Smart Subsidy for Community Development

FEATURES

- A primer on the role of subsidy in economic and community development
- An overview of the historical and current use of public incentives in community development
- Research on how subsidy is being used efficiently and effectively to promote community development

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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.

The Economics of Subsidies for Community Development: A Primer[7]

Robert K. Triest

Introduction

Subsidies are ubiquitous in modern market economies such as the United States. Our tax code is rife with special provisions that subsidize some endeavors at the expense of others. The government also subsidizes activities through direct provision, payment to private organizations, or regulation. Subsidies for housing (which benefit from the tax deduction for mortgage interest payments along with many other smaller subsidies) and some forms of agriculture are two examples of subsidies that affect nearly everyone. In essence, virtually every citizen of the United States—and nations with similar economies—is a direct or indirect beneficiary of subsidy programs.

Yet the term "economic subsidy" has a negative connotation in many circles. Subsidies must be paid for by taxing other activities and endeavors more heavily, distorting market incentives. The predominant view is that an activity worth undertaking must meet the market test: there must be sufficient demand for the private sector to profitably engage in the activity. The need for a subsidy is a signal that the activity fails the market test, and so may not be worthwhile. Even if there is a consensus that a subsidy largely benefits a group that society would like to help, out of considerations of equity or economic justice, a question arises: why not just give direct monetary grants to those who need them? Or if a subsidy is to be used, why not directly subsidize labor earnings? Even if one is concerned primarily with economic justice and equity, subsidies may not be an efficient means of advancing these goals.

Advocates of this view find some support in economic theory. It has long been recognized by economists that the market mechanism has the desirable property that, using the metaphor introduced by Adam Smith in his *The Wealth of Nations* (1776), individuals are led by "an invisible hand" to promote the public interest. Subsidies, by altering the prices at which goods and services are exchanged, may interfere with the functioning of the invisible hand. However, Smith recognized that there are limits to the extent to which the invisible hand can be depended on, and later generations of economists clarified the sense in which a laissez-faire market economy promotes the public interest and the necessary conditions for it to do so.

Free-market economies promote the public interest, in the sense that they tend to promote an efficient allocation of economic activity and resources. The market mechanism leads to activities being undertaken only as long as the benefits of further activity equal the incremental cost. In a sense, market forces result in automatic benefit-cost analyses guiding decision-making. However, many circumstances bring about "market failures"—the market mechanism breaks down and the actions of the unfettered invisible hand may lead to undesirable outcomes. When market failure occurs, a situation arises that economists refer to as economic inefficiency: the potential to make someone better off without making anyone else worse off—in other words, when there is a 'free lunch.' In contrast, in the absence of market failure, the free market produces economic efficiency. Subsidies can be viewed as distorting the benefit-cost calculus implicit in market decision-making, leading to the economically inefficient outcome described above.

Of course, society values more than just efficiency. In the absence of market failure, the resulting distribution of opportunities and resources is efficient in the economic sense, but it may still strike many as inequitable. There is nothing in the market mechanism to prevent persistent poverty and

[7] The opinions expressed in this essay are those of the author, and do not necessarily reflect the views of the Federal Reserve Bank of Boston or the Federal Reserve System. The author thanks participants at the November 2009 conference on *Smart Subsidy for Community Development* held at the Federal Reserve Board of Governors for their comments on the ideas presented in this primer.

unacceptably high levels of inequality. Social and economic policy goals naturally encompass both equity and efficiency considerations, and many maintain that norms of equity and justice point to some individuals and households being in need of assistance. However, it is not enough for advocates of subsidy programs to simply show that the subsidy benefits a deserving group. The question that must be addressed is whether a subsidy provides that help in the most cost-effective manner. In the absence of market failure, the general presumption by economists is that subsidies will fail this test.

In the aftermath of the recent financial meltdown and "Great Recession," most readers will need little convincing that market failure does occur. The economic approach to the design and analysis of subsidies is still relevant and important, for two main reasons. First, economics can help guide practitioners to design cost-effective programs. Economic analysis can highlight where subsidies are effective in meeting social goals (which encompass both efficiency and equity considerations), and where subsidies are wasteful or distorting. Avoiding distortions and correcting market failures can help a program budget achieve more of its objectives and come closer to its overall aim. The current crisis has precipitated many instances of market failure: businesses and consumers being denied access to credit; displaced workers having difficulty finding new jobs; and deteriorating foreclosed properties generating blight in some neighborhoods. It is important for practitioners to be able identify economic distress caused by market failure, and to respond with appropriate proposals.

A second reason for analyzing subsidies through the lens of economic analysis is that in this era of fiscal austerity, nearly all government expenditures, both explicit spending and implicit "tax expenditures," are coming under close scrutiny. In order to survive, programs will have to be well designed and capable of passing benefit-cost tests. Many public subsidies do little to promote economic equity, and rather than correcting for market failure, they induce distortions in economic decisions and behavior; such programs may justifiably be scaled back or terminated when they come under increased scrutiny. In contrast, well-designed subsidies for community development have the potential to advance both equity and efficiency goals simultaneously. Practitioners need to be prepared to explain how subsidies for their programs differ from the more wasteful ones that many policymakers and others may think of.

This essay provides a primer on the economics of subsidies, with special application to the role of subsidies in community development. The overall goal is to outline the appropriate role of subsidies for community development, with an eye toward using subsidies to improve program design and enhance cost-effectiveness. The exposition is consistent with the standard economic framework underlying benefit-cost analysis, but it makes only minimal use of economic jargon. The first section provides a working definition of subsidy and a discussion of the types of programs and policies that provide subsidies. The next section discusses the goals of subsidy programs and the circumstances in which they are desirable or undesirable. The third section discusses subsidies in the context of benefit-cost analysis and addresses some possible controversies in project evaluation arising from conflicting goals and values. The essay concludes with a brief discussion of the implementation of subsidy programs, when economic considerations must be melded with political and noneconomic concerns in order to for programs to be viable and effective.

What is a Subsidy?

"Subsidy" is a term commonly used in ordinary discourse, but for our purposes it will be helpful to give the term a reasonably precise working definition:

> *A subsidy is a form of assistance provided by the government to a subset of the public that lowers the cost of producing a good or the price that a consumer pays for a good.*

This definition encompasses a fairly wide range of government policies, including goods and services provided below-cost directly by the government; goods and services given favorable tax treatment; and government regulations that indirectly lower the cost of particular goods or services.

The variety of forms that subsidies may take is perhaps best conveyed through example, and housing provides a particularly rich range. Public housing authorities in many cities provide services directly to low- and moderate-income families who rent apartments in publicly owned and managed complexes. The rents are set at below-market rates, providing a direct subsidy to tenants financed by the housing authority's budget.

Although public housing projects are the most visible form of subsidized housing, housing subsidies take many other forms. For example, the Low Income Housing Tax Credit (LIHTC) program provides tax credits to developers of rental housing affordable to low-income families. This program creates a complicated chain of subsidies and is a good example of a subsidy in which the direct recipients are not the ultimate beneficiaries. Rather than directly providing subsidized housing, the LIHTC program subsidizes the development of low-income housing. Low-income families are the ultimate beneficiaries of the program through the expansion of the stock of affordable housing, although they are not the direct recipients of the tax credits. The developers of the housing initially receive the credits, but they also incur costs associated with adhering to rules designed to insure that low-income families benefit. The developers generally sell the tax credits to investors who finance the projects. The investors who buy those tax credits may appear to be the beneficiaries, but since they have to pay for the tax credits (presumably at a fair market rate), they are actually simply using the tax credits to reduce their tax liability.

Low-income households are the primary beneficiaries of the LIHTC program, the largest housing subsidy program in the United States. However, the deduction for home mortgage interest payments in the U.S. federal income tax, along with the failure to tax the implicit income flow from owner-occupied housing, together disproportionately benefit relatively high-income households, dwarfing all other housing subsidies. Homeowners' consumption of housing services is effectively subsidized at a rate equal to one minus the homeowner's federal marginal income tax rate. Because high-income taxpayers tend to have a higher marginal tax rate and consume a larger volume of owner-occupied housing than low-income households, the value of tax-related subsidies for owner-occupied housing tends to increase with income.[8]

Goals of Subsidy Programs

Standard economic theory offers two broad rationales for how subsidies could improve free-market economic outcomes:

- By providing resources to the poor and underprivileged.
- By correcting for the failure of the market mechanism to create an efficient allocation of goods and services.

The first rationale concerns the goal of economic justice: well-designed subsidies have the potential to bring about a more equitable distribution of economic well-being than that generated by an unfettered free-market economy. In contrast, the second rationale concerns the role of subsidies in correcting for market inefficiencies. The relative importance of the two rationales will vary from case to case, and sometimes only one will be of substantial importance. However, in many cases related to

[8] For an analysis of the use of tax subsidies to promote homeownership see Richard K. Green and Andrew Reschovsky's piece in this publication, "Using Tax Policy to Subsidize Homeownership."

community development, both rationales are operative. In these cases, subsidies may simultaneously generate a more just distribution of economic well-being while also promoting more efficient operation of the market economy. Although much of economic policy analysis is concerned with the trade-off between the primary economic goals of equity and efficiency, some subsidies for community development may advance both goals.

Although the equity goal is likely paramount in most community development programs, our exposition will first discuss the sources of market failure and how subsidies may help to improve economic efficiency. We then turn to discussion of the equity goal and the role of subsidies in promoting a more just distribution of economic well-being. The reason for emphasizing market failure in this essay is simple: in the absence of market failure, equity goals will generally be best met by providing direct cash assistance to those in need. When a subsidy also corrects for market failure, equity goals may be met more cost-effectively through community development subsidies rather than through cash assistance.

Market Failure

When a free-market economy is working well, it achieves an efficient allocation of goods and services, i.e., it is impossible to make any one person better off without making at least one other person worse off. This is important. If it is possible to make someone better off without making someone else worse off, then, of course, we would want to do so—but efficiency in allocation does not say anything about whether the resulting distribution of well-being would be regarded as fair. This is the reason that equity and efficiency are generally treated as separate normative goals of economic policy.

There are many circumstances under which the free-market mechanism will not result in economic efficiency: what economists call “externalities” or “public goods,” information asymmetries among market participants that cause some markets to function poorly, and market power. We will briefly examine each of these sources of market failure.

Externalities and Public Goods

Usually, people or firms who engage in an activity that benefits others are fully compensated for their efforts. Economists use the term “externality” when a person’s or firm’s actions affect others in a way that is not internalized by the market mechanism. For example, consider the possible chain of events when a building owner renovates an empty, run-down building. The neighborhood’s streetscape will look more attractive, benefitting everyone who lives or works nearby. As the previously unused property becomes occupied, the neighborhood may also be perceived as safer and more stable.

The building owner who paid for the renovation receives only a portion of the economic benefits—the stream of rental income from the property, or the increase in its resale value (one or the other—considering both would be double-counting). However, a substantial portion of the benefits may accrue to nearby residents, workers, and property owners, who now enjoy a more pleasant, and possibly safer, neighborhood. The private economic return to further property improvements by building owners increases as a result of the initial renovation. This may lead some of these owners to undertake their own renovations, potentially creating a “virtuous circle” of private actions that generate positive externalities, both directly benefiting others and increasing the chance that others will undertake such activities.

The level of positive externality-generating activities undertaken in a laissez-faire economic environment will be unacceptably low. The reason is that, by definition, the parties who undertake the positive externality-generating activity are compensated for their investment with less than their full share of the benefits. If the persons or organizations undertaking the externality-generating activity also received in compensation for their investment the value of their share of the benefits that accrue to others who did not invest in the activity (the external benefits), that would be a proper and economically efficient incentive for investors to undertake the activity. However, because only a fraction of the total benefits accrue to the persons or organizations undertaking the activity, those parties stop short of investing in the activity to an economically efficient extent. This is the essence of the market failure associated with the existence of externalities.

Returning to our example, owners of derelict buildings would be more likely to undertake renovations, and would perform renovations that generate greater externalities, if they were compensated for the full value of the benefits that accrue to others. In this case, a subsidy would enhance the efficiency of the market. A subsidy to building renovations equal to the value of the external benefits of the project (that is, the benefits that are not captured by the owners through increased rents or property values) would produce an economically efficient level of renovation activity. In making renovation decisions, building owners would then act as though they were receiving all of the benefits of the renovations—exactly what is needed for economically efficient decision-making.

How could this approach be implemented? After all, it is difficult if not impossible to determine the precise value of the external benefits of any project. From the standpoint of the building owner, it is simply a case of the improvement project's failureto generate sufficient profits, considering the risks. A developer will require a subsidy to undertake the project. It is up to policy analysts to determine whether a subsidy is justified, given the externalities generated by the project and the alternative possible uses of the public funds.

Externalities can be negative as well as positive. The best-known example of a negative externality is pollution: the polluter accrues only a portion of the total cost of his actions. Some of the cost falls on other people or firms, and the polluter has an incentive to pollute more than the economically efficient amount. The classic policy solution for pollution externalities is to impose a tax on pollution at a level such that the polluter acts as though it is incurring all of the costs of pollution.

A given situation can be viewed as involving either positive or negative externalities. For example, instead of viewing the renovation of a derelict building as generating positive externalities, we could instead choose to view the failure to renovate as generating negative externalities. Leaving a building in derelict condition not only reduces the rent the building owner can command, but also depresses the rent that may be charged by the owners of nearby properties and may contribute to the general decay of the neighborhood. From this vantage point, the natural policy solution now seems to be a tax on the failure to keep the building in decent condition. If the tax were set to reflect all of the costs that the derelict building owner imposed on others (and importantly, if the tax changed to reflect the change in these external costs whenever the owner engaged in maintenance or renovation projects that changed the level of external costs imposed on others), the owner would be guided to engage in the economically efficient level of maintenance and renovation activity.

Either a subsidy for building renovations or a tax on allowing buildings to fall into disrepair can correct the market failure resulting from the externalities associated with the effect of the condition of a building on the surrounding neighborhood. Both tax and subsidy schemes can lead to economically efficient solutions, but the distribution of gains and losses differs with the policy solution chosen. Building owners will certainly prefer receiving a subsidy for renovation to being taxed for not maintaining their buildings! The tax and subsidy schemes may also differ in their practicality and political feasibility. Tax proposals tend to generate more heated political opposition than proposed subsidies do (although the revenue to pay for subsidies must come from taxing something!). It may also be easier to design a subsidy for building improvements (where expenditure is an easily documented measure of the subsidized activity) than it is to design and implement a tax on the failure to maintain a building, which would require a quantitative measure of the degree to which building maintenance falls below a mandated standard.

In addition to the subsidy and tax policy solutions to market failure resulting from externalities, it is often possible to devise a regulatory policy solution. If the regulatory authority can determine the economically efficient level of an activity (which, in practice, will be difficult), a mandate to maintain this level can be adopted. There is a close connection between this solution to the externality problem and the tax approach outlined above. A regulation enforced by levying fines is essentially a tax on the negative externality. In the end, the particular policy solution chosen to address the externality problem will likely depend on a combination of political feasibility and administrative practicality.

What economists term “public goods” are closely related to externalities. In economic theory, a “pure public good” is a good or service that satisfies two criteria: first, any one person’s enjoyment of the good does not detract from any other person’s enjoyment of the good; second, it is impossible to exclude anyone from enjoyment of the good. The classic example is that of national defense services. Having one extra person enjoy the benefits of national defense does not take away anything from the benefits any other person enjoys from national defense. It is also impossible to exclude any national resident from the protection offered by national defense. One can easily see the connection between externalities and public goods—a pure public good is one that generates externalities that affect everyone. Profitable provision of pure public goods by private unsubsidized firms is not feasible. Because no one can be excluded from enjoying pure public goods (by definition), no one has to pay for a public good in order to enjoy it; thus the only revenue would come from voluntary donations. Pure public goods need to be supplied either directly by the public sector or by heavily subsidized private firms.

There are very few examples of pure public goods, but they are still relevant for our discussion. The polar opposite of a pure public good is a pure private good—a good or service that affects only the person who directly consumes it; in other words, a good that generates no externalities. A free-market economy will generally automatically ensure that an economically efficient quantity of a pure private good is produced and consumed. Anything between the polar cases of pure public goods and pure private goods can be considered impure public goods. For these goods and services, there is a potential need for subsidies to ensure an economically efficient level of provision. Although most goods arguably fall somewhere in the continuum between pure public goods and pure private goods, in many cases the degree of to which something is a public good is sufficiently small to be of little concern for public policy.

Neighborhood amenities such as parks, sidewalks, lighting, and public safety have a strong public good component. They are valued in their own right, but are also complementary to economic development. Amenities make private development more likely to become profitable, or at least require smaller subsidies.

More generally, neighborhood vitality itself can be considered a public good. Like other public goods, it will tend to be underprovided by private market mechanisms. All neighborhood stakeholders benefit from the vibrancy of the area, but because the benefits are shared and diffuse individual stakeholders lack sufficient incentives to undertake the investments needed to restore a neighborhood to health, a suboptimal amount of neighborhood vitality would be provided without intervention to correct the market failure. In this type of situation, subsidies for the development of neighborhood infrastructure can correct the market failure and set the stage for profitable private development.

Asymmetric Information

Another source of market failure arises when the market for a good or service performs poorly as a result of information asymmetries between buyers and sellers. As is often the case, especially in insurance and financial markets, one party to a transaction has access to pertinent information that the other party lacks. Consider the case of a potential borrower who has a well-thought-out plan to expand a small business and is confident of her ability to repay a loan for this purpose. Unless the borrower has substantial collateral and a documented history of good credit (leading to a high credit score), she may have difficulty obtaining a bank loan to finance the expansion. Although based on her own private information she is a good risk, from a bank's perspective, she is a high-risk borrower and would likely be turned down for a loan. She would be able to go ahead with her expansion plans only if she could finance the project with family wealth or through wealthy personal connections.

It might seem somewhat puzzling that a bank would turn the borrower down outright, rather than just making a loan at a very high interest rate. However, this is a perfectly rational response, because the bank knows that if it offers high-interest-rate loans to potential borrowers for whom it has relatively little information, there will be a tendency for the highest-risk borrowers to accept the terms of the offered loans and for the lowest-risk borrowers to turn down the loan offers. The lowest-risk borrowers will be more likely to convince family members and friends to supply financing on more advantageous terms than those offered by the bank, and so will tend to turn down the bank's loan offer. The highest-risk borrowers will not want to jeopardize the funds of personal contacts and family members (or will not be trusted by those who know them well) and so will be likely to accept the loan offers. As a result, any loans made will likely be unprofitable even if high interest rates are charged.

The market failure in this case arises from the lack of a well-functioning market for loans. Because of information asymmetries, some borrowers who are actually reasonable risks will not have access to financing. This leaves potentially profitable investment opportunities unexploited, leading to economic inefficiency.

Government policy can sometimes play a role in at least partially alleviating this form of market failure. Government intervention in lending programs is often motivated by the problem of potential borrowers who lack collateral, making them either unable to borrow or able to borrow only on very disadvantageous terms. The government subsidies or guarantees of repayment common in student loan programs help to correct for this type of market failure. In community development, similar problems affect the ability of community groups to obtain loans necessary to advance their projects. The groups' status as not-for-profit entities and lack of collateral are often obstacles to obtaining loans through traditional channels. However, unlike the case of externalities, where the link between subsidies and correcting market failures is clear and direct, the case of market failure in loan markets is more nuanced, and the form that subsidies should take is less clear.

The Community Reinvestment Act (CRA) may be viewed as an attempt to address credit markets that function poorly due to market failures associated with information asymmetries. By mandating that banks serve all communities within geographic areas where they are chartered to do business, the Act provides a de facto subsidy to lending in low and moderate-income neighborhoods. Low-income neighborhoods may be particularly vulnerable to information problems. Lack of access to collateral, difficulty in documenting qualifications, and weak networks of informal sources of credit may all be prevalent in low-income neighborhoods. Lending requirements embedded in the CRA may help to circumvent these problems. The CRA may also help to bridge other forms of market failure. For example, a basic level of financial literacy among the citizenry can be regarded as a public good—it contributes to a better-functioning economy. By promoting access to financial services, the CRA likely contributes to this public good. In addition, to the extent that it promotes redevelopment of low-income neighborhoods, the CRA may also help to alleviate externalities associated with urban blight. The CRA is also an important tool for addressing market failure associated with high fixed costs of serving low-income communities, as discussed below.

Market Power and High Fixed Costs

Among the general public, the most common concern about monopolies and other firms with significant market power is that because their profits will be greater without significant market competition, consumers will lose out. To economists, however, the root cause of the market failure associated with monopolies is that monopolists charge consumers a price that exceeds the marginal cost of production. Consumers will purchase a good or service only if the subjective benefit ("utility" in economic jargon) is at least as great as the price they pay. So, in a monopolized market, the marginal benefit to consumers of the monopolist's output is greater than the marginal cost of production. If more were produced and sold, then the added benefit to consumers would more than cover the additional production cost. The fact that more is not produced is the source and evidence of the market failure.

Monopolists do not necessarily generate above-normal rates of profit. In some cases, the reason that only a single firm serves the market is that high fixed costs of operation make it uneconomical for more than one firm to operate. If the fixed costs are large enough relative to the scale of the market, then even if the monopolist exploits its pricing power, the maximum profit it can extract may actually result in a subnormal rate of return on its investment. In cases such as this, the firm will need to be subsidized if it is to stay in business.

Providers of services in some low- and moderate-income markets may fall into this category—if the market were large enough, they could survive without subsidy. However, because of high fixed costs and limited demand (which may be due to low family income in their markets), they are not economically viable without some sort of subsidy. Examples include bank branches and supermarkets, which may be missing in low-income neighborhoods because the expected volume of business is not sufficient to cover the fixed costs of operation. The high fixed costs lend these businesses some of the characteristics of public goods: everyone in the neighborhood would benefit if such businesses located nearby. Consider the case of a neighborhood supermarket. It would be viable if enough individuals increased their spending at the store, but any given individual lacks the incentive to do so because the benefit (the continued existence of the store) is shared with everyone else in the neighborhood. Providing a subsidy for the business, perhaps through below-market rent, may be necessary for it to be profitable. Businesses that are a necessary part of a community's basic economic infrastructure, such as supermarkets and banks, may be profitably provided without subsidy in high-income neighborhoods, but require subsides to be viable in low-income neighborhoods.

In the case of financial services, the CRA helps to overcome the fixed costs of serving low-income neighborhoods. By mandating that banks serve low-income areas where high fixed costs may make operations unprofitable, the CRA helps to correct for market failure.

Economic Equity

Finally, we come to economic equity, which is generally the main goal of community development organizations. Even without market failure, many members of society may not regard the distribution of well-being produced by free markets as equitable. Exactly what an equitable distribution would look like, of course, depends on value judgments, and equity goals are sometimes viewed as more subjective than the goal of economic efficiency. There is general agreement on the forms of market failure that must be corrected in order to achieve economic efficiency, but much less agreement on when the distribution of economic well-being is inequitable. For example, some people place special emphasis on ensuring equality of opportunity, while others are more concerned with the distribution of economic outcomes. Even among the latter group, there is sometimes disagreement over what aspects of the distribution are of greatest concern. For example, are we most interested in poverty alleviation, with little attention to the distribution of income over the poverty line, or is the size of the gap between high- and middle-income households also of concern?

Although there may be more disagreement over equity goals than over efficiency goals, it is clear that equity and efficiency are both normative considerations, and one cannot presume *a priori* that one is necessarily of greater importance than the other. Moreover, it is important to remember that efficiency is only a means to an end—it is valued only because the existence of inefficiency implies that we could potentially make someone better off without making anyone else worse off. There are hypothetical examples of efficient economies that nearly everyone would view as undesirable because of a very concentrated distribution of well-being (for example, where one person reaps nearly all the gains from the economy, with little left for anyone else). There are also hypothetical examples of economies with a very equal distribution of well-being, but with such a high degree of inefficiency that the overall level of economic welfare is very low. In evaluating real policy proposals and alternatives, the relative importance attached to efficiency and equity goals will depend on the particular policy and setting. In the case of community development in low and moderate-income neighborhoods, it seems reasonable that equity goals will be paramount.

Equity and efficiency are often depicted as conflicting goals, requiring policy makers to choose between the two. In Arthur Okun's (1975) famous metaphor, using public policy to redistribute resources from the well-off to the poor is like carrying water in a leaky bucket.[9] Some of the water makes it to the destination (redistribution does occur), but some of the water leaks out and is wasted (there is a loss of efficiency). An obvious source of "leakage" in programs designed to address inequity is the administrative cost of running the program. A more subtle, but often more important, source of leakage is the distortion of the incentives introduced by many programs. For example, providing means-tested subsidies to disadvantaged people may distort the incentives they face to work and save, resulting in a loss of economic efficiency and a reduction in the effectiveness of the subsidies.

However, subsidies do not necessarily result in efficiency losses (or "leakages"). When market failures adversely affect people who have low-to-moderate income, correcting those failures can simultaneously enhance market efficiency and advance equity goals. Many of the examples discussed above pertain to market failures that adversely affect residents of low-income neighborhoods. Subsidies that help to correct these market failures contribute to equity goals while also enhancing economic efficiency. In the absence of market failure, subsidies will cause market distortions, and some of the money spent on the subsidy will accrue as wasted "deadweight loss." In contrast, subsidies that correct market failures produce benefits in excess of the monetary cost of the subsidy (in essence, a negative deadweight loss).

In addition to causing or contributing to economic inefficiency, market failure may also cause or contribute to economic inequity. For example, credit restrictions due to market failure arising from information asymmetries may be particularly severe in low-income communities, leading to reduced opportunities for entrepreneurship and economic advancement. Externalities associated with urban blight may discourage schooling and employment, leading to a cycle of poverty. In such instances, addressing market failure may be essential to advancing equity goals.

Designing programs to simultaneously address economic inequity and market failure may help to build political support for the programs and remove the stigma associated with subsidies. Rather than distorting incentives or leading to a poverty trap, a subsidy designed to correct market failure corrects a problem that prevents markets from working efficiently. Moreover, as discussed below, taking account of market failure may help to build the business case for well-designed subsidies.

Benefit-Cost Analysis of Subsidy Programs

Benefit-cost analysis is arguably the most fundamental tool of economic decision-making and is the foundation (explicit or implicit) of the business case for a proposed investment. Businesses apply benefit-cost analysis to nearly all their decisions, although they rarely refer to it as such. To a private business motivated only by profit, the benefit-cost criterion is simple: does the proposed action increase

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

profits? A careful business will take account of the uncertainty of projected future cost and revenue streams, adjusting for risk and discounting for the time-value of money. Nevertheless, the criterion is still whether profits are projected to increase—considerations of economic equity, potential externalities, and other aspects of economic welfare are irrelevant unless they affect profits.

Nonprofits, government organizations, and some businesses whose missions encompass more than profit-making have broader objectives, and as a result decision-making must include more than just analyzing the effect of an action on profits. External costs and benefits that would be irrelevant to a for-profit firm should be taken into account, as should any impacts on economic equity. External costs and benefits are more difficult to quantify than are standard accounting cost and revenue streams, but it is important to make some attempt to do so. At the very least, it should be possible to calculate the subsidy necessary to induce a private business to undertake the project. The required subsidy can then be compared to a reasonable range of estimates of the value of external costs and benefits.

Equity considerations are also nearly impossible to quantify directly into costs and benefits. One way they can be incorporated into benefit-cost analyses is by ranking projects. There are many instances of market failure and we cannot fund public expenditure or subsidy programs to address them all. Distortionary taxes must be levied to raise the funds for public expenditures and subsidies. Such taxes result in efficiency losses, so it would not make sense to fund projects to eliminate all sources of market failure. In determining which projects to fund, the distribution of benefits and costs can be analyzed, with preference given to those that advance equity goals. Alternatively, if each of the proposed alternatives is expected to have the same impact on equity, the project with the greatest net benefits, taking full account of external benefits, could be chosen.

Conclusion

This essay makes the case that economic analysis can help in determining when subsidies for community development are appropriate and justifiable. Although many of the largest subsidy programs, such as the home mortgage interest deduction, distort economic incentives and skew the distribution of well-being toward the relatively affluent, subsidies for the development of low- and moderate-income communities can not only enhance economic efficiency but also ameliorate problems of poverty, inequality, and obstructed economic opportunity.

Community development often simultaneously corrects for more than the source of market failure. A project will often generate positive externalities and also suffer from lack of access to financing through traditional sources. Subsidizing the financing of community development projects is one policy response designed to correct sources of market failure that adversely affect low- and moderate-income communities. Such subsidies may be a more cost-effective way of helping residents of these communities than either direct cash payments or direct government provision of services.

It is important to recognize that the public sector is not the only source of subsidies to address problems of inequity and market failure. Private philanthropists, foundations, and nonprofit enterprises may apply the same principles used by public-sector decision-makers, although the relative weights placed on different aspects of community development may differ between the public and nonprofit sectors. A nonprofit organization may wish to promote the provision of a specific public good or service that is particularly valued by its funders. For example, a patron of the arts may wish to subsidize programs aimed at providing public displays of art or musical performances in communities that would otherwise be underserved in this regard. Some nonprofit groups work in collaboration with the public sector and rely partly on public funds. However, even when there is no direct public funding involved, there is public subsidy implicit in the tax deductibility of charitable contributions and the favorable tax treatment of nonprofit organizations. Although direct public expenditures receive more attention, the tax expenditures associated with charitable giving and nonprofits are an important source of funds for community development.

Community development practitioners may question the extent to which the economic considerations outlined above actually guide real-world policy-making in community development. Practical considerations such as balancing the differing interests of competing groups of stakeholders and administrative feasibility are often paramount. However, policy-making is about more than just balancing the interests of different groups of stakeholders. Projects need to start with a well-thought-out plan that can gain support among community stakeholders and funding sources. Economic analysis of the need for, and effects of, subsidies should play an important part in this process.

Stakeholders are often concerned with objectives they consider essentially noneconomic. However, many such objectives, such as placing inherent value on promoting safe and economically vibrant communities for all to enjoy, can be viewed as a combination of economic efficiency and equity goals. Having safe and vibrant communities can be viewed as a public good, and targeting subsidies to providing that good in low- and moderate-income areas is a way to advance equity objectives. When done right, benefit-cost analysis can incorporate these 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.

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Where Do Our Federal Tax Dollars Go?

Center on Budget and Policy Priorities (CBPP)

Updated April 14, 2011[1]

The federal government collects taxes in order to finance various public services. As policymakers and citizens weigh key decisions about revenues and expenditures, it is instructive to examine what the government does with the money it collects.

In fiscal year 2010, the federal government spent $3.5 trillion, amounting to 24 percent of the nation's Gross Domestic Product (GDP). While the level of 2010 expenditures—as a share of GDP—exceeds those of recent years, the composition of the budget largely resembles the patterns of recent years. Of that $3.5 trillion, almost $2.2 trillion was financed by federal tax revenues. The remaining $1.3 trillion was financed by borrowing; this deficit will ultimately be paid for by future taxpayers. (See text box below for the recession's impact on the budget.) As shown in the graph below, three major areas of spending each make up about one-fifth of the budget:

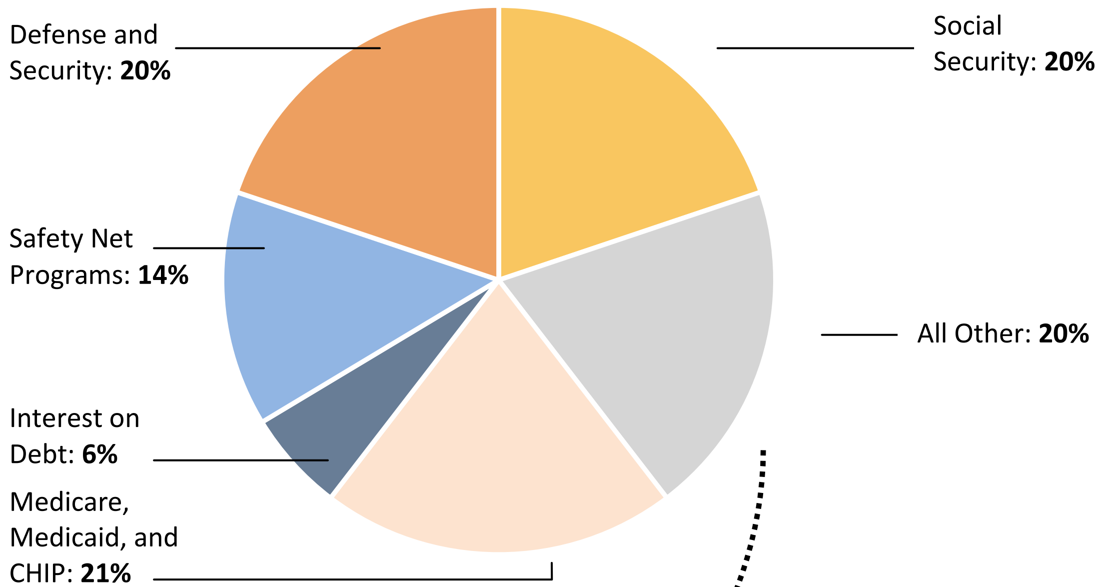
- Defense and security: In 2010, some 20 percent of the budget, or $705 billion, paid for defense and security-related international activities. The bulk of the spending in this category reflects the underlying costs of the Department of Defense and other security-related activities. The total also includes the cost of supporting operations in Iraq and Afghanistan, which totaled $170 billion in 2010.

- Social Security: Another 20 percent of the budget, or $707 billion, paid for Social Security, which provided retirement benefits averaging $1,175 per month to 34.6 million retired workers in December 2010. Social Security also provided benefits to 2.9 million spouses and children of retired workers, 6.4 million surviving children and spouses of deceased workers, and 10.2 million disabled workers and their eligible dependents in December 2010.

- Medicare, Medicaid, and CHIP: Three health insurance programs—Medicare, Medicaid, and the Children's Health Insurance Program (CHIP—together accounted for 21 percent of the budget in 2010, or $732 billion. Nearly two-thirds of this amount, or $452 billion, went to Medicare, which provides health coverage to around 47 million people who are over the age of 65 or have disabilities. The remainder of this category funds Medicaid and CHIP, which in a typical month in 2010 will provide health care or long-term care to about 60 million low-income children, parents, elderly people, and people with disabilities. Both Medicaid and CHIP require matching payments from the states.

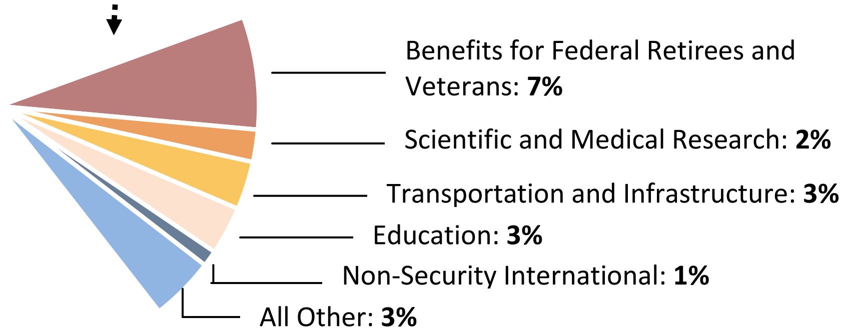
[1] Originally published under the same name by the Center on Budget and Policy Priorities. http://www.cbpp.org/files/4-14-08tax.pdf.

Figure 1: Most of Budget Goes Toward Defense, Social Security, and Major Health Programs



Source: Congressional Budget Office, 2010
Note: Percentages may not total 100 due to rounding

Figure 2: Details of the "All Other" Budget Category



Source: Congressional Budget Office, 2010
Note: Percentages may not total 20 due to rounding

Two other categories together account for another fifth of federal spending:

- Safety net programs: About 14 percent of the federal budget in 2010, or $496 billion, went to support programs that provide aid (other than health insurance or Social Security benefits) to individuals and families facing hardship.

  These programs include: the refundable portion of the earned-income and child tax credits, which assist low- and moderate-income working families through the tax code; programs that provide cash payments to eligible individuals or households, including Supplemental Security Income for the elderly or disabled poor and unemployment insurance; various forms of in-kind assistance for low-income families and individuals, including food stamps, school meals, low-income housing assistance, child-care assistance, and assistance in meeting home energy bills; and various other programs such as those that aid abused and neglected children.

  A CBPP analysis shows that such programs kept approximately 15 million Americans out of poverty in 2005 and reduced the depth of poverty for another 29 million people. (Such programs likely kept even more Americans out of poverty since the recession began. For example, seven provisions of the Recovery Act enacted in February 2009 kept more than 6 million additional people out of poverty in 2009, according to a CBPP analysis.)

- Interest on the national debt: The federal government must make regular interest payments on the money it has borrowed to finance past deficits—that is, on the national debt held by the public, which reached $9 trillion by the end of fiscal 2010. In 2010, these interest payments claimed $196 billion, or about 6 percent of the budget.

As the graph shows, the remaining fifth of federal spending goes to support a wide variety of other public services. These include providing health care and other benefits to veterans and retirement benefits to retired federal employees, assuring safe food and drugs, protecting the environment, and investing in education, scientific and medical research, and basic infrastructure such as roads, bridges, and airports. A very small slice of this remaining 18 percent—about 1 percent of the total budget—goes

2009 and 2010 Budget Outcomes Skewed by the Recession

Due to one of the worst economic downturns since the Great Depression—and the policies enacted to combat it—2009 and 2010 tax and spending levels diverged from recent patterns. Plunging federal revenues amounted to less than 15 percent of GDP in 2009 and 2010, the lowest levels in decades. The efforts to prevent collapse of the financial system and to deal with the failure of Fannie Mae and Freddie Mac, the automatic expansion of programs like unemployment insurance and food stamps (which always grow during economic downturns to meet rising need), and spending from the February 2009 stimulus package together pushed federal outlays to 25 percent of GDP in 2009 and nearly 24 percent of GDP in 2010. As a result, deficits reached record levels.

It will take the economy several years to fully recover, and during that time federal revenues and expenditures will continue to differ from historical experience. However, the composition of the budget in 2010 largely resembles recent federal spending patterns.

to non-security programs that operate internationally, including programs that provide humanitarian aid.

While critics often decry “government spending,” it is important to look beyond the rhetoric and determine whether the actual public services that government provides are valuable. To the extent that such services are worth paying for, the only way to do so is ultimately with tax revenue. Consequently, when thinking about the costs that taxes impose, it is essential to balance those costs against the benefits the nation receives from public services.

Appendix

We based our estimates of spending in fiscal year 2010 on the most recent historical data released by the Office of Management and Budget (OMB). (The Federal fiscal year 2010 runs from October 1, 2009 to September 30, 2010.)

The broad expenditure categories presented in this paper were constructed on the basis of classifications commonly used by budget agencies. The categories are constructed by grouping related programs and activities into broad functions, which are further broken down into subfunctions. The details of how the categories used in this paper were constructed from those functions and subfunctions are described below.

Defense and security: The largest component of the “defense and security” category is the national defense function (050). In addition, this category includes the international security assistance subfunction (152) of the international affairs function.

Social Security: This category consists of all expenditures in the Social Security function (650), including benefits and administrative costs.

Medicare, Medicaid, and CHIP: This category consists of the Medicare function (570), including benefits, administrative costs, and premiums, as well as the “Grants to States for Medicaid” account and the “Children’s health insurance fund” account (both in 550).

Safety net programs: This category of programs includes all programs in the income security function (600) except those that fall in the following two subfunctions: federal employees’ retirement and disability (602) and general retirement and disability insurance (601). The latter contains the Pension Benefit Guarantee Corporation and also covers programs that provide pension and disability benefits to certain small groups of private sector workers.

Interest on debt: This category contains the net interest function (900).

Everything else: This category includes all federal expenditures not included in one of the five categories defined above. The subcomponents of this category that are displayed in the graph are defined as follows:

- **Benefits for federal retirees and veterans**: This subcategory combines the veterans' benefits and services function (700) and the federal employee retirement and disability subfunction (602, which is part of the income security function).

- **Education**: The education subcategory combines three subfunctions of the education, training, employment, and social services function: elementary, secondary, and vocational education; higher education; and research and general educational aids (subfunctions 501, 502, and 503 respectively).

- **Scientific and medical research**: This subcategory consists of the general science, space, and technology function (250), and the health research and training subfunction (552).
- **Transportation**: This subcategory consists of the entire transportation function (400).
- **Non-security international**: This subcategory consists of the international affairs function (150) except for international security assistance, which is included with defense, above.
- **All other**: This subcategory consists of all other federal expenditures.

Tax Expenditures and Social Policy: A Primer

Daniel Mandel

What Are Tax Expenditures?

Congress uses the tax code to promote a broad range of policy objectives. Rather than directly spend government revenue on policy programs—or implement new regulation—Congress has enacted a series of tax provisions that effectively subsidize certain politically and socially desirable activities.

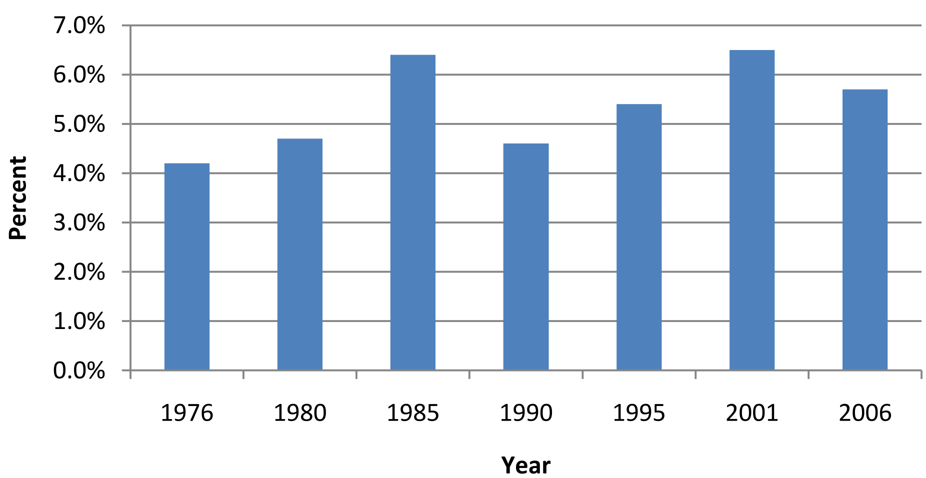
These "tax expenditures" take the form of deductions, exemptions, or credits to taxpayers who engage in the targeted activity. From a budgeting perspective, they are treated as foregone government revenue, rather than increased government expenditure.

> *"[Tax expenditures are r]evenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral or liability."*
> *–The Congressional Budget Act of 1974, which mandated the tax expenditure budget.*

How Big Is the System?

In a word: big. Recent decades have seen an increase in both the overall number of expenditures and, in some cases, the size of existing expenditures, according to the Urban-Brookings Tax Policy Center.[1] The cumulative value of tax expenditures has risen from 4.2 percent of GDP in 1972 to 5.7 percent of GDP in 2006. For fiscal year 2011, the federal budget includes $1.06 trillion in tax expenditures.[2]

Figure 1
Non-business Tax Expenditures as a Percentage of GDP, 1976-2006



Source: Burman, Toder, and Geissler, 2008

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[1] Leonard E. Burman, Eric Toder, and Christopher Geissler. *How Big Are Total Individual Income Tax Expenditures, and Who Benefits from Them?* Urban-Brookings Tax Policy Center, December 2008. http://www.taxpolicycenter.org/UploadedPDF/1001234_tax_expenditures.pdf.
[2] "Tax Expenditures and Employee Benefits: Estimates from the FY2011 Budget," *FACTS from EBRI.* Employee Benefit Research Institute, March 2010. http://www.ebri.org/pdf/publications/facts/FS-209_Mar10_Bens-Rev-Loss.pdf.

What Do Tax Expenditures Target?

Tax expenditures target a wide variety of policy issues, including housing, health care, national defense, retirement security, education, community development, and the environment. Three of the largest and most well-known tax expenditures are the employer-sponsored insurance exclusion, the home mortgage interest deduction, and the 401(k) plan deferral.

The goals of these "big three" are clear: incentivize employer-provide healthcare coverage, increase homeownership, and encourage saving for retirement (respectively). But the costs are significant: as Figure 2 shows, these three expenditures alone will cost the federal government nearly $4 trillion in foregone revenue over the next five years. The tax expenditures that specifically benefit low-income families and communities are, by comparison, miniscule (see Figure 3).

Figure 2
The Ten Largest Tax Expenditures, 2010 – 2015[3]

Tax Expenditure	Projected Foregone Revenue, 2011 – 15 ($ billions)
Exclusion of employer contributions for medical insurance premiums and medical care	$ 1,053.79
Deduction of mortgage interest on owner-occupied homes	$ 637.56
401(k) plan contributions	$ 360.84
Deductibility of non-business state and local taxes other than owner-occupied homes	$ 300.06
Step-up basis of capital gains at death	$ 282.79
Capital gains (except agriculture, timber, iron ore, and coal)	$ 270.91
Deductibility of charitable contributions, other than education and health	$ 257.14
Employer pension contributions	$ 247.48
Exclusion of net imputed rental income	$ 223.89
Capital gains exclusion on home sales	$ 215.88

Figure 3
Select Tax Expenditures Benefitting Low-Income Families and Communities

Tax Expenditure	Projected Foregone Revenue, 2010 – 14 ($ billions)
Earned income tax credit	$ 41.00
Low-income housing tax credit	$ 36.31
Exclusion of scholarship and fellowship income	$ 12.22
Low- and moderate-income savers credit	$ 5.32
New markets tax credit	$ 3.79
Work opportunity tax credit	$ 1.82
Investment credit for rehabilitation of structures (other than historic)	$ 0.15
Welfare-to-work tax credit	$ 0.02

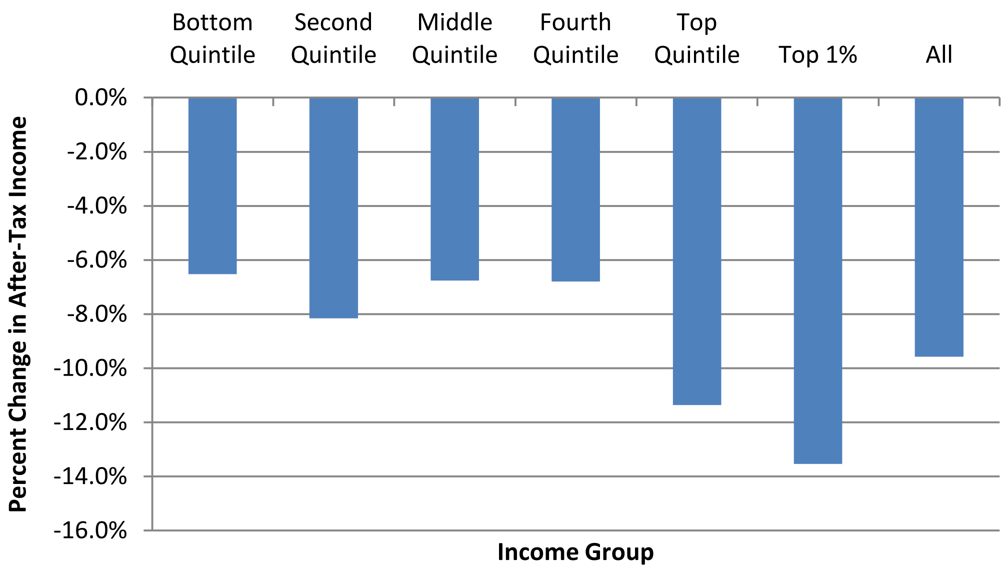
Source: *Analytical Perspectives, 2011.*

[3] *Analytical Perspectives: Budget of the U.S. Government*, Fiscal Year 2011. http://www.gpoaccess.gov/usbudget/fy11/pdf/spec.pdf.

Who Benefits From Tax Expenditures?

Most tax expenditures—and the largest ones in particular—benefit high-income taxpayers. Burman, Toder, and Geissler (2008) found that eliminating all tax expenditures would reduce the income of the top 1 percent of earners by 13.5 percent, while the income of the bottom 20 percent of earners would decline by just 6.5 percent (see Figure 4).

Figure 4
Distributional Effects of Eliminating All Tax Expenditures, Percent Change in After-tax Income



Source: Burman, Toder, and Geissler, 2008.

According to the Center on Budget and Policy Priorities, a public policy organization that studies programs affecting low- and moderate-income Americans, the bottom 20 percent of taxpayers benefit almost exclusively from refundable tax credits (totaling $89 billion in 2007) such as the Earned Income Tax Credit.[4] By contrast, a plurality of the gains from much larger categories, such as exclusions from income ($326 billion in 2007) and itemized deductions ($153 billion in 2007), accrue to the top income quintile.

> *"The benefits of tax expenditures accrue disproportionately to more affluent citizens and powerful corporations."*
> *–Christopher Howard,* The Hidden Welfare State*, Princeton University Press, 1999.*

[4] Chye-Ching Huang and Hannah Shaw, *New Analysis Shows "Tax Expenditures" Overall Are Costly and Regressive*. Center on Budget and Policy Priorities, February 23, 2009. http://www.cbpp.org/cms/index.cfm?fa=view&id=2662.

What's Wrong With the Current System?

Critics contend that tax expenditures are:

- *Expensive*, depriving the federal government of significant revenue;
- *Regressive*, disproportionately benefitting the wealthy;
- *Distortionary*, altering consumer behavior in inefficient ways;
- *Ineffective*, failing to achieve their stated goals; and,
- *Non-transparent*, immune from the annual budgeting process.

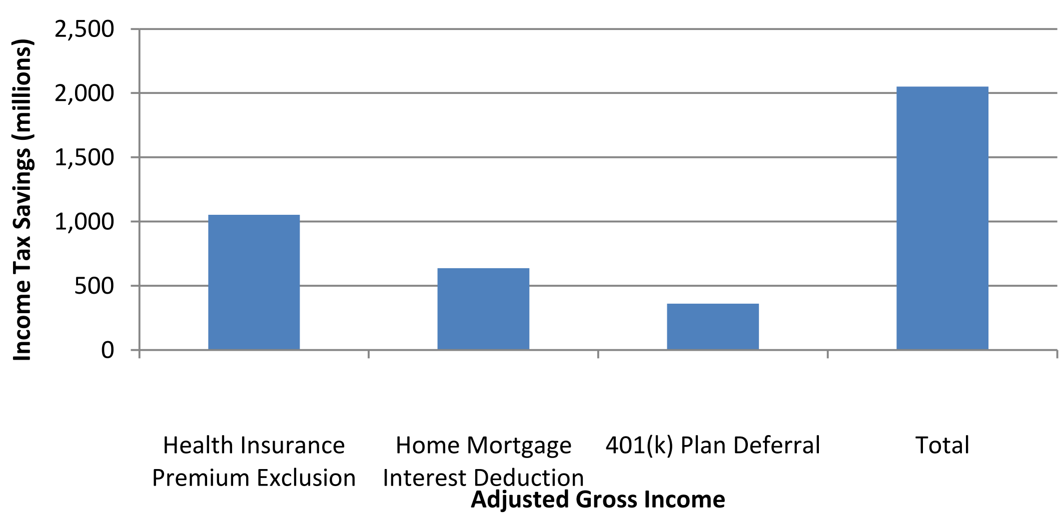
In 2005, President George W. Bush's Advisory Panel on Federal Tax Reform recommended eliminating many targeted tax breaks, while preserving and simplifying the benefits for home ownership, charitable giving, and health care.

> *"Many of these provisions shrink the size of the tax base…require higher tax rates generally to raise the same amount of revenue, and require a more graduated tax rate schedule to achieve a given distribution of the tax burden."*
> *– Robert Carroll, John E. Chapoton, Maya MacGuineas, and Diane Lim Rogers, "Moving Forward With Bipartisan Tax Policy," The Concord Coalition, February 12, 2009.*

The "Big Three" Tax Expenditures

Figure 5 illustrates the size of the "big three" tax expenditures: The employer-sponsored health insurance exclusion, the home mortgage interest deduction, and the 401(k) plan deferral. More detail on each of these tax expenditures is provided in the sections below.

Figure 5
How Big are the "Big Three"?



Source: *Analytical Perspectives, 2011*

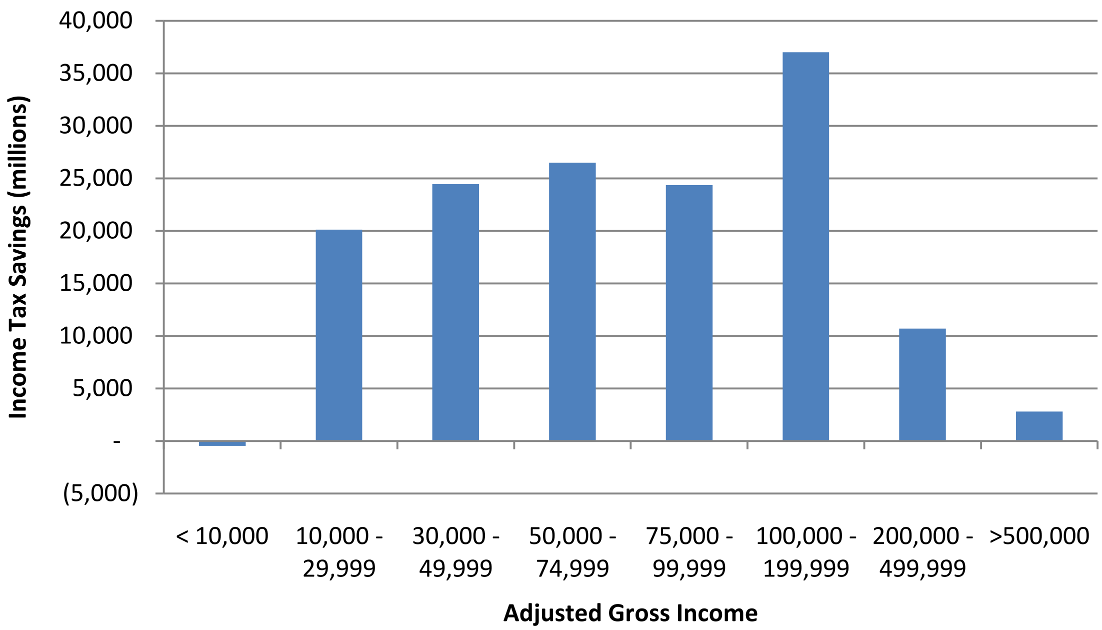
The Employer-Sponsored Health Insurance Exclusion

Employers pay zero federal income or payroll taxes on payments toward employee health insurance and medical care. This exclusion is one major reason why most Americans—61.8 percent in 2008, according to Congress' Joint Committee on Taxation (JCT)—are insured through their employer.[5] Moreover, employer insurance contributions are excluded from employees' taxable wages, even though they technically qualify as compensation.

The insurance premium exclusion is the leading component of a broad system of tax subsidies for healthcare, and the largest single tax expenditure overall. Unlike most other tax expenditures, there is no upper limit on the dollar value of health benefits an employer can provide tax-free. Altogether, healthcare tax expenditures totaled approximately $302 billion in fiscal year 2007 (JCT). However, there is little or no subsidy for insurance purchased outside the employer market, which raises equity issues. The healthcare tax expenditures also distort consumer behavior, potentially leading employers to purchase more insurance than their employees actually need. Moreover, the largest tax savings accrue to employees earning more than $100,000 a year.

Figure 6

Employer Insurance Premium Exclusion: Tax Savings by Income Level, 2007



Source: Staff of the Joint Committee on Taxation, 2008.

The Home Mortgage Interest Deduction

For taxpayers who own their home and elect to itemize deductions—33.7 percent of homeowners in 2003—the home mortgage interest deduction reduces annual taxable income by the amount of interest paid on a home loan in the given year. Before the Tax Reform Act of 1986, the interest on *all* personal loans was tax deductible. That legislation narrowed the scope of tax benefits to include only home loans,

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[5] Joint Committee for Taxation, *Tax Expenditures for Health Care,* prepared for a Public Hearing Before the Senate Committee on Finance, July 30, 2008. http://www.jct.gov/publications.html?func=startdown&id=1193.

with the policy goal of increasing homeownership. Although homeownership rates did increase from 63.8 percent in 1986 to 69.0 percent in 2004, the increase could be attributable to a number of factors, and the 2003 data show that high-income households benefit disproportionately from the home mortgage interest deduction. Households earning more than $100,000 make up only 8.7 percent of all taxpayers, yet claim 35.5 percent of the tax savings.

Figure 7

The Home Mortgage Interest Deduction: Benefits by Income Level, 2003[6]

Adjusted Gross income	Percent of Home Mortgage Interest Deduction Claimed	Percent of All Tax Returns in Income Group	Average Mortgage Interest Deduction Per Return	Percentage of Returns Claiming Mortgage Interest Deduction
Under $20,000	4.2%	37.8%	$278	4.0%
$20,000 - $29,999	5.1%	14.1%	$910	13.1%
$30,000 - $39,999	7.2%	10.7%	$1,674	24.2%
$40,000 - $49,999	7.9%	8.0%	$2,462	35.2%
$50,000 - $74,999	21.7%	13.3%	$4,068	50.9%
$75,000 - $99,999	18.2%	7.3%	$6,210	69.0%
$100,000 - $199,999	**24.4%**	**6.8%**	**$8,928**	**78.9%**
$200,000 and over	**11.2%**	**1.9%**	**$14,374**	**75.7%**

Source: Prante, 2006

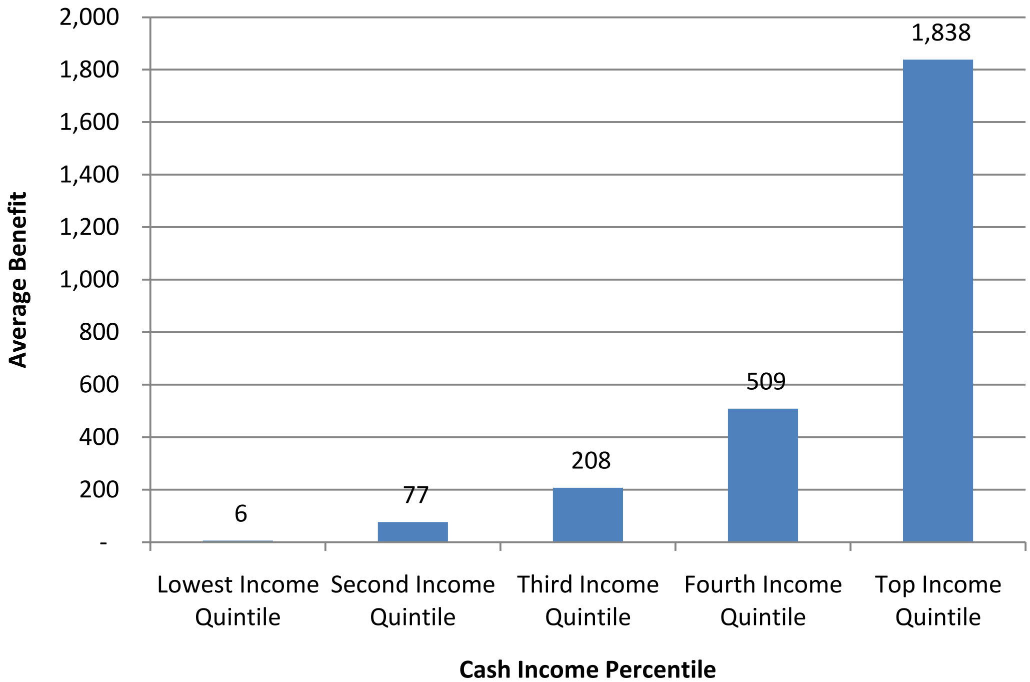
The 401(k) Plan Deferral

Congress also uses tax expenditures to encourage workers to save for their retirement—in particular, by allowing individuals and firms to defer taxation on their contributions to employer-sponsored 401(k) plans. (Participants in 401(k) plans do pay income tax, often at a lower marginal rate, when their retirement savings are withdrawn). In recent years, defined-contribution plans like the 401(k) have replaced traditional defined-benefit pensions as the most common retirement savings mechanism.

According to the Tax Policy Center, the deductibility of employee inputs to retirement savings plans disproportionately benefits higher-income workers, because these workers contribute more and because they deduct their contributions at higher marginal tax rates. By contrast, the tax code provides few incentives for lower-income workers to save—although the Saver's Credit explicitly targets households with incomes under $50,000, providing about $1 billion in annual tax benefits.

[6] Gerald Prante, *Who Benefits from the Home Mortgage Interest Deduction?* The Tax Foundation, February 6, 2006. http://www.taxfoundation.org/research/show/1341.html.

Figure 8
Defined-Contribution Retirement Plans: Average Cash Savings, 2004[7]



Source: Burman, Gale, Hall, and Orszag, 2004.

Why Is Reform so Difficult?

Most budget experts—and many social policy advocates—readily admit the shortcomings of tax expenditures as a policy instrument. Not only have they contributed to America's sprawling tax code, but the evidence also suggests that tax expenditures disproportionately benefit the wealthy, distort market incentives, cloud important policy debates, and supplant more efficient uses of government revenue.

Nevertheless, reforming tax expenditures has proved formidable for a generation of presidents and policymakers. Reform of any longstanding government program is difficult, but there are several reasons why tax expenditures have been particularly intractable:

- Because tax expenditures are tools for achieving policy goals, rather than goals themselves, debates about their merits are muddied.
- Tax expenditures are popular with both political parties, as they can be marketed as either tax cuts (appealing to many Republicans) or social programs (appealing to many Democrats).
- Many of the policy objectives behind tax expenditures are generally worthwhile and enjoy bipartisan support, even if tax expenditures are not the most effective means of fulfilling those objectives.
- Powerful interests have invested significant resources in maintaining the status quo.

[7] Leonard E. Burnan, William G. Gale, Matthew Hall, and Peter R. Orszag, *Distributional Effects of Defined Contribution Plans and Individual Retirement Accounts*. Urban-Brookings Tax Policy Center, August 2004. http://www.urban.org/UploadedPDF/311029_TPC_DP16.pdf.

- Because most tax expenditures are *available* to the middle class, even if they disproportionately benefit the wealthy, they enjoy broad popularity with the public.

What Might Reform Look Like?

Short of eliminating many tax expenditures outright, advocates have proposed reforms including the following:

- Replace deductions and exclusions with tax credits, to increase the benefits for lower-income workers.
- Lower the absolute dollar limit of certain deductions and exclusions, and/or the rate at which they are assessed.
- Increase the scrutiny and transparency of existing tax expenditures.
- Treat tax expenditures more like spending programs in government accounting and the public discourse.

Tax expenditures play a vital role in social policy at the federal level, yet often go unnoticed in public discourse. As policymakers seek novel solutions to pressing social problems amid tighter fiscal times, this trillion-dollar system warrants closer examination.

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Community Development and Federal Subsidies: A View from 40,000 Feet

Alan Okagaki

Overview

This paper presents a broad overview of the community development industry and its use of subsidy, examining historic trends and speculating about the future. Its approach is to contextualize community development within federal poverty policy and within a changing economic and financial services world.

One of the conclusions I reach is that community development as it is currently envisioned commands a small fraction of public subsidy and plays a relatively small role in national poverty policy. My observations suggest a set of questions that the community development field will need to answer about its use of public subsidy in light of the changing economic, financial, and fiscal contexts: What should the role of community development be within federal poverty policy? What institutional infrastructure is necessary for community development to be undertaken effectively? And what subsidies are necessary to build this infrastructure?

Historic Connections: Community Development and Federal Anti-Poverty Policy

The modern community development movement originated arguably in the 1960s. The Economic Opportunity Act of 1964—the centerpiece of the War on Poverty–declared:

> [It is] the policy of the United States to eliminate the paradox of poverty in the midst of plenty in this Nation by opening to everyone the opportunity for education and training, the opportunity to work, and the opportunity to live in decency and dignity.

Prior to 1964, the federal government had established programs that addressed the *effects* of poverty. For example, the Housing Act of 1937 provided federal subsidy to construct public housing for low-income families; the Social Security Act of 1935 created Aid to Dependent Children, an income transfer program for poor families; and the Housing Act of 1949 ushered in “urban renewal,” efforts to eliminate physical blight and create “a suitable living environment for every American family.” With the 1964 Economic Opportunity Act (the Act), however, the federal government took responsibility for eliminating the *root causes* of poverty. The Act, in concert with other legislation, took a four-pronged approach: 1) macroeconomic policy to stimulate economic growth (a tax cut); 2) workforce programs to prepare poor people for the new jobs; 3) civil rights legislation to end discriminatory hiring practices; and 4) bureaucracy reform intended to increase service coordination and political participation by the poor themselves.[1] On paper, these four strands framed a coherent, plausible anti-poverty strategy.

Overseen by the newly-created Office of Economic Opportunity (OEO), the Act funded a number of programs that still exist today such as Head Start, Volunteers in Service to America (now Americorps VISTA), Job Corps, Legal Services (now the Legal Services Corporation), Summer Youth Programs, Adult Basic Education, and others. It also created the Community Action Program (CAP) and by 1966 was funding some 1,600 local community action agencies (CAAs).[2] While some 90 percent of CAP expenditures supported social services, an underlying assumption of the CAP was that poor people should have a stronger voice with the political institutions that affected their lives. Accordingly, the early

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[1] Robert H. Haveman. “Introduction: Poverty and Social Policy in the 1960s and 1970s—An Overview and Some Speculations” in Robert H. Haveman (ed.) *A Decade of Federal Antipoverty Programs: Achievements, Failures, and Lessons.* New York: Academic Press, 1977.

[2] Robert F. Clark. *The War on Poverty: History, Selected Programs and Ongoing Impact.* Lanham, MD: University Press of America, 2002.

community action agencies were largely independent of local governmental control and functioned as platforms for community empowerment and political reform. Mayors and other officials found this activism to be untenable, however, and later drove amendments to the Act that gave local governments more control over the CAAs and dimmed the promise of community participation.[3]

The Emergence of Place-Based Programs

While the CAAs operated in low-income *areas*, they primarily delivered a collection of *people-based* social services, many aimed at preparing the poor for jobs. However, advocates for community development believed that successful *communities* were necessary for poor people to compete economically and integrate into mainstream society. They called for new efforts to build strong communities that would be led by local institutions trusted by local residents. In 1966, Senators Robert Kennedy and Jacob Javits introduced Amendment I-D to the Act, creating the Special Impact Program (SIP) which emphasized the role of economic development in alleviating poverty.[4] The SIP funded community development corporations (CDCs), place-based non-profit organizations that could carry out a wide spectrum of market-oriented activities. The early CDCs were governed by community-controlled boards of directors. These institutions were not "invented" by federal government, but rather their precursors had already formed in certain neighborhoods as local responses to local needs. With federal funding available, these rudimentary CDCs proliferated and by the mid-1970s, they numbered about 100 to 150.

Thus, community development emerged as a place-based complement to the original people-based programs of the Economic Opportunity Act. The practice of community development, as embodied in the CDCs, assumes that poverty is a function of place and environment rather than just the "shortcomings" of particular individuals. It sees poverty as a consequence of interconnected factors that require action on multiple fronts, including economic development, workforce preparation, housing, social services, physical infrastructure, education, and public safety. Unlike social service interventions, community development deploys market-related tools such as real estate development and business development to address the economic roots of poverty. Community development also asserts that residents can and should shape the future of their communities.[5]

The Nixon administration disbanded the OEO in 1974 and direct federal support to CDCs diminished. However, in 1974, Congress merged seven categorical federal funding programs into community development block grants (CDBG), distributed to cities and states on the basis of need, with goals of extinguishing poverty and urban blight. Many cities began funding CDCs out of their CDBG allocations and, thus, the number of CDCs actually grew even though the SIP was being phased out.

In the 1980s and 1990s, more CDCs formed as a result of changes in federal housing policy. Under the Reagan administration, federal support for low-income housing was reduced by 70 percent, and states and localities had to come u0070 with new solutions.[6] A second wave of CDCs was started in the 1980s, generally smaller organizations specialized in building affordable housing. Their growth was aided by three national intermediaries—NeighborWorks America, the Local Initiatives Support Corporation (LISC), and Enterprise Community Partners—who mobilized public, private, and philanthropic resources and created financing and capacity building systems to support affordable housing. The Community

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[3] Lawrence F. Parachini, Jr. *A Political History of the Special Impact Program.* Cambridge, MA: Center for Community Economic Development, 1980.

[4] Julia Sass Rubin. "Chapter 1: Introduction" in Julia Sass Rubin (ed), *Financing Low-Income Communities: Models, Obstacles, Future Directions.* New York: Russell Sage Foundation, 2007.

[5] Neal R. Pierce and Carol F. Steinbach. *Corrective Capitalism: The rise of America's Community Development Corporations.* New York: Ford Foundation, 1987.

[6] Diane R. Suchman, et al. *Public/Private Housing Partnerships*. Washington, DC: Urban Land Institute, 1990.

Reinvestment Act (CRA) of 1977 incentivized banks to increase their lending in the low- and moderate-income communities where they operate and banks became an important financing partner in affordable housing. The Low Income Housing Tax Credit (Tax Reform Act of 1986) created an incentive for private equity investment in affordable housing.

By 1988, the country had 1500 to 2000 CDCs.[7] In 1990, Congress authorized the HOME Investment Partnership Program, a block grant distributed by the Department of Housing and Urban Development (HUD) subsidizing housing for low and very low-income Americans. The HOME program is the largest federal grant program for low-income housing. It also requires that jurisdictions reserve 15 percent of their funding for projects developed, sponsored, or owned by non-profit community housing development organizations (CHDOs). Thus, the HOME program catalyzed formation of still more CDCs in the 1990s.

Another set of community-based development organizations, community development financial institutions (CDFIs), emerged in the 1960s and 1970s.[8] These mission-driven institutions include non-profit loan funds, microenterprise funds, credit unions, venture capital companies, and banks. They provide loans, investments and other financial services to individuals and organizations inadequately served by conventional financial institutions.

The early CDFIs did not have a dedicated federal funding resource like SIP. Instead, they raised capital and operating subsidy from philanthropy and from diverse programs within HUD, the U.S. Department of Agriculture (USDA), and the Department of Commerce. Like CDCs, CDFIs were affected by CRA and the housing devolution policies of late 1980s. Many CDFIs were started or evolved to meet the financing needs of affordable housing development organizations. The creation of the CDFI Fund within the Treasury Department (1995) further accelerated the industry's growth. Although the program has never been large (the core funding program usually has no more than $100 million available each year), it can provide the core equity capital with which CDFIs can leverage the more readily available debt capital from banks and other sources. The New Markets Tax Credit (NMTC) program, established in 2000, provided an incentive for private investment in job creating projects located in low-income communities. With these federal subsidies, the CDFI industry expanded rapidly in the 1990s and 2000s.

This framework of federal policies and subsidy programs–CDBG, HOME, CRA, CDFI Fund, LIHTC and NMTC—propelled the growth of the community development industry through the 2000s. A 2005 census of CDCs estimated 4,600 CDCs across the country.[9] A more recent study reported community developer production at nearly 100,000 affordable housing units annually with cumulative production over 1.6 million units.[10] CDCs had also developed over 21 million square feet of commercial and industrial space between 2005 and 2007. As of December 2010, the federal CDFI Fund had certified 931

[7] *Reaching New Heights: Trends and Achievements of Community-Based Development* Organizations. Washington, DC: National Congress for Community Economic Development Census, 2005. http://www.ncced.org/documents/NCCEDCensus2005FINALReport.pdf.

[8] This history of CDFIs is taken from Kirsten Moy and Alan Okagaki, *Changing Capital Markets and Their Implications for Community Development Finance.* Washington, DC: Brookings Institution, 2001; and Julia Ann Parzen and Michael Hall Kieschnick, *Credit Where It's Due: Development Banking for Communities.* Philadelphia: Temple University Press, 1992.

[9] *Ibid*.

[10] *Rising Above: Community Economic Development in a Changing Landscape.* Washington, DC: National Alliance of Community Economic Development Associations, 2010, www.naceda.org.

CDFIs.[11] In 2008, the Opportunity Finance Network reported data from 495 institutions that collectively had total assets of $29.4 billion and total financings outstanding of $20.4 billion.[12]

Evolving Models

The community development industry has morphed in profound ways over 40 years. It shifted strongly towards affordable housing in the 1980s and 1990s. In order to reach scale and become financially self-sustaining, many organizations followed a path of tight financial management, standardized products and services, and more efficient systems based on IT platforms. Often, these organizations chose to become highly specialized rather than working across the multiple dimensions of poverty. Many have also de-emphasized the less tangible aspects of community development such as empowering residents, participating in political alliances, and acting as a nexus point between community and external actors.

As a response to the trend of specialization, a new form of community development, sometimes referred to as "comprehensive community-building initiatives" (CCIs), appeared in the 1990s. While CCIs varied greatly, they generally assessed a community's assets and problems holistically; involved community residents in designing and executing a plan of action, and engaged a diverse array of community, civic, private and public sector partners. Their activities spanned a wide range as they sought economic and social change in the livelihoods of individuals and families, in neighborhoods, and in public and civic systems. In her review of the 20 year history of CCIs, Anne Kubisch lists 43 major community building initiatives, many carried out in multiple neighborhoods.[13] However, many prominent CCIs were time-limited experiments that did not culminate in permanent institutions, programs, or partnerships. While some CCI principles were embedded in federal programs such as HOPE VI, the Empowerment Zones, and Weed and Seed, it is hard to connect the CCI movement to particular federal policies or subsidy sources. More often, foundations and local governments have been the driving force behind CCIs.

Interestingly, the major intermediaries have been shifting towards more holistic conceptions of community development in recent years. The Neighborhood Housing Services network rebranded itself as "NeighborWorks America" to communicate its wider set of community concerns. Living Cities, a major philanthropic intermediary, has rolled out a new funding strategy based on "a general recognition that we need to treat our cities' problems comprehensively—strengthening neighborhood institutions from the bottom up and reengineering, from the top down, the public systems that fail to create adequate opportunities."[14] Similarly, LISC has re-tooled itself around a vision of Sustainable Communities, where "human opportunity and social and economic vitality combine with a continuous process of growth, adaptation, and improvement."[15] NeighborWorks, Living Cities, and LISC are moving back towards the original conception of CDCs: comprehensive approaches to poverty and development, resident engagement, and CDCs acting as a bridge between communities, the public sector, and the market.

There are numerous examples of individual CDCs and CDFIs taking integrated approaches. For example, in 2009, the Ford Foundation's Rural Livelihoods Learning Group studied five organizations serving chronically impoverished rural areas: Enterprise Cascadia in the Pacific Northwest, Southern

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[11] *Certified Community Development Financial Institutions—By Organization Type.* Washington, DC: The CDFI Fund, 2010, http://www.cdfifund.gov/docs/certification/cdfi/CDFIbyOrgType.pdf.

[12] CDFI Data Project. *Providing Capital, Building Communities, Creating Impact. Fiscal Year 2008; 8th Edition,* http://opportunityfinance.net/store/downloads/cdp_fy2008.pdf.

[13] Anne C. Kubisch, Patricia Auspos, Prudence Brown, and Tom Dewar. *Voices from the Field III: Lessons and Challenges from Two Decades of Community Change Efforts*. Washington, DC: Aspen Institute, 2010.

[14] Living Cities Integrative Approach, http://www.livingcities.org/innovation/integrative/.

[15] LISC Annual Report for 2009, http://www.lisc.org/annualreport/2009/pdf/09report.pdf.

Bancorp in the Mississippi Delta, Mountain Association for Community Economic Development and Federation for Appalachian Housing Enterprises in Appalachian Kentucky, and Four Bands Community Fund on the Cheyenne River Reservation in South Dakota. The research was part of an international study of "hybrid organizations," so called because they bring together unusual combinations of poverty strategies. All five organizations are CDFIs, but they view their missions much more expansively than loans or financial services. Each has a deep analysis of poverty that encompasses local economic, political, social, and cultural factors. Their strategies attack poverty at multiple levels, from the individual to broader systemic and policy change. They operate in partnership with other organizations that provide complementary services and institutional strengths. They are actively engaged in their communities and, in different ways, seek to empower residents or cultivate local leadership.

The world of community development today is more complex than it was in the 1960s and 1970s. There are dozens of federal funding sources, and even more philanthropic and private funding sources. There are many types of organizations engaged in community development activities besides CDCs and CDFIs, including social service agencies, civic associations, foundations, local governments, community advocacy groups, and universities. The boundaries of community development activities are murky: A compendium on *Reengineering Community Development for the 21st Century* contains papers on bicycling, smart growth, foster care, crime, and transformational asset building.[16] The complexity and murkiness have made it more difficult to place community development into the broader framework of American anti-poverty policy. This problem arises in part because of the confusing shape of federal poverty policy generally. For all of its failings, one could find policy coherence in the 1960s War on Poverty and one could logically fit community development within that framework. In today's milieu, community development has grown not so much as an intentional result of federal policy, but opportunistically, as community development entrepreneurs have found ways to exploit subsidy sources in the federal budget.

Community Development and its Present Use of Subsidy

So what does the current picture of federal subsidy for community development look like? Cashin, Gerenrot, and Paulson estimated total governmental community development expenditures in 2004 at over $45 billion.[17] Their analysis defines community development as "construction, operation, and support of housing and redevelopment projects and other activities to promote or aid public and private housing and community development" and it includes state and local expenditures in addition to federal support. The Federal Reserve Bank of Boston placed federal community development spending at about $22 billion in Fiscal Year 2004, excluding procurement, wages and salaries, and tax expenditures such as the Low Income Housing Tax Credit (LIHTC).[18] This analysis divided the federal budget into 20 "functional" categories, of which community development is one. However, community development practitioners utilize subsidy programs that are classified in other functional categories, such as business and commerce, housing, education, and employment, labor and training. This estimate also does not include all federal spending that supports key community development activities such as

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[16] Donna Fabiani and Terry F. Buss (eds). *Reengineering Community Development for the 21st Century.* Armonk, NY: M.E. Sharpe, 2008.
[17] "Determinants of Federal and State Community Development Spending: 1981–2004," *Profitwise News and Views.* Chicago: Federal Reserve Bank of Chicago, 2007, http://www.chicagofed.org/digital_assets/publications/profitwise_news_and_views/2007/pnv_regedoct07_web_casgerpau.pdf.
[18] "Federal Spending and Incentives: What Does the Data Tell Us?" *Community Affairs Brief* (unpublished). Boston: Federal Reserve Bank of Boston, 2007.

institution building, community mobilization, and connecting local economies and residents to external resources.

A different approach to elucidate federal subsidies for community development is to examine the funding sources for CDCs and CDFIs, two large categories of institutions that self-identify with community development. The 2005 census of CDCs reported that 88 percent of all CDCs received at least $50,000 in grants investments or loans from the federal government, followed by banks (49 percent) and foundations (49 percent).[19] The 2007 CDC census listed the following federal programs as most frequently accessed by CDCs: HUD HOME Program (53 percent of all CDCs), HUD's Community Development Block Grant (CDBG) program (40 percent), HUD's Section 8 program (28 percent), and the LIHTC program (28 percent). However, the most striking finding is the sheer number of federal programs utilized by CDCs. The 2007 Census lists 37 separate federal funding sources, several of which represent multiple funding programs. The total number of distinct federal programs utilized by CDCs might very well exceed 100.

Data of comparable quality has not been collected on the subsidy sources for CDFIs. However, in a 2007 survey by the Aspen Institute Economic Opportunities project, nearly 80 percent of respondents listed the government (not differentiated by federal, state or local) as one of their top three funding sources, followed by foundations (66 percent) and private financial institutions (50 percent).[20] As with CDCs, CDFIs piece their funding together from many different federal programs. The CDFI Fund in the Treasury Department administers several funding programs including the NMTC program. In addition, HUD, USDA, and the SBA have various specialized programs which provide capital or operating subsidy to CDFIs.

Table 1 presents 2009 federal budget data, primarily taken from the *Catalog of Federal Domestic Assistance,* for some of the most important CDC and CDFI funding programs. The data suggests that programs targeted specifically to CDCs and CDFIs (such as the CDFI Fund) are usually small. For the larger subsidy sources, such as the HUD programs, CDCs and CDFIs compete with local government, other non-profits, and for-profit companies and receive only a fraction of the total funds available. For the single biggest funding source, the USDA Section 502 Single Family Loan Program, the subsidy flows directly from USDA to the homebuyer and thus, does not contributes to the financial strength of a CDC or CDFI.

Table 1
Federal Funding Sources for CDCs and CDFIs, $ millions[21]

CDC Funding Sources	2009 Budget	CDFI Funding Source	2009 Budget
HUD HOME Program	$1,825	CDFI Fund, Core Financial Assistance	$102
HUD CDBG	$3,634	CDFI Fund, BEA	$22
HUD Section 202/811 Elderly/Disabled Hsg	$1,086	SBA Microloan Program	$74
HUD McKinney Act Shelter & Care	$593	USDA Intermediary Relending Program	$34

[19] *Reaching New Heights,* 2005
[20] Aspen Institute Economic Opportunity Program. *Approaches to CDFI Sustainability* Aspen Institute, July 2008.
[21] NMTC data from www.cdfifund.gov; data for LIHTC from http://www.novoco.com/low_income_housing/resource_files/research_center/cbo_housingprograms_110309.pdf; and remaining data from the *Catalog of Federal Domestic Assistance,* www.cfda.gov.

USDA Section 502 Single Family	$9,034	USDA Rural Business Enterprise Grants	$38
USDA Section 523 Self Help Housing	$32	Charter School Credit Enhancement	$8
Low Income Housing Tax Credit	$6,000	New Markets Tax Credit	$5,000

How much of these federal community development expenditures are captured by CDFIs and CDCs is largely guesswork. The federal programs that provide the most dollars to CDCs and CDFIs are probably the HUD HOME program, the LIHTC, and the NMTC program. A very rough estimate is that CDCs and CDFIs receive a third of the total allocation from the first two sources and a smaller fraction of the NMTC program. Using these figures as a base, I estimate that the total federal subsidy received by CDCs and CDFIs is likely more than $4 billion but probably less than $8 billion.

Subsidies to CDCs and CDFIs should be viewed in the larger context of the federal budget. According to the Center for Budget Policy and Priorities, in fiscal year 2010, the federal government spent $3.5 trillion, of which $496 billion (14 percent) supported safety net programs.[22] Thus, CDCs and CDFIs capture between 0.1 percent and 0.2 percent of the total federal budget, or about 1 percent to 2 percent of federal expenditures for safety net programs.

Another part of the subsidy picture for community development is the flow of resources from banks and thrifts to low-income communities as a result of CRA.[23] The CRA changed the behavior of banks with respect to lower-income areas both in terms of amount and nature of lending, investment, and services. As a result of CRA, banks provide more money and have also developed innovative products to serve this population. Collectively, banks benefit from the greater information available about these markets as a result of their CRA activities, and now see these neighborhoods as viable places to do business. Banks can receive CRA credit for their support to CDCs and CDFIs, thereby supporting the community development infrastructure in these communities. The aggregate volume of this lending is substantial. In 2008 (before the recession), banks and thrifts made $60 billion of small business loans and $73 billion of community development loans to low- and moderate-income (LMI) census tracts. They originated and held $12 billion of mortgages in LMI census tracts; Fannie Mae, Freddie Mac, and Ginnie MAE originated and held another $98 billion of mortgages. The total volume of CRA-related lending in 2008 was $243 billion.[24]

Table 1 also identifies that community development utilizes subsidies in many different forms other than direct grants, including tax expenditures (LIHTC and NMTC), loans, and loan guarantee or insurance

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[22] "Where Do Our Federal Tax Dollars Go?" *Policy Basics* (Washington, DC: Center on Budget and Policy Priorities, updated April 15, 2011), http://www.cbpp.org/files/4-14-08tax.pdf. Safety Net Programs include income security functions such as the refundable portion of the Earned Income and Child Care tax credits, Supplemental Social Security Income for the elderly or disabled, unemployment insurance, food stamps, school meals, low-income housing assistance, child-care assistance, assistance in meeting home energy bills, and various programs for abused and neglected children, but not social security, Medicare or Medicaid.

[23] CRA encourages commercial banks and savings associations to meet the credit needs of borrowers in all segments of their communities, including low- and moderate-income neighborhoods, consistent with safe and sound operation. Regulatory agencies examine banks for CRA compliance and use this information when considering applications for new bank branches or mergers and acquisitions, See http://www.fdic.gov/regulations/laws/rules/6500-2515.html#6500hcda19.

[24] CRA data from the Federal Financial Institutions Examination Council, http://www.ffiec.gov/craadweb/national.aspx. In 2009, banks and thrifts made $43 billion of small business loans and $35 million in community development loans to LMI census tracts. They originated and held $16 billion of mortgages in LMI census tracts; Fannie Mae, Freddie Mac, and Ginnie MAE originated and held another $105 billion of mortgages. The total volume of CRA-related lending in 2009 was $199 billion.

programs. Federal poverty policy since the 1970s has moved beyond the traditional tools of income transfer payments, direct service provision by government, and federal grants to include a larger set of tools such as tax expenditures, regulation, loans, loan guarantees, and insurance. The new policy tools help leverage private investment (as with tax credits and loan guarantees) and recycle capital (as with loans) but require financial sophistication to deploy. These alternative tools are often large compared to the more traditional grant programs. For example, LIHTC, at almost $6 billion, is several times the size of the HUD HOME Investment Partnership Program, at $1.8 billion.

To summarize, the total volume of subsidies to CDCS and CDFIs is small compared to other federal anti-poverty expenditures and the funding is highly fragmented, a patchwork quilt rather than an intentionally designed funding system. Much of the subsidy takes the form of loans, loan guarantees, and tax credits rather than direct grants. About one-half of CDCs and one-half of the CDFIs cite banks and other private financial institutions as significant sources of funding, which suggests the powerful role that CRA has played in the overall funding system. The flow of private sector lending into LMI communities ($242 billion) prompted by CRA is much larger than the federal subsidies for community development as a whole ($45 billion) or to CDCs and CDFIs (estimated between $3 and $6 billion).

Looking to the Future

Thus far I have looked backward at how federal anti-poverty policy and subsidy programs have helped shape the modern community development sector. Below I examine four trends with the potential to significantly alter the shape of the community development sector going forward. Each trend presents an opportunity for community development organizations to leverage their assets to strengthen their value proposition. These trends also pose some opportunities and problems to be addressed by future reform of community development policy and subsidy.

The Significance of Place

Since the 1960s and early 1970s, the fundamentals of our economic geography have been transformed. The “global economy” has become a cliché and nearly all markets evidence a much higher degree of geographic integration. A neighborhood can no longer be plausibly treated as a semi-autonomous economic unit. Instead, it functions within an interconnected metropolitan economy. Rural economic development, which had previously been the province of individual towns and counties, is similarly moving towards regional approaches that encompass many counties and often cross state lines.[25] For everyone, the internet and overnight shipping have disconnected business from place.

The changing economic geography calls into question the continued significance of place. Many have argued that the nation should invest solely in people-based anti-poverty policies—education, training, job and family counseling, relocation assistance—rather than place-based policies. Place-based policies are thought to be economically inefficient because they “trap” poor people in low-income areas and because they distort business and human migration decisions.[26] Community development takes a more nuanced view about the relationship between poor people and poor places, a view which is supported by a recent body of literature. Research on “concentrated poverty” demonstrates that poor people living in very poor communities face a double burden, the challenge of surviving on insufficient income plus the problems associated with poverty-stricken areas. These problems include: 1) fewer local

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[25] Brian Dabson, *Generating Rural Innovation and Regional Partnership,* Keynote Presentation at the 2010 Northeast Rural Summit, Burlington, VT, April 2010. http://www.rupri.org/Forms/Dabson_NortheastRuralSummit_April2010.pdf.

[26] See, for example, David Kraybill and Maureen Kilkenny, “Economic Rationales For and Against Place-Based Policies,” *Staff General Research Paper No. 1173*, Department of Economics, Iowa State University, 2003.

job opportunities, limited local amenities, and lack of quality housing options; 2) higher prices for goods and services; 3) lack of networks that help people find jobs and advance in their careers; 4) weaker schools; 5) high crime; and 6) depressed property values.[27]

Areas of concentrated poverty persist over time. Partridge and Rickman found an 84 percent correlation between county-level poverty rates in 1979 and 1999.[28] The USDA's Economic Research Service has identified 340 "persistently poor" non-metropolitan counties which have had poverty rates of 20 percent or greater in every decennial census between 1970 and 2000.[29] Jargowsky found that while the national poverty rate was fairly constant between 1970 and 1990, the number of poor people living in urban high-poverty neighborhoods almost doubled.[30] This pattern reversed somewhat in the 1990s, evidently the product of strong economy.[31] However, as poverty rates increased in the 2000s, the pattern of geographically concentrated poverty reappeared and strengthened. While poverty and unemployment rates broadly track each other at the national level, Partridge and Rickman found this relationship does not necessarily hold within smaller geographies. They write: "poverty varies greatly within broad regions. Even within narrower areas such as states or metropolitan areas, clusters of high and low poverty often exist in relatively close proximity...[A]t the state or more broadly, the regional level, there can be large relative changes in poverty rates over time, but at the disaggregated county level, relative poverty is often quite persistent."

Partridge and Rickman's research offers four insights on the relationship between county-level poverty rates and labor market trends. First, county-level poverty rates respond slowly to economic shocks such as a decrease in the unemployment rate. Job growth does eventually reduce the local poverty rate but only after a long period of time. While a five year period of sustained job creation yielded an impact on poverty rates, job growth over a two year period did not. Second, child poverty rates were more sensitive to changes in local labor market conditions than the overall adult poverty rates. Thus, reducing local unemployment rates had a more powerful impact uplifting families with children than it did on households without children. Third, in metropolitan areas, new job growth had a stronger effect on reducing poverty in the inner city than it did in the suburbs. Fourth, in rural areas, employment growth appeared to have a stronger impact on reducing poverty than it did for the country as a whole.

The Federal Reserve System and the Brookings Institution researched persistent concentrated poverty in 16 communities across the country.[32] The study examined diverse areas: urban and rural geographies and weak and strong markets composed of populations with different ethnic and racial backgrounds. A common theme among the case studies was isolation between the community and the surrounding regional economy. Isolation sometimes took the form of physical barriers such as an Indian Reservations located many miles from metropolitan areas or a freeway separating a neighborhood from the downtown or segregated neighborhoods resulting from exclusionary zoning. In other cases, racial or ethnic discrimination or linguistic barriers produced the isolation. The research also revealed poverty as a problem with multiple and interconnected causes. According to the report, "The high levels of poverty in these communities are the product of long-term, complicated economic and social dynamics, as well

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[27] David Erickson, et al., eds., *The Enduring Challenge of Concentrated Poverty in America: Case Studies from Communities Across the U.S.,* The Federal Reserve System and the Brookings Institution, 2008.
[28] Mark D. Partridge and Dan S. Rickman, *The Geography of American Poverty: Is There a Need for Place-Based Policies?* Kalamazoo, MI: W.E. Upjohn Institute for Employment Research, 2006.
[29] Rural Income, Poverty, and Welfare: Poverty Geography, USDA Economic Research Service, http://www.ers.usda.gov/Briefing/IncomePovertyWelfare/PovertyGeography.htm.
[30] Paul Jargowsky, *Povery and Place: Ghettos, Barrios, and the American City,* New York: Russell Sage Foundation, 1997.
[31] Erikson et al, 2008.
[32] *Ibid*.

as deliberate public- and private-sector actions." A third theme was the importance of history in persistent poverty. In most of the case studies, communities had experienced high poverty rates for more than three decades and economic decline could be traced to specific events.

The complex interaction of history and social, economic, and cultural variables suggest that neither macroeconomic policy nor people-based policies on their own can effectively impact concentrated, place-based poverty. There is a disconnect between persistently poor communities and the larger economy that can be seen quantitatively through labor market analysis and more qualitatively through history and this theme of isolation. This disconnect suggests the relevance of community development methodologies: targeting a persistently poor community, strengthening internal capacities, and making connections to regional economic strengths. The renewed emphasis on comprehensive and integrated anti-poverty strategies aligns well with this research on the importance of place.

The Changing Financial Services Industry

The transformation of the financial services world continues to shape community development. When the CRA was passed in 1977, banks and other depositories held 57 percent of all financial industry assets, the national personal savings rate fluctuated between 8 percent and 12 percent , predatory lending was largely left to loan sharks rather than publicly traded corporations, the check cashing industry had a minor presence, and workers had pensions rather than 401(k)s and IRAs.[33,34] In 2009, depositories held 27 percent of financial industry assets, the personal savings rate fluctuated between 0 percent and 4 percent (during 2000-2009), predatory financial products flooded many communities, not just low-income ones, and the shift away from defined benefit retirement plans and new, complex financial products has made managing personal finances much more challenging. During the 1970s, banks satisfied most of the average person's financial needs: they provided credit, savings accounts, and transactions products such as checking accounts and credit cards.

Since then, the economics of banking have worked to the disadvantage of low-income communities and people. Low-income consumers, on average, maintain low account balances, have only one or two accounts, make a large number of small transactions, and tend to conduct their business with tellers rather than through low-cost transaction channels such as the Internet and ATMs. Banks have increasingly focused on costumers in the top three income quintiles in order to remain profitable. As such, they have increasingly weeded out low- and moderate-income customer segments through fees and minimum balance requirements.[35]

With banks moving upmarket, check cashers, payday lenders, and other alternative service providers have grown in number and scope. A 2006 study of the industry estimated 13,000 check cashing outlets, cashing over $80 billion of checks annually, of which 80 percent to 90 percent were payroll checks with an average size of $500 to $600.[36] Alternative service providers provide over 100 million payday loans annually, often at annual interest rates equivalent of 261 percent to 913 percent.[37] A 2008 survey by the Center for Financial Services Innovation study found that about one-third of the

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[33] Statistics on the share of financial industry assets held by banks and thrifts are taken from Board of Governors of the Federal Reserve System, *Flow of Funds Accounts of the United States*, Third Quarter 2009.
[34] This and subsequent statistics on personal savings rate are taken from http://en.wikipedia.org/wiki/File:US_personal_saving_rate_1960-2010.jpg.
[35] See *FDIC National Survey of Banked and Underbanked Households.* December 2009, http://www.fdic.gov/householdsurvey/full_report.pdf and John P. Caskey, *Lower-Income Americans, Higher-Cost Financial Services.* Madison, WI: Filene Research Institute, 1997.
[36] Mark S. Gottlieb, *Check Cashing: An Industry Survey.* Great Neck, NY: MSGCPA, 2006, www.msgcpa.com.
[37] *Ibid.*

U.S. population had made at least one non-bank financial transactions in the past 30 days.[38] While the median household income of those making the transactions was low ($26,390 compared to a national median household income of $50,740), most were employed full-time or part-time and of those not employed, more than half were either retired or homemakers.

The economic crisis begun in 2007 has significantly impacted bank lending in lower-income communities. Despite the infusion of hundreds of billions of TARP funds, credit markets remain constricted because of slow demand and tighter underwriting standards.[39] It is also clear that low-income neighborhoods, minority and poor populations, have been hit hardest by contraction of the financial services industry. LISC reported that community development lending—which includes lending for real estate development including multi-family housing and to nonprofits—has substantially decreased and that the only such lending that is going on is a result of CRA.[40] A study by a consortium of CRA and fair lending advocates examined changes in prime conventional mortgage lending in seven major cities between 2006 and 2008. It found that prime mortgage lending declined by 60.3 percent in communities of color as compared to 28.4 percent in predominantly white neighborhoods, and that prime refinance dropped by 6.4 percent in communities of color, compared to 13.9 percent in white areas.[41] In light of factors such as tighter credit markets, the seizing up of securitization markets, and the decline in credit ratings of households and small businesses in lower-income areas, how quickly and how extensively bank lending in these communities will return is an open question.

Similarly, the future of community development institutions within this evolving picture is unclear. Capacity is well-developed in some segments of the financial services market and underdeveloped in others. In the affordable housing industry, CDCs and CDFIs account for at least one third of total federally subsidized housing units produced.[42] Similarly, CDCs and CDFIs have captured a significant share of the low-moderate income mortgage market in certain low-income communities. On the other hand, CDFIs made only 21,000 payday loan alternatives in 2007 which is 1/6000th the number of loans made by the payday lenders.[43] CDFIs financed or assisted about 9,000 small businesses and microenterprises in 2007, whereas banks and thrifts reported making about 310,000 small loans (less than $1 million) to businesses in low-income census tracts. Thus, CDFIs reach at least 3 percent of the total number of businesses served by banks and thrifts. If we allow for the probability that some businesses received multiple loans from banks, this figure might be as high as 5 percent.

While the total volume of lending by CDFIs in low-income communities is small compared to bank lending, these numbers understate their role in those markets. With affordable rental projects, community facilities and even homebuying (where second mortgages or downpayment assistance is involved), CDFIs often serve critical functions in complex systems that leverage private and public sector financing. A paper entitled "Evolving Roles of Mission-Focused and Mainstream Financial Organizations" by Newberger, Berry, Moy and Ratliff explores the role of CDFIs as intermediaries between the financial industry and low-income communities. The study profiles nine CDFIs and the techniques they use to leverage mainstream capital into community development projects or low-income communities. It

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[38] *The CFSI Underbanked Consumer Survey: Underbanked Consumer Overview and Market Segments, Fact Sheet.* Chicago, IL: Center for Financial Service Innovation, 2008.

[39] Binyamin Appelbaum, "Cautious about the Economy, Big Banks Report Slow Lending" *Washington Post*. January 21, 2010. http://www.washingtonpost.com/wp-dyn/content/article/2010/01/20/AR2010012000875_pf.html.

[40] Benson F. Roberts, Local Initiatives Support Corporation. Testimony on Community Reinvestment Act before U.S. House Committee on Financial Services. September 16, 2009.

[41] California Reinvestment Coalition, et al. *Paying More for the American Dream: The Decline of Prime Mortgage Lending in Communities of Color*. May 2010. http://www.woodstockinst.org/publications/research-reports/10/

[42] *Rising Above*, 2010.

[43] Loan origination data obtained from the CDFI Data Project. See http://www.opportunityfinance.net/industry/industry_sub2.aspx?id=236.

shows that even with regulatory pressure from CRA, capital often does not flow easily from the private sector into low and moderate income neighborhoods. CDFIs and CDCs must work hard and creatively to make that financing happen. The paper illustrates the CDFI/CDC role as a nexus between the low-income community and the private sector.

In addition to community development and business lending, low-income communities need access to basic consumer financial services such as checking and savings accounts, debit and credit cards, consumer loans, and credit counseling and financial literacy. Many consumers will want additional products such as loans for automobile purchase, home repair, home purchase and higher education, or other savings products such as mutual funds and retirement accounts. It is unlikely that a single institution such as the neighborhood bank will meet all of these needs. Instead, a more complex infrastructure will emerge consisting of several different types of service providers. The new infrastructure will likely be based heavily on new technology platforms, such as prepaid, reloadable debit cards, and other forms of smart cards. While banks and other depositories will be among the service providers, there are a host of new entrants, from large corporations such as Walmart, which offers prepaid debit cards and walk-in bill-paying service, to mission-driven non-profits such as Community Financial Resources (CFR), which offers a low-fee Visa pre-paid card as part of a suite of services for helping the poor build assets. With the proliferation of funding initiatives around savings Individual Development Accounts (IDAs), credit counseling, first time homebuyers, Volunteers in Tax Assistance (VITA) sites, a whole new infrastructure of community based organizations has also grown up providing financial education.

In sum, a new financial infrastructure for low-income neighborhoods must evolve, replacing the simpler historic role of the full service community bank.

The Intersection with Human Capital

Many of the early CDCs operated employment and training programs, a pattern which still holds today. The 2007 CDC census reported that Education and Training services were offered by 43 percent of community developers, Job Skills training by 22 percent, Job Readiness training by 20 percent, and Job Placement services by 20 percent.[44] However, our understanding of workforce issues has evolved over the last 30 years. In the 1980s and 1990s, workforce development was largely confined to two areas: 1) efforts to bring the chronically unemployed into the workforce through job placement, skills training, adult basic education, and the like; 2) the school-to-work transition, including programs targeted at-risk youth and efforts to better align community colleges with labor market needs.

Over the last ten or fifteen years, the field has shifted to a broader conception of *human capital* development that incorporates cognitive growth in younger children and inter-generational effects. Human capital is cultivated over a long period of time, starting with birth, and continuing through early childhood education and elementary and high school. Rolnick and Grunewald, referencing the evaluation literature on educational preschool, have argued that early childhood development programs should be treated as an economic investment and that they yield a higher return on investment than other economic development programs.[45] Partridge and Rickman emphasize the importance of intergenerational linkage, noting a growing consensus in the literature that the income of a child’s family has long-term impacts on that child’s health, education, nutrition, and future income and welfare as an adult.[46]

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[44] *Rising Above*, 2010.
[45] Art Rolnick and Rob Grunewald. *Early Childhood Development: Economic Development with a High Public Return.* Federal Reserve Bank of Minneapolis, December 2003.
[46] Partridge and Rickman, 2006.

These intergenerational linkages suggest that investments that reduce poverty among families with young children may pay large benefits in the future. In contrast, Carneiro and Heckman (2003) note that later interventions, such as tuition policies for underprivileged college students, likely have smaller marginal effects on improving future earnings. Finally, a paper by Nancy Andrews takes the research on cognitive development and poverty and applies it directly to community development.[47] Research has found that stable housing situations reduces stress and facilitates cognitive development in infants. She argues that our vision cannot be community development alone, but rather community and human development together. A well functioning neighborhood is a place where investments are made in families and children, where they find the support they need to build the skills that secure a better future.

Human capital development is, of course, the quintessential people-based strategy. However, as Andrews writes, "Our field operates at the nexus between people and place."[48] Andrews identifies three major points of intersection between human capital and the built environment: child care, housing affordability, and education. In the last decade, the financing of charter schools and child care centers have become major growth sectors for CDFIs. CDCs have started or supported child care centers and family development programs that teach parenting skills such as techniques that enhance cognitive development. The comprehensive neighborhood development approaches advanced by LISC and Living Cities also reflect this marriage of people and place-based strategies. However, more fundamentally, practitioners must broaden their concept of community development to better incorporate human capital and look for more ways they can add value with their skill set. With their eyes looking to find new possibilities, innovation will follow.

Opportunity as an Overarching Theme

The public debate on federal poverty policy is largely tied up in a values struggle that pits individual self-reliance against the responsibilities of government. Americans place a high value on self-reliance and, consequently have conflicted attitudes towards public expenditures for the poor. A 2007 survey by the Pew Research Center for the People and the Press illustrates the ambivalence. It found 69 percent of respondents agree with the statement "Poor people are too dependent on government programs."[49] However, 69 percent also believed "Government should guarantee food and shelter for all," and "Government is responsible to take care for those unable to care for themselves."

Community development is fundamentally directed towards economic opportunity rather than entitlement. The Special Impact Program was administered by the Office of *Economic Opportunity*. The National Community Capital Association rebranded itself as the Opportunity Finance Network because the major purpose of CDFIs was to promote greater opportunity, not just to make loans. LISC describes community development as "places where human opportunity and social and economic vitality combine." The theme of opportunity resonates with the American public. In the Pew survey, 91 percent agreed that "our society should do what is necessary to make sure that everyone has an equal opportunity to succeed," the highest approval level of all 40 values statements tested by the survey.

This theme of opportunity is embedded deeply within the American psyche. It is synonymous with the American Dream, the notion that anyone can rise above his birth status and achieve a better life through hard work and initiative. As Herbert Croly wrote at the beginning of the 20th century:

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[47] Nancy O. Andrews with Christopher Kramer, "Coming Out as a Human Capitalist: Community Development at the Nexus of People and Place," *Community Investment Review.* San Francisco: Federal Reserve Bank of San Francisco, 2009.

[48] *Ibid.*

[49] As cited in Cliff Zukin, *The American Public and the Next Social Contract: Public Opinion and Political Culture in 2007.* Washington, DC: New America Foundation, 2008.

"[the native-born American and the alien immigrant] conceive the better future which awaits himself and other men in American as fundamentally a future in which economic prosperity will still be more abundant and still more accessible than it has yet been either here or abroad…The Promise, which bulks so large in their patriotic outlook, is a promise of comfort and prosperity for an ever increasing majority of good Americans."[50]

American social policy–including federal anti-poverty policy–can be interpreted through the lens of opportunity rather than in terms of entitlement. Michael Lind and David McNamee have re-conceptualized American social policy as a kind of *social contract*, "a system of economic and social arrangements—never permanent, always evolving—that help Americans as they exert themselves in individual efforts to achieve the American Dream."[51] While America often resists the European-style social welfare state, the nation has nevertheless sought to enlarge opportunity over its 220 year history.

Lind and McNamee argue that this American version of the social contract is consistent with the tradition of limited government and the "deeply rooted belief that individual dependence on public welfare is likely to corrupt dependent individuals and endanger the republic."[52] Compared to European social democracies, social welfare goals in America are more frequently pursued through publicly-incentivized private spending (tax expenditures) and regulation rather than direct public expenditures and programs. Federal resources are used to leverage state, local, private and philanthropic dollars; the private sector is incentivized to provide social goods rather than having those goods delivered directly by "big government." Consequently, the American system places the burden of execution more heavily on outside actors, such as private firms and non-profit organizations, rather than government bureaucracies.

Lind and McNamee identify five "pillars" that make up economic opportunity: economic liberty, economic access, economic ability, economic adequacy, and economic security. Within this schema, community development fits primarily within the category of economic access. Economic access "requires a dynamic economy in which concentrations of wealth tend to dissipate rather than endure and in which hard working Americans have access to property, credit and other resources necessary for individual success."[53] Lind and McNamee root economic access in the Jeffersonian ideal of the yeoman farmer, who was not dependent on an employer for wages or government subsidy or charity. While a republic of yeoman farmers is untenable in today's world, the value of ownership and its connection to citizenship still hold sway. John Rawls, in his *Theory of Justice*, distinguishes a "property owning democracy" from a welfare state. Consequently, "Americans favor policies that encourage markets where there is widespread asset ownership over policies that simply redistribute income."[54] The social goals of widespread economic opportunity are best achieved by "helping citizens by regulating land, labor and credit [rather than] after tax distribution of income." In short, good social policy uses market interventions that level the playing field.

The legacies of the yeoman farmer tradition play out today in several realms. Americans place a high value on independently-owned small businesses, on homeownership, and on the personal ownership of financial assets. These values correspond well to the products and outcomes of community development: jobs, entrepreneurship, homeownership, affordable housing, savings and asset building, and investments in people that enhance their competitiveness in the workplace. While community

[50] Michael Lind and David McNamee. *The American Social Contract: A Promise to Fulfill.* Washington, DC: New America Foundation, 2008.
[51] *Ibid*.
[52] *Ibid.*
[53] *Ibid.*
[54] *Ibid.*

development advocates have adopted the vocabulary of opportunity, my sense is they have not found the fullness of language or the historic touchstones to fully distinguish it from entitlement strategies. They have not wedded community development with our history of opportunity in a concise, powerful way.

The Shape of a Subsidy System

The fragmented nature of federal subsidies has had positive and negative consequences. On the positive side communities have more flexibility to combine the resources which best meet local needs and opportunities. The negative consequence has been inefficiency: CDCs must structure complicated, layered financing for their projects; CDFIs have multiple funding sources for their lending and investments, each with their own restrictions and requirements. This complexity results in high transaction costs and high compliance/reporting costs which inhibit efficiency and growth. The lack of uniform, rigorous standards has also enabled many low performing organizations to survive that probably should go out of business.

The community development industry would be better served if federal subsidies were aligned into a more rational, intentional system. To a certain extent, the national intermediaries such as LISC, Enterprise, and NeighborWorks have been able to create some order to national and local funding systems. However, these systems would function more effectively if their funding sources were intentionally designed to work together.

In designing a federal subsidy system for community development, one goal should be greater consistency across the country. The CDC movement has always been strongest in the Northeast and the Midwest. Although the 2005 Census revealed more even distribution across all regions of the country, there are still great geographic disparities in capacity. Geographic coverage is probably more uneven for CDFIs.[55] While six states have 33 or more certified CDFIs, 10 have five or fewer. California has 80 certified CDFIs whereas Kansas has one. While some of the differences can be explained by population differences, large parts of the country are inadequately served.

Secondly, subsidy programs have to acknowledge the business models that underpin CDCs and CDFIs and provide them a path to growth. Community development organizations use subsidy in many different ways. CDFIs utilize federal subsidies as lending capital, core equity, operating subsidy, loss reserves, and sources of liquidity. CDCs deploy subsidy for project financing, project operating subsidies, program operating subsidies, and core operations. For both CDFIs and CDCs, subsidies fit into a business model built on combinations of earned revenue and subsidies. The current system of subsidies makes it difficult for CDCs and CDFIs to grow. Without a pathway to growth, CDCs and CDFIs will not reach the scale necessary to significantly affect poverty. Thirdly, the subsidy system has to reward mission performance, productivity and sound financial management. Poor performing organizations should not be allowed to capture subsidy that could be better deployed elsewhere.

This paper has attempted to place community development within the universe of economic and financial industry change and federal poverty policy. Clearly, our current policy has not been satisfactory. Since the mid-1960s, the national poverty rate has been stuck in a band between 11 percent and 15 percent.[56] The optimism of the 1960s has been tempered. Even the most ardent supporter of federal anti-poverty investments is more sanguine today about the effectiveness of our strategies and tools. Christopher Howard opens his book *The Welfare State Nobody Knows: Debunking*

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[55] "Certified Community Development Financial Institutions - Alphabetical By Organization," CDFI Fund, http://www.cdfifund.gov/docs/certification/cdfi/CDFIList-ByName-12-31-10.pdf.
[56] U.S. Poverty Timeline, Wikipedia, http://en.wikipedia.org/wiki/File:US_poverty_rate_timeline.gif.

Myths About U.S. Social Policy by declaring "The American welfare state is known far and wide as a chronic underachiever."[57] While "there has actually been a remarkable amount of activity in the American welfare state," Howard concludes that "all this activity has not had much impact on the core problems of poverty and inequality."[58]

Future federal subsidy for community development will depends on its advocates articulating a distinctive and effective role within the broad question of national policy poverty. Community development offers the value of a more integrative approach to poverty and responsiveness to community needs in a world where funding sources are siloed. It can target places of concentrated and persistent poverty. It can deploy subsidy efficiently and leverage private investment with public expenditure. Community development institutions such as CDCs and CDFIs bring market expertise and financial sophistication to the table on behalf of low-income communities. They operate at the nexus point between persistently poor places and the outside world, including the market economy and public sector systems. While community development commands a small percentage of federal expenditures, it has a potentially compelling niche within American poverty policy.

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[57] Christopher Howard. *The Welfare State Nobody Knows: Debunking Myths About U.S. Social Policy.* Princeton, NJ: Princeton University Press, 2007.
[58] *Ibid.*

Subsidy and the Charter School Facilities Finance Market

Annie Donovan

Introduction

This study describes how Community Development Financial Institutions (CDFIs) have used public incentives to increase access to capital by public charter schools in the United States.

Charter schools are an important innovation that has improved the educational outcomes of many low-income children and positively affected the broader communities in which the schools are located. Charter schools are public schools; however, they are permitted to operate independent of the traditional structures that govern public schools in exchange for achieving the academic goals specified in their charter contract. Charter schools are not permitted to practice selective enrollment or to charge tuition. In most states, they are given a five-year period to demonstrate results and are required to have their charter renewed at the end of that term. “Chartering,” as it is called, has made way for an era of educational entrepreneurship. New discoveries clearly demonstrate that all children can learn and excel academically regardless of their socio-economic background. However, as with every entrepreneurial endeavor, there are challenges and risks.

The funding formula for charters presents a significant obstacle. Public funds are usually allocated on a per-pupil basis at an amount comparable to what district schools spend to educate a child. Unfortunately, funding formulas consider only the cost of operations and do not factor in capital costs for facilities. Charter schools have generally had to find and finance facilities on their own, relying on the financial markets to supply capital. The capital markets have stubbornly resisted financing charter schools because of the risks inherent in the chartering and renewal processes and the relatively short operating history of the industry.

In response to these challenging circumstances, the federal government developed two national subsidy programs in the 1990s designed to help the charter school movement go to scale. The Charter Schools Program, first authorized in 1994, provides charter school organizers with early-stage venture capital to develop resources and get new schools started. The program also provides resources to collect and disseminate information on the policy and practice of charter schools.

A second federal initiative, the Credit Enhancement for Charter School Facilities Program (CECSF), began in 2002. This program helps charter schools obtain financing for facilities through intermediaries that offer credit enhancement to investors. While this program was not intended specifically for CDFIs, they have proven to be the most effective vehicle for organizing and delivering capital to this nascent market. CECSF has created greater access to capital, spurred financial product innovation, and bolstered the importance of CDFIs within the educational sector. CDFIs played a key role in helping charters gain access to capital, both by taking on risk early in the field’s development and by using federal subsidies to attract considerable private capital to the charter school movement.

The federal programs used to support the charter school industry can be considered smart subsidies for several reasons. Charter schools convey social benefits deemed important by society through improving educational outcomes for low-income children, enabling them to become productive members of society, and reducing public expenditures related to poverty and unemployment. The two federal programs have clearly helped charter schools overcome common barriers to their establishment and development, resulting in substantive growth of the field. Additionally, CDFIs are effective and efficient intermediaries between charter schools and the capital markets, putting federal dollars to work with good results and leveraging $8 in private-sector capital for every $1 of federal funds.[1]

The Obama Administration has raised scale and innovation in education reform to a new level through Race to the Top and the Investing in Innovation Fund (i3 Fund) programs. These programs should benefit charter schools by improving the general environment for education; but it is unfortunate that these programs do not address the facilities financing issues for charter schools. Facilities are likely to remain a major constraint to scaling up the charter movement.

A Closer Look at Charter Schools and the Facilities Conundrum

In this section I describe why charter schools are promising innovations for underserved communities and the challenges these schools face in raising capital to finance facilities.

The Case for Charters

Charter schools have gained momentum not only because of weaknesses in the overall academic performance of public schools, but also because traditional public schools have not adequately addressed the achievement gap between white and minority students.

Since the publication of the 1983 landmark study, *A Nation at Risk,* education reformers have struggled to address what the report cites as "disturbing inadequacies" in our public school system that threaten to erode the foundations of American society.[2] According to the study, the underpinning of a thriving democracy is an educated population. Despite the overall gains in performance since 1983, the US ranks only 18th among the 36 industrialized nations in terms of secondary education, according to the Organization for Economic Cooperation and Development.[3]

In addition, despite the promise of school desegregation since *Brown v. the Board of Education*, the achievement gap between white and minority students has remained an intractable problem. The achievement gap is defined as the difference between the average scores of student subgroups on standardized assessments. According to *The Nation's Report Card,* an annual report prepared by the National Assessment of Educational Progress (NAEP), in 2009 the 4th-grade reading achievement gap between white and black students was 26 points, and the gap between white and Hispanic students was 25 points (see Figure 1).[4] About 42 percent of white, 16 percent of black, and 17 percent of Hispanic 4th-graders performed at or above the *Proficient* achievement level.[5] In mathematics, the achievement gap between white and black students in 2009 was 26 points and the gap between white and Hispanic 4th-graders was 21 points (see Figure 2). About 51 percent of white, 16 percent of black, and 22 percent of Hispanic 4th-graders performed at or above the *Proficient* achievement level.

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[1] The Charter School Coalition, an unincorporated group of 18 community development practitioners working together to preserve and enhance federal support for charter school facilities funding. http://www.thechartercoalition.org/.

[2] *A Nation at Risk: The Imperative for Educational Reform*. The National Commission on Excellence in Education, 1983. http://www2.ed.gov/pubs/NatAtRisk/index.html.

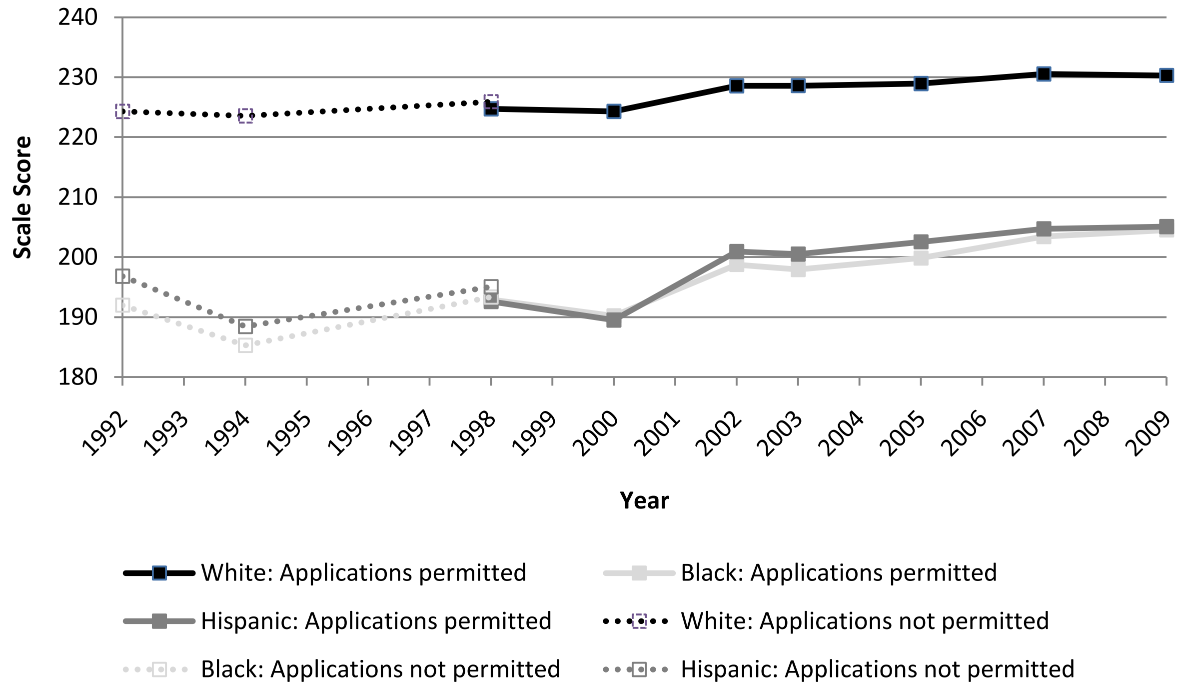
[3] "U.S. Slipping in Education Rankings," United Press International, http://www.upi.com/Top_News/2008/11/19/US_slipping_in_education_rankings/UPI-90221227104776/.

[4] *The Nation's Report Card: Grade 12 Reading and Mathematics 2009 National and Pilot State Results*. National Assessment of Educational Progress (NAEP), 2010. http://nces.ed.gov/pubsearch/pubsinfo.asp?pubid=2011455.

[5] Alan Vanneman, Linda Hamilton, Janet Baldwin Anderson, and Taslima Rahman. *Achievement Gaps: How Black and White Students in Public Schools Perform in Mathematics and Reading on the National Assessment of Educational Progress.* National Center for Education Statistics, Institute of Education Sciences, U.S. Department of Education. Washington, DC, 2009.

Figure 1

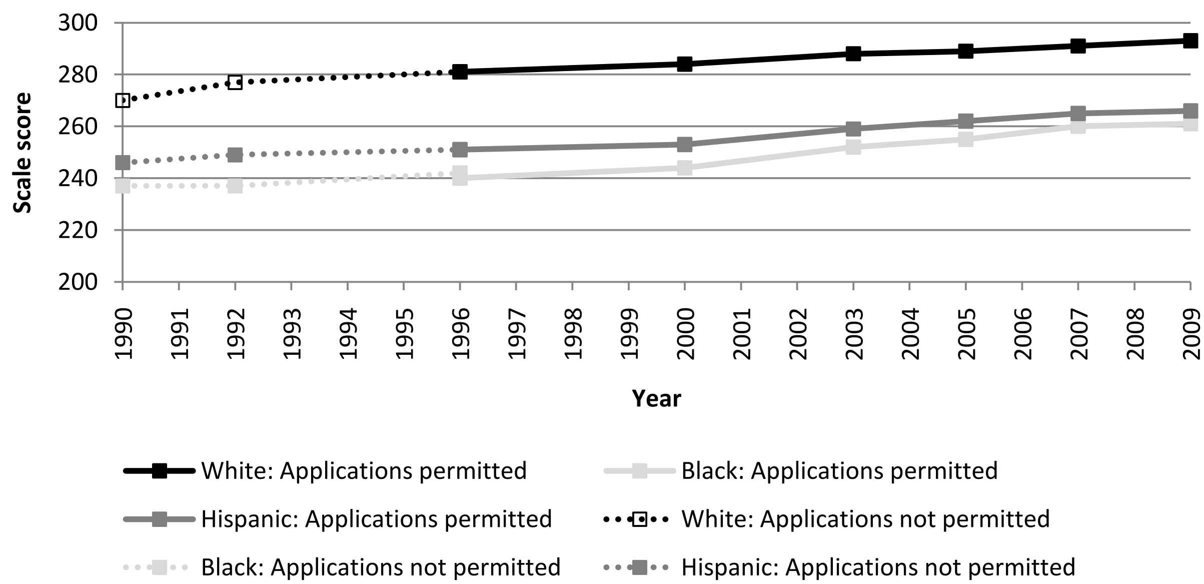
Average 4th-Grade Reading Scale Scores, by Race/Ethnicity: 1992-2009



Source: U.S. Department of Education, National Center for Education Statistics, National Assessment of Educational Progress (NAEP), selected years, 1992–2009 Reading Assessments, NAEP Data Explorer.

Figure 2

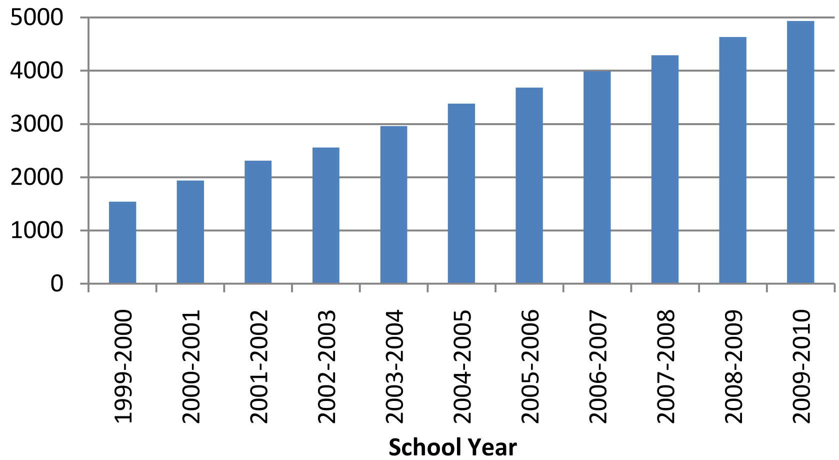
Average 8th-Grade Mathematics Scale Scores, by Race/Ethnicity: 1990–2009



Source: U.S. Department of Education, National Center for Education Statistics, National Assessment of Educational Progress (NAEP), selected years, 1990–2009 Mathematics Assessments, NAEP Data Explorer.

While many valuable experiments have been devised to spark changes in public school performance, no other innovation has been as widespread as the creation of charter schools. As of August 2010, 40 states and the District of Columbia had charter laws. Figure 3 illustrates the growth of charter schools since the first law was passed in Minnesota in 1991.

Figure 3
Number of Operating Charter Schools

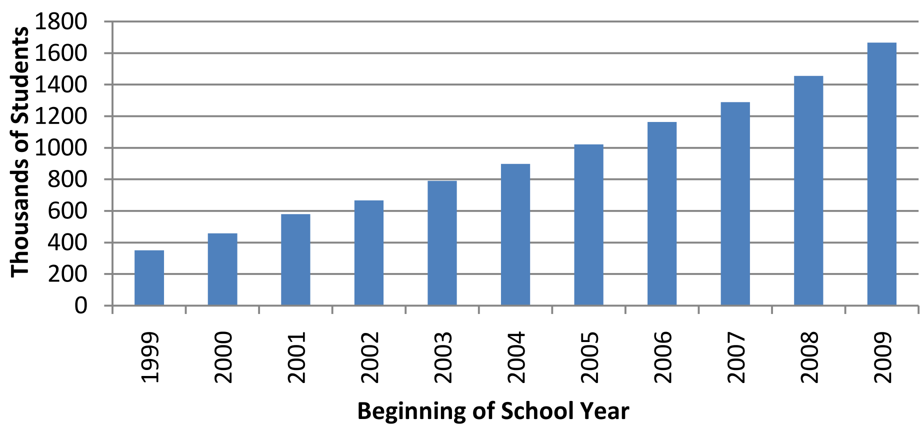


Source: National Alliance for Public Charter Schools (2010), http://www.publiccharters.org/.

Today, approximately 4,936 charter schools operate across the United States, with enrollment of more than 1.5 million students.[6] They now make up 5 percent of all U.S. public schools. As the number of charter schools has grown, so has the number of students enrolled in these schools (see Figure 4). In some cities, such as New Orleans and Washington, D.C., charter schools account for a significant percentage of total public school enrollment. For example, New Orleans has 60 percent of its public school students enrolled in charter schools, making it the only city in the nation where the majority of public school students attend charter schools. Washington, D.C. has approximately one third of its total school population in charter schools.

[6] National Alliance for Public Charter Schools (2010), http://www.publiccharters.org/.

Figure 4
Charter School Enrollment Over Time

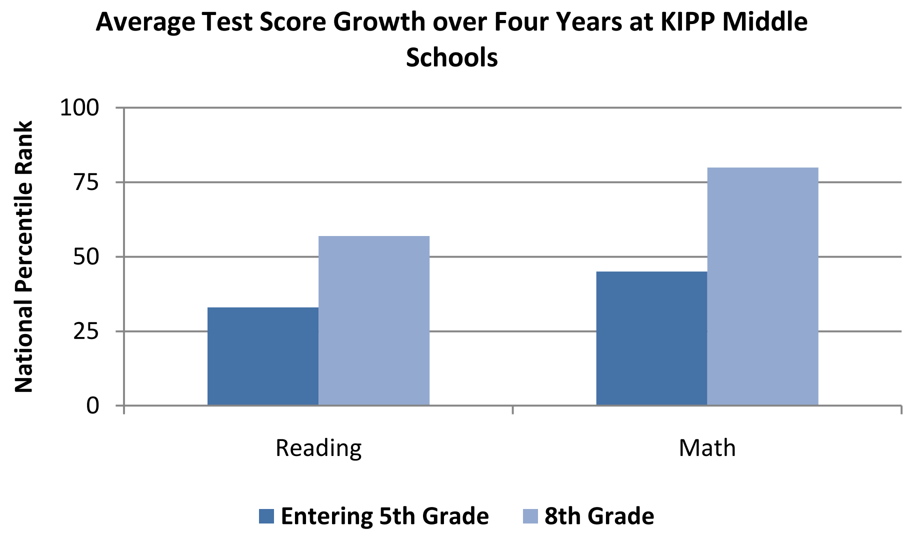


Source: National Alliance for Public Charter Schools (2010), http://www.publiccharters.org/.

In terms of addressing overall academic performance, charters show mixed results when aggregated. However, some charter schools outperform their peer public schools by large margins, and many are showing real progress in closing the achievement gap. For example, the well-known Knowledge Is Power Program (KIPP) begun in 1994 now has 82 schools serving 21,000 students in more than 40 underserved communities across the country. KIPP annually measures the performance of its middle-school students against national norms. The 2009 data show that students on average entered KIPP in fifth grade ranking in the 45th percentile in math and the 33rd percentile in reading. By the end of eighth grade, KIPP students were performing on average in the 80th percentile in math and the 57th percentile in reading (see Figure 5). These figures reflect comparisons against all students in the United States, not only other urban schools or other low-income, minority students. In the 2008–2009 school year, 100 percent of KIPP schools outperformed their district and state averages in both reading and math.[7]

[7] Knowledge is Power Program (KIPP). Kipp Report Cards 2007 and 2009. http://www.kipp.org/about-kipp/results/annual-report-card/annual-report-card/updateapp/false.

Figure 5
Comparison of KIPP Schools to National Norms



Charter School Funding

Because they receive funding only for operations, not facilities, all charter schools struggle to secure a space to call home. Unlike school districts, charter schools do not have the authority to issue bonds that can be repaid with tax proceeds. The problem is made worse by the lack of funding parity with their traditional public-school counterparts. Data from the National Alliance for Public Charter Schools show that charter schools, on average, collect about 78 percent of what traditional schools are allocated on a per-pupil basis.[8] Addressing the facilities problem is important because:

- Facilities issues absorb the time and energy of school administrators, whose expertise is education, not real estate development.
- Facilities costs can deplete resources that should be spent on instruction rather than on bricks and mortar.
- Facilities problems prevent some schools from expanding to meet demand and, in some cases, block new charter schools from opening.

Despite these challenges, the number of charter schools has grown rapidly, creating a demand for facilities financing in the tens of billions of dollars. Annual demand is conservatively estimated to be approximately $1.5 billion.[9]

[8] National Alliance for Public Charter Schools, 2008. http://www.publiccharters.org/.

[9] There are no formal estimates of charter school demand for facilities financing. The author estimated demand using two methods. The first calculation assumed that each student requires 100 square feet of space, and that each square foot of space costs on average $200 to develop, including hard and soft costs. Assuming an average life of the space of 20 years, and equal spacing of construction over 20 years, demand per annum at today's enrollment would be $1.5 billion. If it is assumed that 20 percent of schools need facilities development, the number rises to $6 billion.

Another calculation was made using the estimated demand for facilities investment by all public schools and multiplying it by the charter school market share of 3 percent. A June 2000 report from the National Center for

Why are Charter Facilities So Hard to Finance?

Charter schools that seek to finance their facilities face the challenge of finding capital in an underdeveloped market. Banks and other financial institutions have been reluctant to lend to all but the most credit-worthy charter schools. The reasons for this are not surprising. They include:

- Charter schools in need of financing are likely to be start-up or early-stage ventures with an unproven financial track record.
- The terms of their charters are usually three to five years, yet they may require amortization schedules of 20 years or more to make debt service affordable.
- Charter contracts stipulate the closure of the school if it fails to reach its academic goals.
- The risk of not meeting the conditions of the charter is increased by charter schools' tendency to enroll low-performing students.
- Charter school buildings are often single-purpose assets with limited reuse potential. In addition, the facilities are often located in low-income communities where real estate values may not support the cost of redevelopment.
- Charters can face opposition at the state and local levels from stakeholders within the traditional public school system. Objections are most passionate around the autonomy and resources granted to charter schools.

With such a long list of significant risks to mitigate, traditional investors have shied away from charter schools. Because of this—and because of the potentially high social benefits of supporting charter schools—efficient and effective use of public incentives are an important mechanism for attracting private investment. CDFIs entered the charter school market because they saw an opportunity to add value even before public incentives for financing facilities were made available. Further, CDFIs found charters to be a mission-rich market, as described more fully below.

The Role of CDFIs

CDFIs have been providing facilities financing to charter schools for more than 15 years. This section describes why CDFIs entered the charter market, how they have shaped it, and how CDFIs have effectively used federal subsidy programs to develop the market for facilities financing.

Why Charters?

Most CDFIs do not think of themselves as educational reformers. So what motivates them to be players in the charter school market? There are three major influencing factors.

The first is simply the demand for development capital. Because charter schools must look to the private market for capital to support facilities, from the outset they discovered that finding, developing, and paying for a facility were among the most formidable obstacles to starting and expanding their schools.[10] Initially capital market investors were unresponsive to the financing needs of charter schools.

Education Statistics estimated that $127 billion is needed to fix America's school buildings (*Condition of America's Public School Facilities*). This figure is consistent with the findings of a 1994 GAO study that estimated the cost of bringing schools into good overall condition to be $112 billion (*School Facilities: Conditions of America's Schools*). Others estimate that the cost to construct new schools and classrooms and to modernize existing schools is more than $300 billion nationwide. If we take the lowest estimate of $112 billion and multiply by 3 percent, this would result in a demand calculation of $3.4 billion. To be conservative, it is assumed that demand is at least $1.5 billion.

[10] Paul Bernan, John Ericson, Beryl Nelson, Rebecca Perry, and Debra Silverman. *A National Study of Charter Schools: Second-Year Report*. U.S. Department of Education, July 1998.

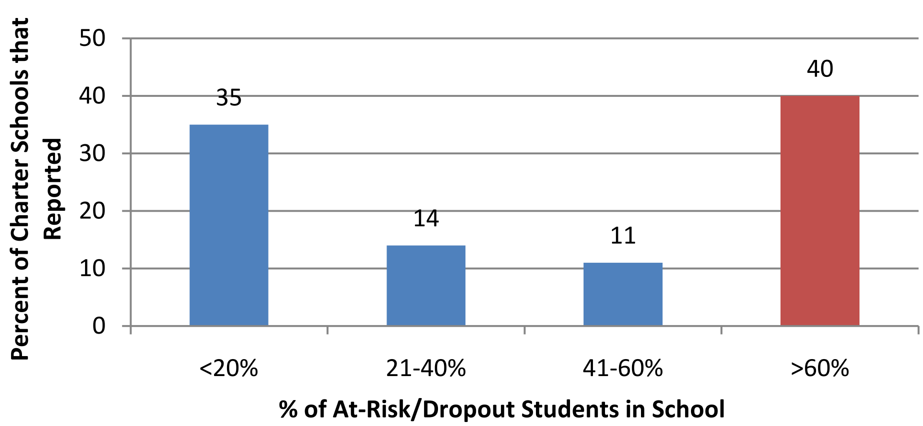
As a result, CDFIs moved in to fill the void. However, even after more than 15 years of operations, charter schools still find financing facilities to be a major concern.

A second factor that drew CDFIs to the market is that, although created to improve the quality of public education, charter schools are proving to be an effective tool for community development and revitalization. Because they tend to serve low-income, minority students, charter schools are disproportionately located in urban areas that are financially underserved—a prime market for CDFIs. Charter schools often redevelop underused or dilapidated properties and convert them into attractive spaces. The adaptive reuse of existing facilities helps to preserve land and reduce sprawl. These smart-growth principles contribute to community and neighborhood sustainability. The schools create jobs and attract ancillary businesses and services to the immediate neighborhood, helping to anchor community development efforts.

A third factor, and perhaps the most compelling, is that charter schools are designed to improve the quality of education for low-income students in many communities. Most charters are founded by parents, teachers, educational entrepreneurs, and other community leaders seeking better educational outcomes for low-income children who otherwise have no choice but to participate in an educational system most agree is failing them.

Depicted in Figure 6 are data from the Center for Education Reform showing that 40 percent of charter schools serve student populations among whom 60 percent or more are considered “at-risk.” In communities where children have less than a 50-percent chance of completing high school, some charters work to prepare these students for college. This is a significant poverty alleviation strategy.

Figure 6
Charter School Demographics: At Risk/Dropout



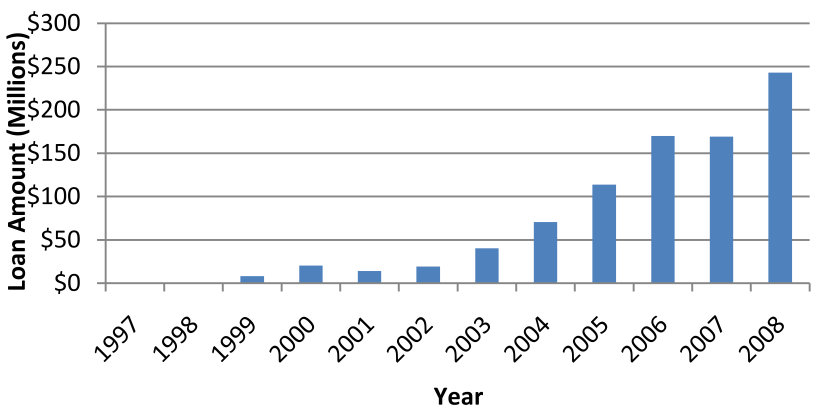
Source: *Annual Survey of America’s Charter Schools*, The Center for Education Reform, 2010. http://www.edreform.com/Resources/Publications/?Annual_Survey_of_Americas_Charter_Schools_2010.

The Impact of CDFIs

CDFIs began addressing the needs of charter schools shortly after the first state charter law was enacted. In 1993, NCB Capital Impact made a small pre-development investment of $25,000 in EdVisions, a teacher-owned cooperative that opened Minnesota New Country School (NMCS), one of a small group of charters operating in 1994. According to the Local Initiatives Support Corporation (LISC), there are now 29 private nonprofit organizations offering facilities financing.[11] Collectively these organizations provided more than $1.1 billion in direct financial support. All organizations surveyed in the report are either certified as CDFIs by the Treasury Department's CDFI Fund or are nonprofit organizations with a common mission of providing development finance to one or more underserved markets.

Figure 7 shows the aggregate growth of charter lending volume among the nine most active CDFIs: Community Loan Fund, IFF, LISC, Low Income Investment Fund, NCB Capital Impact, Raza Development Fund, Nonprofit Facilities Fund, Self-Help, and The Reinvestment Fund. From 1997 to 2008, CDFI disbursements grew from $275,000 to nearly $250 million per year. Cumulative disbursements over this 12-year period exceeded $870 million, a volume that achieves sufficient scale to affect the industry and attract the attention of the capital market investors. Over 80 percent of the schools financed serve a majority of low-income children. CDFIs provided a range of products, including loans for mortgages, leasehold improvements, and working capital.

Figure 7
CDFI Loans to Charter Schools



Source: NCB Capital Impact Survey

In the earliest days of the charter movement, schools had to raise start-up funds through charitable gifts and high-risk loans. When the Clinton administration established the Charter Schools Program in 1994 to provide start-up funding under Title X of the Elementary and Secondary Education Act, the need for high-risk start-up working capital loans was alleviated.

The problem of finding, leasing or buying, and renovating space then rose to the top of the list as the biggest barrier to opening schools. The first studies of charter schools commissioned by the U.S. Department of Education in the late 1990s showed that charters tended to be smaller than the average public school, with seven out of ten leasing space, a trend that continues today.[12] Average enrollment in

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[11] Elise Balboni, Reena Bhatia, Kathy Olsen, Sara McCuistion, Jeffrey Meyers. *Charter School Facility Finance Landscape*. Local Initiatives Support Corporation, June 2010. http://www.lisc.org/content/publications/detail/18446/.

[12] Berman, Ericson, Nelson, Perry, and Silverman, 1998.

charter schools has been 22 percent lower than in conventional public schools, and only 33 percent of charter schools own their buildings.[13]

When it came to space, many schools had to improvise, occupying temporary spaces, church basements, vacant storefronts, or unused public school buildings. Accordingly, leasehold improvement loans, as well as first-mortgage loans available to those schools capable of owning their facilities, have been important products of CDFIs. Loan amounts tended to be in the $250,000 to $2 million range. Charter school loans held by CDFIs have performed well, despite the perceived risks in the market. Most CDFIs experienced default rates of less than one percent, with no history of loan losses. By borrowing and paying back loans, charter schools were beginning to establish creditworthiness.

Banks, however, were still reluctant to get involved. While the tax-exempt bond market, the source of affordable, long-term debt for traditional public schools, was beginning to pay attention to charter schools, there was still a healthy dose of skepticism elsewhere. Not more than a handful of bond deals for charter schools had been executed. In 1999, Moody's Investment Services published its first analysis of the charter school market. Standard and Poor's and Fitch soon followed. Most bond deals were rated below investment grade, which meant that charter schools were still paying relatively high rates for capital. In a 2002 report, Fitch asserted that despite strong demand, "Schools without three to ten years of successful operating history or substantial credit enhancing features will remain hard pressed to earn investment-grade ratings. Most proposed bonds in the sector possess credit features consistent with the 'BB' or 'B' rating categories."[14]

The continued growth in charter school demand, as evidenced by increased enrollment at existing schools and the opening of new schools, put more pressure on those already willing to make charter loans. CDFIs were quickly running out of capacity to provide financing. Enrollment was growing at double-digit rates. Charter operators needed room to grow, and also wanted to upgrade their space to reflect their becoming long-term institutions.

Occupying permanent space was a way to achieve both. Transaction sizes began to climb as a result, requiring CDFIs to find even more creative solutions to serve the market. Fortunately, the federal government devised a useful way to help.

Federal Support for Charter School Facilities

To encourage investors to respond to the needs of charter schools, Congress appropriated $25 million in 2001 to create a credit enhancement demonstration program.[15] The original purpose of the program was to find innovative, market-based solutions to the facilities financing problem. After a successful first year, the Charter School Facilities Program (CECSF) program was authorized under the No Child Left Behind Act and funded at approximately $36 million per year through 2007. In 2008 and 2009, funding dropped to $8.3 million per year.

To date, the U.S. Department of Education, through the Office of Innovation and Improvement, has awarded $222 million under the program, 85 percent of which has gone to CDFIs.[16] Although the program is open to a variety of organizations, CDFIs have proven to be the most effective vehicles for delivering capital to this nascent market. As referred to earlier, data compiled by The Charter School

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[13] *Annual Survey of America's Charter Schools.* The Center for Education Reform, 2010.
[14] *Growing Pains: Charter Schools Begin their Second Decade*. Fitch, Inc., April 29 2002. http://www.fitchratings.com.
[15] The term "credit enhancement" in this context is defined as any mechanism that reduces the credit risk of investors in a financial transaction or shields investors from losses. Loan guarantees and reserves for loan losses are commonly used credit enhancements.
[16] See the Department of Education Web site for a list of awardees by year, http://www.ed.gov/programs/charterfacilities/granteelist.doc.

Coalition show that program grantees have raised $8 of private capital for every dollar of federal funding. Cumulative program awards to date have infused more than $1.7 billion into the market. Despite an estimated annual demand of $1.5 billion per year and an even greater total market size, the program is still not big enough to meet the full needs of the market. But CECSF has unquestionably created greater access to capital, spurred innovation, and bolstered the importance of CDFIs to the sector.

In 2008, the Department of Education issued a report on the CECSF program.[17] While the study period extends only from 2003 to 2005, its findings are still useful for assessing the effectiveness of the program. The report draws the following conclusions:

- Many charter schools are unable to qualify for loans that could be used for facilities-related purposes because lenders perceive them to be too great a risk. The credit enhancements funded by the program reduce lenders' exposure to losses in the event that a charter school defaults on its loan. As a result, the program has improved charter schools' access to capital markets, resulting in more lending than would have occurred without the program.
- Many of the assisted schools, according to representatives of grantees, commercial lenders, investment banks, and rating agencies, would not have received facility loans at any price before the program, because lenders believed that these schools reflected a prohibitively high level of risk. With the addition of credit enhancements, assisted schools received loans with rates and terms that were better than would otherwise be available.
- Based on a review of loan-level data and information provided by grantees and assisted schools, there is evidence that grantees are using innovative methods, especially related to helping charter schools borrow directly from private lenders.
- Grantees disproportionately made loans to charter schools in which lower-income and minority students comprised a larger share of enrollment as compared to all charter schools and all U.S. public schools.
- Finally, the assisted charter schools themselves were located in census tracts with lower median household incomes and a larger proportion of minority residents than the counties in which the schools were located.

Figure 8 shows that 59 percent of the 23,162 students enrolled in CDFI-assisted charter schools were eligible for free or reduced-price lunches, compared to 39 percent of all students in public schools and 44 percent of all charter school students. Minority students accounted for a larger proportion of students in schools assisted by credit enhancement program grantees between FY 2003 and FY 2005 compared to students enrolled in all charter schools and all public schools. Between FY 2003 and FY 2005 the proportion of white students was 24 percent in schools assisted by grantees, 42 percent in all charter schools, and in all public schools it was 58 percent.

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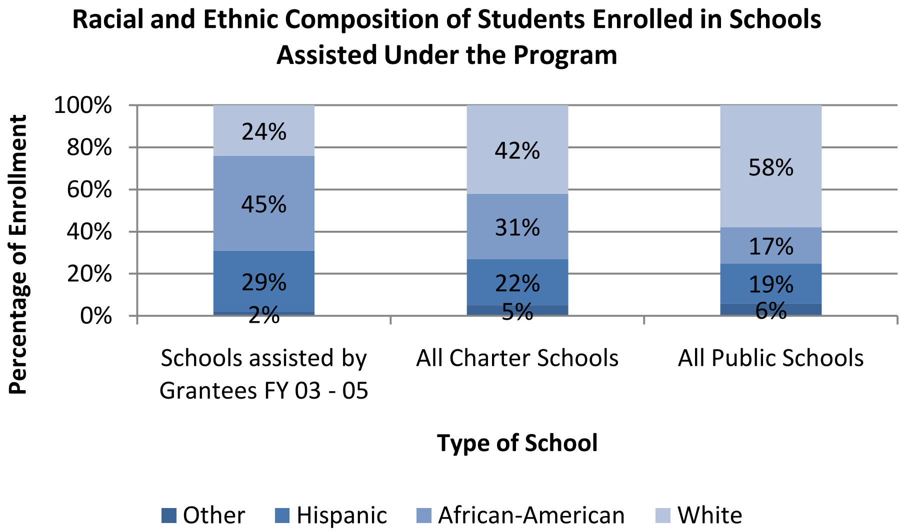
[17] *Report on Implementation of Credit Enhancement for Charter School Facilities Program.* U.S. Department of Education, 2008.

Figure 8
Comparison of Racial/Ethnic Composition Served by Different Types of Schools FY 2003–FY 2005



Source: U.S. Department of Education, 2008

These results show that subsidy can effectively increase access to capital. CDFIs have been necessary intermediaries in the effective execution of the program. As banks utilized a small amount of credit under the CECSF program, it appears that without CDFI intervention, most banks would not have been motivated to come to the table. That the program disproportionately serves low-income students creates added social benefit. The CECSF helps address inequities in the capital markets as well as public education, a worthwhile use of public dollars.

Subsidy Spurs Access to Capital and Innovation

To understand further the benefits of the program, it is useful to describe some of the initiatives and products that have been created with CECSF support. They tell the story of how CDFIs have used subsidy for innovation and collaboration to shape a market response to the financing of charter school facilities.

With first-round funding, The Reinvestment Fund (TRF) and NCB Capital Impact collaborated to create the Charter School Capital Access Program (CCAP) Fund. TRF and NCB Capital Impact used a $6.4 million grant as a first-loss reserve to create a $45 million lending pool capitalized by leading banks and thrifts such as Citibank, JPMorgan Chase, and Bank of America. For many of the participants in the fund, CCAP was their first foray into charter school lending. Part of the goal for TRF and NCB Capital Impact was to demonstrate that charter loans could be prudent investments.

CCAP was a much easier proposition for financial institutions to consider than a direct loan to a charter school, in part because the banks did not actually have to make the loans themselves and therefore did not have to establish an in-depth understanding of the industry. At the time of creation, TRF and NCB Capital Impact each had at least five years of experience in the market, a collective portfolio of nearly $40 million, and no loan losses to date. The two organizations had underwriting criteria that were consistent and time tested. The first-loss reserve was also attractive, since it fully protected investors for the first $6.4 million of loan loss. Additionally, TRF and NCB Capital Impact each invested $5 million into CCAP in a subordinate position to further protect the senior lenders. Under such a scenario, it became highly unlikely that investors would suffer losses.

The CCAP Fund has now run its course, and the credit enhancement dollars are being recycled into new deals, increasing the leveraging impact of the program. As of September 30, 2009, CCAP, along with an additional $3.6 million supplemental grant added in a subsequent round of funding, has enhanced $63 million in loans to 20 charter schools. Total leverage in these transactions was $142 million, or over 14x.

Another grantee, IFF, used the CECSF program to pioneer the use of the CESCS program to enhance tax-exempt bonds for charter schools in Chicago. Through its Illinois Charter Capital Program (ICCP), created with an $8 million grant from the CECSF, IFF facilitated bond issuances for charter operators by funding loss reserves that reduced the cost of bond insurance. The first two transactions, totaling $18.7 million, created four new campuses serving 1,873 students, approximately 90 percent of whom are low income. The bonds are 25-year fully amortizing notes and are attractively priced.

In 2009, LISC used $1 million in credit enhancement to leverage a $10 million Program-Related Investment from the Gates Foundation to back over $70 million in tax-exempt bonds for several schools in Texas. This was the first time a foundation pledged its balance sheet to enhance a bond, and it would not have happened without LISC's participation.

Another program currently under development is the Charter School Financing Partnership (CSFP). Though the financial crisis slowed its progress considerably, the program is still moving forward. In this case, the CECSF program enabled CDFIs to expand the boundaries of collaboration to achieve both product innovation for charter schools and industry innovation for CDFIs. A group of leading CDFIs facilitated by the Housing Partnership Network (HPN) gathered in Chicago at the MacArthur Foundation several years ago to discuss ways of working together to gain greater access to the capital markets. Various strategies were discussed, ranging from creating a CDFI-owned bank to aggregating and securitizing pools of loans. The conversation was initially not specific to charter schools but included all asset types originated by CDFIs. To find common ground, participants submitted data on lending activities segregated by asset type.

The data revealed something important that had not yet been quantified by participants: CDFIs were building enough scale in the charter sector to be taken seriously by the capital markets. To pursue the concept of securitizing charter school loans, a subgroup was formed that included the Low Income Investment Fund, NCB Capital Impact, the Raza Development Fund, Self-Help, The Reinvestment Fund, HPN, and the Community Reinvestment Fund, a national nonprofit financial intermediary that securitizes economic development loans.

The group created the CSFP as a cooperatively owned nonprofit LLC originally designed as a conduit to accumulate charter school debt and sell securities backed by the debt into the capital markets. It received a $15 million grant from CECSF to implement its strategy. Unfortunately, shortly after its incorporation, secondary markets virtually disappeared in the financial melt-down. CSFP responded nimbly by crafting new approaches that it tested in the market until it reached its current design, a tax-exempt bond product targeted to charter schools that are either too small or too risky to access the tax-exempt market on their own. Alone, these charter schools would likely have credit ratings just below investment grade. The CSFP product will allow them to reach investment-grade rates and enjoy the benefits of better pricing and terms. CSFP attracted an additional $5 million PRI from the Walton Family Foundation that is structured to achieve even lower interest rates than the market would offer on its own. The program is sized at approximately $100 million.

The depth of collaboration required by CSFP exceeds any prior experience of its members. To accomplish its goals, CSFP participants use common underwriting criteria, adopt standard documents, and take shared risk in transactions. Further, the financial model of CSFP does not follow the "old rules." CDFIs do not hold originated assets in their portfolios, except for small residuals. This has an impact on both the income statements and the balance sheets of the CDFIs who originate loans. Fees replace earning assets, helping liquidity. To make the model work for both the market and CSFP, a high volume of product origination is needed. Customized loan structuring as a way of doing business, a hallmark of CDFIs, is challenged under this model.

Finally, the most recent innovation spurred by CECSF is a $250 million program created by JP Morgan Chase (JPMC) to finance charter facilities. JPMC chose three program grantees (NCB Capital Impact, TRF, and LIIF) to be its lending partners in a program that blends credit enhancement, subordinate capital, and New Markets Tax Credits to create seven-year, interest-only loans for charter facilities. The subordinate capital supplied by the CDFIs is in part funded by grants from JPMC to program participants. The grants will represent about 15 percent of total deal size. While the grants are restricted capital for the CDFIs, they nonetheless serve to strengthen their balance sheets.

The success of CECSF clearly illustrates the value of subsidy to create both access to capital and innovation in an underserved market. In this case, subsidy creates a better-functioning market. It is a key part of the formula for inducing market investment that creates social impact and long-term economic opportunities.

Conclusion

Charter schools are an important innovation in education that holds considerable promise to help low-income people and communities end the cycle of poverty. However, charter school laws have created a gap in funding for school facilities. CDFIs and the federal government have used subsidies to induce private capital to address this need.

The value of subsidy provided by the federal government for credit enhancement cannot be understated. Without the incentives generated by the CECSF program, and without CDFIs to structure and administer them effectively, the growth of the charter school movement would have been inhibited.

CDFIs have proven their value as strategic players who can correct market failures by combining resources from the public and private sectors, resulting in the efficient deployment of capital to otherwise underserved markets, as they have done in the charter school facilities market.

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Public Subsidy as a Catalyst for Private-Sector Solutions: Creating Job Opportunities for People Who Face Barriers to Employment

Carla I. Javits

As the Obama Administration moves forward with its Social Innovation Fund, Congress contemplates deficit reduction, and the nation faces intransigent high unemployment, it is an especially fitting moment to consider how public policy and targeted subsidy can catalyze the growth of sustainable, cost-effective, and locally initiated solutions that create jobs and put unemployed people to work.

Federal, state, and local policy-makers have experimented for decades with various job-creation strategies and subsidies to increase the workforce attachment of people with low incomes. Policies have included tax incentives for businesses locating in enterprise zones, mandates and incentives for the hiring of specific populations, and targeted commercial lending to businesses located in low-income communities.

While these policy initiatives have helped many low-income people connect to the labor market, few policy initiatives have been effective in increasing the workforce engagement of individuals and families with significant and often multiple barriers to employment. Though there have been some notable innovations in this area, particularly among certain locally based programs, relatively few have reached significant scale.

This paper describes a promising approach that we will refer to as *employment social enterprises*. The model has been effective in reaching this population and in efficient and sustainable use of subsidies. Well-designed and well-administered public policy can leverage these efforts and help them go to scale. An existing national system that helps people with severe disabilities participate in the labor force can serve as a model for a similar program aimed at benefiting others with significant barriers to employment.

Defining the Problem

Millions of working-age adults remain in poverty despite the changes to workforce and welfare policies of the 1990s. Hundreds of thousands of these adults face significant and multiple barriers to employment, including:

- Histories of incarceration;
- Periods of homelessness;
- Mental illness or mental health problems;
- Drug or alcohol dependence; and/or
- No high school diploma.

They face extraordinarily high rates of unemployment, sometimes exceeding 50 percent. Their disproportionately low rates of workforce engagement result not only in poverty, but also in significant public expenditures ranging from the costs of law enforcement and incarceration to emergency, entitlement, and safety net services. Society also foregoes the tax revenues, social benefits, and other positive contributions that would accompany their gainful employment.

For these individuals, persistent poverty exacerbates and protracts already difficult circumstances. Their limited access to employment and education not only result in significant financial and personal costs but ultimately constrict social mobility and civic participation, in many cases for multiple generations.

Even in better economic times, these job applicants are much less attractive to employers than others. When they are hired, they are less likely to retain jobs or advance, often because of underdeveloped work habits and interpersonal skills or economic, health, or personal crises that interfere with work. Employers may also have limited tolerance for these challenges among their frontline workforce, and consider their high turnover a routine cost of doing business. As a result, these individuals remain on the outskirts of the workforce, unable to take advantage of education or training.

While many communities have made great progress in their overall efforts to move welfare recipients from Temporary Assistance for Needy Families (TANF) into the workforce, less progress has been made with young people and other adults who struggle with homelessness, incarceration, mental health issues, and substance abuse in addition to chronic poverty and limited education.

Not only have few communities implemented successful employment strategies for this population, but policy disincentives actually discourage organizations from even trying. For instance, the Workforce Investment Act (WIA) requires grantees to meet pay-for-performance criteria that encourage assistance to people with fewer barriers, who can move rapidly through job training and into full-time employment. Funding is not structured to assist people who may take longer to enter full-time private-sector employment or to help those who may require longer-term support to keep their jobs.

One approach communities have tried is to require that people with employment barriers be hired in large-scale, publicly-funded construction projects. However, the results have been mixed. Even when compliance with these hiring requirements is enforced, there is often little support available to help those with significant barriers get or retain these temporary jobs or to help them move on to other private-sector employment once a particular project ends. While some of the “most able” succeed through these programs, those with the greatest barriers are far less likely to secure long-term employment.

A second approach has been to create temporary job placement agencies to move individuals with severe and multiple barriers into the workforce. The Mott Foundation is currently assessing the results of such a multi-state effort. A 2009 study reports positive results, and Mott is expanding the program while continuing to measure results.[1]

A third approach has been to provide subsidized, transitional jobs in for-profit companies, government agencies, or nonprofits. These efforts have demonstrated positive results, and several are undergoing rigorous evaluation. While promising, a major challenge of such approaches is that they depend on government-funded wage subsidies that are unstable, especially in a time of constrained public resources. An example of this is the TANF Emergency Fund created and funded by the American Recovery and Reinvestment Act (ARRA), i.e., the “stimulus bill.” The TANF Emergency Fund, among other things, provided funds in 2009 and 2010 to help states subsidize wages to provide jobs in private- and public-sector settings for several hundred thousand parents. The TANF Emergency Fund ended on September 30, 2010.

Despite these experiments, we have relatively little data on what really works for those with the most severe employment barriers. MDRC, the leading welfare program research institution in the United States, summarizes the status of the field in a policy brief:

> We know how to move many welfare recipients into jobs. Less is known about how to (1) help low-wage workers advance in the labor market and (2) *promote employment among “hard-to-employ” individuals* [emphasis added]. A rich body of rigorous research—conducted in a variety of labor markets, during healthy and not-so-ideal economic environments—suggests that the most effective welfare-to-work programs require recipients to participate in employment-

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[1] Duane M. Elling, *Study Suggests Staffing Model Supports Success for Workers, Employers,* Charles Stewart Mott Foundation, January 14, 2009. http://www.mott.org/news/news/2009/alternativestaffing.aspx.

related activities, provide a mix of job search assistance and short-term education/training, and use financial work incentives to supplement low-paying jobs. Ongoing studies sponsored by the Department of Health and Human Services are examining two key "next stage" questions: (1) how to promote stable employment and wage progression among former welfare recipients and other low-wage workers and (2) *how to promote employment for the "hard to employ"—recipients facing serious barriers to steady work, such as mental and physical health problems and substance abuse. There have been some hints of success, but much remains to be discovered* [emphasis added].[2]

A Promising Grassroots Approach

One promising approach to promoting employment for people with significant and often multiple barriers has arisen out of local nonprofits' development of a particular subset of social enterprise that we will call *employment social enterprise*. The Social Enterprise Alliance defines *social enterprise* as "an organization or venture that advances its social mission through entrepreneurial earned income strategies." An employment social enterprise's mission is the employment of individuals who are most disconnected from the workforce due to chronic poverty and other major challenges.

With a market-oriented approach focused on creating social value, employment social enterprises leverage private resources with public subsidies to efficiently create and fill jobs with people who would otherwise have a hard time getting or keeping a job. From the sale of goods or services, employment social enterprises earn income, which covers most normal business costs such as wages, benefits, and equipment. Subsidies help cover some of the costs of the support systems to help employees succeed. Employment social enterprises provide their employees with a real job, a paycheck, a forgiving and supportive environment, and coaching and other supports to help them move into the private-sector workforce and retain jobs.

Employment social enterprises provide not only an entry point to employment, but they also develop the individual's employable skills. Some, especially those focused on young people, also incorporate formal education. The best examples of such enterprises build relationships and pathways to help their employees, once they have achieved on-the-job success, move on to private-sector employment in companies that need prepared entry-level workers, helping to create opportunities for long-term employment and the potential for advancement. Many track outcomes in order to improve performance and achieve even greater success over time.

REDF, a San Francisco-based nonprofit, has for more than a decade invested time and resources into many of the outstanding San Francisco Bay Area employment social enterprises and has now started to expand to other parts of California. This assistance has included start-up or venture capital and business assistance. Groups currently or previously supported by REDF include Buckelew Programs, Community Gatepath, the Community Housing Partnership, Chrysalis, the Center for Employment Opportunities, Community Vocational Enterprises, Juma Ventures, New Door Ventures, Rubicon Programs, San Francisco Conservation Corps, San Francisco Clean City, and St. Vincent de Paul of Alameda County, Urban Strategies (Green Streets), and Weingart Center Association. Common elements of these enterprises are:

- A double bottom line, focused on (1) employment of people with significant barriers and (2) operation of a sustainable business;

[2] *New Strategies to Promote Stable Employment and Career Progression: An Introduction to the Employment Retention and Advancement Project,* U.S. Department of Health and Human Services Administration for Children and Families, February 2002. http://www.mdrc.org/Reports2002/era_conferencerpt/era_2000_2001.pdf.

- The sale of goods and/or services to government and/or private-sector purchasers; and
- A supportive operational environment that directly provides or facilitates employees' access to a range of services intended to assist them to retain jobs, move into the private-sector workforce, and advance.

Not all of the enterprises that have entered this field have been successful. Under the best of circumstances it is a challenge to start up viable businesses, let alone ones whose mission is to employ people with significant challenges. Though not all have been able to flourish, promising results have been achieved. Even for those enterprises that have been successful, individual organizations and the industry as a whole has not reached scale. While we do not know with certainty the full scope of the industry, a subset of unpublished data from a survey administered by the Social Enterprise Alliance indicates that a little fewer than half of 135 social enterprise respondents that are focused on workforce development employ between six and 50 people.[3] About 25 percent employed five or fewer, and the balance employed more than 50. While we do not have a precise count of such enterprises around the country, we do know that about 600 nonprofits are part of a network that employs people with disabilities supported by NISH/AbilityOne, a national nonprofit dedicated to this purpose.

What We Know about Outcomes and Cost Effectiveness

For more than a decade, REDF has tracked the activities and outcomes of its partner employment social enterprises. The purpose of this effort has been two-fold: to help employment social enterprises learn and improve; and to meet philanthropic and public funders' requests to assess the value of their investments.

REDF devised a set of tools and measures to track the progress of social enterprise employees. This includes collecting demographic data and information on employees' use of public services or incidents of homelessness or incarceration. To track progress, data are collected at the time of hire, and interviews are conducted every six months for two years thereafter.

The results thus far are promising.[4] Among those interviewed 18 months after hire, 77 percent report working at some time in the previous six months. Enterprise employees' average hourly wage increased by 31 percent and monthly income from employment nearly doubled between time of hire and the follow up. Over time more people move from enterprise to non-enterprise employment.

REDF also measures how employment affects public expenditures such as public safety net costs and incarceration. Pioneering the notion of "Social Return on Investment" (SROI) as an alternative to accounting methods that focus solely on financial return, REDF combines community cost savings with the social enterprise's revenue generation data. The results demonstrate the economic and social value

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[3] *Social Entrepreneurship: A Portrait of the Field*, Community Ventures, Inc. http://www.communitywealth.com/pdf-doc/Field%20Study%20FINAL%207.14.2010.pdf.

[4] From 1998 to 2008 REDF partnered with BTW Consultants (BTW), an evaluation consulting firm, to gather long-term data about REDF portfolio social enterprise employees through a series of interviews conducted at time of hire and then at 6-month intervals for up to two years—regardless of whether the employee had left the nonprofit social enterprise. Results from BTW's research involved approximately one-third of the 3,313 employees hired in REDF grantee social enterprises between 1998 and 2006. This evidence is promising, yet has the limitations associated with preliminary evidence. In addition to the lack of comparison data, the loss to follow up was high, and analysis showed those lost to follow up were more likely to have histories of homelessness. More information on this research is available from REDF at www.redf.org.

of employment social enterprises.[5] Employees are not just working and paying taxes; they are also using homeless shelters or other safety-net programs and going to prison less frequently. Importantly, earned income is covering most of the costs of what public and philanthropic resources would otherwise fund as part of job training.

REDF continues to build on its early measurement efforts, working with its partners to improve and streamline data collection. A new, improved approach to assessing “social return on investment,” incorporating what REDF has learned from previous efforts, is also in the works.

In addition to REDF’s work, there have been other empirical studies on the impact of employment social enterprises and of alternate approaches to employment for people with severe and multiple barriers. A three year random assignment study conducted by MDRC of the transitional jobs social enterprise run by the Center for Employment Opportunities (CEO) in New York City found definitive reductions in recidivism overall, and further that, “CEO had its strongest reductions in recidivism for former prisoners who were at highest risk of recidivism, for whom CEO reduced the probability of rearrest, the number of rearrests, and the probability of reconviction two years after random assignment.”[6] MDRC is engaged in a major federally funded assessment of employment programs for hard-to-employ people. A 2002 Mathematica study shows the promising results of a transitional jobs approach.[7] The Joyce Foundation is working with the National Transitional Jobs Network to assess their impact on helping ex-prisoners re-enter the labor force.[8] As mentioned earlier, the Mott Foundation initiative to create alternative staffing models for people with barriers to work are also yielding promising results.

AbilityOne: A Federal Program that Helped Take the Employment Social Enterprise to Scale

Program leaders and policy makers have struggled to turn successful but limited-scope local innovations to employ people with multiple and significant barriers into sustainable national strategies. The investment required to take a strategy to scale can be substantial; risk and uncertainty are also concerns. How can we assess preliminary results in the absence of long-term control-group studies? Are the program activities necessary and sufficient to reach the desired outcomes? Are innovations duplicable and scalable, and will the efforts be sustainable over time? Can subsidies be used efficiently and effectively to reach this population at scale?

To a certain extent, this is a chicken-and-egg dilemma: the investment necessary to scale a strategy depends upon the ability to answer at least some of these questions; but the answers will only come

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[5] REDF’s SROI measurement toolkit provides only a partial cost-benefit analysis. It does not compare the employment social enterprise model to other methods of moving people into the workforce (largely because the large costs of such an assessment). Also, the SROI model does not allow for explicit attribution of the social return to the employment social enterprise efforts as opposed to other programs or changes in peoples’ lives. Nonetheless, the outcomes suggest it is worth exploring the potential of the employment social enterprise model further.

[6] Janine Zweig, Jennifer Yahner, and Cindy Redcross, *Recidivism Effects of the Center for Employment Opportunities (CEO) Program Vary by Former Prisoners’ Risk of Reoffending,* MDRC, October 2010. http://www.mdrc.org/publications/574/full.pdf.

[7] Transitional jobs are generally wage-subsidized, time-limited jobs in for-profit companies, nonprofits, and government agencies. Many employment social enterprises provide transitional jobs but with some important differences. Instead of relying on wage subsidies, employment social enterprises pay employee wages through earned income. As such, the earned income approach may offer a useful complement to a transitional jobs strategy. In addition, some employment social enterprises do not require employees to move on to other jobs within an explicit time frame.

[8] The evaluation is being jointly funded by Joyce, the New York-based JEHT Foundation, the U.S. Department of Labor, and various state corrections departments.

from implementing the strategy in a sustained way. Practically speaking, efforts that diminish risk and uncertainty will be necessary. An example in the disability sphere offers some insights into the use of incentives to create (at scale) enterprises benefiting people with significant barriers to work.

A powerful precedent for the promotion of employment social enterprises is the successful public-private partnership established by the Javits, Wagner, O'Day (JWOD) Act of 1971. This Act revised a federal program initially created in 1938 to employ blind people by purchasing the mops and brooms they manufactured. The federal program, now known as AbilityOne, was expanded in 1971 to include all people with severe disabilities and to include a broader array of goods and services purchased by many different federal agencies. More than 600 nonprofit agencies participate in the AbilityOne network, selling goods and services to the federal government, and thus creating and providing jobs and increased independence to more than 40,000 people with severe disabilities each year.[9]

Three elements of federal policy catalyzed the growth of the AbilityOne network:

1. ***Procurement incentives that promote a sustainable market for the goods and services produced.*** First, federal law provides an incentive—a streamlined procurement process—to federal agencies that choose to procure goods or services through AbilityOne. The enterprises in turn must meet specific goals for the employment of people with severe disabilities. Federal agencies now annually purchase $1.6 billion of products and services from the network, providing employment for 40,000 people annually.

2. ***Business assistance and other supports that help social enterprises to maximize earned income.*** Several of the social enterprises that are part of the AbilityOne system have flourished and grown not only because of their access to federal contracts but also because these contracts have been stable, allowing the businesses to grow with some predictability. As the businesses have become stronger over time, they have been able to market their products and services to other private-sector customers. For example, a group of social enterprises in California provided document destruction services to the Treasury Department. Once they were running well, these businesses successfully marketed their services jointly to other private-sector clients.

   To support and grow these businesses, Congress chartered an independent intermediary with two primary purposes: to cultivate business from federal agencies and to deliver technical assistance to employment social enterprises. The intermediary works to ensure that the employment social enterprises fulfill their contracts and meet their employment objectives. The intermediary is funded by a fee on contracts.

3. ***Subsidies for the necessary support services.*** The third policy element has been the alignment of AbilityOne with an existing workforce program, the Department of Education's vocational rehabilitation (VR) system. The only pure subsidy program among the policy elements described, the VR system is funded by federal tax revenues and provides supportive services to people employed through the AbilityOne network to help them retain their jobs.

Together, these three policies have resulted in the growth of a sophisticated and effective network of nonprofit-run private-sector enterprises that employ tens of thousands of people with disabilities. These sustainable businesses provide jobs through income earned by delivering necessary goods and services to the federal government. While NISH/AbilityOne has published reports on the cost savings

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[9] For more information, see NISH's website: http://www.nish.org/NISH/Rooms/DisplayPages/layoutInitial?Container=com.webridge.entity.Entity%5BOID%5B3289C649A4B65B4AB7BF230AC4F5A53F%5D%5D.

resulting from the employment of tens of thousands of people with disabilities, critics of the model point to two concerns: (1) that too little effort is made to help the enterprise employees transition to private-sector jobs, and (2) that the model is too dependent on public, rather than private-sector, market opportunities. The AbilityOne/NISH program has begun to address the latter through new efforts to market to the private sector; and some of the nonprofit enterprises in its network have expanded job placement efforts, although as numerous studies indicate, people with serious disabilities continue to face a job market that often discriminates against them in hiring.

Taking Grassroots Efforts to Scale

Based upon the results of grassroots initiatives, employment social enterprises appear promising not only for the people served by NISH/AbilityOne who have serious physical and developmental disabilities, but also for individuals with significant barriers to work, including young adults disconnected from school and work, and individuals with histories of incarceration and homelessness. Extending the AbilityOne model to those with other significant and multiple barriers to employment could be a practical pathway to success. This strategy has significant opportunities as well as challenges, as detailed below.

1. ***Procurement policies.*** Incentives and other policies that encourage routine public and private-sector procurement from employment social enterprises would fuel the stability and growth of the sector and create jobs.

   Opportunities: Procurement could be increased by state and local governments in the context of new spending, for example, on energy programs, infrastructure revitalization, and redevelopment projects. Private-sector firms, particularly those that operate in publicly regulated environments or whose consumers would respond favorably to socially motivated business practices, could also be incentivized to procure services or goods from employment social enterprises. The Small Business Administration, and private entities like the Supplier Development Council could incorporate nonprofit-run employment social enterprises into their definition of supplier diversity, or new entities could emerge that incentivize increased procurement through various “carrot and stick” approaches.

   Challenges: Current procurement policies and related tax incentives designed to drive business toward specific niches tend to favor women and minority-owned businesses, businesses owned by disabled veterans, small businesses, and businesses located in designated low-income neighborhoods like enterprise zones. Nonprofit-owned social enterprises are now rarely part of the equation, although new policies could change that. A clear, widely accepted definition of certification of social enterprises would be a necessary prerequisite. The Social Enterprise Alliance has taken preliminary steps to do create this. In government procurement, there are sometimes restrictions on contracting out, particularly if doing so displaces public employees. Constituencies that oppose outsourcing, especially in a tough economy, may view employment social enterprises as competitors. Both the private and public sector are seeking the highest-quality, most experienced, lowest-cost contractors. Employment social enterprises would have to be competitive on both price and quality, and may also be held to certain wage requirements making competitive pricing more challenging.

2. ***Start-up grants and business assistance to social enterprises***. Financial investments and business assistance are needed to start up and improve the competitiveness, scale, and

efficiency of employment social enterprises so that they can succeed in obtaining contracts while also fulfilling their workforce development mission.

Opportunities: Foundations and individual donors interested in market-based social innovations may be willing to invest in these costs directly or through intermediaries. A recent federal Social Innovation Fund grant to REDF provides $3 million over two years for these kinds of investments, and may serve as a catalyst for additional philanthropic and governmental support. Another opportunity is expansion of the federal Community Economic Development/Job Opportunities for Low-Income Individuals (JOLI) Program administered by the federal Department of Health and Human Services, which provides start-up funding that many local nonprofits have used to expand social enterprise and create jobs. The ultimate goal of these programs is economic self-sufficiency for the targeted populations. The programs are now being reduced in size and targeted to the federal Healthy Food Financing Initiative, but increased funding, latitude, and flexibility on use of the funds, and the types of businesses funded, along with providing more resources for in-depth capacity building and technical assistance would fuel expansion of social enterprise.

Challenges: To attract philanthropic funding, donors must see that the other elements that make social enterprise sustainable—such as public and private procurement and financing for wrap-around service supports—are in place so that their resources are leveraging scale. Government has to be convinced of the value of social enterprise to invest in start up and capacity building.

3. ***Subsidies for wrap-around and retention services.*** Subsidies must be available for employee supports—the services necessary to help a multi-barrier population succeed in the work place, connect with educational programs, and prepare to move into the private-sector workforce.

   Opportunities: WIA funding is often used for training that develops the soft skills (work readiness) of people with significant barriers; this leaves little funding for work support, retention, and advancement services. Under the employment social enterprise financial model, earned income covers the soft-skills training, freeing up resources for longer-term supports that can help employees with severe and multiple challenges become more successful on the job. Reauthorization of WIA may provide an opportunity for improvements. Another promising opportunity may be offered by a Ford Foundation–supported demonstration project of the benefits of “Lifelong Learning Accounts” (LiLA) through a project of the Council for Adult and Experiential Learning (CAEL). The program aims to increase funding for career-related education and training among all workers, with a focus on low-income adults. An evaluation of the impact on participants is under way.

   Other federal programs (Food Stamp, Employment and Training Fund, TANF, etc.) and state programs (criminal justice system efforts to reduce recidivism, for example) as well as local entities (such as community colleges) can also contribute. Reforms to health insurance may also offer some opportunities to access resources for health, mental health, and substance abuse-related employee supports. In some cases, foundations may be willing to subsidize some employee support costs, but their resources are limited compared to the magnitude of the costs and the long-term nature of the need.

Over time, as social enterprises scale, they may be able to contribute a portion of the costs of delivering employee supports through their earned income. Additionally, by offering the on-the-job work experience that is so valuable and hard to come by, social enterprise organizations may find that they can leverage contributions from public and private agencies willing to offer employees work supports, training in hard skills, and assistance with job placement.

Challenges: Because funding for these kinds of services may flow from multiple agencies, it can be costly and inefficient to apply for, manage, and report on. In addition, the performance-based incentives within WIA tend to direct funding toward more able workers, who can more easily meet the job placement goals. Lastly, foundations are reluctant to provide significant funding without knowing that their resources will eventually be replaced with funding from another source.

Conclusion

Employment social enterprises, with their locally based, business-oriented innovations, have shown considerable promise in helping low-income populations overcome significant and multiple barriers to employment. While scaling these efforts nationally faces considerable challenges, well-crafted public policies and private initiatives that not only provide the right mix of services and supports but also build a sustainable delivery system can lead to more effective outcomes and more efficient uses of subsidies over the long term. The AbilityOne program can serve as a model for taking employment social enterprises to scale. The Social Innovation Fund grant to support a project that aims to scale social enterprise in California offers an important opportunity to strengthen the data on results while putting thousands more people to work, and bringing together a broader community of practitioners, funders, and evaluators to hone and articulate a widely replicable, sustainable model that delivers results based on evidence-based practice.

If private and public funders seize this opportunity to influence developing programs to focus on performance and measure progress against clear objectives, they can incentivize desired outcomes such as long-term private-sector job retention and educational pathways that lead to advancement on the job. They can also prioritize services for specific populations such as young adults or those who have been incarcerated.

Well-crafted public policies can address the challenges described above to make the employment social enterprises more effective in helping people succeed at work and become tax-paying, contributing members of society, while reducing the taxpayer costs of poverty, incarceration, and homelessness. As the employment social enterprise industry grows and matures, the approach will be further improved. In addition, ever-improving cost-benefit and outcome assessment will drive smart approaches to the use of subsidy and the pathway to scale.

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Using Tax Policy to Subsidize Homeownership

Richard K. Green and Andrew Reschovsky

Introduction

Encouraging homeownership has long been a cornerstone of U.S. domestic policy, and homeownership is an important goal for most American families. For some it is an affirmation of being part of the middle class; for others it is a means of accumulating assets. The popularity of homeownership helps explain why leaders of both political parties have consistently pursued policies designed to expand homeownership.

While it is easy to understand why subsidizing homeownership is politically popular, many economists argue that subsidies can be justified only if the decision of an individual household to own a home has benefits for the rest of society. Although data indicate that, compared with renters, homeowners take better care of their homes, live in neighborhoods with less crime, are more likely to participate in neighborhood organizations, have children who do better in school, and are less likely to end up on welfare, it is difficult to prove that homeownership *per se* leads to these desirable outcomes.

Even if the external benefits of homeownership are not large, there may be other reasons for the federal government to subsidize it. U.S. housing policy, primarily through Section 8, subsidizes rental for low-income households. As Carasso, Steuerle, and Bell (2005) demonstrate, these rent subsidies create a *negative* incentive for homeownership for households with incomes below about $30,000. Gale, Gruber, and Stephens-Davidowitz (2007) suggest that one justification for subsidizing homeownership for low-income households would be to "keep renting and owning on a level playing field" by offsetting the negative homeownership subsidies now in place.

One lesson from the recent sub-prime mortgage debacle is that, given the chance, many households want to own houses, even if they have low or uncertain incomes and few if any assets. Although the evidence is unclear, some maintain that widespread availability of "teaser" rates and no-down-payment loans during the first part of the decade beginning in 2000 led to an upsurge in homeownership among low-income households. Lenders also came to believe that credit score models alone were sufficient for underwriting, and often ignored payment-to-income ratio guidelines or failed to document income and down-payment sources. Whether it was greed, foolishness, or ignorance on the part of borrowers; or deceptive practices, the exploitation of unsophisticated borrowers, or outright fraud on the part of lenders and mortgage brokers, it is certainly clear in retrospect that homeownership is inappropriate for many people who took out mortgages.

Households with very low or fluctuating/uncertain incomes, those whose jobs are likely to require frequent moves, or those who can afford housing only in blighted neighborhoods, might do well to avoid homeownership.[1] Nevertheless, many families not only want to own their own home, but for them homeownership makes economic sense. However, many of these households cannot now afford to become homeowners without some outside assistance. Given that the U.S. government currently subsidizes homeownership for most middle- and high-income households, it is reasonable to argue that the government should do more to subsidize homeownership for at least some households who cannot currently afford it.

Since the late 1950s the homeownership rate in the U.S. has exceeded 60 percent. In 2004 it reached a peak of 69 percent, and in the first quarter of 2010 stood at 67.1 percent. Despite the relatively high overall rate of homeownership in the U.S., there are large disparities among racial and income groups (U.S. Census Bureau, 2010). The homeownership rates among African Americans (46.1

[1] See Denton (2001) for a discussion of the benefits and disadvantages of homeownership for low-income households.

percent) and among Hispanics (48.5 percent) are both less than two-thirds the rate among non-Hispanic whites (74.5 percent). Despite the relative economic gains of minorities over the past few decades and government efforts to reduce housing market discrimination, there has been little reduction in the racial disparities in homeownership.[2] Between 1989 and 2008, the percentage difference in homeownership rates between black and non-Hispanic white households remained virtually unchanged. In 2009, however, the gap grew by one percent. Hispanic homeownership rates showed a modest two percent increase relative to rates among non-Hispanic whites over this period (U.S. Census Bureau, 2009). It is also noteworthy that the racial/ethnic differences in homeownership rates persist even among high-income households (Gale, Gruber, and Stephens-Davidowitz, 2007).

In recent years, a number of studies (ably surveyed by Haurin, Herbert, and Rosenthal, 2007) have attempted to explain the persistent racial gaps. Although discrimination in mortgage and housing markets plays a role, the empirical evidence suggests that the strongest factors in the homeownership gaps are differences among racial and ethnic groups in income, wealth, and marital status. This finding seems to suggest that tax policy, if appropriately targeted to households with low incomes and wealth, could help reduce existing homeownership gaps.

Reflecting broad public support, there has been strong bipartisan support for policies that provide subsidies for homeownership. Although a number of small programs assist first-time homeowners by providing direct cash subsidies for down payments, the largest source of subsidies by far operate through the tax system. These tax provisions primarily function by reducing the annual costs of homeownership. They not only provide an incentive for renter households to become homeowners, but by reducing annual housing costs they may reduce (though certainly not eliminate) the chances of foreclosure for homeowners struggling to remain in their homes.

Each year, the President is required by law to produce a tax expenditure budget as part of his annual budget submission to Congress. Tax expenditures are estimates of the revenue losses from various tax provisions, such as exclusions, deductions, exemptions, credits, or other preferential treatment for activities that Congress wishes to encourage. For fiscal year 2010, tax expenditures related to homeownership totaled nearly $185 billion (Office of Management and Budget, 2010). By far the largest of these tax provisions is the mortgage interest deduction, which provides tax savings of $92.2 billion. Other large tax expenditures are the deduction of state and local government property taxes on owner-occupied homes ($18.9 billion) and the exclusion from income taxation of the capital gains from the sale of an owner-occupied home ($24 billion).[3] Not surprisingly, as housing prices have fallen across the country over the past few years, the value of the capital gains exclusion has dropped.[4]

Here we will focus primarily on the mortgage interest deduction (MID). All taxpayers who itemize deductions on their federal income tax returns can deduct annual mortgage interest payments on mortgage loans of up to a million dollars on their primary and secondary residences. As deductions reduce *taxable income*, every dollar of additional MID reduces income taxes by a taxpayer's marginal tax

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[2] In 1975, the median income of black households was 60 percent of the median income of white households. By 2007 median incomes of blacks had risen to 65.1 percent of the median income of whites. The relative growth of income among Hispanics went from 71.8 to 74.2 percent over this period (U.S. Census Bureau, 2008).

[3] Married couples can exclude from income taxation up to $500,000 of capital gains on the sale of their principle residence ($250,000 for taxpayers filing single returns). To take advantage of this provision a taxpayer must have owned the property for two years and occupied it for at least two of the past five years (Auten and Reschovsky, 1998).

[4] Just three years ago, in the President's fiscal year 2007 budget, the estimated tax expenditure for fiscal year 2009 for the capital gains exclusion on owner-occupied homes was $41 billion.

rate on their last dollar of taxable income.[5] Under the federal income tax system, marginal tax rates rise as incomes rise. As a result, higher-income taxpayers derive larger tax savings from an extra dollar of mortgage interest than lower-income taxpayers. For example, a $1,000 MID would reduce the federal tax liability of a taxpayer at the 10 percent marginal rate by $100 (10 percent of $1,000) and the tax liability of someone facing the 35 percent marginal tax rate by $350.

If one set out to design a policy to encourage homeownership, it would make sense to target the largest subsidies to the households least likely to be homeowners, while providing little or no subsidy to households likely to become homeowners even without a subsidy. Data from countries that do not subsidize homeownership (such as Canada, Australia, and Japan) indicate, not surprisingly, that homeownership rates rise with household income. This suggests that a policy to encourage homeownership should give the largest incentives to households with modest incomes and no subsidies to high-income households.

The MID, however, does exactly the opposite. For low- to middle-income taxpayers, the mortgage deduction provides little financial incentive to abandon renting for homeownership. For those purchasing modestly priced houses and facing the lowest marginal tax rate (currently 10 percent) the benefits of the mortgage deduction are small. In fact, for households with low state income taxes, the mortgage deduction may be of no value at all, because the mortgage deduction, even when combined with other itemized deductions, may be smaller than the standard deduction.

For most high-income taxpayers, the tax savings resulting from the MID are a minor influence on their decision to become homeowners; these households are likely to own a home regardless of the tax treatment of housing. Rather than encouraging homeownership among high-income households, the MID provides an incentive to buy a larger house and to take out a bigger mortgage. Economists have long argued that the result is an inefficient pattern of investment, with too many resources invested in housing and too few resources placed in more productive investments in factories and machinery (Mills, 1989; Poterba, 1992).

Given that the MID is both exceedingly expensive and ineffective at increasing the homeownership rate, the most sensible policy would be to eliminate the deduction and replace it with a more effective, and perhaps less expensive, subsidy for homeownership.

We will analyze a proposal from the President's Advisory Panel on Federal Tax Reform (2005) to replace the MID with a 15 percent *Home Credit*. Unlike a deduction, under which the tax benefit depends on the taxpayer's marginal tax rate, tax credits provide the same dollar tax benefit to all eligible taxpayers. Despite the advantages of eliminating the MID, we regretfully came to the conclusion that the elimination of the deduction is a politically unlikely. We reached this conclusion after reviewing the political history of the MID and recognizing that the proposal of the President's tax reform panel was met by strong opposition from the home building and real estate industries and was never given serious consideration by Congress.[6]

If it is impossible to eliminate the MID, yet the goal of subsidizing homeownership for low-income and minority qualifying remains, the best alternative may be an "optional" mortgage credit allowing taxpayers to choose between the existing mortgage interest tax deduction or a new mortgage interest tax credit. Our analysis indicates that the optional credit would substantially increase the homeownership rate for households with modest incomes, especially minority households. Also, in the

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[5] Since 1990, itemized deductions have been limited for higher-income taxpayers. For the 2008 tax year, the income above which deductions were limited was $159,950 (or half that amount for married couples filing separately).

[6] Even President Obama's proposal to scale back modestly the mortgage interest deduction was met with such hostility that he quickly abandoned the idea.

long run, as fewer households benefit from the deduction, it may become politically feasible to either limit or even completely eliminate the MID.

Our examination is based on the results of a statistical analysis of housing tenure choice (to rent or to own) and housing expenditures. The results were applied to a tax simulation model for tax year 2004 that allows us to calculate federal income tax liabilities of all taxpayers under existing tax policy and under alternative homeowner subsidy proposals.

In the next section, we briefly describe our methodology and data. We then summarize the results of our analysis of the impact of tax policy on the decision of households to become homeowners. In the following section, we evaluate the current MID. We then turn to an analysis of the recommendations of the President's advisory panel on federal tax reform as well as an analysis of our optional tax credit proposal. We conclude the paper with a discussion of the role of tax subsidies in a post-housing-crisis world.

Modeling the Decision to Become a Homeowner

In this paper, we build on past research presenting clear evidence that federal income tax incentives for homeownership do in fact influence families' housing tenure-choice decisions (Rosen, 1979a; Rosen, 1979b; Green and Vandell, 1999). This research is based on the assumption that the decision of a renter household to become an owner depends on a set of characteristics, such as income, household size, marital status, and race, and what economists call the *user cost* of owning relative to renting: the amount of money a household must spend if it owns rather than rents an identical house or apartment. As we will describe below, tax policy can be used to reduce the user cost of owning relative to renting and thus potentially influence households' decisions to purchase a home.

For homeowners the before-tax user cost is the sum of the mortgage interest, the property tax, the net depreciation, and the overall maintenance (which includes insurance and utility costs). As demonstrated by Green and Vandell (1999), the ability of homeowners to deduct their mortgage interest and property tax payments from their gross income reduces the user cost of owner-occupied housing relative to renter-occupied housing by an amount equal to the federal marginal tax rate times the deductible portion of total user cost. Alternatively, giving taxpayers a fixed tax credit for their payment of mortgage interest and property tax reduces the user cost of owner-occupied housing relative to renter-occupied housing by the amount of the credit.

In order to calculate the ratio of user costs of owner-occupied relative to renter-occupied housing and to determine the sensitivity of housing tenure decisions to relative user costs, we employ a model that includes a housing expenditure and housing tenure choice equation. For a detailed description of our methodology to estimate housing tenure, see Green and Vandell (1999) and Green and Reschovsky (2007).

To test the hypothesis that the MID has a direct impact on the rate of homeownership in the United States, we use multivariate statistical techniques to determine whether the deduction leads to an increase in the rate of homeownership by reducing the cost of obtaining a mortgage.[7] Our results provide strong evidence that tax policy influences households' decisions to become homeowners. The tax variable is both large and statistically significant.[8] Separate statistical analyses for households by race/ethnicity revealed that both black and Hispanic households are somewhat more sensitive to mortgage interest-related tax incentives than white households.

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[7] We estimate probit regression, where the dependent variable is one if a household owns a home, and zero otherwise. In addition to the tax variable, the regression includes a set of other household characteristics that may influence households' decisions whether to own or rent.

[8] Our results indicate that a one percentage point change in the tax variable results in a 0.63 percentage point change in the predicted homeownership rate for the average household.

Modeling the Tax System

Data regarding the effect of tax policy on the rate of homeownership provides us with only part of the information we need to analyze the full impact of housing-related tax policies. For most households, changes in housing-related tax policies will produce no change in housing tenure, but may well result in substantial changes in income tax liability. In order to evaluate alternative policies, we designed a simulation model to calculate the income tax liabilities of each household in the Public Use Microdata Sample (PUMS) dataset. The model was constructed to allow calculation of tax liabilities under both the existing tax system and a number of policy alternatives. We built our tax simulation model to reflect 2004 tax laws by mimicking the procedure each household would follow in calculating its 2004 federal income tax liability.

Assessing the Mortgage Interest Deduction

The MID is actually a remnant of the original IRS code of 1913, under which all interest was deductible. As very few wealthy taxpayers were subject to the income tax during its early years, it is not likely that Congress thought of the deductibility of mortgage interest as encouraging homeownership. However, over time the favorable tax treatment of mortgage interest has become very popular. In the mid-1980s proposals were advanced to eliminate the deductibility of all consumer interest. In part because of heavy lobbying by the National Association of Realtors, the Mortgage Bankers Association, and the National Association of Home Builders, the resulting legislation, the Tax Reform Act of 1986, phased out deductions for all consumer interest except mortgage interest (Dreier, 2006).

Using our tax simulation model, we estimate the benefits of the MID to households in various income categories. Our model determines whether households with outstanding mortgages itemize on their federal income tax return, and if so, whether they utilize the MID. The model then determines the size of each deduction and the dollar value of the related tax benefit (or tax savings). The tax benefit is calculated by multiplying each household's MID by that household's marginal tax rate. Our simulations indicate that in 2004 the MID provided $67.1 billion in aggregate tax benefits, somewhat larger than the $63.5 billion estimate by the Department of the Treasury of the tax expenditure for the MID.

Table 1 illustrates how the use of the MID rises with income. Although 46 percent of households had incomes below $40,000 in 2004, only 38 percent of homeowners had incomes under $40,000. The last two columns help illustrate why low- and moderate-income homeowners (and potential homeowners) get so little benefit from the MID. At household incomes below $30,000 (in 2004 dollars), fewer than half of all homeowners have mortgages. In contrast, at incomes above $75,000 approximately four out of five homeowners have mortgages. One reason that so few lower-income homeowners have mortgages is that many are elderly and have already paid off their mortgage. Census data indicate that 54 percent of homeowners with incomes under $25,000 are over 65, and two-thirds of those over 65 have no mortgage. The final column in Table 1 demonstrates that, while among those with incomes above $75,000, nearly all homeowners with mortgages take advantage of the MID, many homeowners, especially those with incomes below $30,000, do not itemize deductions. In nearly all cases, homeowners who do not itemize gain a larger tax benefit from utilizing the standard deduction. However, the net result is that for these homeowners, the U.S. tax system provides no subsidy for mortgages.[9]

The focus of Table 2 is homeowners who do take advantage of the MID. Clearly the tax subsidies provided by the MID are relatively modest for most low- and middle-income itemizers. Because both the probability of taking the MID and the amount of the tax benefit from the deduction rise with income, it

[9] It should be noted that all homeowners, including non-itemizers, benefit from the exclusion from taxation of the imputed rent from homeownership.

is not too surprising that nearly half of the total tax benefit from the MID accrues to the 18 percent of homeowners who have incomes (in 2004) exceeding $100,000. The U.S. government is currently spending about $100 billion per year to subsidize homeownership through the MID. Table 2 demonstrates that not only are the benefits of this subsidy flowing primarily to Americans with above-average incomes, but that the many homeowners who are now struggling to fend off foreclosure receive little benefit. The bottom line is that the MID does almost nothing to encourage and facilitate homeownership for households wanting to own their own home or to assist those in danger of losing their homes.

Replacing the MID with a Mortgage Tax Credit

In 2005, President Bush appointed an advisory panel and charged it with developing proposals for reforming the federal tax system. The panel's final report included a proposal to eliminate the MID and to replace it with a 15 percent non-refundable tax credit on mortgage interest paid on a principal residence (President's Advisory Panel on Federal Tax Reform, 2005). Because the new credit would be non-refundable, the maximum credit a household could receive would be limited to the size of the household's pre-credit federal income tax liability. Data from the IRS indicate that in 2006, 29 percent of all taxpayers who took the MID and had adjusted gross incomes below $40,000 did not have a positive income tax liability (Internal Revenue Service, 2008). None of these homeowners would be eligible for a mortgage tax credit under the advisory committee's proposal. The proposal also placed a limit on the size of the credit any household could receive, by specifying that interest on mortgage loan amounts of over $412,000 would not be eligible for the 15 percent credit.[10]

In principle, this proposal would achieve several goals. First, it would reduce the overall size of the mortgage interest–related subsidy to homeowners, because the revenue gained by eliminating the MID would be greater than the cost of the proposed credit. Second, as the credit received by each household varies by the amount of mortgage interest paid, but not by the homeowner's marginal tax rate, the share of the mortgage subsidy going to low- and middle-income homeowners would increase and the share going to high-income homeowners would decrease. Third, because larger mortgage interest-related subsidies would flow to households with modest incomes, the replacement of the deduction with a credit should encourage homeownership among such households.

We used our tax simulation model to predict whether the proposal by the Advisory Panel would in fact achieve its goals. We began by considering how much money the U.S. Treasury would gain by eliminating of the MID. However, obtaining the answer is not as simple as looking up the value of the tax expenditure associated with the mortgage deduction. Unless prohibited by the terms of their mortgage, taxpayers may respond to the loss of the deduction by paying off, in part or in full, their mortgage balance. One reason taxpayers may want to accelerate paying off their mortgage once it loses its tax-preferred status is that homeowner equity (effectively, the net imputed rent on their home) would remain untaxed. If taxpayers sold interest- or dividend-producing taxable assets in order to pay off their mortgage, the revenue gain to the Treasury from the elimination of deductibility would be diminished.

Data from the Federal Reserve Bank's *Survey of Consumer Finance* demonstrates that most homeowners have few financial (non-retirement) assets. This means that most households have quite limited ability to pay off their mortgages early. As a result, we estimate that if the Advisory Panel's proposal to replace the MID with a non-refundable 15percent mortgage interest credit had been implemented in 2004, the Treasury would have gained a relatively small amount in revenue: about $9 billion.

[10] This limit would apply to houses in parts of the country with the highest housing prices. Homeowners in parts of the country with cheaper housing would be subject to lower limits, with the limit set at $227,000 in areas with the nation's lowest housing prices.

Table 3 details how the Advisory Panel's proposal would redistribute income tax burdens. The average affected homeowner (i.e., those with mortgages) would pay $267 in additional income taxes (indicated in Table 3 as a loss of tax benefits). As expected, a larger share of homeownership-related tax subsidies would now flow to those with lower incomes. On average, homeowners with incomes below $80,000 would benefit under the proposals, while those with higher incomes would lose.

The central panel of the table shows that only about 10 million homeowners would benefit from the proposal. At incomes below $60,000, the majority of homeowners would not be affected by the proposal, primarily because they do not hold mortgages on their homes. The data also show that among high-income homeowners, most would pay higher taxes as a result of the proposal, and a few would see their tax liability decrease. Although not shown in the table, approximately 170,000 renter households would become homeowners. Comparing the final columns of tables 2 and 3 demonstrates that the adoption of the Advisory Panel's proposal would shift the share of total mortgage interest–related tax benefits to households with income below $80,000 (in 2004) from 25 to approximately 45 percent.[11]

Using our model to simulate the impact of the Advisory Panel's proposal on homeownership rates, we predicted a half percent **reduction** in the overall rate. This lowering of the average homeownership rate reflects the fact that some households would decide to become renters in response to an overall reduction in their housing-related tax subsidy. The main beneficiaries of the advisory panel's plan are households with low or moderate incomes. Some are renters who respond to the increased housing subsidy by becoming homeowners. For households with incomes below $10,000, the ownership rate would not change; for those with incomes of $10,000-20,000 and $20,000-30,000, the homeownership rate would rise by 0.5 percent and 0.7 percent, respectively. However, we should note that the statistical precision of our models is not sufficient that these numbers are actually different from zero.

The Political Durability of the MID

Although it is widely recognized that the MID is ineffective as a policy for encouraging homeownership and bestows most of its benefits on high-income homeowners, it appears to be a very well entrenched feature of our tax system. Peter Dreier (2006) has pointed out that the political power of the real estate industry has kept Congressional support for the MID both strong and bipartisan. A recent proposal by President Obama to limit the value of itemized deductions by capping the marginal tax rate applied to deductions at 28 percent was met by fierce opposition and was never seriously considered by Congress.

Another reason it is so politically difficult to eliminate the MID is the spatial concentration of its tax benefits. Gyourko and Sinai (2003) demonstrate the extent to which the largest benefits from the deduction are concentrated in a very small number of metropolitan areas (and hence Congressional districts). They show that if the revenue gained by the Treasury from the elimination of the MID were returned as an equal lump-sum payment to all taxpayers, the number of households that would be "winners" would greatly outweigh the number of "losers." However, the average value of the gains would be small, while many losers would suffer large losses. The political power of the losers is accentuated, because they are concentrated in a relatively small number of Congressional districts, while the winners are spread throughout the country.

[11] The changes in tax benefits shown in Table 3 are probably somewhat underestimated because the estimates assume that changes in tax subsidies will have no impact on the demand for housing. The evidence, however, suggests that the reduction in tax subsidies for high-income homeowners will reduce demand for expensive houses and result in a decline in housing prices (Capozza, Hendershott, and Green, 1996).

Establishing an *Optional* Mortgage Interest Tax Credit

As much as we support the elimination of the MID, such a policy is not politically viable. This realization led us to search for an alternative tax policy that would retain the mortgage interest deduction but also create larger incentives for homeownership for those households, especially those with modest incomes and minorities who are most likely to require financial help in order to become homeowners[12]. Below we analyze a policy that establishes an optional mortgage interest tax credit. Under our proposal, each homeowner with a mortgage (or prospective homeowner) can choose between a 15 percent *refundable* mortgage interest credit and the existing mortgage interest deduction. We assume that taxpayers will choose the option that results in the lowest federal tax liability.

With a refundable credit, if the credit is larger than a taxpayer's previous federal income tax liability, the taxpayer would receive any excess credit as a tax refund. We hypothesize that making the credit refundable will increase the financial attractiveness of homeownership for many minority and low-income households.

We therefore use our model to simulate the impact of the optional credit proposal on housing tenure and on the income tax liability of each household in the PUMS dataset. The results of this exercise on changes in homeownership rates by household income and by race/ethnicity are presented in Table 4. The overall homeownership rate would increase by 2.5 percent. For those households with incomes below $20,000, there would be a 5.2 percent increase in the ownership rate; for those with incomes between $20,000 and $40,000, the rate would increase by 3.8 percent. Our simulations indicate that the optional credit would have a greater impact on minorities than on whites. The optional credit would increase the homeownership rate by 4.2 percent for blacks and by 4.5 percent for Hispanics. These increases partly reflect that fact that black and Hispanic households have lower-than-average incomes, and, based on the results of our model, appear to be more sensitive to tax subsidies than white households at every income level.

Under the optional credit proposal, 22.8 percent of all households would receive a credit, with an average credit of $663 per recipient household. As illustrated in Table 5, the 24 million credit recipients would be made up of 2.6 million renter households who become homeowners as a result of the credit, and 21.4 million current homeowners with mortgages who take advantage of the credit. This latter group includes many homeowners who did not previously benefit from the MID because they were not itemizers. For existing homeowners the credit would play an important role in reducing the financial burden of homeownership.

We have estimated that in 2004 the optional credit would have cost approximately $15.1 billion. Although this amount would increase the already large tax subsidy going to homeownership, the additional subsidy is very well targeted to homeowners with low and moderate incomes. The tax benefits are on average largest for households earning less than $40,000 per year, with such households receiving 69.1 percent of the total tax benefits. Although there are very few high-income beneficiaries, these households would continue to receive the full benefit of the MID.

Figure 1 allows us to compare the distribution of mortgage-related homeownership tax benefits under current law to the distribution of total benefits under the optional tax credit, where benefits include both tax savings attributable to the credit for homeowners who choose the credit and tax savings from the MID for homeowners who take the deduction. The adoption of the optional credit proposal would nearly double the share of total mortgage interest–related tax subsidies going to households with incomes (in 2004) below $60,000, from 17 percent to 30 percent. Higher-income

[12] We assume that encouraging homeownership remains a good thing. Whether it is or not is a discussion for another day.

homeowners would receive a smaller share of the total tax subsidy, with the share of tax benefits going to households with incomes above $100,000 falling from 46 to 38 percent.

Conclusions

The United States has a long tradition of using its tax system to subsidize homeownership. Nearly half of the $185 billion tax subsidy currently going to homeowners comes in the form of the mortgage interest deduction. Here we have sought to demonstrate that the MID is a highly inefficient policy for increasing the rate of homeownership. Despite the annual expenditure of billions of dollars, the large gaps in homeownership rates between black and non-Hispanic white households and between Hispanic and non-Hispanic white households have persisted. We also showed that the MID targets most tax subsidies to higher-income households, with nearly half of its benefits going to households who earn more than $100,000 per year, an allocation of benefits that many people would consider unfair.

Despite these serious shortcomings, eliminating or curtailing the MID appears to be highly unlikely. Recent evidence of the political durability of the MID comes from the reaction to the recommendation of a high-level tax reform panel established by President George W. Bush. The panel's recommendation to eliminate the deduction and replace it with a non-refundable mortgage interest credit was considered to be "dead on arrival" and was subsequently ignored by the President. We have demonstrated in this paper that the tax reform panel's proposal would in fact make the tax system fairer, would actually generate some revenue, and would have essentially a neutral effect on the ownership rate.

As an alternative to current law and to the tax reform panel's proposal, we analyzed a proposal to allow homeowners to choose between a 15 percent refundable mortgage interest credit and the existing MID. As our analysis indicates, not only would such a policy shift a larger share of the total mortgage-interest related tax subsidies to households with incomes below $60,000, but would also increase homeownership rates for households with modest incomes, especially minorities. The great political strength of our proposal is that no one would involuntarily forfeit the MID.

In this era of both unmet needs and a rising federal deficit, it is difficult to argue for further increasing the size of the already large federal tax subsidies for homeownership. However, because the MID is so well entrenched, the price of badly needed reform may well be the expenditure of more money. Especially given the current economic and fiscal climate, we would support an increase in individual income tax rates as a means of funding the relatively modest additional costs of an optional mortgage interest credit.

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an advisor to the Financial and Fiscal Commission in South Africa. In addition to his work on tax policy related to homeownership, he is currently conducting research on whether rising property taxes are forcing elderly homeowners to move and on the fiscal condition of central cities. Professor Reschovsky earned his Ph.D. in economics from the University of Pennsylvania.

Table 1

Distribution of Mortgage Interest Deductions (MIDs) by Income class, 2004

2004 Household Income	Number of Households	Percent of Total Households	Percent of Households Who are Homeowners	Percent of Homeowners with Mortgages	Percent with Mortgages Who Take the MID
Less than $10,000	9,539,000	9.0%	47.8%	28.2%	43.1%
$10,000 - $19,999	12,821,800	12.1%	56.7%	32.3%	62.7%
$20,000 – $29,999	13,385,600	12.7%	59.8%	45.2%	65.2%
$30,000 - $39,999	12,418,900	11.8%	62.0%	58.4%	75.0%
$40,000 - $49,999	10,966,500	10.4%	68.2%	66.1%	75.7%
$50,000 - $74,999	20,663,800	19.6%	74.4%	76.3%	76.7%
$75,000 - $99,999	11,008,500	10.4%	81.6%	83.1%	100.0%
More than $100,000	14,675,600	13.9%	89.0%	78.8%	95.7%
Total	**105,479,700**	**100.0%**	**68.6%**	**43.8%**	**80.6%**

Source: Authors' calculations using data from the Public Micro Sample of the 2000 Census and 2004 Statistics of Income. All data have been inflated to 2004 values.

Table 2

Distribution of Tax Benefits from the Mortgage Interest Deductions (MID) by Income Class, 2004

	For Households Taking the Mortgage Interest Deduction			
2004 Household Income	Average MID	Marginal Income Tax Rate	Average Tax Benefit from MID	Percent of Total Tax Benefit from the MID
Less than $10,000	$ 7,280	9.2%	$ 671	0.5%
$10,000 - $19,999	$ 6,658	11.4%	$ 762	1.6%
$20,000 – $29,999	$ 6,756	12.8%	$ 868	2.9%
$30,000 - $39,999	$ 6,850	14.7%	$ 1,005	4.8%
$40,000 - $49,999	$ 7,059	17.9%	$ 1,261	6.7%
$50,000 - $74,999	$ 7,861	17.8%	$ 1,402	17.8%
$75,000 - $99,999	$ 8,814	21.2%	$ 1,869	19.6%
More than $100,000	$12,613	26.3%	$3,316	46.1%
Total	**$ 8,991**	**19.7%**	**$ 1,874**	**100.0%**

Source: Authors' calculations using data from the Public Micro Sample of the 2000 Census and 2004 Statistics of Income. All data have been inflated to 2004 values.

Table 3

Distribution of Tax Resulting from Proposals of President's Advisory Panel on Federal Tax Reform

	Homeowners with Mortgages			Current Homeowners			
2004 Household Income	Average Credit Received	Average Deduction Lost	Average Gain (or Loss)	Number Who Gain	Percent Who Gain	Percent Unaffected	Percent of Total Benefit from Credit
Less than $20,000	$ 92	$ 69	$ 23	728,000	6.9%	93.1%	0.8%
$20,000 - $39,999	$ 281	$ 112	$ 168	3,142,300	19.8%	79.7%	5.6%
$40,000 - $59,999	$ 722	$ 505	$ 217	3,267,000	21.8%	72.1%	17.9%
$60,000 - $79,999	$ 953	$ 837	$ 116	2,259,500	20.4%	67.1%	19.8%
$80,000 - $99,999	$1,027	$1,385	-$ 358	814,000	11.8%	34.6%	14.1%
$100,000 - $119,999	$1,231	$2,000	-$ 769	44,700	1.1%	25.5%	10.7%
$120,000 - $139,999	$1,400	$2,330	-$ 929	21,200	0.8%	22.9%	7.1%
$140,000 - $159,999	$1,517	$2,729	-$1,213	9,900	0.6%	27.2%	4.8%
More than $160,000	$2,302	$4,879	-$2,577	12,800	0.3%	27.7%	19.2%
Total	**$ 882**	**$1,149**	**-$ 267**	**10,299,400**	**14.2%**	**64.2%**	**100.0%**

Source: Author's calculations using data from the Public Use Micro Sample of the 2000 Census (inflated to 2004 values)

Table 4

Impact on Homeownership Rates of an Optional and Refundable 15% Mortgage Interest Tax Credit

	Entire Sample			Blacks Only			Hispanics Only		
2004 Household Income	Number of Households	Homeownership Rate Current Law	% Point Change in Homeownership Rate	Number of Households	Homeownership Rate Current Law	% Point Change in Homeownership Rate	Number of Households	Homeownership Rate Current Law	% Point Change in Homeownership Rate
Less than $10,000	9,539,000	47.7%	6.4%	2,054,100	35.4%	7.3%	1,052,900	32.7%	7.4%
$10,000 - $19,999	12,821,800	56.7%	4.3%	1,808,100	41.1%	5.6%	1,318,300	38.2%	6.5%
$20,000 – $29,999	13,385,600	59.8%	3.5%	1,601,800	42.5%	4.8%	1,374,800	41.6%	5.3%
$30,000 - $39,999	12,418,900	62.0%	4.1%	1,299,000	46.0%	5.0%	1,169,100	43.3%	6.1%
$40,000 - $49,999	10,966,500	68.2%	2.4%	1,025,400	52.7%	3.2%	955,500	48.3%	3.9%
$50,000 - $74,999	20,663,800	74.4%	0.8%	1,666,500	60.0%	1.3%	1,551,100	55.0%	2.3%
$75,000 - $99,999	11,008,500	81.6%	0.3%	764,000	69.2%	0.6%	685,800	63.2%	1.4%
More than $100,000	14,675,600	89.0%	0.0%	742,700	79.0%	0.4%	695,300	74.4%	0.8%
Total	**105,479,700**	**68.7%**	**2.5%**	**10,961,600**	**49.3%**	**4.2%**	**8,802,800**	**47.6%**	**4.5%**

Source: Author's calculations using data from the Public Use Micro Sample of the 2000 Census (inflated to 2004 values)

Table 5

Distribution of Tax Benefits from an Optional and Refundable 15% Mortgage Interest Tax Credit

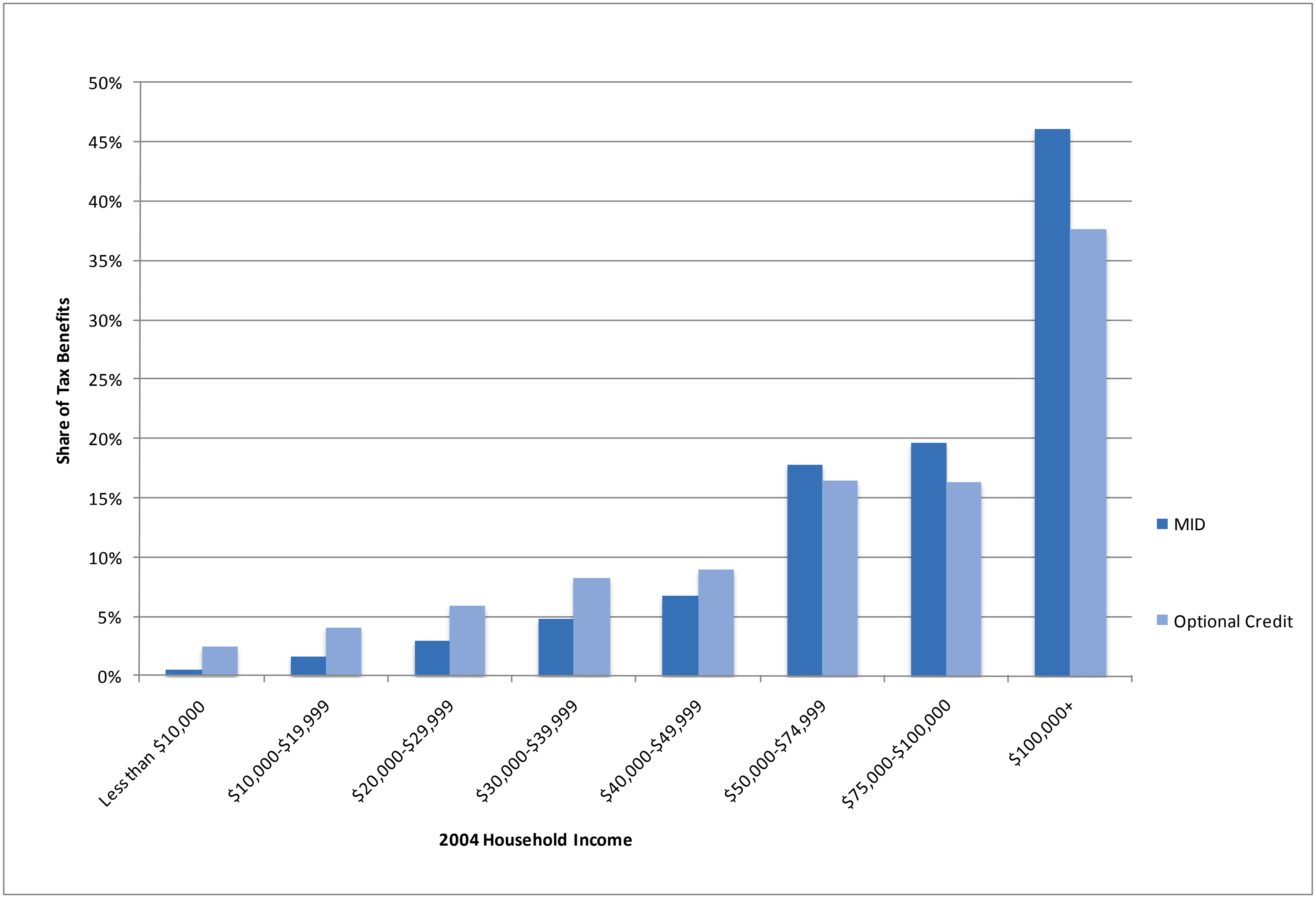
	Current Homeowners			**Current Renters**			
2004 Household Income	Number Receiving Credit	Percent Receiving Credit	Average Credit*	Number Receiving Credit	Percent Receiving Credit	Average Credit*	Percent of Total Credit Amount
Less than $10,000	1,289,900	28.3%	$ 1,292	610,496	12.3%	$ 215	11.3%
$10,000 - $19,999	2,275,800	31.3%	$ 975	551,337	9.9%	$ 295	15.0%
$20,000 – $29,999	3,495,100	43.7%	$ 829	468,496	8.7%	$ 334	19.2%
$30,000 - $39,999	4,203,000	54.6%	$ 846	509,175	10.8%	$ 383	23.6%
$40,000 - $49,999	3,841,200	51.4%	$ 747	263,196	7.5%	$ 479	18.8%
$50,000 - $74,999	4,601,600	29.9%	$ 341	165,310	3.1%	$ 601	10.5%
$75,000 - $99,999	1,436,000	16.0%	$ 166	33,026	1.6%	$ 838	1.7%
More than $100,000	284,200	2.2%	$ 18	1,303	0.1%	$ 1,506	0.0%
Total	**21,426,800**	**29.6%**	**$ 701**	**2,602,339**	**7.9%**	**$ 346**	**100.0%**

*Average credit among those receiving credits

Source: Author's calculations using data from the Public Use Micro Sample of the 2000 Census (inflated to 2004 values)

Figure 1

Distribution of Tax Benefits for the Mortgage Interest Deduction (MID) and the Proposed Optional Mortgage Interest Tax Credit



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Community Development Financial Institutions in Civic Ecosystems

Robin Newberger, Michael Berry, David Black, and Kirsten Moy

Introduction

The purpose of this article is to examine the roles and value-added services that Community Development Financial Institutions (CDFIs) provide to local and regional public-sector agencies, and to illustrate how collaboration between CDFIs and local public-sector agencies impacts the effectiveness and efficiency of community development investments.

Examining CDFIs from the perspective of their relationships with state and local governments is a seldom-explored but straightforward way to illustrate how CDFIs help create community assets and public goods, particularly in distressed communities. When community development practitioners receive financial support from the public sector, they often use these funds to promote greater economic opportunity and quality of life. Among many positive outcomes, these investments foster entrepreneurship in communities with low employment; lending and counseling resources that promote stable homeownership in neighborhoods impacted by predatory lending; and better access to quality education and healthcare. Studies on CDFIs rarely delve into their non-financial, public-purpose functions, or how these activities help support the mandates of state and local governments to provide services and infrastructure to communities in need.

The CDFIs studied for this article are Charlotte Mecklenburg Housing Partnership (CMHP), Neighborhood Housing Services of Chicago (NHS), Enterprise Corporation of the Delta (ECD/HOPE), Community Preservation Corporation (CPC), The Reinvestment Fund (TRF), and Primary Care Development Corporation (PCDC). These CDFIs were chosen in part because of the significant roles they play in their communities. They provide financing and collect data to support affordable single- and multi-family housing, primary-care health centers, charter schools, and retail/small businesses. In telephone interviews with each of these organizations, we explored the origin of their cooperation with local and state governments, the qualities and expertise that singled them out as valued partners, and the main civic issues that they address in conjunction with public-sector organizations. A brief description of each of the six CDFIs is found in Figure 1 below.

Figure 1
Overview of Organizations Interviewed

Charlotte Mecklenburg Housing Partnership, Inc. (CMHP) is a private, nonprofit housing development and financial corporation organized to expand affordable and well-maintained housing within stable neighborhoods for low- and moderate-income families in the City of Charlotte and Mecklenburg County in North Carolina. CMHP was incorporated in 1988 in response to the research and recommendation of a local citizens' forum. The Housing Partnership provides a comprehensive range of affordable housing services focused on revitalization, education, and development. CMHP is a charter member of the NeighborWorks® America network.

Neighborhood Housing Services of Chicago (NHS) is a nonprofit organization established in 1975 that offers Chicago residents affordable resources to buy and maintain their homes. It is a counseling agency and developer of rehabilitated single-family and (limited) multi-family housing. The lending function of Neighborhood Housing Services, Neighborhood Lending Services, Inc., is the only nonprofit mortgage lender licensed in the State of Illinois. NHS partners with neighborhood organizations, financial institutions, the City of Chicago, corporations, and foundations. NHS is a charter member of the NeighborWorks® America network.

Enterprise Corporation of the Delta (ECD/HOPE) is a nonprofit CDFI that provides commercial financing, mortgage loans, and technical assistance to support businesses, entrepreneurs, homebuyers, and community development projects. ECD's mission is to strengthen communities, build assets, and improve the lives of people in economically distressed areas of Arkansas, Louisiana, Mississippi, and Memphis, Tennessee. ECD also sponsors Hope Community Credit Union, which provides a range of financial products and services that meet the needs of low- and moderate-income residents in its four-state service area.

The Community Preservation Corporation (CPC) is a nonprofit corporation founded in 1974 to stabilize, strengthen, and sustain low- and mixed-income communities. CPC provides mortgage, construction, and other lending for the housing needs and the ancillary commercial activities that are necessary for achieving sustainable communities. CPC operates in New York and is funded by a consortium of 90 banks, which contribute capital, participate in lending activities, and provide governance by sitting on CPC's board, lending committee, and other policy-making bodies.

The Reinvestment Fund (TRF) is a socially responsible community investment group. Established in 1985 as a community organization, TRF lends and invests in real estate development, charter schools, businesses, and sustainable energy programs. TRF works to transform neighborhoods, creating opportunity for economically challenged families and communities. TRF works in Pennsylvania, New Jersey, Delaware, Maryland, and Washington, DC.

Primary Care Development Corporation (PCDC) is a private nonprofit organization founded in 1993 that provides capital financing and technical assistance to expand and improve primary care in community health centers and hospitals in New York. The mission of PCDC is to expand and enhance primary and preventive care in underserved communities. PCDC provides primary care financing, policy, and planning. It is the first and largest CDFI in the country specializing in primary care financing for low-income communities.

Based on interviews with representatives of the six CDFIs, we find that these institutions share some traits that enable them to fill gaps between public agencies and for-profit entities. First is the vision and capacity to look beyond a single project or program and second, the ability to articulate well their value proposition in their civic contexts. Third is an awareness of the need for and ability to build infrastructure that fosters further development and documents learning from past efforts. This may take the form of data-gathering (as exemplified by TRF), mutually accepted documentation and standards (as exemplified by CPC), or organizational networks (as exemplified by ECD/HOPE) that provide complementary services. Fourth is a level of flexibility and familiarity with state and local agencies that allows for risk-taking and experimentation derived from the success of past endeavors. This coordination leads to integrated responses and creates opportunities for leverage and greater impact.[1]

[1] Another common trait is that each of these organizations is a nonprofit loan fund and as a general principle, deals in immature credit markets with the goal of eventually “mainstreaming” unconventional borrowers and types of credit. CDFI loan funds typically have bank financial partners, but are not directly subject to specific capital and reserve requirements. However, in more recent years, both public and private financial partners have tended to impose concrete performance expectations.

These activities highlight the differentiated roles of public, for-profit, and nonprofit (CDFI) entities, suggesting that effective community development may emanate in part from the partnerships among such entities, or what we call the *civic ecosystem*. The key roles of CDFIs include mitigating risk; serving as stewards of funds from multiple sources; providing hands-on debt servicing that goes beyond the simple recapture of monies owed; building networks of long-term, productive relationships with complementary partners; and gathering/assimilating relevant longitudinal data to inform community development investments. CDFI activities often entail customized work beyond the capacities of purely for-profit or government organizations, and they often require significant upfront investment (subsidy), which end users cannot generally repay, at least not directly.

The following sections review the services that CDFIs provide to regional, state, or local governments. We identify six categories of functions that these CDFIs perform, recognizing that this is not an exhaustive list. We illustrate each role with an example from one organization, although in reality the CDFIs studied here carry out many of the value-added functions simultaneously.

CDFIs have the ability to blend resources and attract subsidies otherwise unavailable to the public or private sectors.

CDFIs provide both financial and non-financial value in executing their civic and community development strategies. Money may be the most tangible contribution; CDFIs often provide credit for new, non-mainstream, and/or riskier purposes, often with risk-mitigating tools such as government-funded first-loss reserves that allow private financial institutions to enter a new credit market without running afoul of risk policies and regulatory concerns. However, their roles are much more far-reaching and transformational for the places they serve. CDFIs also attract greater funding for housing and neighborhood redevelopment efforts by consolidating public and private resources. They work to bring critical assets and services to communities in need through their close relationships with both government agencies and private funders.

Charlotte Mecklenburg Housing Partnership (CMHP) offers an example of the CDFI as public-private nexus. CMHP was formed in 1987 by civic leaders and housing advocates to address the need for affordable housing and the revitalization of distressed neighborhoods in the growing City of Charlotte, North Carolina. As in many other cities, the housing agenda at that time included the elimination of sub-standard housing as well as the expansion of affordable housing options. The newly formed Housing Task Force envisioned mixed-income communities that did not segregate the poor and lead to unstable conditions. The Task Force also favored comprehensive approaches and sought to build strong partnerships with public, financial, social service, and religious communities.

Civic leaders went through a careful process to implement this strategy. Because their goal was to develop mixed-income communities, they believed that an alternative was needed to both the City's housing authority and the private market. They visited a number of cities to see what worked. Ultimately, they concluded that a mission-based nonprofit could sustain deliberate, long-term revitalization strategies and hold assets consistent with their charitable intent. This nonprofit entity could work in partnership with various sectors, consolidating and blending resources, and bringing in new subsidies. In addition, it would combine a development capacity with lending and support services.

The City of Charlotte began providing housing and revitalization subsidies to CMHP, both on an annual allocation basis (with clear performance criteria) and on a competitive basis. A small portion of the annual funds would go to CMHP operations. The City would also provide comprehensive support services to revitalization efforts, such as public safety and clean-up efforts. Mecklenburg County would provide funds for housing counseling. The civic sector would continue to provide high-level expertise to CMHP, helping the organization make and execute smart financial decisions, and bring a high level of clout to its housing and community revitalization efforts. Several banks would also pool resources for an affordable mortgage program in CMHP.

Through strong partnerships with the public and private sectors, CMHP has been successful in developing housing and revitalizing neighborhoods. Initially, its focus was affordable for-sale housing. As the private market picked up a greater share of the entry-level for-sale offerings, CMHP moved more heavily into affordable rental housing. Though CMHP's initial focus was stimulation of revitalization efforts in severely distressed communities, as CMHP has built its capacity over time, its role has changed in response to changing market circumstances. It assumed a master developer role for large-scale revitalization efforts, and became a partner with private developers on the affordable components of market-initiated developments. CMHP currently holds a strong portfolio of housing that it owns and manages.

The partnerships between the public sector and CMHP have not always been easy, however. Initially CMHP spent the majority of its time on the technical aspects of the work. When it almost lost its contract with the City of Charlotte after changes in elected leadership, it began to devote more significant effort to developing and maintaining the relationships that make successful public-civic partnerships, including assuring that the value-added of CMHP’s contribution is clear and apparent. CMHP is an independent organization that must weigh fiscal and operational issues before taking on any project, and it keeps a careful eye on its own sustainability.

CDFIs provide critical services to borrowers in conjunction with their lending to help stabilize frail neighborhoods in ways that local governments cannot.

In Chicago, the Department of Community Development has a longstanding record of coordinating and financing multi-family affordable rental housing, but no practical means to address the needs of homeowners or potential homeowners in redeveloping communities at scale. Given the large proportion of one- to four-unit structures in Chicago, a key goal of city government is stable residential housing markets, a goal that that is difficult for many urban governments to address or achieve on their own. The infrastructure, skills, and discipline that go into lending/expending $10 million for a multifamily rental housing development differ from those required to ensure that hundreds of individual mortgages represent sound investments. Lending to, counseling, and servicing the mortgages of inexperienced, first-time home buyers require additional layers of skill, effort, and experience.

Neighborhood Housing Services (NHS) of Chicago has been an important partner for the City to deliver on this goal. NHS is part of the NeighborWorks® network of nonprofit housing organizations nationwide that serve primarily lower-income and disadvantaged urban residents. NHS serves Chicago residents who for various reasons—credit history, language barrier, limited financial sophistication—cannot access the conventional mortgage market, or need assistance to stay in or repair their home. For decades, NHS’s implicit and often stated mission has been to foster stable home ownership and neighborhoods in lower-income and otherwise disadvantaged areas. NHS offers a comprehensive array of housing-related services, including foreclosure intervention services, and is the only nonprofit licensed mortgage lender in the state.

After more than 25 years of serving Chicago housing markets, NHS in 2002 formed a large, multi-purpose loan pool funded from differing sources, with primarily private-sector (bank) funds. It consolidated all lending in one pool, subject to multi-year commitments from its many bank lending partners (i.e., pool participants). This was a tipping point for the City of Chicago to turn over serving the (affordable/subsidized) single-family home market to NHS. Prior to 2002, NHS had received many federal and local grants and loans from the City to rehab houses, counsel home buyers/owners, and make mortgages and emergency loans to homeowners facing temporary setbacks. It had for many years prior to 2002 received (and still does receive) CDBG and other grants for its various activities and lending under different internal programs. Importantly, NHS fastidiously reported its use of funds and related results to the City and the Department of Housing. But it was in 2002 that the City effectively delegated its affordable single-family lending, counseling, and rehab development to NHS.

The City of Chicago provides a portion of the reserve funds for the loan pool. This investment allowed NHS to leverage private funding with public funds, providing an additional layer of deferred or forgivable financing to income-eligible borrowers. Only through a long track record of superior loan performance, low default rates, and careful reporting on the use and impact of invested funds was NHS able to establish and repeatedly renew commitments for a flexible, $100 million loan fund that, starting in 2002, allowed NHS for the first time to consolidate all of its basic lending functions.

In addition to the houses that NHS actually acquires, rehabs, sells, and finances, it addresses hundreds more homes annually in the City through the Home Repair for Accessible and Independent Living (HRAIL) program and the City's Lead-Based Paint Abatement program. NHS receives City funding through both, as well as funding to improve the energy efficiency of homes it touches.

In response to high foreclosure rates in its target Chicago neighborhoods, in 2003 NHS initiated the Home Ownership Preservation Initiative (HOPI), which also represents a blending of resources from the City of Chicago and various mortgage lending and servicing organizations. HOPI provides a comprehensive package of counseling and lending services in concert with the City of Chicago and major mortgage servicers to avert foreclosure, or otherwise reach the least damaging outcome (through e.g., short sale or deed-in-lieu) for at-risk borrowers. The HOPI infrastructure—the network of counselors, servicer agreements that promote modifications over foreclosure when possible, and funds for emergency loans—has been held up nationally as a model partnership involving a CDFI, local government, and private-sector lenders.

Using deep local market knowledge, extensive networks, and well-developed resource management skills, the most effective CDFIs respond nimbly to community crises, thereby attracting additional governmental and private assets.

The development needs of the Mississippi Delta region are much greater than any one organization, or any one sector—private, nonprofit, or philanthropic—can address alone. Enterprise Corporation of the Delta (ECD/HOPE) views itself as a "connector," working to identify and address regional needs and opportunities. ECD/HOPE also works to bring the resources of public agencies and the power of state and federal officials and organizations to bear in the communities.

In the 10 years prior to Hurricane Katrina, ECD/HOPE had worked to develop a network of nonprofit organizations providing vital services to disadvantaged populations. After the hurricane, ECD/HOPE received more than $20 million in several allocations from the Mississippi Development Authority. In addition, it received inquiries from individuals, charities, faith-based coalitions, and corporations seeking to donate money and resources to a regionally based nonprofit organization. Most people were looking for an entity that could identify the needs of local people and deploy the resources in a timely manner while maintaining the financial integrity of their donation. As a well-established community development intermediary, ECD and its affiliated Hope Credit Union had systems and networks in place to efficiently bring resources into the region, connect to grass-roots organizations on the front lines of response, and appropriately manage resources designated for relief and recovery.

ECD/HOPE provided affordable financial services to more than 4,500 residents in response to Hurricane Katrina; assisted 450 homeowners with repair and rebuilding; generated more than $20 million in financing to consumers, homeowners, and small businesses; made 900 bridge loans to people and businesses waiting for insurance and government payments; and connected 1,500 people to free legal assistance, evacuation and relocation support, and other recovery services. A housing development affiliate was also involved in rebuilding homes. With funding from the State of Mississippi, ECD/HOPE counseled over 10,000 state residents whose homes were destroyed in the hurricane, which enabled those households to access state rescue funds of between $500 and $600 million. ECD/HOPE also spearheaded efforts to get loans to small businesses affected by the storm. In the wake of Katrina, through a well-developed network of nonprofits offering myriad services, ECD/HOPE was able to refer thousands of individuals and businesses to needed services, in addition to those it served directly.

CDFIs help rationalize fragmented marketplaces composed of many small players and financing from multiple sources and sectors. They do this by attracting private and public funds, creating and disseminating standards, and streamlining the approval process to execute relevant, coherent strategies at scale.

Over the last several decades, housing financing programs have become increasingly piecemeal and interdependent. Among other screening procedures, most public and quasi-public funding sources require other funding/subsidy to be in place before committing their funds. Locally based housing development funds and public-private partnerships have had to consolidate resources (public federal, state, and local; private philanthropic and corporate) to meet community development goals. CDFIs are often valued for their ability to negotiate this fractious system. In addition to understanding the mechanics of applying for grants, CDFIs are often able to initiate deals; serve as stewards of existing assets; gather, assess, and control data and information resources; and maintain advocacy pressure for continuing development efforts.

The Community Preservation Corporation is an example of an organization that has helped streamline the complex process of developing affordable housing. CPC was established in the mid-1970s through joint work by the public sector and financial institutions. The decisive moment came during New York City's fiscal crisis; many neighborhoods that had suffered from years of middle-class flight were in ruin. Virtually no capital was going into multi-family housing in the South Bronx, Harlem, and other previously economically stable, middle-class areas. Abandonment was materially shrinking the affordable housing stock. At the City's urging, David Rockefeller (who headed Chase Manhattan Bank at the time) and other civic "statesmen" created CPC, a "public charity," to intervene. Washington Heights in Manhattan and Crown Heights in Brooklyn were the initial target communities. In its first six years, CPC financing led to the rehabilitation of about 12 percent of the housing in Washington Heights—about 9,000 units.

The concept of a bank-capitalized community development loan fund was not common at the time, but was considered an effective means to spread risk across multiple institutions. It was also a way to increase both the amount and impact of the funds brought to bear. CPC's key insight was to appreciate the potential impact of standardizing the process of developing affordable multi-family housing (through the Participation Loan Program of the City of New York). CPC created common documents, standards, and objectives that the public sector, the private sector, and small developers could all accept. Prior to the creation of these documents, each actor in a deal followed its own protocols. The private-sector staff and capital lenders approached a deal with a high degree of sophistication, but had their own guidelines for rehabs. Smaller developers had to work out their own rehab scope (i.e., non-standardized specifications for plumbing, masonry, etc.) and price guidelines for each deal, which made the process very inefficient. The developers also wanted access to public subsidies, but were not always clear about eligibility requirements. The City had its own protocols and documents—and a byzantine process for qualifying developers.

CPC developed its own documents and protocols that also met the needs of developers of affordable housing, private lenders, and the City housing authority (and other subsidy providers). It created universal, well-considered forms and standards (specifications, documents, agreed-upon underwriting standards) with respect to operating cost estimates, rehab cost guidelines, and debt structures. These made it easier for developers of low-income housing to access subsidies from the public sector, so that lenders (banks to which CPC sells loan participations) could take part in financing the development of affordable housing—once considered a risky investment on its face—without breaching regulator-proscribed risk tolerances. Though CPC received no direct City or State funding, its efforts greatly improved the efficiency of bringing about affordable housing in NYC. The "one-stop shop" became CPC's moniker for this streamlining effort.

CPC reports having provided $7.3 billion in public and private financing for the rehab and development of over 136,000 apartments since its 1974 inception. This type of track record gives confidence to local governments looking to commit tax dollars efficiently and wisely. In CPC's early years, about 70 percent of its loans combined public low-interest mortgages with CPC-supplied bank debt. Today, the proportion of subsidized loans is substantially less. This can be attributed in part to changes in the housing market and in public budgets. By providing training and resources for relatively inexperienced developers of affordable housing, CPC has helped bring new actors to a space that might otherwise be secondary or tertiary work for mainstream, larger for-profit developers. But the increased prevalence of conventionally financed community investment demonstrates something very positive: mainstream lending now occupies a far larger share of community development finance.

Building on a successful history of housing finance (with comprehensive services for developers), streamlined documentation and underwriting across City, bank, and CPC underwriters, CPC was able to simplify the low- and moderate-income rehab process for upstate communities as well. A CDFI Fund award to CPC allowed it to replicate its work elsewhere in New York State and apply the funding towards soft second mortgages. This package was a major incentive to smaller communities to engage CPC's services and deploy local resources. CPC was particularly successful in Beacon, NY, and Albany, the state capitol.

CDFIs inform the development of more intelligent community and economic development strategies on the part of state and local officials by collecting, developing, and analyzing data (often not easily available) on the places they serve.

The Reinvestment Fund (TRF) finances various types of ventures including housing, community facilities, charter schools, commercial and retail businesses, clean energy technologies, and leasing, and does predevelopment, construction, and permanent financing.

TRF distinguishes itself from most CDFIs, however, through its multi-dimensional market knowledge and data tools. TRF puts together large statistical and spatial models for consumption by public agencies, such as housing finance agencies and the offices of mayors and governors. TRF aggregates these data in part from its own long-term work in economic development and neighborhood financing, and derives data from other sources as well. The type of nuanced neighborhood information that TRF analyzes provides the basis for more informed and effective community investment.

TRF's "PolicyMap" product allows subscribers to overlay demographic and other data (e.g., labor statistics, bankruptcy filings, location of LIHTC-financed housing) on city maps to determine areas of need for retail or other development and where capital can be put to best use. Public agencies use the tool to help them think about allocation of public resources. Similarly, TRF's Market Value Analysis (MVA) product helps cities to identify distinguishing real estate market characteristics that help to classify and prioritize needs for underinvested neighborhoods. Just as the data help TRF assess and invest more effectively, TRF helps others to do the same, making TRF valuable to local government entities. Additional data users include foundations and other civic organizations, developers, mainstream lenders, news media, planning agencies, and private consultants.

While TRF is a qualified and skilled lender, it considers the aggregation and organization of data a "different credential" and a means to undergird and even help pave the way for broader, complementary community and economic development initiatives. This ability and capacity forms the basis not only for TRF's state/local relationships in various cities and regions, but also for the continual refinement and expansion of its data tools for maintaining them.

As an intermediary for both capital and data, TRF has evolved into not only an entity skilled at attracting and effectively deploying private-sector investment but also a steward of public-sector money. By building a large network of civic and policy relationships, TRF has become influential in civic discussions on a broad spectrum of economic and community development issues. By working to align the interests of actors across the civic/business spectrum, TRF is positioned at the center of civic discussion, debate, and policy-making on economic development in areas of New Jersey, Pennsylvania, Delaware, Maryland, and other localities. Important relationships include the governors of the states TRF serves, legislators, local venture capitalists, religious groups, private developers, and myriad banking institutions. Participation in the civic debate has also made TRF into the player that gets things done, drives resources, and opens channels to the CDFI Fund and other federal support, as well as state/local money. It has allowed TRF to bring greater value to the public-private-intermediary triumvirate.

CDFIs carry out public-purpose functions on behalf of a broad coalition of civic actors, often as the delegate agency for local governments.

Helping the public sector provide more efficient services drove the creation of the Primary Care Development Corporation (PCDC). In 1993, the City of New York undertook a special initiative to develop primary care in the City's underserved communities. Mayor David Dinkins responded to a strong public consensus among City and State health care agencies, providers, policymakers, foundations, and community and advocacy groups that primary care resources were significantly lacking in underserved communities. The Mayor decided this need could be met most efficiently through a non-governmental organization, and PCDC was formed. It was critical that PCDC be an independent, accountable entity, with a strong board and the credibility to attract private investment.

To assist PCDC in this effort the City of New York made tax-exempt bond financing available, while a group of foundations provided start-up funding. A group of major banks and public sources (federal, state, and city) provided funds for PCDC's Capital Financing services to lend for: property acquisition and pre-construction work; renovations, expansions, equipment acquisition; construction of health centers in under-invested communities; and temporary (bridge) financing for projects with committed permanent financing. PCDC provides incentives for both private and public investors by putting up first-loss reserves, an important factor in credibility and the willingness of investors to lend.

PCDC needed an important stakeholder—a local/state agency, or even a large foundation—to take a deep interest in primary health care. The motivation for the City of New York was at least in part that much of the State's Medicaid funding was going toward delivery of primary health care, and even treatment of more serious but not (immediately) life-threatening conditions, in emergency rooms. The potential to reduce costs and deliver better-suited care to large populations effectively aligned the interests of the City, PCDC, private lenders, the uninsured (i.e., care recipients), and ultimately taxpayers.

In addition to the City's support, PCDC built a community of interest around the success of primary care in part through the selection of its board of directors. The board members are invested in the success of primary care and have been pivotal in problem solving, bringing additional resources, and building the reach and credibility of the organization. PCDC's board includes representation from national corporations, financial institutions, foundations, the Mayor's office, and the City Council. It also includes primary care physicians, a former Assistant Secretary from the Health and Human Services Department (HHS), and the heads of the New York City Department of Health and Mental Hygiene and the New York City public hospital system. One of PCDC's founding board members later became the director of the HHS Health Care Financing Administration.

Health care centers that serve primarily lower-income communities and clients with only Medicaid or no health insurance face significant headwinds. Most mainstream investors would be reluctant to invest in these facilities due to their narrow financial margins and the risk and complexity of delivering care to a low-income clientele. As a result, this sector typically lacks experience in the complex processes of facility planning and development. PCDC's capital financing and technical assistance have provided the expertise and resources to address both issues. Beyond financing, PCDC works with the management of these facilities to develop and refine core processes, to (among other benefits) facilitate electronic record-keeping, develop emergency preparedness, and streamline care delivery. It effectively aligns the interests of investors, borrowers, and government agency partners, who practically speaking could not manage such an ambitious and effective financing vehicle without a strong intermediary, or otherwise bring the collective of funding and resources to bear.

While not constituted as a policy organization, PCDC is recognized as the authority on the financing and delivery of primary care and has developed a reputation for expertise and neutrality, placing it in an influential position. As its partners, City, State, and private foundations frequently turn to PCDC for information and advice. As New York State has moved toward health care reform and health system restructuring, PCDC has become a strong and respected voice for primary care. The City of New York's interest in reducing the cost of health coverage for lower-income households (i.e., the Medicaid system, a portion of the costs of which is borne by the City of New York) has only grown in the years since PCDC's founding, and primary care is increasingly seen as a keystone to both keeping people healthy and lowering overall healthcare costs. PCDC's commitment and skills have also drawn the attention of state agencies around the country who want to learn more about the PCDC's services and techniques.

Conclusion

This article explores the theory that renewed support from local and regional governments is evidence of the essential contribution CDFIs make to their local economies. As we show here, the roles of CDFIs extend far beyond loan underwriting. CDFIs use their technical know-how to pioneer markets for emerging products in low- and moderate-income communities, such as primary health care facilities, charter schools, foreclosure mitigation services, and technical assistance for small businesses. They aggregate and interpret data from diverse fields often not explored together to inform the allocation of scarce public resources. CDFIs help develop the infrastructure—the systems, practices, documentation, data, relationships, networks, and learning from long-term community development endeavors—for lower-cost finance by identifying community needs and better ways to deliver products that meet these needs, leading to greater availability of affordable housing and a variety of critical services.

We use the term *civic ecosystems* to describe the partnerships between CDFIs, the public sector, and private interests that have been formed in the service of community development. In this study, we show that the CDFIs and their partners built strong relationships to establish a greater consensus on what was needed to connect low- and moderate-income communities to the economic mainstream. By involving a broad group of civic actors in the development of their own organizational goals and governance, the CDFIs contributed to the sustainability of their own institutions and of the projects they supported. This alignment helped lengthen the timeline of public support for community development projects, allowing the CDFIs to make investments they might not otherwise have made. Partnerships that were carefully constructed and capitalized on the strengths of the various players involved managed to carry out complex and comprehensive community development activities that utilized subsidies efficiently and effectively. Partnerships among public agencies, for-profit entities, and CDFIs led to community development projects whose results exceeded the sum of their parts.

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What Makes for a Smart Community or Economic Development Subsidy? A Program Evaluation Perspective

Martin D. Abravanel, Nancy M. Pindus, and Brett Theodos

Many public dollars and numerous federal government programs support community and economic development activities in the United States. One report put federal community development spending at over $45 billion in 2004 (Gerenrot, Cashin, and Paulson 2006), and another identified 14 federal agencies that spent a total of $76.7 billion on 250 separate programs involving activities "useful to regional economic development" in FY 2006 (Mills, Reynolds, and Reamer 2008). While these expenditures constituted only a small fraction (roughly 2-3 percent) of federal spending in those years, the amounts are nonetheless substantial.

Given the multiplicity of federal community and economic development programs, obvious questions include whether they represent a smart use of public subsidy and if so, which approaches are the smartest. Much of the conversation involving smart subsidies either follows logically from economic theory or is based on real-world practitioner experience with initiating and financing community or economic development projects. These perspectives are compelling, but there is another way to consider whether a subsidy is smart: empiric evaluation of actual projects undertaken in conjunction with federal programs. As distinct from rules-compliance reviews or routine program monitoring, formal program evaluations tend to be done only occasionally to learn whether programs are on target to achieve, or are actually achieving, intended objectives. We turn to the program evaluation literature as an alternative perspective on whether federal community and economic development subsidies are smart.[1]

History, Scale, and Trends in Federal Community and Economic Development Programs

A case can be made that the Public Housing program, initially authorized in 1937, was the first major federal government initiative to attempt to improve the economic viability and development of low-income communities. The Housing Act of 1937 was intended to provide not only affordable housing resources but also employment opportunities, economic stimulation, and slum removal. Prior to that, public responsibility for such activities tended to reside with state or local governments. It was not until Title 1 of the Housing Act of 1949, however, that the Urban Renewal program, which was originally designed to eliminate slums, evolved to emphasize economic development in lower-income urban areas. Similarly, several programs to develop rural areas were created in the 1930s and 1940s—including those administered by the Rural Resettlement Administration and, later, the U.S. Department of Agriculture's Rural Electrification Administration, Rural Development Assistance program, and Farmers Home Administration.

In recent decades there has been a succession of federal government programs or regulations designed to improve the economic viability and development of communities. Some of these have already expired but many continue to operate. These programs include: the Small Business Loan Guaranty (1953–) and Venture Capital (1958–) programs, which in 1964 incorporated an explicit emphasis on economically distressed communities; the Economic Development Administration (EDA) grant programs (1965–); the Model Cities program (1966–1974); the New Communities program (1968–

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[1] For a more extensive review of the literature, see Martin D. Abravanel, Nancy M. Pindus and Brett Theodos, *Evaluating Community and Economic Development Programs: A Literature Review to Inform Evaluation of the New Markets Tax Credit Program:* Washington, DC: The Urban Institute, September 2010. That review, which serves as a basis for this chapter, was supported by the CDFI Fund of the U.S. Department of the Treasury as part of a program evaluation of the New Markets Tax Credit program.

1983); various National Park Service grant programs (1968–); the Community Development Block Grant (CDBG) program together with the Section 108 Loan Guarantee program, the Economic Development Initiative (EDI) and the Brownfields Economic Development Initiative (BEDI) (1974–); the EDA Revolving Loan Fund (1974–); the Urban Development Action Grant (UDAG) program (1977–1986); Rehabilitation Tax Credits (RTC) (1977–); the Community Reinvestment Act (CRA) (1977–); the Low Income Housing Tax Credit (LIHTC) program (1986–); the HOME Investments Partnership program (1990–); the HOPE VI program (1993–); the Renewal Community/Empowerment Zone/Enterprise Community (RC/EZ/EC) initiative—along with Neighborhood Revitalization Zones, HUB zones, and the Gulf Opportunity Zone (1993–); USDA Rural Development loan and grant programs relating to business development, housing, community facilities, electricity, telecommunications, and water (some of which date back to the 1930s and 1940s and were reorganized in 1994-); and the Community Development Financial Institutions (CDFI) Fund's New Markets Tax Credit (NMTC) program (2000–).[2]

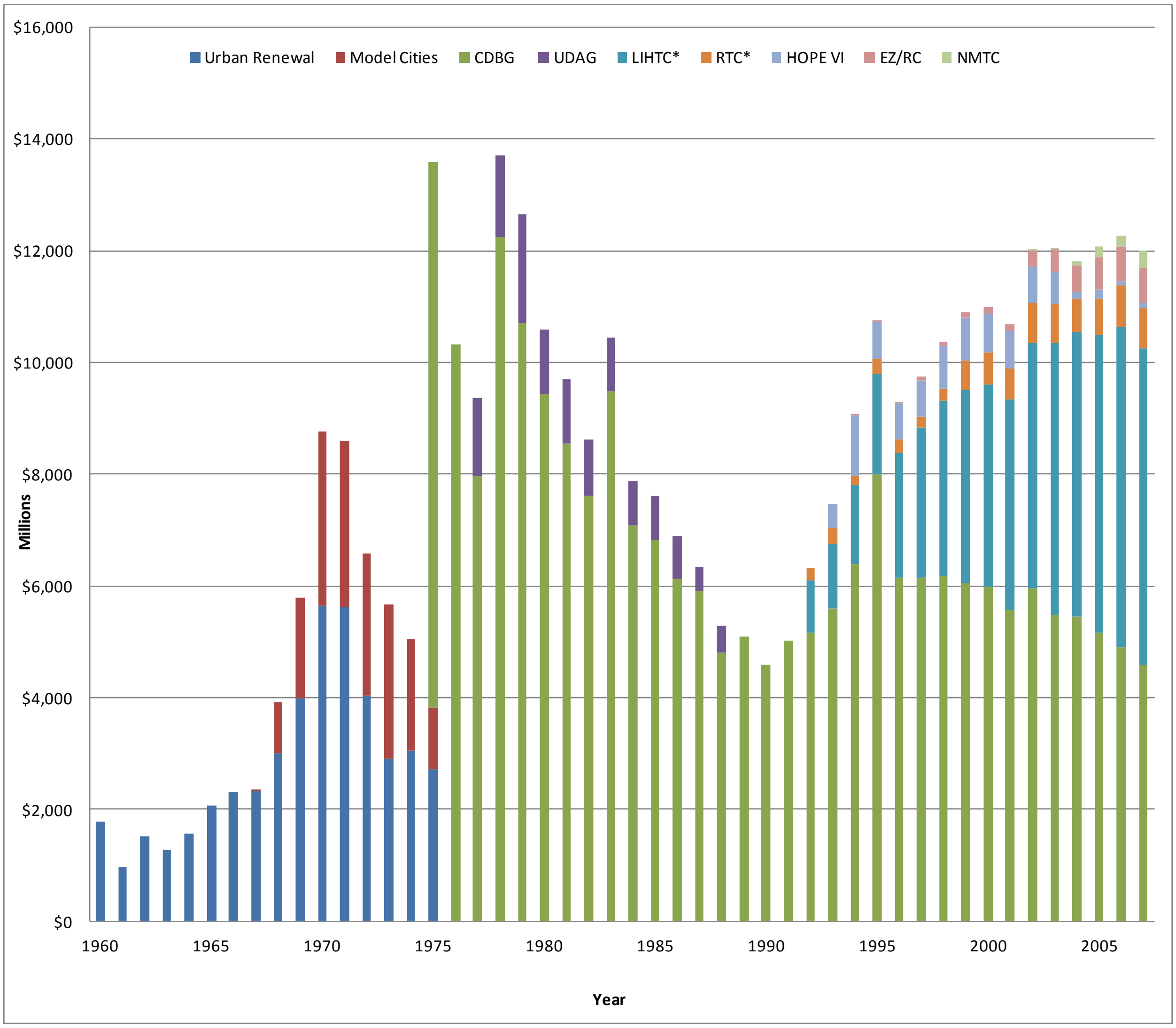
To provide a basic sense of the scale and trends in federal community and economic development funding, figure 1 displays the pattern of appropriations (expenditures) and foregone taxes associated with nine prominent federal community and economic development programs, by year, beginning in 1960. The data are adjusted to reflect constant 2007 dollars. During the earlier portion of the period, the Urban Renewal program and, later, the Model Cities program accounted for between $2 and $9 billion annually, peaking in the early 1970s. With the advent of the CDBG program in the mid-1970s and the addition of the UDAG program, total appropriations (and foregone taxes) reached their high-water mark, varying from more than $9 billion to about $14 billion annually through the early 1980s. Economic development funding declined through the rest of the 1980s before climbing again in the early 1990s. For most of the 2000s, the programs that continued have accounted for about $12 billion annually.[3]

[2] In addition to federal programs, many states and localities have their own community and economic development programs, ordinances, and tools—some of which may work in conjunction with federal programs. These include state tax credits for business, tax increment financing (TIF), industrial revenue bonds (IRBs), industrial development bonds (IDBs), state enterprise zones (EZs), tax abatements, inclusionary zoning ordinances, and community benefits agreements (CBAs).

[3] Annual expenditure variations for some programs (such as CDBG) depend on Congressional appropriations whereas the amount of foregone taxes associated with the RTC program depends on taxpayer claims, which are not capped on a yearly basis. Note that program spending does not necessarily occur in the same years in which funds are appropriated or credits are allocated; hence, investments made from such appropriations or allocations may lag.

Figure 1

Expenditures and Foregone Taxes for Nine Community and Economic Development Programs, in 2007 Dollars



* RTC and LIHTC data are not available prior to 1992.

Learning what Community and Economic Development Programs Achieve

To objectively assess whether programs accomplish their goals generally requires conducting formal program evaluations. These can range from relatively simple and straightforward efforts to studies that are extremely involved and demanding. Several prominent governmental and academic observers have recently argued that evaluations of community and economic development programs, in particular, tend to fall at the challenging end of the range. This is often because of the variety and complexity of the interventions (projects) undertaken, the dynamic contexts in which they occur, and the special difficulties of measuring results and attributing them to the interventions.

Communities are multifaceted systems consisting of interrelated structures and activities that, along with external factors, influence the very conditions any community and economic development program seeks to alter. Also, it is often the case that community and economic development program investments are small relative to the neighborhoods or communities in which they are made. This means that such investments are unlikely to have large impacts, and that any impact may not be easily detected with respect to the problems they aim to ameliorate—such as high levels of poverty or lack of community economic vitality (GAO 2009; Hollister 2007). Identifying outcomes, determining whether benefits flow to those with greater needs, and sorting out both short-term and long-term causes and effects are challenging undertakings.

There are various types of program evaluations. Bartik and Bingham (1997) provide a useful framework in the form of a continuum roughly corresponding to a program's life cycle. It has six different "levels," each of which builds on the previous, as follows:

Monitoring Daily Tasks	**Assessing Program Activities**	**Enumerating Outcomes**	**Measuring Effectiveness**	**Calculating Costs and Benefits**	**Assessing Impact on the Problem**

Process/Formative Evaluation

Outcome/Summative Evaluation

The initial levels involve formative or process evaluation, focusing on how a program is delivered. Level one consists of monitoring the internal workings of a program to assess, for example, what tasks are taking place, whether they are being carried out efficiently, or whether contractual obligations are being met. Level two involves assessing program activities to determine such things as how simple or complicated procedures are or how well the program is being implemented. The third level entails determining whether a program's objectives are being achieved; it is the initial stage of an outcome or summative evaluation. Further along the continuum is effectiveness measurement, which considers whether a program is working and whether its goals have been accomplished. The final two levels include cost-benefit analyses and impact assessments, the latter seeking proof that a program is in fact having a measurable impact on the problem(s) to which it was designed to respond.

Each successive level of program evaluation presents increasingly difficult challenges. The ultimate challenge, at the impact-assessment level, is to establish what would have happened in the absence of a program (i.e., the counterfactual) to ensure that the intervention and not other factors brought about particular outcomes.

Outcomes are events and conditions that follow from an intervention, whereas impacts are events and conditions that are directly caused by it. Experimental methods—where treatment and control groups are randomly selected and outcomes are tracked and compared between the two—are preferred for impact assessment. Whether conducted at the project, neighborhood, or community level, however, there are both substantial issues (as mentioned above) as well as non-trivial costs associated with implementing such designs in evaluating community and economic development program interventions (GAO 2002, 2009). Because rigorous efforts to prove cause and effect might be feasible in very few circumstances, researchers often use quasi-experimental methods—including econometric simulation, propensity-score matching, geographically based adjusted time series analyses, or financial or social accounting standards—to assess program outcomes (Immergluck 2008; Hollister 2007). Even then, quasi-experimental designs are not always feasible or practical for evaluating programs that operate in complex and dynamic contexts (Margolis et al. 2009).

As applied to many federal programs, community and economic development evaluations have been inconsistent with respect to methods, evidence, and rigor, and also uneven with respect to coverage. Diverse topics have been addressed: the extent and nature of targeting; program design and operations; management and financial performance; capital flows; stimulation of enhanced local or institutional capacity; the nature or extent of public participation; the extent of leveraging of program dollars for other dollars; the pricing efficiency of credits (for tax credit programs); direct, indirect (also called contingent), or community-scale outcomes; the extent of substitution of federal investment for private or other public investment; and the sustainability (growth or decay) of program outcomes. These topics extend across the full evaluation continuum, yet it is not until the middle of the continuum that emphasis turns to results—i.e., what outcomes follow a community or economic development program intervention.

Criteria for a Smart Subsidy, Following from Outcome-focused Program Evaluations

A review of the community and economic development program evaluation literature that emphasizes results highlights two criteria that together can be said to distinguish a smart subsidy: (a) whether *beneficial* outcomes follow from project investments; and (b) whether *public subsidies are needed* to make those project investments happen.[4] Each criterion is necessary but not sufficient for a subsidy to be smart; together, the two are sufficient. The policy rationale for this definition is that scarce public resources are wasted either when beneficial outcomes do not result from program investments or when projects would have happened even in the absence of public subsidies. Below is a brief review of the literature dealing with evaluation of community and economic development project outcomes and need for subsidies—in the latter instance, from federal programs.

Project Outcomes

The literature provides no uniform definition of, or approach to measuring, community and economic development program outcomes. However, evaluations have distinguished between direct and indirect outcomes, short-term and long-term outcomes, and outcomes associated with the supported projects as distinct from outcomes associated with neighborhoods or communities. Because of the challenges and high costs of measuring indirect outcomes, long-term outcomes, and outcomes involving neighborhoods or communities, evaluations have most often concentrated on direct, short-term project outcomes.

The outcomes expected from community and economic development programs have varied according to each program's objectives. A complication is that some programs are single-purpose while others are multi-purpose. A single-purpose program, such as one that solely provides venture capital for small businesses, would be expected to produce business development outcomes, while those like the CDFI Fund's NMTC program and the Section 108 program of the U.S. Department of Housing and Urban Development (HUD) would be expected to produce a range of outcomes. The latter may include employment, physical development, housing opportunities, public or community facilities, business development, industrial or commercial or mixed-use enterprises, or enhanced institutional capacity. Clearly, no single metric applies across all community and economic development programs or even across all projects undertaken in conjunction with multi-purpose programs. Likewise, outcome measurement will draw on different data sources (including secondary as well as primary) and involve different data analytic methods (including quantitative as well as qualitative).

Discussed below are a variety of outcomes and measures that have been associated with various community or economic development program evaluations.

[4] While, according to this definition, beneficial outcomes are an attribute of a smart subsidy, the program evaluation literature has not established empirically the relative value of one type of outcome over another with respect to ameliorating community and economic development problems. Which outcomes are more desirable than others tends to be a policy consideration more so than a program evaluation matter.

1. Employment

A common measure of the success of community and economic development programs is the extent to which they create new jobs or retain existing jobs. Related to this is the efficiency of job creation/retention under one program versus another, the quality of the jobs created or retained, and who benefits from such jobs.

Job creation and retention. A fundamental question asked about many community and economic development programs is how many jobs they produce. Studies of the UDAG program, CDFIs, EC/EZs, and many others, offer examples of how jobs outcomes have been measured.

The UDAG program was intended to stimulate private investment, jobs, and tax revenues in distressed cities and urban counties. Since employment impacts were critical to its success, HUD attempted to evaluate its jobs outcomes after four years of UDAG implementation (HUD 1982). The focus was the number of jobs created or retained, the costs per job, and the extent to which jobs could be attributed to the program. Jobs were measured in terms of full-time equivalent positions (some jobs were full-time and some were part-time). Construction employment was separated from other jobs because these were primarily short-term. New permanent jobs were distinguished from retained jobs, and jobs for low- and moderate-income persons were distinguished from those for others. With respect to new permanent employment, the evaluators concluded that 77 percent of the jobs anticipated in initial grant agreements were actually being produced.

Several studies of CDFIs have also assessed employment outcomes. Rubin (2006) describes two studies conducted by LaPlante in 1996 and 2004 that examined the impact of the Maine-based CDFI, Coastal Enterprises Incorporated. In the first study, LaPlante estimated initial employment levels and job growth. LaPlante also surveyed firms about job quality and asked them to assess the impact of Coastal Enterprises funding on job creation. However, Hollister (2007) notes that many analysts are extremely skeptical about the value of responses to such survey questions. LaPlante's 2004 evaluation used state unemployment insurance records to measure wage growth.

An assessment of the first round of EZ/ECs used establishment-level data to measure changes in economic activity in EZ areas before and after initiation of the zone programs. It compared employment growth in an EZ area to a designated comparison area within the same city during the same period of time to determine development impacts (Hebert et al. 2001). The study found that job growth occurred in five of the six EZs and that, in four of the six, it outpaced job growth in contiguous areas. In a later study of EZ/ECs, the GAO also compared designated EZ and EC program areas with comparison areas over time (GAO 2006), calculating changes in unemployment rates from 1990 to 2000 and the total number of jobs from 1995 to 2004. GAO observed that improvements in poverty, employment, and economic growth had occurred in the ECs and EZs but that econometric analysis could not definitively tie changes to EC/EZ designation.

The CDFI Fund collects data related to the NMTC program, including job creation. The measure used is the number of jobs created, as reported on transaction-level reports that Community Development Entities (CDEs) submit to the Fund. CDEs can report on three types of jobs: those associated with the construction of a NMTC-financed real estate project; permanent jobs associated with a business receiving NMTC-financed investment; and permanent jobs associated with businesses that are tenants of a NMTC-financed real estate project (Bershadker et al. 2008). These data cover some but not all possible measures of job growth and do not address job benefits.

Job quality. Some researchers have noted that smart subsidies should create not just jobs but *quality* jobs (Felsenstein and Persky 1999). Indicators of job quality include wage levels, opportunities for advancement, job skills or training provided, and benefits. Benefits can be measured by the percentage of employees offered health insurance, a pension plan, a savings plan, sick leave, tuition assistance, or vacation time.

With respect to job quality, Seidman (2007) proposes that recipients of NMTC funds should also consider how to improve traditionally low-wage jobs that often accompany the introduction of community services to neighborhoods, such as grocery stores and credit unions. In a commentary on federal economic development programs, Markusen and Glasmeier (2008) point out that the current stress on short-term job creation in many programs comes at the expense of investment in human capital such as opportunities for continuing education and the skill-building that is needed for long-term productivity and growth. Reese and Fasenfast (1997) also call for evaluations that incorporate broader social values using measures that go beyond employment and economic growth to include such concepts as economic empowerment and sustainable improvement in income levels.

Jobs beneficiaries. Programs vary with respect to their focus on outcomes in a particular location and outcomes benefitting the *residents* of such a location. Immergluck (2008) notes that distinguishing among such strategic approaches is critical to developing outcome measures. For example, a place-based strategy aimed at improving the physical and economic vitality of a neighborhood may not differentiate between improved jobs and income for current residents and economic improvement via in-migration or out-migration. In addition, it is difficult to target employment at the neighborhood level due to the larger geographic scale of labor markets.

Depending on program goals, a number of evaluations have considered the proportion of jobs created that are filled by local residents rather than outsiders, and by targeted groups such as low-income or minority residents. Other factors to consider when evaluating employment benefits include commuting patterns, opportunity for career advancement, and multiplier effects.

The availability of employee-level data permits more detailed analyses. For example, in a case study of the impacts of chain supermarket development in the Philadelphia area, researchers measured the extent to which urban supermarket employees lived in socioeconomically distressed communities and their proximity to their place of work (Goldstein et al. 2008). Using data provided by a supermarket chain, they were able to identify the census tract of residence for employees and found that those at three store locations lived in tracts with very low household incomes, high poverty rates, or high unemployment rates. They concluded that urban supermarkets bring new job opportunities to residents in distressed communities but cautioned that, from a regional perspective, a new store does not necessarily create a net increase in the number of jobs.

2. Real Estate Construction and Rehabilitation

Real estate construction and rehabilitation (both commercial and residential) are major components of many community and economic development programs. The extent to which programs produce construction and rehabilitation outcomes has been assessed in various ways, often beginning with a basic accounting of outputs—i.e., the number of square feet developed or rehabilitated by a project. As with measurement of employment outputs and outcomes, some evaluators probe beyond these measures (depending on program goals) to consider types or uses of the real estate projects, their locations, and who benefits (or suffers) from them. With respect to adverse effects, real estate construction and rehabilitation projects have the potential for displacing existing residents and businesses. Finally, a longer-term measure included in some evaluations is the effect of real estate projects on adjoining property values.

Amount of construction and rehabilitation. A simple measure of change with respect to nonresidential real estate involves commercial property square footage. Voluntary reporting to the CDFI Fund on NMTC project outcomes includes the square footage of real estate developed or rehabilitated (Bershadker et al. 2008). More detailed measures that describe the type or purpose of the building constructed have been used in some studies, including the percentage of nonresidential versus residential construction and the percentage of new construction versus rehabilitation of existing stock.

For example, given that the RTC has been available for both housing and nonresidential projects, Listokin, Listokin, and Lahr (1998) tracked the types of projects using RTC and found that about half of them were exclusively housing and another 20 to 30 percent were in the mixed-use/other category. The remainder consisted of commercial/office renovations.

Uses of construction and rehabilitation. In addition to enumerating the number of units of housing or square feet of space constructed or rehabilitated, evaluations of community and economic development programs consider the benefits they bring to a distressed community. HUD's UDAG evaluation (HUD 1982) considered who benefits from two perspectives—whether the housing was located in deteriorated or transitional neighborhoods and whether the housing was targeted (or priced) for low- or moderate-income households. Rubin (2006) reports that some CDFIs report on the number of units designated as affordable to low-income households. Relatively few CDFIs track the income or other characteristics of ultimate tenants. A useful measure of a program's ability to address community need is the percentage of low- and moderate-income units developed as a fraction of the total units developed (Listokin et al. 1998).

***The effects of construction and rehabilitation on property values*.** Property values are often used as a proxy for the neighborhood effects of community and economic development investments. As quality of life improves in neighborhoods (e.g., lower crime rates and better access to amenities), these improvements are capitalized in the prices of residential properties such that property values are expected to rise (Immergluck 2008; Galster, Tatian, and Accordino 2006). It should be noted that while property values are one of the most commonly used measures, they do have limitations. Immergluck (2008) cautions that property values may not incorporate the value of other neighborhood qualities such as social capital. Especially during speculative bubbles, property values may overestimate the value of the neighborhood.

A number of studies illustrate that housing investment can have a significant positive impact on neighboring property values. However most such studies are not limited to property values but consider them only one indicator of the neighborhood effects of community and economic development (Ding and Knapp 2003; Schill et al. 2002; Ellen and Voicu 2006).

Galster, Tatian, and Accordino (2006) point out that indicators of neighborhood inputs and outcomes should ideally be measured frequently, over an extended time, both before and after the intervention, and on a small geographic scale. In their analysis of the impact of a localized economic development initiative, the Neighborhoods in Bloom program (1998– 2004), they compared differences in: (a) home prices between the target and comparison neighborhoods before and after the intervention and (b) the levels and trends in home prices between the target and comparison neighborhoods while controlling for coincident citywide trends.

3. Business Development

Many community and economic development programs strive to increase business development. This may involve business start-ups or expansion of existing establishments. In addition to jobs created and retained, measures of business activity include the number of establishments, the ratio of businesses to population, average receipts of businesses, and percent of businesses with paid employees. These numbers can be tracked over time for a particular program and for populations of interest and compared to a period prior to program implementation, to other similar communities, or to national or regional benchmarks. One limitation that has been noted is the lack of data on business establishments by census tract; U.S. Census data show business establishments only at the state, county, metropolitan area, and city levels (Gittell and Thompson 1999).

4. Services and Amenities

Services and amenities play a central role in many community and economic development programs. Some initiatives promote investment in amenities in order to stimulate growth and to attract new businesses and increased investment. Others, particularly the comprehensive community initiatives that emerged during the late 1980s and early 1990s, take a broader approach. Funded by national or community foundations, they sought to promote positive change in disadvantaged neighborhoods through holistic approaches that addressed physical, social, and economic conditions (Fulbright-Anderson 2006). The provision of services and amenities involved a variety of establishments, both nonprofit and for-profit. Potential outcomes included: access to quality public facilities (schools, health care, training centers, child care centers, etc.), access to grocery, banking, and other commercial/retail services, access to education (financial literacy, consumer education, entrepreneurial education), and access to financial products (bank accounts, payday loan alternatives, consumer loans, car loans, mortgages, equity financing). Currently, the CDFI Fund asks NMTC allocatees to report on the capacity of community facilities (arts centers, child care facilities, educational facilities—usually charter schools, health care facilities, and other facilities). Capacity is reported as number of slots, student-seats, or patient capacity (Bershadker et al. 2008).

Researchers have also developed composite indicators of service availability. For example, Florida, Mellander, and Stolarick (2007) use the diversity of consumer service firms as a proxy for regional amenities. Other recent efforts have measured amenities such as arts and culture and access to parks and outdoor recreation. Jackson et al. (2006) define cultural vitality as evidence of creating, disseminating, validating, and supporting arts and culture as a dimension of everyday life. Their measurement framework considers: the presence of opportunities for cultural participation, cultural participation in its multiple dimensions, and support systems for cultural participation. Other studies have assessed the community impacts of supermarket development (Goldstein et al. 2008), access to bank accounts and other banking services, as well as financial education (Kolodinsky et al. (2002).

5. Infrastructure Development

Public investments in infrastructure—such as roads, streets, bridges, water treatment and distribution systems, waterways, airports, and mass transit—can enhance community and economic development by offering a locational advantage to businesses, either by increasing productivity or reducing factor costs (Eberts 1990). Deborah Caroll (2008), in her general discussion of Tax Increment Financing (TIF), makes the same point—i.e., that TIF policy is based on the premise that public infrastructure promotes private investment by reducing the cost of business relocation and expansion. This is not a universally held belief among researchers, however, as it has been theorized that infrastructure is not a cause, but a result of economic growth (Norcross 2007). Nevertheless, if infrastructure investment is a program objective, it is necessary to consider appropriate outcome measures.

Infrastructure can be measured using a monetary approach (measuring physical capital in monetary terms by adding up past investment) or an inventory approach (assessing the quantity and quality of all pertinent structures and facilities). No single consistent measurement standard is used by researchers. Based on a review of the research on the relationship between public infrastructure investment and economic development, Eberts (1990) reports that studies show that public infrastructure investment significantly affects economic activity, but the magnitude of the effect is much smaller for public investment than for private investment (in most cases public and private capital are complements, not substitutes).

6. Beautification

Visual improvements to a neighborhood (e.g., improving street fronts and removing graffiti, litter, trash) can be seen as a physical marker of three historic ideals of spatially targeted community and economic development efforts (Thomson 2008): preservation; redevelopment; and revitalization. Preservation seeks to curb the decline of an area by retaining and strengthening physical structures (along with existing residents and businesses). Redevelopment is the effort to transform a distressed area into a newer, more economically vibrant region and often requires demolition and construction of new physical structures (along with the displacement of residents). Finally, revitalization endeavors to reverse an area's decline and employs both preservationist and redevelopment approaches.

Examples of economic development programs that implement these strategies—transforming the physical appearance of a community to assist in transforming its economic vitality—include the RTC, LIHTC, Urban Renewal, and HOPE VI programs. Studies by Thomson (2008), Listokin et al. (1998), and Whalley (1988) suggest that the process of beautification may have a positive multiplier effect on the community by stimulating repairs and renovations of surrounding properties. Measures of the effects of beautification strategies include participation rates, additional private investment, and lower displacement rates. The literature also supports the notion that physical appearance affects homeowners' perceptions of neighborhood conditions. Residents' perceptions with regard to their neighborhood have been used in numerous studies as a qualitative component of the overall evaluation of the impact of neighborhood development programs (see, for example, HUD 2003 and GAO 2006).

7. Tax Revenue Generation

Tax revenues generated by community and economic development programs can include sales taxes, payroll taxes, and income taxes paid by individuals employed as a result of a project, as well as corporate and property taxes paid by businesses supported by the project. Tax revenues have been used in cost-benefit analyses and estimates of taxpayers' return on investment. However, in a critique of such an approach used by Thomas Miller in an evaluation of the Kentucky Highland Investment Corporation (KHIC), Hollister (2007) expresses the opinion that increased tax revenues should not count as benefits at all, since they were not one of the goals of the initiative: "If this were the government's goal, it might find that investing in a golf course in a large urban area offers far better returns." The government, he asserts, invests in a CDFI such as KHIC because it believes it to be an effective tool for creating new employment opportunities in a low-income region, and that the new jobs will benefit low- and moderate-income households in the area. Under this scenario, the relevant measure is the dollar benefit to lower-income households in the region as a result of KHIC's intervention. On the other hand, HUD's evaluation of UDAG (1982) did not discredit tax revenue as a measure of economic development performance; they argued that increasing the local tax base helps alleviate a community's distress, which was one of the objectives of the program.

Need for Federal Program Subsidies

Legislators, budget and management analysts, and evaluators often want to know whether federal program funds are the primary impetus for achieving program objectives or merely substitute for other funding available for the same purpose. This interest is premised on the notion that the effectiveness of federal programs is lessened either when resources are used for projects that could or would have proceeded as a result of other investments or when programs provide more subsidy than is necessary to accomplish their objectives. According to Redburn et al. (1984), "When public funds are merely substituted for private funds in this fashion, no real public benefits have been created and public resources have been wasted."

Substitution occurs in federal community or economic development programs when federal funds are used to pay for some portion of a project that either the private sector or state or local governments would have paid for in the absence of the federal program. If the project would not have occurred "but for" the federal program, there is no substitution. Recognizing that community and economic development projects are often location- and scope-sensitive, this test needs to take into account not only whether a similar project would have occurred at about the same time, but also in about the same place, and at about the same scale were it not for the program investment.

A more nuanced approach involves not only whether, but also to what degree, there is substitution. Some basic distinctions involve full versus partial substitution and whether there is duplication or excessive use of subsidies. For federal government programs, full substitution occurs when a federal program investment substitutes completely for private or nonfederal public investment possibilities that could or would have been used in the absence of the federal subsidy. Partial substitution takes place when a federal program investment substitutes for only a portion of other investment possibilities. Finally, duplication or excessive subsidy occurs when more federal program investment is provided (either from a single program or in combination with other federal programs) than is needed to accomplish an objective.

Federal community and economic development programs vary with respect to their legislative or regulatory provisions pertaining to substitution, and methods for implementing such requirements are determined by each administering agency. Formal non-substitution requirements are central to some programs but not to others. For example, HUD's CDBG program generally does not require that state or local government grantees consider whether uses of CDBG funds substitute for other public or private dollars. However, there are two cases in which a formal substitution determination is required. For public services programs, CDBG funds cannot supplant state or local government funds that have been previously used to pay for the same activity within the last 12 months.[5] In addition, the public benefit standards for economic development programs require that CDBG funds cannot be used to reduce the amount of nonfederal funds for an activity.[6]

The authorizing legislation for HUD's UDAG program contains a requirement that UDAG funds not substitute for or replace other nonfederal funds, and that a formal determination be made that a project would not occur but for a UDAG award.[7] In essence, the program was intended to be used only when it could be demonstrated that it was a necessary catalyst or inducement for economic development.

SBA's business loan programs are required by law to serve only borrowers who otherwise could not secure loans from another source.[8] This means that no financial assistance is to be extended if an applicant can obtain credit from nonfederal sources on reasonable terms and conditions (SBA 2000).

LIHTC administrative guidelines issued by HUD require that the U.S. Department of the Treasury's credit allocating agencies—generally state housing finance agencies—adhere to a set of rules when allocating tax credits to LIHTC projects that will also receive additional subsidies from HUD. Known as the "subsidy layering rule," a minimum contribution to the development is mandated from each credit recipient to ensure that no more tax credits are awarded to any project than are necessary to fully finance it (McClure 2000).

The NMTC program has no legislative or regulatory requirements related to substitution of a federal subsidy for other available investment resources. Program rules provide considerable flexibility as to what kinds of investments are made and their scope, purposes, and desired impacts. Although the CDFI Fund formally certifies CDEs and competitively awards NMTC allocations to a portion of them, it does not review individual projects or become involved in underwriting decisions. Those responsibilities reside with individual CDEs and their investors, who consider which investments are made, the need for NMTCs in these projects, and prospective project impacts. This flexibility means that, except for compliance with core CDFI Fund and Internal Revenue Service regulations, there is no single standard

[5] Rule 570.201.
[6] Rule 570.209 and Appendix A.
[7] Wyder Amendment, P.L. 96-153, Section 104, Housing and Community Development Act of 1974.
[8] 15 U.S.C. §636(a).

that determines whether a project is the best choice for the use of tax credits or whether the credits were essential to the project's initiation.

While substitution is a valid concern for government subsidies, agencies must balance the risk of excessive subsidy against the risk of hampering investment with overly rigid rules. Assessing whether (or the extent to which) a federal community or economic development program substitutes for other sources of funds is the equivalent of performing an impact evaluation—i.e., one that focuses on whether a particular program caused certain outcomes (Armistead 2005; Rubin 2006). In this instance, however, the focus is not outcomes such as job creation, business development, etc., but whether a project that might produce those types of outcomes would have occurred in the absence of a community or economic development program. Further, inasmuch as any rigorous effort to evaluate impacts ideally requires some type of experimental or quasi-experimental design that incorporates pre- and post-measurement and comparison of "treatment" and "control" groups, a thorough substitution evaluation would require a comparable effort. Thus, it is widely recognized among community and economic development practitioners and researchers that evaluation of substitution is extremely difficult.

Given that experimental or random assignment studies of substitution are generally impractical for community and economic development programs, an alternative approach involves "naturally occurring" experiments. This consists of comparing pairs of projects similar in all respects (such as their type, attributes, location, timing, and scale) except for receipt or non-receipt of program subsidies. The presumption is that if comparable projects not receiving a subsidy are initiated and completed, the subsidies that were provided were unnecessary.

However, several issues arise with respect to studying substitution using matched pairs of comparable projects. First, for many types of community and economic development projects, it is not always possible to identify appropriate comparables. In addition, it may be impossible or impractical to obtain the necessary information about comparable projects that are not recipients of a program subsidy, since such information is often proprietary. In addition, knowing whether a project would have proceeded without a subsidy is not simply a post-hoc program evaluation challenge; it may also be a practical challenge to those involved in attempting to initiate a project. For example, when financing packages are being assembled for some community and economic ventures, even the principals may not know with any certainty what is likely to happen if a particular subsidy were not available. In some instances, the timing and circumstances associated with such projects make it infeasible to explore alternate sources of financing, especially in complex transactions involving multiple investments, each contingent upon the others. Post-hoc determination of substitution, therefore, can be especially problematic.

Among the community and economic development programs discussed above, UDAG had the most explicit statutory mandate not to substitute for private or other public funds. When HUD conducted a 1982 evaluation of the program, therefore, considerable effort was expended to find a sensible way to assess the extent of substitution—in light of the methodological challenges identified above (HUD 1982). The approach consisted of a combination of extensive fieldwork on, and independent expert analysis of, a sample of projects selected to be representative of the program as a whole.

The fieldwork for the UDAG evaluation involved conducting detailed, on-site discussions with those directly involved in putting together each of the sampled projects (including private developers, lenders, and city officials), reviewing site histories and market conditions, examining other economic development activities in the surrounding area, and considering the intentions and long-term economic interests of the primary project actors. A triangulation process in which the answers of various parties were compared provided an opportunity to discover discrepancies and probe for differences of opinion. The expert analysis portion consisted of convening an independent panel of finance, accounting, legal, and development practitioners who were not associated with any of the projects or communities involved, and seeking their considered judgment as to whether substitution occurred based on the information collected. Examples of issues considered were: the length of time sites had been available; the market value of the land; surrounding land uses; the value of possible alternative sites for a project; previous investor interest; the availability of alternate financing or alternate sites; and the prospective profitability of an investment compared to similar investments.

The evaluators concluded that UDAG funds were definitely needed to stimulate the private investment and benefits that resulted in 64 percent of the projects. In contrast, UDAG was needed for stimulating only a portion of the private investment in 13 percent of the projects and totally unnecessary for stimulating any of the private investment in eight percent.[9] Based on these findings, the evaluators estimated that the amount of unnecessary UDAG funds awarded to projects, program-wide, was one dollar for every six expended, and used these findings to adjust or "discount" the value of the outcomes attributed to the program—such as the amount of private investment leveraged, number of new permanent and temporary jobs created and retained, amount of tax revenues generated, and number of rehabilitated housing units produced.

Joining Two Criteria to Define a Smart Subsidy

Worthy objectives of community and economic development program evaluations include a demonstration, or at least consideration with as much evidence as possible, of how frequently (a) program subsidies are needed for projects to come to fruition and (b) projects have beneficial outcomes. This approach is depicted in the following two-by-two table, which shows the need for program subsidies and beneficial project outcomes as conceptually distinct variables that can interact to form four possible situations (cells).

		Is a community or economic development program subsidy needed for a project to come to fruition?	
		Yes	No
Are a project's Are a outcomes positive?	Yes	**1**	2
	No	3	4

Cell 1 constitutes the optimal situation and best exemplifies a smart subsidy. The worst situation is when a program's projects neither require program subsidies to come to fruition nor have beneficial outcomes (cell 4). Between a smart subsidy and the worst case are programs whose projects result in beneficial outcomes but do not require a subsidy for that to happen (cell 2), and those that need a subsidy but otherwise do not produce beneficial outcomes (cell 3).

While the table is a useful illustration, the reality is certainly not as clear-cut. This is because, as discussed above, outcome and need assessments can take various forms. For example, a community or economic development project may not require a subsidy in order to happen, but the subsidy may

[9] The evidence was inconclusive for the remaining 15 percent.

permit desired enhancements or enable the project to be completed sooner rather than later. Likewise, a project that does not produce beneficial outcomes in the short term may simply require more time.

Conclusion

Many federal community and economic development programs provide resources for low-income people and communities, and there is the reasonable expectation that a public subsidy involved in such programs is needed to accomplish beneficial objectives. Yet the uneven patchwork of evaluation evidence across programs makes it difficult to know whether this is the case—i.e., how well each program works or which of them work better than others. Evaluation issues have not been consistent among programs or over time with respect to comprehensiveness, metrics, approaches, or methodologies. This is due in part to methodological challenges, but another strong factor may be a basic disinterest in, or distrust of, evaluation on the part of some policy makers, program administrators, or the community. Regardless, the result is that economic theorists and program practitioners more often speak with the air of authority on this issue than do empirical evaluators.

A hopeful sign with respect to program evaluation is the federal Office of Management and Budget's (OMB's) current effort to encourage all executive agencies to undertake rigorous, independent evaluations to determine whether programs are efficiently achieving their intended outcomes. This involves initiation of several government-wide efforts to help develop better systems for conducting evaluations that can "determine the causal effects of programs" (Orszag, 2010). However, whether program evaluation will improve has to take into account at least two observations from past experience. The first is that some community and economic development programs are innately difficult to evaluate using methods like random assignment experiments. Such programs may have multiple types of outcomes that are not easy to specify or measure. Indeed, the U. S. Government Accountability Office (GAO, 2002) went so far as to observe, with respect to the NMTC program:

> Because each method for assessing effectiveness has significant disadvantages, definitive conclusions about the effectiveness of the NMTC program may not be possible. The methods may not establish that the NMTC causes new investment or economic development (p. 27).

The second observation is that some program stakeholders and advocates fear evaluations, believing that only bad can come from them; in some instances evaluations are performed only in reaction to negative program reviews by OMB. When evaluations are undertaken reluctantly, they can be underfunded and focus excessively on short-term outputs—intended mainly to support (or oppose) program reauthorization or re-appropriation.

Given current fiscal circumstances, evaluation funding may be at risk even though the need for it may be greater than ever. As such, there is reason to engage anew a constructive conversation among policy makers, program administrators, and other interested parties to consider the desirability and possibility of:

- Prioritizing the issues that are worth addressing through program evaluation and the kinds of methods, evidence, and standards that that are practical and realistic to apply;
- Developing comprehensive evaluation agendas across agencies and programs that allow for some standardization and comparison;
- Building incentives into programs at the demonstration stage or beyond, such that evaluation is also valued for improvement purposes;

- Ensuring that formal program evaluation is properly and adequately integrated into major new federal government programs such as: HUD's Choice Neighborhoods Initiative;[10] HUD's, the Department of Transportation's and the Environmental Protection Agency's Sustainable Communities Planning Grants;[11] the Corporation for National and Community Service's (CNCS's) Social Innovation Fund;[12] and the Department of Education's Promise Neighborhoods initiative;[13] and,
- Funding evaluation at a level that is appropriate to the challenges and issues involved.

A robust program evaluation agenda should encourage smarter subsidies, helping to ensure that current and future community and economic development programs are focused on worthwhile objectives and are instrumental in bringing them about.

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[10] This initiative intends to make transformative investments in high-poverty neighborhoods where public and publicly assisted housing for low-income households is concentrated.
[11] This initiative intends to catalyze the next generation of integrated metropolitan, transportation, housing, land use and energy planning using the most sophisticated data, analytics and geographic information systems.
[12] This initiative intends to target millions of dollars of public-private funds to support grantees (intermediaries) that will work with community-based nonprofit organizations to address urgent needs in three key issue areas—economic opportunity, healthy futures, and youth development and school support.
[13] This initiative intends to significantly improve the educational and developmental outcomes of children in the nation's most distressed communities.

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