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"Housing Solutions: Cutting Through Government Red Tape"

Chairman Davidson, Ranking Member Cleaver and Members of the Subcommittee, thank you for the opportunity to testify and share my perspectives on government red tape and its adverse impact on housing, and particularly affordable housing, in the United States.

My name is Paul Compton and I have practiced law at the intersection of real estate, banking, tax, securities and affordable housing for more than 30 years. After my Senate confirmation in a bipartisan vote in 2017, until 2020, I served as General Counsel of HUD under Secretary Ben Carson. Since that time I have returned to private law practice in Birmingham, Alabama, continuing to focus on affordable housing and commercial real estate.

At the outset, it is my view that there are hundreds of federal federal government red tape impediments and tens of thousands of state and local ones (some spurred by federal requirements), which like the tiny ropes of Lilliputians in *Gulliver's Travels*, ensnare and keep flat on its back market forces and entrepreneurship which could otherwise make housing much more abundant and less costly in the United States. I believe that Jonathan Swift's classic, *Gulliver's Travels*, remains as accurate a political satire today as it was when written almost 300 years ago. And the problems America faces in this case are as old as bureaucracy.

In many cases, it is not the requirements or expense of the red tape itself directly that is the chief impediment but rather the enormous cost in time which these cumulatively impose. For instance, many governmental applications cannot move forward until there is a Phase I Environmental review conducted. That is sensible in many respects but takes time and money. Then we see that the governmental process may take six months or more to run its course. By that time, the environmental review, under applicable standards, has gone "stale" and in order to move to the next step, it must be re-done. That process may itself take another several weeks to months. Moreover, in a complex project, this cycle can be repeated several times and not just with, as in my example, the environmental review, but with respect to many other items.

For projects costing in the hundreds of thousands to many millions of dollars, these extended timetables imposed by otherwise not individually unreasonable government objectives collectively impose enormous costs. First, they impose costs for professionals and for reviewing and coordinating them. Second, there is the time value of money. Third, and perhaps most importantly, they impose the cost of much more risk. Simply put, bad things can happen during delay, such as increased costs, higher interest rates, land sellers who lose patience, investors who find other opportunities, and downturns in the economic cycle.

Is it any wonder that in jurisdictions where these problems are most acute, such as San Francisco, that there is little new production of housing stock? With respect to San Francisco, where the time from commencement to completion of construction during my tenure at HUD averaged about seven years, is it surprising that it has the highest construction costs in the world? [Per CBRE] I personally toured a renovation project in Chinatown where "affordable" multifamily rental apartments had a cost of more than $800,000 per unit. That is simply not sustainable at scale.

But having identified the issue in a broad sense, fashioning a remedy, without metaphorically giving Gulliver death by a thousand cuts or banishing all Lilliputians as we try to strip away those tiny ropes, is a great challenge. I believe that the best course, while not ignoring obvious opportunities to snip away at these little lines of red tape where we can (more on that below), is to think about this systemically. We need to fashion checks and balances on what we have seen has been runaway regulation over the past 30 years. Some studies I have read indicate that local, state and federal regulation for the construction of housing and the operation of rental housing during the last 40 years has more than tripled.

Perhaps not coincidentally, that growth in regulation has occurred since individual and small business real estate investors were economically pushed out of the market by the 1986 Tax Act. Indeed, the Reagan 1986 Tax Act brought us the low-income housing tax credit, a temporary provision at the time, which was intended to help offset the recognized impact of effectively taking individual and small business investors out of the residential rental real estate market. Now the low-income housing tax credit program is permanent and must carry much of the multifamily housing burden while being increasingly overloaded with its own government red tape. What was once a program intended to let the private market fund and police the program has grown over time to have nearly as many bells and whistles and secondary objectives as the direct financing under HUD programs which it largely replaced. As one of my law partners reminds me, it is much like the plight of *Thidwick the Big-Hearted Moose*. In Dr. Seuss's classic, Thidwick nearly meets his demise by seeking to accommodate the ever-increasing demands of a menagerie of neighbors in the forest.

Indeed, Secretary Carson and I used to laugh with one another that we were seeking to run the Department of <u>Housing</u> and Urban Development for the United States but the primary source of funding for new affordable housing the United States was actually at the Internal Revenue Service through the low-income housing tax credit.

The most problematic tax provision is the so-called passive activity loss limitation contained in Section 469 of the Internal Revenue Code. This essentially precludes anyone, other than a "widely-held C corporation", which typically means a public corporation, from using "passive losses", which include any losses generated from real estate, primarily through depreciation, to offset either active income or so-called portfolio income, which would include dividends and capital gains. There is an exemption for "real estate professionals" but that is only someone who essentially is involved full time in the real estate business as a developer or broker – usually the people who are actually looking for investors and are not frequently the principal investors themselves.

What this has resulted in is that real estate investment trusts, large private equity funds and public corporations (and especially large financial institutions with respect to LIHTC investment), mainly located in money centers, dominate real estate investment across the United States. Crucially, this has disconnected the grass roots of local politics – those people who know personally, vote for and fund the election campaigns of mayors, members of city councils and state legislators – from any direct financial interest in the state and local laws, regulations and ordinances that form the bulk of the government red tape surrounding the construction and operation of housing in the United States.

Further, this cordoning off of individual investors located in the same communities they would in many cases be investing in has skewed development in the United States to larger projects and larger cities. Stated most clearly, a real estate investment fund in Manhattan, New York has little interest in participating in the development of small-scale market-rate housing in Manhattan, Kansas.

Thus, my first and principal suggestion, especially as the Congress will soon turn its attention to considering the expiration of the Tax Cut and Jobs Act, is to restore the ability of individual investors and closely held businesses to invest in local residential real estate. Specifically, I recommend that passive loss limits and other related impediments to investment in residential real estate be repealed with respect to those individual investors and closely held businesses, at least if investing within, say, 50 miles of the home or principal business office of such individual or business.

This will not correct the problems that we face for all of this Lilliputian red tape immediately, but it will put us on a better path in the long run for housing in the United States. I believe that this would be more effective and preferable to a "top-down" federal government approach concerning these issues which would be in conflict with the principles of federalism and local control.

Second, the following are some of those Lilliputian pieces of red tape on the federal level which could be "snipped":

1. Eliminate inclusion of Federal Housing Administration ("FHA") loans under the coverage of the National Environmental Protection Act ("NEPA"). As you know, NEPA is not actually an environmental protection statute but instead is a bureaucratic requirement for notice and comment which, originally intended for major actions, such as hydroelectric dams and airports, now is deemed to apply even to the

rehabilitation of a 24 unit apartment complex in the middle of a fully developed city block. Inclusion of FHA loans adds nothing to actual environmental protection but much to cost, principally through delays. This could be done without legislative action.

2. Abolish so-called mixed wage decisions with respect to the application of the Davis Bacon Act to residential development. Treat all residential development as simply that – residential without dividing the project up into subsets creating incredible complexity and cost for builders. Note that this occurs simply through (likely unenforceable) administrative fiat at the Department of Labor and not even regulation or official guidance. Thus, it can readily be rescinded.

3. Restrict the regulatory (and sub-regulatory) doctrine of "Choice Limiting Activity" in the context of environmental reviews to actual physical changes in the property which would materially and adversely affect the ability to conduct an environmental site assessment and not merely changes in legal title, minor preparatory steps (such as grubbing and clearing) and other routine development steps that are privately funded which would not materially and adversely affect the performance of Phase I Site Assessments.

4. Withdraw HUD's policy concerning limitations on criminal background checks for rental tenants -- the so-called "Check the Box Rule". This was implemented simply by a memorandum of the General Counsel of HUD during the Obama administration without any administrative process, and now is in clear contravention of Supreme Court guidance on disparate impact. The effect of the rule was suspended during the Trump administration by virtue of its regulations concerning unenforceability of sub-regulatory guidance, but with the reversal by the current administration of those regulations concerning sub-regulatory guidance, it sprang back into effect. Further, the current administration has published further sub-regulatory guidance broadening its scope. It makes operating rental properties more costly, especially with respect to liability insurance, and increases risk of crime to other tenants.

5. Withdraw the Memorandum of Understanding among the IRS, the Department of Justice and HUD concerning imposition of crippling tax penalties merely upon the allegation of a violation of the Fair Housing Act by HUD or the Department of Justice. This MOU is blatantly unconstitutional for its lack of due process and provides an *ad terrorem* weapon for overreaching by the Department of Justice, particularly concerning enforcement of design standards in affordable housing. Because of this rule, for many years no one has been willing or able to challenge ever increasing outlandish positions of the Department of Justice, such as there being no statute of limitations on its claims and the fact that two or more instances of non-compliance, which may simply amount to two toilets, each being more than one inch off center, constituting a "pattern and practice" of violation of the Fair Housing Act. Now every LIHTC supported multifamily project spends thousands of dollars (paid with tax credits) on consultants, in addition to architects and engineers, to double check compliance with fair housing design standards. And developers avoid elevators (and taller buildings) if they can because those design elements increase their obligations under Fair Housing Act and ADA design standards.

6. Reconsider the scope of limitations on development imposed by habitat restrictions related to threatened and endangered species, such as the northern long-eared bat. Its covered habitat is most of the eastern half of the continental United States. It precludes cutting trees for significant parts of the year, thus affecting thousands of projects.

7. Review and streamline HUD site and neighborhood standards regulations. These are based on 50 year old notions of what land use planning should be. They are, in effect, an additional federal zoning layer.

8. Require the Internal Revenue Service to issue guidance clarifying that LIHTC tax credit investors have no legal basis to require affordable housing developers to either restore deficit capital accounts or permit the tax credit investors, after they have claimed all of the benefit of the tax credits, from also getting all or a substantial portion of their original capital contribution back. Institutional tax credit investors and their counsel insist on these onerous provisions saying the Internal Revenue Service requires it, although it appears that is not the case though these tax regulations are extraordinarily complex. This pattern and practice by these "aggregator" investors often results in affordable housing projects being converted after 15 years into projects with higher rents instead of permitting them to continue at more affordable rents or even to be rehabilitated (at lower costs than constructing new units), for continued long-term commitment as affordable housing. This happens because that is the only thing developers can afford to do or because the aggregator investors have the economic incentive to exercise contractual rights to force conversion to higher market rate rents. These investors are essentially double-dipping on the tax credit program.

9. Reconsider pending proposals regarding Affirmatively Furthering Fair Housing ("AFFH"). The current proposing release stretching to 75 pages in the Federal Register derives from just 22 words contained in a paragraph concerning the functions of the Secretary of Housing and Urban Development (HUD). Those 22 words are that the Secretary shall "administer the programs and activities relating to housing and urban development in a manner affirmatively to further the policies of this subchapter". This is hardly a sweeping Congressional directive to reorder the make-up of communities across America.

a. AFFH at its heart rests on the same theories that undergird disparate impact treatment. Think of it as addressing disparate impact before it occurs. The Supreme Court in a 5-4 decision in 2015, Texas Department of Housing and Community Affairs v. The Inclusive Communities Project, Inc., upheld the existence of disparate impact theories of liability under the Fair Housing Act, subject to the establishment of "safeguards" and the recognition that mere statistical disparity should not give rise to liability, but instead it should be based only on policies which are "artificial, arbitrary or unnecessary." Interestingly, the 2023 AFFH proposal at no point even cites the Supreme Court decision in Inclusive Communities.

b. During my tenure at HUD, we identified that the greatest source of "disparate impact" as a factual matter in housing was, in most communities, the high price

of housing which made quality housing and housing choice difficult for many persons in protected classes. In January 2020 Secretary Carson released a proposed AFFH rule which was focused on encouraging communities to take steps to lower the cost of housing by reducing local impediments. Instead of the stick of withholding federal money (the remedy under both prior AFFH regimes and the current proposal, which has actually happened only twice in more than 50 years and is unlikely to happen in the future for political reasons), Sec. Carson's proposal was intended to create a "race to the top" by fostering better practices in local housing which would increase supply and decrease cost.

c. I believe that we will find much consternation from local jurisdictions seeking to put into effect the current administration's AFFH proposal. Under the proposed program, power is potentially vested in a HUD official ("Responsible Civil Rights Official") who perhaps did not even go through Senate confirmation. This political unaccountability, the broad discretion given to approving or disapproving plans, the substantial penalties that exist and the way that they can be arbitrarily applied (are you in a weak or powerful or favored or unfavored jurisdiction) raises substantial issues.

d. An underlying goal of the proposed regulation is to move low-income residents into higher income neighborhoods. This is based both on academic studies that suggest better life outcomes for low-income persons living in affluent areas and also Great Society approaches to desegregation. However, by exerting pressure to move all affordable housing into high income neighborhoods, we are literally spending hundreds of millions, if not billions, of dollars, through higher property costs and more challenging permitting processes, which raise costs and slow down production. I also note that the academic theory that seems to have ignored the most powerful indicator of positive life outcomes, strong nuclear families.

e. Finally, the one thing that is sure is that AFFH will slow down, complicate and make more expensive the creation of housing, especially that supported by HUD. The AFFH proposal imposes a process under which everyone can complain about anything with the result being a slow-down in the production of housing. For instance, some people will complain that low-income housing is not being built in low-income areas, which seems a lot like classic redlining. Alternatively, if it is built in low-income neighborhoods, it is often challenged as gentrification.

10. Review generally any "add on" requirements to programs which impede the speed or efficiency with which they can be implemented. Examples would be incentives for construction which require union labor or specific domestic content, requirements for construction which impose specific climate or energy requirements, childcare requirements for employers, particularly precise tenant targeting requirements, or general requirements that impose upon private business the obligation to operate under bureaucratic norms (more policies and more paperwork).

Thank you for this opportunity to bring these thoughts and issues before you. I look forward to your questions and the opportunity to hopefully provide further insights into this crucially important but immensely complex issue.