



U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410-4500

OFFICE OF INSPECTOR GENERAL

**NOTE: Attachments not included
in this electronic format. For
hardcopies contact Dept. of HUD,
Office of Inspector General, 451
7th Street, Room 8266, Washington,
DC 20410-4500.**

August 31, 1995

MEMORANDUM FOR: Henry Cisneros, Secretary, S

Andrew Cuomo, Assistant Secretary For Community
Planning and Development, D

FROM: Chris Greer, Assistant Inspector General for Audit, GA

SUBJECT: Audit of Empowerment Zone, Enterprise Community and
Economic Development Initiative Grant Selection
Processes (Audit Case No. 95-HQ-154-0002)

INTRODUCTION

This report presents the results of our audit of the Empowerment Zone (EZ) and Enterprise Community (EC) designation process. We also included the Economic Development Initiative (EDI) grant award process in our audit, because of its close ties to the EZ/EC designation process. Our primary objective was to determine if fair and equitable processes were developed and followed in making all EZ/EC designations and awards of EDI funds in accordance with statutory requirements. The audit was initiated at the request of Senator Bond, Chairman of the Senate Appropriations Subcommittee on Veterans Affairs, HUD and Independent Agencies, and Senator Mack, Chairman of the Senate

Banking, Housing and Urban Affairs Subcommittee on Housing Opportunity and Community Development.

In conducting the audit, we flowcharted the EZ/EC application review and designation process (Attachment 1), and assessed the adequacy of the Office of Community Planning and Development's (CPD) management controls over the process. We interviewed EZ/EC Task Force staff, including application review team members and review panel members, as well as CPD's legal advisors, the Assistant Secretary for CPD and the Secretary of HUD. The scope of our audit included all activities related to the EZ/EC designation process, from the June 30, 1994 application receipt deadline through the final designation date on December 21, 1994. Similar audit steps were performed for the EDI grant application selection process, which took place between December 7, 1994 and December 21, 1994.

The below captioned sections present: a summary of our audit results, program background information, detailed descriptions of the EZ/EC and EDI selection processes, and our recommendations for needed corrective actions. Our audit, which was performed during the period January 4, 1995 through May 12, 1995, was conducted in accordance with generally accepted governmental auditing standards. We considered and have attached HUD management comments on our draft report, which were transmitted by the Secretary.

SUMMARY OF RESULTS

The processes used in making EZ/EC designations and EDI grant awards did not provide reasonable assurance that the best eligible applications were selected for benefit designations and funding awards. The original process designed for making EZ/EC designations was not fully followed, and the nature of alternative procedures used was not described in writing. More importantly, assessments of the eligibility, as well as an application's relative rating and ranking against other applications, were inadequately documented to enable an independent reviewer to determine the bases for decisions made. As a result of these process weaknesses, we were unable to satisfy ourselves as to the basis for or reasonableness of:

- The final designation of 6 EZs from a total of 22 EZ applications which were generally categorized as "strong" by the application review process,
- The final selection of 14 EC applications which were

categorized as "weak" or no longer under further consideration by the application review process, and

- A decision to limit EDI grants to 6 strong rated EZ applicants who did not receive EZ designations.

The CPD staff responsible for the EZ/EC application review process advised us that they avoided detailed written rating, ranking and decision processes -- in favor of group discussions and general consensus ratings -- given the newness and complexity of the EZ/EC program concept, and their perceived need to maintain an openness and flexibility in the decision process. The Secretary informed us that he used the CPD staff's general input, as well as his personal knowledge and perspectives on individual community needs, commitment and leadership, in making the final designations and award decisions. He indicated he had been advised by senior CPD program staff that he had the legal authority to make decisions in this manner. While the Secretary had the authority to make the final EZ/EC designations, the basis for selections should have been limited to the application of the specific selection criteria provided in the program statute and published in the Notice Inviting Applications. It is not evident that this occurred in each of the final 71 EZ/EC designations made by the Secretary.

Given the significant staff commitment to the application review process -- a 5-month, 90-person, Federal task force to review 290 proposals -- the Secretary's final decision making process could have been better served with more diligent staff work to present him with more objective information on application eligibility and comparative strengths and weaknesses. However, given that there is a degree of subjectivity in any competitive selection process, and given that 57 of the Secretary's 71 EZ/EC designations were from the EZ/EC Task Force's final recommended list of 90 applications for selection, we have only questioned the 14 EC designations that were not recommended by the extensive application review process.

The basis for the selection of these 14 lower rated EC applicants was undocumented. In the case of some of the 14 questionable EC designations, we believe the eligibility of the application's designated zone is in question, and in need of clarification. Furthermore, we believe the stated reliance on unspecified "needs" and "geographic diversity" selection criteria was unfair to applicants that were previously determined to have better met the defined statutory and regulatory selection criteria through an extensive review process. In this regard, the final selections do not logically flow from the defined application review process, giving the appearance that the process was open

to favoritism.

With respect to the EDI awards, the Secretary's reliance on the completed EZ application review process for final selections ran contrary to EDI's separately published Notice of Funding Availability (NOFA) requirements, and is in our opinion a violation of HUD Reform Act requirements for competitive grant awards. In response to our draft audit report, CPD obtained a formal legal opinion from HUD's Office of General Counsel to support prior verbal legal advice that HUD Reform Act requirements did not apply to EDI funding. Notwithstanding this opinion -- with which we disagree -- we still contend that the manner in which HUD solicited and selected applications was unfair to potential or actual applicants.

Our draft audit report contained recommendations that the eligibility and quality of the questioned 14 EC and 6 EDI cases be reassessed, with changes to the status or conditions of their designations or awards, as appropriate. Given HUD management's stated disagreement with the nature of our concerns and the need to address them (see Attachment 5), we have deleted these recommendations to HUD from our final report. We will, however, distribute this report to HUD's Congressional Oversight Committees for their consideration of whether HUD has acted in accordance with Congressional intent. We are also retaining our recommendations that HUD assure adequate documentation of the basis for all future selections and awards, and formally condition any EC designations where changes to proposed zone boundaries were necessary to meet eligibility criteria.

BACKGROUND

Title XIII of the Omnibus Budget Reconciliation Act of 1993 (the Statute) authorized HUD to designate six Empowerment Zones and up to 65 Enterprise Communities in urban areas. The Department of Agriculture was likewise authorized to designate three rural EZs and 30 rural ECs. The program is intended to combine the resources of the Federal government with those of State and local governments, educational institutions, and the private and non-profit sectors to implement a comprehensive Strategic Plan to revitalize distressed areas. Communities must meet certain eligibility criteria regarding size, poverty, unemployment and general distress.

A Strategic Plan, developed with the input of community

residents, is required to describe the community's vision for the future and how the vision will be implemented. The Strategic Plan is judged on the basis of four principles: economic opportunity, sustainable community development, community-based partnerships, and strategic vision for change. While the basic eligibility criteria are important for identifying the needs of the communities, it is the Strategic Plan that describes how the communities will implement corrective actions to address the identified needs.

The EZ/EC selection process and program are administered by an interagency task force consisting of approximately 90 individuals. CPD's Office of Economic Development oversees the task force. All final EZ/EC designations were to be made in consultation with the Community Enterprise Board, which the President established on September 9, 1993. The board is comprised of 17 executives from Federal Agencies and chaired by the Vice President.

Each EZ and EC designation is to be given special consideration for various Federal programs and other assistance, including HHS Social Service Block Grants, tax exempt Facility Bonds, tax incentives for zone employees, and other special consideration for existing Federal programs and future Federal awards. These incentives make the program extremely advantageous for the designated communities.

Section 232 of the Multifamily Housing Property Disposition Reform Act of 1994 authorized the Economic Development Initiative (EDI) Grant Program. The program was intended to increase economic development activities in communities by augmenting the use of CPD's Section 108 Loan Program. The Section 108 Loan Program allows Community Development Block Grant (CDBG) recipients to borrow against future block grant awards for economic development activities. The types of activities financed with Section 108 loans are often high risk activities. The enactment of the EDI grant program was intended to lower a community's risk by providing grant funds to buy down the interest on these loans. The EDI grant is intended to supplement the Section 108 Loan Program by making it less risky and therefore more desirable.

EZ/EC APPLICATION SELECTION PROCESS

The Notice Inviting Applications for Designation of Empowerment

Zones and Enterprise Communities was issued on January 18, 1994, with applications due by June 30, 1994. Two hundred and ninety urban communities submitted proposals for EZ/EC designations as follows:

TYPE OF DESIGNATION	APPLICATIONS RECEIVED	SELECTIONS TO BE MADE
Empowerment Zones	78	6
Enterprise Communities	212	65

The original documented design of the EZ/EC Task Force review process called for a rating of each application on a relative point scale, where points would be awarded for specific criteria such as the strategic plan, the level of innovation, community partnerships, and need. Before the application review process began, CPD officials decided that applications would not be numerically scored.

According to panel members, the EZ/EC selection process was thought to be unique from most other HUD competitions in that it included: unprecedented complex and comprehensive applications, reviewers with different experience levels from 11 Federal agencies, and a variety of evaluation factors not easily susceptible to simple numerical scores. At the request of the Assistant Secretary for CPD, one panel member conducted a comprehensive analysis of other competition formats used at HUD. This analysis, which was not documented, reportedly led to the revised EZ/EC review process actually used in making final designations. The revised process was not established in writing. However, Attachment 1 provides a flowchart of the actual process, which was constructed during our audit.

After receipt of applications, interagency EZ/EC task force members were assigned to provide narrative assessments of applications, noting their strengths and weaknesses. This interim record was used in making oral presentations to a "review panel," consisting of three senior CPD officials. At least one member of the review panel was to read the application in advance of it being presented. We were told by review panel members that no final rating decisions were made until all applications were reviewed, offering the presenters and review panel the broadest possible perspective on application quality.

The review panel categorically rated the applications as strong, medium, weak, or under further consideration (UFC). In effect, the UFC designation meant the application was no longer under

consideration because it was poorly developed in comparison to other applications. According to one panel member, the UFC category was created to guard against the premature release of a list that would reveal to outsiders which cities had been preliminarily **eliminated** from the competition. A total of 164 of the 290 applications received were categorized as UFC.

While the review panel members expressed their beliefs that every application received a thorough written and oral review, the review panel did not provide for distinctions within each rating category, e.g., the strongest of the strong. This general categorical rating system gave the Secretary great responsibility and flexibility in making the final designations.

On December 5, 1994, the review panel gave the Secretary a final referral list of 13 "strong" rated EZ applications for the selection of the 6 EZ designations. No written information was provided to allow the Secretary to distinguish among these applications. Furthermore, the review process had resulted in a total of 22 EZ applications in the "strong" category, but there was no record as to how that number was reduced to the 13 on the referral list to the Secretary. The applications were never placed in any rank order and the panel did not identify any preferences for one application over another. While some discussions were held between the Secretary, Assistant Secretary and/or panel members in identifying the best applications, it appeared as though the Secretary was largely left on his own to make these decisions, without the full benefit of input from the staff intensive EZ/EC application screening process.

There is no written documentation as to the factors the Secretary used in making each final EZ selection. There was a series of telephone calls to the final 13 EZ applicants in the running to update the application's standing in case there had been any changes. Again, there was no documented analysis or conclusions from this update process. Since there was no individual scoring of the applications, and the basis for final selections was not documented, we could not readily determine if the final six designations were the best of the 13 strong applications referred to the Secretary. The Secretary advised us that he consulted with the Assistant Secretary for CPD and review panel members to assess the strengths of his 6 finalists, and that it was their assessment that the 6 stood well above the other applicants.

On December 5, 1994, the review panel also referred 77 EC applications to the Secretary for his consideration in making the final 65 EC designations. This list consisted primarily of the EC applicants rated as "strong" and "medium" by the panel. The

list also included 23 "alternate" selections because the Secretary asked the panel to include at least one jurisdiction for every state, regardless of general rating, for possible consideration in providing greater geographic diversity. The Secretary's final selections included 14 weak and UFC applications not among the 77 referred applicants. These 14 low rated applications were selected over eight "strong" and 21 "medium" rated applications. Attachment 2 identifies the 14 weak or UFC applicants that were not on the review panel's referral list, as well as the referred stronger rated applications that were not selected.

The Statute permitted the Secretary to identify additional selection factors that he could use in the designation of EZs and ECs, subject to publication in the interim and final program rule and Notice Inviting Applications. An additional selection factor was established for "geographical diversity," but the meaning and intended application of this general factor was never clearly established for the benefit of potential applicants or application reviewers. The Secretary indicated that the geographic diversity factor was intended to allow him to disperse the designations if the review panel's recommendations were too clustered in specific areas of the country.

As an example, the Secretary used geographical diversity to spread out designations within a State. However, there was no consistency in the manner in which geographical diversity was applied between States. For example, Los Angeles received a supplemental EZ of \$125 million, yet the Secretary wanted an EC near the Los Angeles area and selected Huntington Park. On the other hand, New York City received an EZ designation and the Secretary decided that the other strongly rated EC applicants in the vicinity of the designated EZ were too close, resulting in the selection of lower rated applications in other parts of New York. Attachment 3 shows the distribution of the final EZ, EC and EDI selections resulting from these processes.

In providing for greater geographical diversity, the Secretary also decided to select at least one EC for each State where jurisdictions applied, regardless of the application's rating by the review process. Had a clearer definition of geographic diversity been made known in the EZ/EC application solicitation, it may have changed who applied for designations and how applications were evaluated and screened by the review panel. For example, five States had only one jurisdiction applying. These jurisdictions could have been quickly checked for eligibility since the quality of their applications was ultimately not a factor in their selection for geographic diversity. Yet, effort went into the application evaluation

process by the EZ/EC review team and the panel. In addition, seven States had no jurisdictions applying for EZ/EC designations. Jurisdictions in these States may not have applied because they felt that their chances of designation were remote. Had they known that the Secretary would interpret geographic diversity to allow the selection of at least one EC from each State, they may have applied.

The interim rule indicated that other selection factors could be identified by the Secretary, if the factors were published in a Federal Register notice. In our discussions on actual factors used in the selection process, "need" was described as an additional factor that was used by the Secretary in making his final selections. The element of need was a built-in, quantifiable selection criterion, given that the statute and regulations specified required levels of poverty for areas to be eligible for designation as an EZ or EC. Furthermore, the extensive application review process considered other required quantifiable needs information, such as unemployment rates, in determining the best applicants for referral to the Secretary. Nevertheless, CPD staff interpreted Section 597.301(a)(4) of the interim rule as giving authority for the Secretary to select based on "additional" needs criteria without a Federal Register notice defining such criteria. We believe the Secretary had no authority to select lower rated applications based on additional need or other factors, because applicants were not given notice of any such criteria in the Federal Register.

The Secretary advised us that he considered his personal knowledge of communities in making final EC designations. In each case where a lower ranked application was brought up, the Secretary told us that he asked the Task Force Director to re-examine these applications and determine if they were strong enough to compete. In our earlier discussions with the Task Force Director, he indicated he provided no additional application information to the Secretary after the panel recommendations were submitted on December 5, 1994. The Task Force Director did indicate he was aware that some additional communities were under consideration by the Secretary and the Task Force verified the basic eligibility of those applications. Some examples of the Secretary's deviations from the recommendations of the application review process are as follows:

- Charlotte N.C. - The Review Panel rated Charlotte weak based on the merits of their application. The Secretary indicated he selected Charlotte because of their strong community leadership and their former successes in other HUD programs.
- Rochester N.Y. - The Review Panel rated this application UFC

because of limited community participation and the lack of a time line for achieving results. The Secretary indicated he chose Rochester because they had a great need based on the recent downsizing of a major corporation in the city.

- East St. Louis, IL - The Review Panel rated this application UFC based on no private commitments and a lack of detail on how Federal funds would be spent. The Secretary indicated he selected East St. Louis because he knew they had great need and also he wanted to add geographical diversity within the State.

Overall, the Secretary indicated he had a great knowledge of many communities and their needs based on personal visits. In some cases, the Secretary felt his knowledge was greater than that of the panelist and task force members. His stated criteria for selection were leadership, public/private initiatives, need and geographical diversity.

EC ELIGIBILITY CONCERNS

The basic eligibility of some of the EZ and EC areas designated by the Secretary is in need of clarification. The eligibility requirements for an EZ or EC are prescribed in the Statute. A jurisdiction must demonstrate in its application that the nominated area meets minimum poverty levels. Nominated areas are identified by census tracts. The nominated area may contain up to 3 non-contiguous areas but each area must separately meet the eligibility requirements. For each non-contiguous parcel all census tracts must have 20% plus poverty, ninety percent of the census tracts must have 25% plus poverty and fifty percent of the census tracts must have 35% plus poverty. The Bureau of the Census 1990 Data is used to measure population and poverty levels for each census tract.

A Management Information System (MIS) was developed to aid the EZ/EC task force members in evaluating applications. The MIS was loaded with 1990 Census information. The Census information in the application was then compared to the MIS. Problems with the MIS program caused a high rate of rejections which required applications to be manually checked against Census information available in the HUD library. Consequently, most eligibility checks were made late in the review process.

The Statute allowed EC applicants to request exemptions from

certain poverty thresholds in order to qualify for designation. Both the statute and the interim rule contain the same unclear language regarding exemptions from poverty requirements. With regard to the adjustment of census tract data, the statute and rule state:

"the Secretary may reduce by 5 percentage points one of the following thresholds for not more than 10 percent of the population census tracts (or, if fewer, 5 population census tracts) in the nominated area....."

In the parenthetical note above, it is unclear what "if fewer," references. The EZ/EC team members interpreted the language to permit either a 10 percent exemption or a reduction of 5 tracts. This interpretation was used in the application guidelines and throughout the evaluation process. One panel member stated that much discussion was generated over the exemption requirements and that the Office of General Counsel was consulted on how to interpret this provision.

We reviewed the Statute's conference report to determine whether exemption language may have been incorrectly drafted into the legislation. In the conference report the parenthetical note reads:

"... the appropriate Secretary may reduce one of these poverty criteria by five percentage points for not more than 10 percent of the population tracts (up to a maximum of five population census tracts) in the nominated area."

This conference report language should govern since the statutory language is unclear. In other words, if a nominated parcel contained less than 10 census tracts, no exemptions are permitted by Statute. Yet, the Task Force permitted up to 5 exemptions, no matter how small the parcel. The task force interpretation of the exemption language resulted in 3 EC designations where applicants did not meet statutory requirements.

The Albany, Schenectady, and Rensselaer, NY designation is one example where too many exemptions were granted. This application contained three separate parcels and each must separately meet the eligibility requirements. Albany sought an exemption for one of six census tracts in their parcel and Schenectady sought an exemption for one of three census tracts in their parcel. The Rensselaer parcel contained an ineligible Central Business District tract (24% poverty). Exemptions were granted although technically not permitted by the Statute. We noted similar problems with the Huntington Park, CA and Manchester, NH EC designations.

After exemptions were granted, some applicants still had census tracts remaining that could not meet statutory requirements. The task force dropped ineligible census tracts from the nominated area for these designated EZ or ECs. Such modifications are permitted in the designation process under Section 597.300(d) of the Interim Rule. The language requires modifications to strategic plans or boundaries to be "reasonable."

In the modification for the Kingston/Newburgh, NY EC, two of three parcels were dropped leaving only the Newburgh parcel. The remaining part of the EC is one third the original size and two thirds the original population. We question whether such a major modification can be considered reasonable.

In addition, if the statutory requirements for exemptions were properly interpreted for the Albany, Schenectady and Rensselaer, NY EC, five of the 11 census tracts would be ineligible (32% of the population and 53% of the area served.) We believe such a modification would be unreasonable.

We also found that eight designated ECs and one designated EZ with census tracts removed were not notified in writing of their new boundaries. Formal notification should be required to assure that benefits associated with designations are restricted to eligible areas. The EZ/EC Task Force Director indicated that EZ/EC applicants were verbally informed of the revised nominated areas and that he was not concerned that such notification was not formalized. We did not find any written documentation that HUD staff reviewed the strategic plans in these modified applications to assure that a jurisdiction's intended goals were still achievable.

ECONOMIC DEVELOPMENT INITIATIVE AWARD CONCERNS

Six EZ applicants were effectively awarded a total of \$300 million in Economic Development Initiative Grants, in lieu of an EZ designation. The non-competitive manner in which these EDI grants were awarded is in our view a violation of Section 102(a) of the HUD Reform Act of 1989.

The 1993 statute limited the number of urban EZ designations to six. HUD was seeking other funds to further support designated EZ/ECs, and to further advance the EZ/EC concept. HUD's Fiscal Year 1995 authorization bill proposed \$500 million in grants to EZs and ECs to be used in conjunction with CPD's Section 108 Loan

Program. When the bill was not enacted, CPD staff began exploring alternative ways to fund additional highly ranked zones beyond the six formal EZ designations.

HUD's Fiscal Year 1995 Appropriation Bill provided \$400 million in funding for new programs, but the accompanying authorizing legislation for these new programs was never enacted. After the 1994 elections, it became evident that HUD's authorizing legislation would not pass. CPD sought and received an opinion from the HUD General Counsel that it would be appropriate to use the "new programs" funding in the appropriation bill for previously authorized programs such as EDI.

A reprogramming request letter was sent to the Congressional staff members on HUD's Appropriations Committees in late November 1994. The letters asked for authorization to use \$350 million of the funding designated for new programs for EDI grants. HUD requested a rapid response as HUD wanted to announce the EDI awards at the same time as the EZ/EC designations on December 21, 1994. The November 30, 1994 response from the Senate Committee authorized the use of \$300 million for EDI grants for communities that did not receive the EZ designation.

A Notice of Funding Availability was published on December 7, 1994, inviting all 78 previous EZ applicants to apply for \$300 million in EDI funds. The NOFA explicitly stated that the awards would be non-competitive and restricted to the 78 EZ applicants. The NOFA required a 1:1 match of EDI with Section 108 loan authority. Consequently, only entitlement communities with outstanding Section 108 loan authority could apply. The NOFA had a 2-week response time, and 45 communities applied by the December 17th deadline. The Secretary made the final EDI award announcements at the same time as the EZ designation announcements, on December 21, 1994.

At the time of the issuance of the EDI NOFA, 13 communities were under consideration for final EZ designations by the Secretary. Only six of these 13 could receive EZ awards, as authorized by Statute. From our interviews with those involved in the EDI review and selection process, it appeared that EDI funds were only intended for 7 of the final 13 strong rated EZ applicants that would not receive EZ designations. In this regard, it is our opinion that the targeting of the EDI NOFA to all 78 original EZ applicants was unfair. The disposition of the 13 EZ application finalists is shown in Attachment 4.

The authorization to use the \$300 million for EDI awards in early December, and the desire to announce EDI awards at the same time

as EZ/EC designations in late December, left little time for a competitive NOFA. A number of questions centered around whether or not the HUD Reform Act applied to this designation of EDI funds. Section 102(a) of the HUD Reform Act would require establishment of and adherence to a more formal competitive selection process than that used for the EZ/EC designations, with a minimum 30-day announcement period. CPD obtained verbal assurances from their legal counsel that the EDI program could be considered a non-demand program that makes assistance available without a competition. Therefore, it is exempt from the requirements of Section 102(a) of the HUD Reform Act.

We disagree that EDI could be considered a non-demand program that makes assistance available without competition. The Statute sets out specific criteria for the selection of EDI grants. Moreover, the legislative history for EDI reflects Congress' expectations that HUD will design "a method of selecting [EDI] grant recipients that is based on competition," including "a quarterly competition for funds." The EDI NOFAs preceding and following this EDI funding round were both competitive and **expressly** recognized the applicability of Section 102(a) of the HUD Reform Act. No change in the law occurred which would have justified CPD's failure to comply with the HUD Reform Act in its December 7, 1994 EDI NOFA.

The December EDI NOFA's required 1:1 leveraging of Section 108 loans was different from the previous August EDI NOFA, which advocated close to a 10:1 leveraging. The previous NOFA and the legislation identified the need to use EDI to maximize the use of 108 loans through leveraging. It appears from the legislative history that Congress intended the EDI leveraging ratio to be much larger than one to one. The EDI could be used to lower the cost of borrowing to make the economic development project less risky. Several billion dollars of 108 loan authority was available and not being used. The EDI was intended to be a marginal part of the overall loan package. Congress was hopeful that every dollar of EDI could leverage 10 dollars of Section 108 loans. In the December awards the leveraging ratio was 1:1. In other words, there is no leveraging as the EDI grant is sufficient to pay off the Section 108 loan.

After receiving the EDI applications, CPD reviewed the applications for eligibility. The final list of eligible applicants was forwarded to the Secretary who selected 6 EDI awards. The final EDI awards were made to 6 of the 13 EZ finalists that did not receive an EZ designation. The Secretary indicated he limited the EDI awards to only six communities because smaller dollar awards would be ineffective, and the

seventh community on the final EZ selection list, Miami, had received considerable Federal funding in recent years. Two EDI selections received a \$100 million and \$87 million grant, respectively, and were designated by HUD as "Supplemental Enterprise Zones." Four other selectees were awarded EDI grants for \$22 million and were designated by HUD as "Enhanced Empowerment Communities." Aside from public relations value, these HUD designations had no programmatic meaning or statutory basis.

ANALYSIS OF HUD COMMENTS

On July 10, 1995, we provided a draft audit report to the Secretary and Assistant Secretary for CPD for review and comment. Management's response to the draft report is provided in Attachment 5, and the referenced attachments are available under separate cover upon request. The response generally disagreed with our depiction of the selection process and our recommendations to address perceived weaknesses. Our analysis of the response concluded that it: (1) failed to address our primary concern over management's failure to provide reasonable support and justification for all selections made; (2) misconstrued the nature of many of our other concern issues; and (3) portrayed process information and events in a manner which is contradicted by evidence obtained during our audit. For these reasons, the substance of our draft report remained unchanged in this final report.

In management's view, "The most serious allegations in the Draft center on the applicability of the HUD Reform Act to the Economic Initiative grant awards, the interpretation of the Federal register notice of selection factors for EZ/EC designees, and the interpretation of certain eligibility provisions." As a matter of general response, HUD management took the position that its actions were consistent with the opinions of HUD's Office of General Counsel, and that the OIG's questioning of reliance on such opinions was an "ill-advised-- departure from the system of institutional checks and balances governing program office management." During the course of our audit, we were told differing stories as to what legal opinions were sought and provided on the EZ/EC and EDI selection processes. However, it was an objective of our audit to independently assess management's compliance with statutory requirements governing the EZ/EC and EDI selection processes. A discussion of the OIG's mandate for reviewing program compliance with statutory

requirements is contained in the Inspector General's August 31, 1995 memorandum to the Secretary (see Attachment 6).

The following captioned sections provide our analysis of each of the 15 specific draft report issues to which HUD management took exception in its response.

1. Interpretation of the Application of the HUD Reform Act to EDI

Awards - In response to our draft report, HUD's General Counsel issued a July 18, 1995 legal opinion to formalize its prior oral advice to CPD Officials that Section 102(a) of the HUD Reform Act did not apply to the December 1995 NOFA for EDI Grants. The opinion noted that HUD's references to the HUD Reform Act for previous and latter EDI Grants was a matter of "programmatic choice." The opinion also noted "The touchstone for mandatory application of the Section 102 procedures has therefore been whether something exogenous to Section 102 itself -- a statute, regulation, or other requirement -- provides for the competitive distribution of the funding."

The preamble to the HUD rule implementing Section 102 of the HUD Reform Act identifies those programs excluded from the Statute's coverage. These include 1) formula programs, 2) demand programs and 3) programs that distribute assistance on a discretionary (non-formula, non-demand) basis. OGC opined that EDI Grants fall in the last category. However, the HUD rule identifies the specific programs that fall within category three above. It also states that HUD will add other programs as appropriate. EDI Grants are not a listed program.

Additionally, there are many other HUD program statutes that do not expressly prescribe "competition" in the language of the statute. Yet, HUD has interpreted Section 102(a) of the HUD Reform Act to apply to funding under these statutes. Some examples include: Innovative Project Funding under the Innovative Homeless Initiatives Demonstration Program, Youth Development Initiative under PIH Family Investment Centers, Family Investment Centers and Community Outreach Partnership Centers. Our position remains that the HUD Reform Act provisions for competitive award processes should have applied to EDI grants, too.

2. Interpretation of the Use of Need as a Selection Factor -

HUD's response misconstrues our concern, which is limited to the Secretary's authority to use "additional" needs criteria not already considered by the review process, as a basis for his final selections. We fully acknowledge that the EZ/EC application evaluation process took into consideration a community's "need" for an EZ/EC designation by virtue of the

basic poverty level eligibility criteria, as well as requirements to spell out specific community needs as an integral part of a community's strategic plan. These clearly established needs factors were reviewed and rated by the task force and the review panel. We believe the interim rule requires that any "other factors" the Secretary would use (need was cited as an example), required Federal Register notification.

During the course of our audit we met with CPD and General Counsel staff concerning Section 597.301(a)(4) of the interim rule. CPD staff expressed a belief that the interim rule permitted the Secretary to use "need" as a selection factor. We were told by General Counsel staff that CPD staff had not consulted them on this matter, and that additional needs factors not already stipulated in the statute or interim rule would require a Federal Register Notice. In a subsequent August 17, 1995 legal opinion to the Assistant Secretary for CPD, HUD's General Counsel noted "...a construction of the quoted text so as to permit need as a criterion could raise a question of interpretation. It is not, however, an impossible interpretation." While not an impossible interpretation, we continue to believe it was an unfair interpretation to apply any other selection criteria without defining it and allowing all applicants to respond to it.

3. Interpretation of Eligibility Requirements - HUD's response generally questions OIG's role in matters of legal interpretation, and contends its interpretation of EC eligibility requirements was consistent with HUD's legal counsel and a newly introduced legal opinion from the U.S. Department of Agriculture (USDA). We found the language in the Statute and Regulation ambiguous and unclear as to when exemptions to poverty eligibility levels could be granted. During our audit, CPD staff indicated that they relied on HUD Counsel for an interpretation of this language. HUD Counsel told us that they were not consulted on this matter, and their advice to us was consistent with basic principles of statutory construction. These principles permit resorting to extrinsic aids, such as legislative history, to discern Congressional intent.

We found that the conference report for this statute clearly indicates how exemptions can be applied. Notwithstanding that HUD's response to our draft report introduced a USDA legal opinion which supports their position, our position remains that the correct procedures were not used in determining the eligibility of EC applications.

4. Leveraging of EDI Grants with Section 108 Loans - HUD's response misconstrued our draft report language. We did not recommend that the leveraging ratio in the December 1994 EDI awards be 10 to 1. We did point out that Congress was hopeful that EDI dollars would be used to leverage Section 108 loan activities, and cited the 10 to 1 ratio used in other EDI funding rounds as an example. We did express our opinion that a 1 to 1 ratio does not do much to leverage funds. However, a lower ratio requirement would open the limited competition to more applications, and allow more flexibility in the EDI selection process.

5. Documentation of the EZ/EC Application Review Process - HUD's response does not accurately reflect the extent to which the "actual" process used in making EZ/EC selections was documented. The original documented review process procedures provided to us by CPD staff included a process where applications were to be numerically scored and ranked. The review panel later changed the process to eliminate the scoring and ranking of applications, in favor of a revised process using categorical groupings of applications from strong to weak. The intended functioning of the "revised" selection process was not documented.

6. Documentation of the EZ/EC Application Reviews - Our draft report did not criticize the EZ/EC task force staff efforts to assess the strengths and weaknesses of applications. Our issue pertained to the failure to adequately use the results of this effort as a basis for some of the Secretary's final selections.

7. Composition of the Review Panel - Our draft report did not question the composition of the Review Panel, only its effectiveness in preparing the Secretary for making sound and supportable selections.

8. Information Provided to the Secretary - While we agree with HUD's response that considerable information was generally "available" for the Secretary's review and analysis in making his final selections, we continue to question the extent to which the information was actually used, and why the information was not better summarized to support the Secretary's final selection process.

9. Documentation of Additional Review Information - While we agree that additional information was assembled on the top 13 EZ applicants, we are unsure as to the extent that this additional information was made available to the Secretary. The review panel did not analyze or summarize this additional information.

10. Initial Screening Process - HUD's response indicates that the review panel presentations provided to the auditors were preliminary characterizations and not determinative of the final recommendations of the review panel. This response contradicts the information we were provided during the audit. Furthermore, no other information has been provided as the basis for the final determinative results of the application review process.

11. Definition of Geographic Diversity - The response indicates that the audit misconstrues the intent and actual application of the geographical diversity criteria. We disagree. The draft report identified instances where geographical diversity was inconsistently applied and where it could have been better used to solicit additional applicants. In effect, the decision to award at least one EC to each State, regardless of the quality of the State's applications, created an "entitlement" process which HUD's response indicates it did not want to create.

12. Timing of Eligibility Checks - Our draft report did not question the timing of the eligibility checks.

13. Modifications to Boundaries - HUD's response indicates that they did not negotiate boundary modifications. The draft report noted that the regulation only permits reasonable modifications of proposed zones. We pointed out instances where compliance with statutory requirements would require major modifications of zones, and in turn make the application ineligible. Our position on this issue remains unchanged by HUD's response.

14. Notification of Census Tract Eligibility - HUD's response indicates that applicants were notified in writing of ineligible census tracts. The sample notifications provided in the response do not cite the specific ineligible tracts, and do not clearly define the actual final zone designated for benefits under the program. This issue should be brought to closure by HUD.

15. EDI NOFA Eligibility - We interpret HUD's response as supporting our contention that the EDI grants were predetermined to be awarded to the 13 EZ finalists that did not receive an EZ designation. We still contend that this was contrary to the EDI NOFA and unfair to the 45 applicants that applied under the NOFA.

RECOMMENDATIONS

On the basis of the above discussed results of our audit of the

EZ/EC and EDI grant selection processes, and in full consideration of HUD's response to our draft report, we recommend that the Assistant Secretary for CPD take the following actions:

1. Review all EZ/EC selections to identify any waivers of eligibility criteria which impact the boundaries of proposed benefit zones, and assure that those boundary changes are formally acknowledged as part of the designation so that future benefits are directed to the proper areas.
2. Require that any future EZ/EC, EDI or other program selection processes be governed by written processing instructions which assure a fair and equitable application review with sufficient documentation to support the basis for selections made.

Within 60 days, please provide us a status report, for each recommendation, which indicates: (a) the corrective action taken; (b) the proposed corrective action and the date to be completed; or (c) why action is not considered necessary. Also, please furnish us copies of any correspondence or directives issued because of the audit.

Should you or your staff have any questions on our report, please contact me, or James M. Martin, Director of Program Research and Planning, on (202)-708-2306.

DISPOSITION OF 13 EZ APPLICATION FINALISTS

EMPOWERMENT ZONE DESIGNATIONS
ATLANTA, GA
BALTIMORE, MD
CHICAGO, IL
DETROIT, MI
NEW YORK, NY
PHILADELPHIA, PA/CAMDEN, NJ
SUPPLEMENTAL ENTERPRISE ZONES
LOS ANGELES, CA (\$125M EDI Grant)
CLEVELAND, OH (\$87M EDI Grant)
ENHANCED EMPOWERMENT COMMUNITIES
BOSTON, MA (\$22M EDI Grant)
HOUSTON, TX (\$22M EDI Grant)
KANSAS CITY, MO/KANSAS CITY, KS (\$22M EDI Grant)
OAKLAND, CA (\$22M EDI Grant)
EC DESIGNATION
MIAMI, FL

Distribution

Secretary, S (Room 10000)
Deputy Secretary, SD (Room 10100)
Assistant Secretary for Community Planning
and Development, C (Room 7100)
Deputy Assistant Secretary for Economic
Development, DE (Room 7100)
Director, Office of Economic Development, DEE (Room 7136) (2)
Community Planning and Development Audit Liaison Officer, DG
(Room 7204)
General Counsel, C (Room 10214)
Associate General Counsel, Assisted Housing and Community
Development, CD (Room 8162)
Director, Office of Budget, AB (Room 3270)
Director, Office of Management and Planning, AM, Washington
Office Center, Suite 310, 401 Third Street, SW, Washington,
DC, 20024
Acquisitions Librarian, Library, AS (Room 8141)
Chief Financial Officer, F (Room 10166)
Deputy Chief Financial Officer for Operations, FO (Room 10166)
Assistant Director-in-Charge, U.S. General Accounting Office,
820 First Street, N.E. Union Plaza Building 2, Suite 150,
Washington, DC, 20002, Assistant to the Secretary for Field
Management, SC (Room 7106)
Chairman, Ranking Minority Member and Staff Directors of the
Following Congressional Oversight Committees:
Senate Banking, Housing and Urban Affairs Subcommittees on
Housing Opportunity and Community Development, and
HUD Oversight and Structure
Senate Appropriations Subcommittee on
Veterans Affairs, HUD and Independent Agencies
Senate Committee on Government Affairs
House Banking and Financial Services Subcommittee on
Housing and Community Opportunity
House Appropriations Subcommittee on
Veterans Affairs, HUD, and Independent Agencies
House Government Reform and Oversight Subcommittee on
Human Resources and Intergovernmental Relations