provides funds simply to influence the location decision of a business already committed to expansion.

Such relocation of investment and jobs is not neutral in its overall effect, however. It actually causes a net economic loss to society. The reason is that, by law, UDAG money is provided only to enterprises that would not have gone forward without the money--that is, to projects that cannot succeed in the marketplace on their own. But if the project has failed this market test, it means that the costs of the resources devoted to it cannot be

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1 To be eligible for a UDAG grant, a city or county also must show demonstrated results in providing housing for low and moderate income persons and in providing equal opportunity in housing and employment for low and moderate income persons and members of minority groups.

justified by the output likely to grow from the enterprise. In short, the test means that the same resources would produce more jobs and income elsewhere. So if a UDAG grant is necessary for a project to continue, it means both that the greater potential of an alternative use of the private funds is ignored and that additional taxpayers' resources are wasted. The program, in other words, simply robs Peter to pay slightly less to Paul.

"Leveraging" is a Myth

UDAG officials at HUD often try to justify the program by pointing to the amount of private investment leveraged into UDAG projects to match the federal funds. They claim that typically between 5 to 6 dollars of private funds go into a UDAG project for each dollar of the federal funds.[2] But the amount of this leveraged private investment is actually one measure of the amount of economic distortion the program creates, since this leveraged investment is the amount of private resources redirected from more beneficial alternative investments. The greater the amount of such leveraging, the greater the amount of misallocation and economic loss resulting from each dollar in the program.

This net economic loss resulting from the program means that the UDAG subsidy cannot be considered as a net investment stimulus to the economy. Without the subsidy, the proposed project would be worth less than some alternative, more productive investment. To induce private investment into the project, the UDAG subsidy would have to cover the shortfall. Consequently, if the program operates "efficiently" according to the law, the UDAG subsidy actually would be a measure of the economic loss caused by the program. The subsidies go to the private UDAG investors as compensation for this lost value.

Of course, the program does not always operate according to theory. UDAG funds often go to projects that would have proceeded without a grant, thanks in large part to the persuasive powers of developers. In a 1982 study,[3] HUD itself admitted that 21 percent of UDAG projects would have been undertaken in whole or in part without UDAG funds, and HUD officials could not be certain either way about another 15 percent. So even HUD could claim only 64 percent of the grants were in compliance with the program's requirements.

When UDAG funds go to projects that can stand on their own, the UDAG subsidy is totally wasted. Yet, paradoxically, this

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2 Office of Policy Development and Research, U.S. Department of Housing and Urban Development, An Impact Evaluation of the Urban Development Action Grant Program, January 1982; Office of Community Planning and Development, U.S. Department of Housing and Urban Development, 1984 Consolidated Annual Report to Congress on Community Development Programs, April 17, 1984.

3 OPD, HUD, An Impact Evaluation of the Urban Development Action Program, op. cit.

actually results in less harm overall to the economy, because there is less misallocation of private resources than when UDAG assistance leads to an entirely new project. The subsidies go to the same projects the market would have chosen anyway--UDAG simply improves the return.

AN URBAN SLUSH FUND

Misallocated investment due to UDAG does not occur at random. Typically it is redistributed to favor the politically powerful and influential.

The distribution of UDAG grants is remarkably lopsided. Just twenty large cities have received 44 percent of all the program's funds.[4] Wilmington, Delaware, has received $555 in UDAG grants for every one of its residents. Yet of the more than 12,000 small cities and towns that meet the UDAG distress criteria, only about 10 percent have received any UDAG funds at all. And at the last count, only 10 percent of UDAG funds had been awarded to projects in the western United States.[5] In the last round of competition for grants among large cities, only one of 39 grants went to a city in the South or West.

Examples abound of apparent political influence and unfair competition in the awarding of UDAG grants. For instance, in Pottsville, Pennsylvania, reports the Washington Post, Republican Mayor Charles H. Quandel won a $1.2 million UDAG grant for a hotel project in his town, for which his former architecture firm undertook the design work. The following year, Quandel resigned as Mayor and took over as the project's developer. The owner of the Pottsville Motor Inn, a competing hotel, must now face competition from Quandel and his million-dollar-plus federal backing.[6] And according to columnist Warren Brookes, House Speaker Thomas P. "Tip" O'Neill, Jr. (D-MA) exercised his powerful influence during the Carter Administration to obtain for Massachusetts the third highest level of UDAG grants to any state in the nation.[7] Massachusetts has been successful in 80 percent of its UDAG applications, compared with only 52 percent nationwide.

Some of the awards to O'Neill's state stretch the trickle-down theory of economic improvement to the limit. The largest UDAG grant ever in Massachusetts went to the $600 million Copley

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4 Office of Management and Budget, Background on Major Spending Reforms and Reductions in the FY 86 Budget, February 1985, p. 84.

5 CPD, HUD, 1984 Consolidated Annual Report to Congress on Community Development Programs.

6 Howard Kurtz, "Urban Grant Program Is on the Defensive," Washington Post, February 20, 1985, p. A4.

7 Warren Brookes, "Why Tip Was Happy to Kiss UDAG Farewell," Washington Times, March 1, 1985, p. D1.

Place luxury development, which includes a $150-$200 per day Westin Hotel and a shopping mall where, says Brookes, "If you have to ask the price, you can't afford to shop."[8] HUD originally turned down the application for this project in 1979 on the grounds that it was a luxury development that could gain sufficient funding from private sources. But O'Neill reportedly used his considerable power with the Carter White House to reverse this decision.[9]

UDAG grants also have allowed firms to simply shift jobs from one city to another and provided officials in certain cities the opportunity to draw jobs away from rival jurisdictions. Wilmington, North Carolina, for instance, recently won a UDAG grant for a new crane construction plant. American Hoist and Derrick Co., which owns the plant, is now laying off 500 of its 1,100 workers at its St. Paul, Minnesota, plant and moving equipment to the new North Carolina facility.[10] St. Paul Congressman Bruce F. Vento (D-MN) recently wrote to HUD charging that as a result of the grant "cranes will be made...in a federally assisted facility in Wilmington, and the skilled men and women who previously made these cranes will be standing in the St. Paul unemployment lines."[11]

The most outrageous case of cities using UDAG to lure away each other's job-creating firms may turn out to be the ongoing saga of Manhattan versus New Jersey. The largest UDAG grant in history, $40 million, was awarded in 1984 for the massive Newport City office and residential development in Jersey City. This award followed a $9 million UDAG grant in 1983 for the Haborside Financial Center in Jersey City with 2.5 million square feet in planned office space.

Several Manhattan firms have already signed up to move certain of their operations to Harborside. These include Bankers Trust, Telerate, the National Quotation Bureau, and Merrill Lynch. Jersey City seems to be actively recruiting others. In the meantime, Carney, New Jersey, has a UDAG application pending for an industrial park, well suited for many New York City printing operations, and Weehauken, New Jersey, is seeking UDAG funds for still another office complex.

New York City, which over the years has obtained UDAG grants that have no doubt affected New Jersey, has loudly protested the UDAG grants for the Jersey shore projects, claiming that they are designed to "pirate" New York businesses, jobs, and investment. To support their charges of pirating, outraged New York officials point to a Jersey City government study provocatively entitled

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8 <u>Ibid.</u>

9 <u>Ibid.</u>

10 Kurtz, <u>op. cit.</u>

11 <u>Ibid.</u>

"An Analysis of Jersey City Development Opportunities among Cost-Sensitive Industries Operating in New York City." New York has taken HUD to court over the Harborside grant and is threatening to do so over Newport City. It is also lobbying heavily against any further Jersey shore UDAG grants.

In reponse to this and similar controversies, HUD has adopted an "anti-pirating policy" for UDAG projects, designed to reduce relocation. New York City has labeled the policy toothless and unworkable, while New Jersey's congressional delegation has termed it draconian and a cave-in to New York City. In practical terms, the policy seems unenforceable, except in a totally arbitrary and inconsistent manner, given its vagueness and political sensitivity. HUD officials probably recognize privately that they cannot prevent the program's causing relocation. Indeed, since the only way UDAG can "create" jobs in one place is to draw job-creating resources from another, all UDAG grants would have to be curtailed if an effective anti-relocation policy were put into place.

TRICKLE-DOWN ECONOMICS

While UDAG purports to help the economically disadvantaged, the program's funds aid primarily the nation's wealthy developers and business operators. The poor are supposed to benefit indirectly from the projects the wealthy undertake with these funds. But in practice, substantial benefits to the poor are often difficult to find. The latest data show that 58 percent of all UDAG dollars have supported commercial projects,[12] usually involving hotels and office buildings--hardly a source of services or permanent job opportunities for America's poor. The program has assisted in the building of 262 hotels nationwide, benefitting such firms as Hilton, Hyatt, and Marriott.[13] Of UDAG subsidies for housing, no less than 61 percent have funded luxury and middle income units.[14] Presumably, the poor benefit from all this through a few jobs as bellboys, janitors, and doormen.

Only 55 percent of the jobs that UDAG supposedly creates (but actually just relocates) are for low and moderate income workers.[15] Only 16 percent are for minorities.[16] HUD has also discovered that completed UDAG projects result, on average, in only two-thirds of the jobs promised.[17] In addition, just 7 percent of UDAG funds are awarded to minority-owned businesses.[18]

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[12] CPD, HUD, 1984 Consolidated Annual Report to Congress on Community Development Programs, pp. 84-85.

[13] OMB, Background on Major Spending Reforms and Reductions in the FY 86 Budget, p. 85.

[14] Ibid.

[15] CPD, HUD, 1984 Consolidated Annual Report to Congress on Community Development Programs, pp. 89-90.

[16] Ibid., p. 94.

[17] Ibid., p. 91.

[18] Ibid., p. 95.

HUD itself only admits that 64 percent of UDAG projects would not have been feasible without the assistance. In reality, the proportion is probably much smaller. Given the possibility of a UDAG grant, it would be a poor project manager indeed who could not devise a plausible argument that federal funds were essential for the project to go ahead. With a little creative accounting, for instance, private investors can show their "need" for UDAG assistance. For instance, they can slightly overestimate each individual project cost item, include expenses that may not materialize, and underestimate possible revenues. These calculations involve careful judgments and an intimate knowledge of the project--no easy assignment for HUD reviewers. Or the investors can plan to build a bigger or more luxurious project than they would otherwise have undertaken simply to make UDAG funds seem necessary for the entire enterprise. And, of course, the politically well-connected developer can feel confident that he will prevail in any finely balanced dispute over the merits of a project.

Because UDAG does not create new jobs, but merely reshuffles them, estimates of the "cost per job created" are largely meaningless. And even if one were to accept the notion that net new jobs do accompany UDAG spending, the cost per job figures are usually heavily inflated because they include in jobs from the numerous projects that would have been developed without UDAG aid. Such statistics also generally fail to account for other public subsidies typically involved in UDAG projects. In fact, about one-fourth of all the "private" dollars cited in UDAG projects are also being subsidized by some other government program.[19] The value of these other additional subsidies in a typical UDAG project is more than a third of the UDAG grant.[20]

With almost 40 percent of the entire country eligible for UDAG grants, the program is not even well targeted to truly distressed areas, let alone to low income individuals. And the pressure in Congress is always to broaden the program's eligibility criteria, not to narrow them. While the truly needy may receive a few crumbs that fall from the UDAG table, wealthy developers and business operators gain a great deal. They are under less pressure to discover new markets and persuade private investors that their projects are sound. They need only to develop a keen instinct for bureaucratic procedures and establish the right political connections.

UDAG AND STATE SURPLUSES

Federal finances are in shambles with projected annual deficits under current law of more than $200 billion a year. At

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19 Ibid., pp. 102-103.

20 Office of Program Analysis and Evaluation of Community Planning and Development, U.S. Department of Housing and Urban Development, "Public Subsidy in UDAG Projects," September 1984.

the same time, state and local governments are enjoying a fiscal recovery. State governments ended FY 1984 with an operating surplus (not including pension accumulation) of $6.3 billion, plus another $1.0 billion set aside in reserve "rainy day" funds.[21] This total $7.3 billion surplus amounted to 4.4 percent of FY 1984 state expenditures,[22] compared with FY 1984 federal deficit equal to 21.8 percent of expenditures.[23]

The latest available data show that cities ended FY 1983 with a combined $4.7 billion operating surplus (equal to 3.9 percent of expenditures)[24] and accumulated carry-over contingency funds equal to 7.5 percent of expenditures.[25] A recent study by the U.S. Treasury Department, using mid-range economic assumptions, estimates that current state and local tax and spending policies will produce a combined annual surplus for all state and local governments (not counting social insurance funds) of $86.5 billion by FY 1989, an amount equaling 14.1 percent of their expenditures that year.[26]

Clearly it makes little sense for the federal government, facing an unprecedented fiscal crisis, to continue to provide UDAG grants to states and local governments, enjoying current and projected surpluses. If they are persuaded, against the evidence, that UDAG really does create net new employment, then state governments can join with local governments and provide UDAG-type grants to their own jurisdictions. In many instances they would not even have to draw on new funds to provide such grants. Local governments are starting to receive repayment of UDAG funds loaned to projects in the past, and such repayment will continue to grow in the future. Under the law, local governments can use repayment funds to make new UDAG-type loans or grants of their own choosing or otherwise to support economic development activities. Including principal and interest, total UDAG repayments now owed to local governments amount to at least $3.0 billion.[27]

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21 National Association of State Budget Officers and National Governors Association, Fiscal Survey of the States, February 1985 update.

22 Ibid.

23 Office of Management and Budget, Budget of the United States Government, Fiscal Year 1986 (Washington, D.C.: U.S. Government Printing Office, 1985).

24 U.S. Bureau of the Census, City Government Finances in 1982-83 (Washington, D.C.: U.S. Government Printing Office, November 1984).

25 Joint Economic Committee and Municipal Finance Officers Association, Trends in the Fiscal Condition of Cities: 1981-1983 (Washington, D.C.: U.S. Government Printing Office, 1985), p. 72.

26 Office of State and Local Finance, U.S. Treasury Department, "Recent Trends in State-Local Finances and the Long-Term Outlook for the Sector," November 28, 1984.

27 Office of Program Analysis and Evaluation, Community Planning and Development, Department of Housing and Urban Development UDAG Program Paybacks, August 1984).

Funds are owed on 75 percent of all past UDAG projects, and almost all UDAG grants made today require such eventual repayment.[28] Moreover, 21 percent of all UDAG grants since FY 1980 have involved the right to a share of any profits from the project for the local government winning the grant. This income would be in addition to revenue from loan repayment.[29]

Local governments have already begun earmarking and spending these repayment funds for economic development activities. A HUD survey of cities receiving UDAG repayments found that 60 percent had established or had begun to establish revolving loan funds using UDAG repayments for economic development projects.[30] With these funds available to local governments, the federal government need hardly add to its deficit problems by providing more UDAG money to overflowing state and local coffers.

State and local governments also should recognize that probably they would be better off without UDAG and similar federal programs. Such grants have set off bidding wars between jurisdictions for jobs and investment with cities using ever more federal and local funds simply to offset the enticements offered by their rivals. The costs and misallocation associated with this subsidy war of attrition mean fewer jobs for the nation as a whole. Denying cities the use of federal resources in this futile bidding war might be the first step to achieving a cease-fire.

CONCLUSION

Economies do not prosper thanks to government subsidies to business, credit allocation, or even sophisticated "local development strategies," but rather through efficient free markets. This simple truth has become all too evident during the last four years, and it should serve to define the appropriate government approach to economic development. Governments can best stimulate economic development by reducing barriers to risk taking and job creation. This approach requires a comprehensive and vigilant effort to identify and reduce such burdens and restrictions on the private economy as taxation, regulation, and unnecessary government monopolization of services. Maintaining the opportunities for economic advancement offered by freely operating markets is also the most meaningful way to help the poor.

UDAG, however, runs counter to these principles. It increases government interference and distortion in the economy, leading to less total economic activity and fewer jobs. And it provides assistance directly to the wealthy in the optimistic hope that it will trickle down to the needy. The program is part of the problem, not the solution to urban poverty.

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28 Ibid.

26 Ibid.

30 Ibid.

Even without record federal deficits, such a perverse and counterproductive program would be indefensible. But with federal finances awash in red ink, and state and local governments in surplus, continuation of the program makes no sense at all. The Reagan Administration has proposed the elimination of all further budget authority for UDAG in FY 1986. The Senate Budget Committee has recommended merely trimming the program by 20 percent. If Congress is serious about cutting federal spending, it should adopt the President's proposal and save $500 million by eliminating the UDAG program altogether.

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