Introduction

The appropriate role of public subsidy in the American economy is highly debated. The topic is an important one for community development programs, which bring together public funding and private and philanthropic capital for investment in distressed areas and promotion of economic inclusion.[1] Much of the discussion about *smart subsidy* in this publication is from the vantage point of community development.[2] However, the framework we present has relevance for a broader set of public policy issues, including the competitiveness of our markets, the quality of our environment, and job creation and workforce training.

The Community Development Group at the Boston Fed promotes economic growth in lower-income communities. The Economic Opportunities Program at the Aspen Institute supports practices that open up economic opportunities for those who are struggling in the changing economy. In working together on a scale and sustainability initiative for community development finance, we began to notice that in forum after forum, community development practitioners were pointing out how difficult it is to have fruitful discussions about the role of subsidy in community development. As a society, we are conflicted about our use of subsidy. It is not uncommon for the term to be used negatively. To talk of something as being subsidized is to question the efficiency of the activity receiving the subsidy.

But subsidies are a common tool for advancing public policy goals. They are used for such diverse purposes as encouraging business innovation, improving public health, and reducing dependence on foreign energy sources. They are also used to provide lower-income families access to basic necessities such as food, housing, health care, primary and secondary education, and job opportunities.

Federal intervention during the recent subprime mortgage crisis, stimulus spending related to the Great Recession (2007–2009), and growing federal deficits have only intensified the debate over the appropriate role of subsidy (and government) in our economy. Growing income inequality prompts questions about how much inequality is acceptable and how to address inequalities, and the most recent economic downturn, combined with longer-term economic trends such as globalization, raise questions about appropriate government policies for softening the effects of economic shocks on vulnerable individuals and families. All of these questions have particular relevance for the community development field.

This publication seeks to promote a more informed and objective dialogue about the use of public subsidy for community development. Our framework for looking at subsidies in community development examines three critical components of the debate.

First, we examine the prevailing theory of how the economy operates and distributes resources through markets, and when public involvement is considered appropriate and/or necessary. This section introduces economic concepts such as optimum distribution, public goods, market failure, and the efficiency/equity trade-off.[3] The purpose of this section is to provide a common understanding of key concepts, which are illustrated with examples taken from the community development field. The intent

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[1] We define *community development* as locally driven, often nonprofit-led, efforts to revitalize lower-income communities, promote the economic well-being of lower-income individuals, and connect those individuals to economic opportunities. These efforts are undertaken with the input of those who are receiving assistance and involve partnerships between the public, nonprofit, and for-profit sectors.

[2] We use *subsidy* to describe a public incentive that lowers the cost of producing a good or the price that a consumer pays for a good.

[3] *Efficiency* is defined as effective operation, measured by comparison of outcomes with resources used (Merriam-Webster Dictionary). *Equity* is defined as an apportionment of resources or goods that is considered fair (BusinessDictionary.com).

of this section is not to push a particular perspective or school of thought but to establish explicitly some of the assumptions we carry into the discussion of subsidies.

Second, we look at how subsidy is used across our economy and who benefits from it. Examining the federal budget, we see that subsidies are used extensively and for a variety of purposes beyond helping the poor. Indeed, many subsidies are regressive; that is, they benefit higher-income individuals more than lower-income individuals. Subsidies can take many forms, including "off-budget" items such as tax expenditures, which are less transparent because they are not subject to the annual budgeting process. Examination also reveals that the federal system of subsidies lacks any grand design or unifying principle: rather, it is the result of incremental decisions and the politics and processes of federal budgeting. Subsidies for community development—a small fraction of public subsidy overall—might well be more effective if they were part of a more intentional system.

Third, we offer two criteria for *smart subsidy,* that is, subsidy that achieves public policy goals efficiently and effectively. Authors show how specific current and proposed community development programs meet these criteria and suggest that smart programs usually share certain characteristics, such as leveraging private capital and creating new markets by correcting for market failure. To help guide future policy and program choices, we also present a discussion of how to measure and evaluate the smartness of a subsidy program.

Below, we highlight some of the contributions of the various authors for each of our framework's three components.

Public Incentives in Community Development

The economist Robert Triest launches the first set of papers in our collection with a primer on the value of subsidy for correcting market failures and promoting economic equity. He contrasts the crisp theory of self-correcting and efficient markets with the day-to-day realities of imperfect information, the unintended effects of private transactions on third parties (externalities), monopolies, and the need for public goods in situations in which it is not feasible to charge for use or to keep nonpayers from using a particular good or service (such as national defense).

Triest explains that much of economic policy analysis is concerned with the trade-off between equity and efficiency. He discusses one of the most enduring metaphors in economic theory: the leaky bucket. Arthur Okun, an economic adviser to the Johnson administration, illustrated the trade-off of efficiency and equality in the economy with this metaphor. [4] Using public policy to redistribute resources from the wealthy to the poor, while desirable or even necessary, is like carrying water in a leaky bucket in that some portion of the funds are lost before they ever make it to the poor household. The leakages could comprise the costs of administering the income transfer program or the negative impact that income transfers may have on both taxpayers' and subsidy recipients' incentive to work. Any income transfer programs must value and weigh the relative merits of efficiency and equality—how much leakage is acceptable in the process of addressing depravation and inequality—in deciding whether or not the program makes sense. Okun recognized that members of the American public differ greatly on where they draw that line, which makes reaching a political consensus on the topic very difficult.

Triest also points out that subsidies do not necessarily result in efficiency losses. In the absence of market failure, subsidies will cause market distortions, and some of the money spent on the subsidy will be "lost." In contrast, subsidies that correct market failures produce benefits in excess of the monetary cost of the subsidy (are efficient). Community development subsidies that correct for market failures adversely affecting people who have low- to moderate-incomes can simultaneously enhance market efficiency and advance equity goals. Triest adds that benefit-cost analysis, when done right, can

[4] Arthur M. Okun*, Equality and Efficiency: The Big Tradeoff,* Washington, DC: The Brookings Institution, 1975.

incorporate both efficiency and equity goals, reflecting values many practitioners believe to be missing from free-market economics, while still using the power of economic analysis to identify opportunities for the smart use of subsidies.

The next two papers describe the scope and scale of public subsidy in the U.S. economy. "Where Do Our Federal Tax Dollars Go?" from the Center on Budget and Policy Priorities, describes the major categories of the $3.5 trillion federal budget. In 2010, 67 percent of the budget went toward defense and security; social security; Medicare, Medicaid, and CHIP; and paying interest on debt. Fourteen percent went to safety net programs. The remaining 19 percent went to benefits for federal retirees and veterans; scientific and medical research; transportation infrastructure; education; non-security international activities; and "all other." While the analysis does not separate out spending on community development programs, it does help to show that these programs are small relative to other categories mentioned above. The second data piece, "Tax Expenditures and Social Policy: A Primer," by Daniel Mandel describes a second major vehicle the federal government uses to promote policies (aside from direct spending): tax expenditures. Tax expenditures are tax deductions, exemptions, or credits to taxpayers who engage in a targeted activity. Mandel provides a sense of the scale of the vehicle (nearly $1 trillion in forgone tax revenues annually) and identifies the primary beneficiaries of these federal subsidies as higher-income Americans. Mandel raises questions about both the efficiency and equity of the tax expenditure system.

Alan Okagaki's piece provides a nice transition from the overviews presented by the first three papers to the practical discussions of the application of smart subsidy in community development that follow. Okagaki places community development within the history of U.S. anti-poverty efforts and identifies some of the most influential federal community development programs to date. He shows how these programs utilized a "hand up, not a hand out" philosophy to get people out of poverty, and how they were designed to help people to succeed in a market economy, rather than simply alleviate the effects of poverty.

Okagaki also examines the scale of current community development programs, noting that the largest federal funding sources for community development comprise just 0.1–0.2 percent of total federal expenditures and that financial services offered by community development organizations are dwarfed by the scale of services offered by alternative financial service providers, such as check cashers and payday loan companies. Looking forward, Okagaki notes that the community development field has renewed its emphasis on comprehensive community development, acknowledging the need to address the complex interactions of factors affecting lower-income people and places. Okagaki concludes by arguing for a more integrated approach to funding community development, rather than the current patchwork of programs, and urges the field to outline a way to bring their efforts to scale.

Smart Use of Subsidy in Community Development

The second set of papers address the question of what makes for a smart subsidy. Authors were asked to discuss subsidy programs and proposals for programs that are both effective and efficient (or, alternatively, lessons learned from programs that were not). Here we define *effectiveness* as the ability to achieve a set of predefined goals—a workforce development program, for example, should successfully help clients secure jobs and remain in the workforce over the long term. We define *efficiency* loosely as maximizing the return from resources used, which occurs when markets are working well (i.e., market failures are minimized). In determining the *smartness* of a subsidy program, there are several questions we can ask. For example, are there ways to make the program more effective or efficient? Are certain subsidy vehicles (e.g., government guarantees as opposed to grants or cash transfers) more effective or efficient than others for achieving specific goals? Or, are certain program strategies more effective or efficient than others? For example, with early-intervention programs in education, which program strategy leads to better student outcomes: a focus on the quality of the educational institution or on providing supports to parents? If both are important, what is the right balance, given limited resources? Together the authors cover a range of issues relating to the smart use of subsidy, many of which are specific to the community development field.

Annie Donovan provides a recent history of a federal subsidy program that helped spur the development of a market for the financing of charter school facilities. Although charter schools are public, they do not receive public funding for facilities, and traditional lenders have considered them poor risks because of the schools' limited track record and because a charter can be revoked if the school does not meet its academic goals. However, many of these schools could indeed be good investments and there are potential benefits from charter schools that could spill-over to local neighborhoods and residents. The Credit Enhancement for Charter School Facilities Program (CECSF) has helped charter schools attract funding from private investors through intermediaries by providing a federal guarantee for facilities loans made to charter schools. Donovan explains that 85 percent of the CECSF program funding has gone through community development financial institutions (CDFIs), which have applied their experience in other higher-risk, emerging domestic financial markets to this space. Donovan adds that CDFIs have shown through this and other efforts that they are strategic players with a proven ability to combine public and private resources, thereby overcoming certain failures in the market and making possible the deployment of capital in otherwise underserved areas.

Carla Javits takes a different approach: she identifies a need in workforce development and proposes a smart subsidy program to meet it. Certain working-age adults—for example, those with a history of incarceration or periods of homelessness—face significant and multiple barriers to employment. Their rates of unemployment are very high (sometimes exceeding 50 percent), resulting in costs to society in terms of safety net expenditures and forgone tax revenues and other positive contributions that would accompany their gainful employment. Javits notes that *employment social enterprises* have had some success in helping employ these individuals. These programs use earned income to cover normal business costs, including employees' wages and benefits, and use subsidy to cover some of the costs of support systems to help the employees succeed. So far, these programs have been small in scope, but Javits suggests that they can be scaled up on the model of the AbilityOne program. AbilityOne has successfully employed adults with physical and developmental disabilities by providing a streamlined procurement process to federal agencies that purchase goods through the AbilityOne network, business assistance to social enterprises to help them maximize earned income, and subsidies to pay for support services to employees.

Richard Green and Andrew Reschovsky examine the use of subsidy to promote homeownership. In the aftermath of the subprime meltdown, commentators noted that there are many households for whom homeownership does not make economic sense. However, there remain many families for whom it does. Tax expenditures comprise the largest source of subsidies for homeownership, and the largest of these is the mortgage interest deduction (MID) ($92.2 billion in 2010). Green and Reschovsky point out that the program has long been considered expensive and inefficient at increasing the homeownership rate. (Rather, it provides an incentive for those who would be homeowners anyway to buy a larger house or take out a bigger mortgage). Like many others, they argue that the most sensible policy would be to eliminate the MID, but because elimination is politically unlikely, they propose combining a modified MID with an optional mortgage interest tax credit that would provide additional support to lower-income households. They support their arguments with extensive modeling that shows how many additional families would benefit, how much they would benefit, and at what fiscal cost.

Robin Newberger, Michael Berry, David Black, and Kirsten Moy address the important but seldom-explored role of community development institutions in helping the public sector invest effectively and efficiently in community development. Through case studies, they highlight the differentiated roles of public, for-profit, and nonprofit (CDFI) entities in community development, suggesting that effective community development may emanate in part from the partnerships among such entities, or what they call the *civic ecosystem*. In particular, they focus on six roles CDFIs play in helping local public-sector agencies carry out their missions—for example, by being able to respond nimbly to community crises and by collecting and analyzing demographic and market data that can inform public and private investments. The partnerships cited in the paper make a case for alternative forms of public subsidy apart from the direct provision of services. The authors note that while some of these partnerships involved fee-for-service models, many CDFIs undertake activities traditionally associated with public-sector or private-institutions, but without the clear funding streams available to those institutions.

The publication concludes with a comprehensive look at the evaluation of federal subsidy programs for community development. Here Martin Abravanal, Nancy Pindus, and Brett Theodos examine the advantages and limits of empiric evaluation for assessing whether federal programs are on target to achieve or are actually achieving intended objectives. The authors draw their conclusions from an extensive literature review on program evaluation and use an evaluation continuum introduced by Bartik and Bingham (1997). On the easy end of the continuum is monitoring daily tasks; in the middle is enumerating outcomes; on the difficult end is assessing the program's impact on the problem. Because assessing impact is costly and often infeasible, most evaluation happens at the level of enumerating and assessing outcomes. The authors identify two criteria for deciding whether a subsidy is smart, regardless of the evaluation method employed: (a) whether beneficial outcomes follow from project investments and (b) whether public subsidies are needed to make these projects happen (or would they have happened anyway without the use of the subsidy). It is much more difficult to ascertain whether a program would have occurred in the absence of a public subsidy, and agencies must balance the need to identify excessive subsidy with the need to avoid hampering investments with overly rigid rules. The authors conclude that rigorous evaluations processes are impractical in most circumstances, but they call for more consistent approaches for what is measurable and for the funding needed to support such evaluations.

Conclusion

Community development arguably has its roots in the Great Society programs of the 1960s, including the War on Poverty, which grew out of public concern over the persistence of poverty despite postwar abundance. Federal policies were designed to eliminate the root causes of poverty, give the poor a stronger voice, and support the successful communities necessary for the poor to compete and integrate into the mainstream economy. Since then, antipoverty activists, in an effort to build support across political perspectives, often emphasize the goals of building a fairer marketplace and creating economic opportunities.

Similarly, the community development field acknowledges the value of markets as a tool for promoting economic justice by focusing on such themes as "making markets work for all." This publication focuses on how community development organizations are using subsidy effectively and efficiently in markets. But a central role of these organizations is also to organize communities to identify and promote their vision of economic justice. As Okun has noted, our rights as citizens and members of communities are not derived from or distributed through market mechanisms.[5] Our political and social institutions provide universal rights and privileges that are available to all equally, without charge or reward. As part of our nation's network of political and social institutions, community development organizations foster a dialogue among community members about community goals, advocate for these goals inside and outside of the community, and help to execute them.

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[5] *Ibid.*

This dialogue is more crucial than ever, in light of the fundamental questions being asked about the role of public-sector funding and fiscal sustainability. As Federal Reserve chairman Ben Bernanke said in a recent speech, "While it is crucial to have a federal budget that is sustainable, our fiscal policies should also reflect the nation's priorities by providing the conditions to support ongoing gains in living standards and by striving to be fair both to current and future generations."[6] Some of the most transformational examples of community building have neither started nor ended with the marketplace. Instead, they have focused on community relationships and self-determination to define standards for human dignity and quality of life. The authors in this publication offer a variety of perspectives and examples of how community development practitioners are using public incentives to capture opportunities in the marketplace, and implicit in these articles is the work of the community development field to help communities shape and promote their vision of equitable economies.

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[6] Ben S. Bernanke, "Fiscal Sustainability," speech given at the Annual Conference of the Committee for a Responsible Federal Budget, Washington, DC, June 14, 2011, http://www.federalreserve.gov/newsevents/speech/bernanke20110614a.htm.