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Teaching new markets old tricks: The effects of subsidized investment on low-income neighborhoods

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ABSTRACT

This paper examines the effects of investment subsidized by the federal government's New Markets Tax Credit (NMTC) program, which provides tax incentives to encourage private investment in low-income neighborhoods. I identify the impacts of the program by taking advantage of a discontinuity in the rule determining the eligibility of census tracts for NMTC-subsidized investment. Using this discontinuity as a source of quasi-experimental variation in commercial development across tracts, I find that subsidized investment has modest positive effects on neighborhood conditions in low-income communities. Though spillovers appear to be small and crowd out incomplete, the results suggest that some of the observed impacts on neighborhoods are attributable to changes in the composition of residents as opposed to improvements in the welfare of existing residents.

1. Introduction

Over the past several decades, the federal government in the U.S. has revisited its approach to tackling the problem of persistent poverty in low-income communities. Greater emphasis has been placed on market-based incentive schemes that rely on the private sector to provide resources perceived as necessary to alleviate poverty and blight in distressed cities and neighborhoods. As interest in business-oriented mechanisms to address stagnation in disadvantaged communities grew, a number of new programs emerged that attempt to encourage private investments in low-income areas, often using tax incentives.

This paper evaluates the effectiveness of the New Markets Tax Credit (NMTC) program in reducing poverty and improving other neighborhood conditions over the course of the 2000s. The NMTC, which was signed into law in 2000 as part of the Community Renewal Tax Relief Act, arose out a desire to encourage private capital investment in neighborhoods thought to be overlooked during the economic boom of the 1990s. The program provides tax credits to investors who make equity investments in Community Development Entities. These entities are charged with investing the proceeds from the equity investments in businesses and real estate projects in certain designated low-income census tracts.

In order to identify the effects of NMTC-subsidized investment on neighborhood conditions, I take advantage of a discontinuity in the formula used to designate tracts as low-income. The discontinuity generates pseudo-random assignment of investment in tracts around a certain income threshold. Tracts below the threshold are eligible to receive NMTC-subsidized investment, whereas those above it are generally not eligible. However, on all other dimensions, the tracts on either side of the threshold are similar. Hence, comparing outcomes among tracts within a sufficiently narrow window around the cutoff permits one to draw causal inferences regarding the effects of investment subsidized by the NMTC on neighborhood conditions.

Using data from the 2000 Decennial Census and the 2005–2009 American Community Survey, I find modest benefits associated with subsidized investment targeted at low-income neighborhoods. Poverty and unemployment rates fall by statistically significant amounts in tracts that receive NMTC-subsidized investment relative to similar tracts that do not. While also positive, the estimated impacts on other neighborhood characteristics, including house values, are statistically indistinguishable from zero. Moreover, household turnover rates in affected communities are slightly higher, which suggests that the observed changes in neighborhood characteristics may not be entirely driven by improvements in the conditions of existing residents, but rather may at least in part be attributable to changes in neighborhood composition in the wake of new investment. Consistent with the modest positive impact of subsidized investment I find using survey data from residents, I also detect small but positive effects on total employment and the quality of jobs using administrative data derived from unemployment insurance tax records. Finally, the results suggest that while the NMTC program may redirect some investment dollars from higher to lower income areas and could crowd out some unsubsidized investment, spillovers are not large and crowd out is not complete.

This paper makes several important contributions. First, I shed new light on the effectiveness of tax incentives in encouraging local economic development. Much of what we know about the usefulness of tax incentives in revitalizing communities comes from work on

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state enterprise zones (EZs). State EZs provide tax incentives to new and expanding businesses in designated cities and neighborhoods. These incentives can take the form of employment credits or income, property, or sales tax breaks. Evaluating the effectiveness of EZs has proven challenging, in part because of the high degree of variation in program characteristics across states; not only do programs differ in the generosity and types of incentives offered to businesses, but they also vary in the criteria used to determine communities' eligibility for the program. Perhaps partly a result, the findings of existing studies on the effects of the EZs are mixed. Several papers, such as Papke (1994), Billings (2009), Ham et al. (2011) and Freedman (forthcoming), find positive effects of EZs on local economic activity and neighborhood conditions.[1] However, Boarnet and Bogart (1996), Elvery (2009), Neumark and Kolko (2010), and others find that EZs have little or no effect on local employment, casting doubt on the effectiveness of tax incentives in spurring growth in targeted areas.[2]

More broadly, this paper contributes to the growing literature on the impact of a new generation of place-based policies in the U.S. Much of this research has focused narrowly on housing policy (e.g., Baum-Snow and Marion, 2009; Gabriel and Rosenthal, 2009; Freedman and Owens, 2011). The work that has been done outside housing has typically struggled with identification, often due to nonrandom selection of communities into programs. I exploit plausibly exogenous variation in subsidized investment across communities that results from federal rules determining the eligibility of census tracts for NMTC funds.

The paper is organized as follows. The next section provides background on the NMTC program. Section 3 details my econometric approach. After describing the data and providing descriptive statistics in Section 4, I present results on the spatial distribution of NMTC-subsidized investment in Section 5. Section 6 examines how this investment affects housing and resident characteristics in low-income communities. Section 7 takes up the issue of crowd out and the impact of subsidized investment on employment and the composition of jobs in low-income communities. Section 8 concludes.

2. The New Markets Tax Credit program

2.1. Program structure

Introduced in the late 1990s as a pro-business way to stimulate investment in the nation's distressed areas, the NMTC program was signed into law in December 2000 as part of the Community Renewal Tax Relief Act of 2000.[3] Administered by the Community Development Financial Institutions (CDFI) Fund at the U.S. Department of the Treasury, the NMTC program, which allocated a total of $26 billion in tax credits between fiscal years 2002 and 2009, encourages capital investment in businesses that are located in low-income neighborhoods by offering tax incentives to investors who make qualified equity investments (QEIs) in Community Development Entities (CDEs).[4] The credit totals 39% of the cost of the investment and is claimed over a seven-year credit allowance period, with 5% being claimed each year over the first three years and 6% each year over the final four years.

CDEs are domestic corporations or partnerships that meet several criteria. First, their primary mission must be to serve or provide investment capital to low-income communities or persons. Second, CDEs must maintain accountability to the community by including resident representation on any governing or advisory board. Finally, CDEs must be certified by the CDFI Fund. A CDE remains certified for the life of the organization as long as it continues to meet the mission and accountability requirements. As of December 2011, there were 5473 CDEs distributed across all 50 states and the District of Columbia.[5] Among the currently certified CDEs are community development financial institutions, community development corporations, other non-profit financial intermediaries, government agencies, commercial and investment banks, and other for-profit financial institutions (Armistead, 2005).

Each fiscal year between 2003 and 2009, between 40 and 100 CDEs received tax credit allocation rights totaling between $2 billion and $5 billion.[6] The average allocation to a CDE in any given year is close to $50 million. While the NMTC program represents only a fraction of total spending and foregone taxes among federal community and economic development programs, it has expanded over time and continues to grow both because more allocations have been made available by Congress and because tax credits from early rounds continue to be claimed.

Unlike the Low-Income Housing Tax Credit or the Community Development Block Grant programs, which leave decisions about the allocation of funds to states or localities, NMTC allocations flow directly from the federal government to CDEs. The CDEs that receive allocations are selected through a competitive application process, with less than one-fifth of applicants receiving allocations in any given year.[7] Once a CDE is awarded a NMTC allocation, it has five years to use the proceeds of QEIs to provide equity or debt capital in the form of so-called qualified low-income community investments (QLICIs).[8] As Fig. 1 shows, as the amounts that the CDFI Fund allocated to CDEs generally rose over the course of the decade, QLICIs increased steadily until fiscal year 2008, at which point they slowed in the face of the recession. In 2009, however, investment under the program recovered.[9]

NMTC program rules dictate that "substantially all" of the investments made by CDEs go to designated low-income communities (LICs), but these investments can take a number of different forms. Over 85% of QLICIs take the form of loans. However, since investors' returns are at least in part covered by the tax credit, CDEs have the flexibility to offer below-market interest rates or other preferential terms to qualified projects or businesses. Nonetheless, CDEs still have an incentive to assist viable projects with strong prospects. Indeed, there is some concern that the NMTC program crowds out private unsubsidized investment. Gurley-Calvez et al. (2009) argue that crowd out is not complete and that the NMTC program not only

[1] Recent work on federal Empowerment Zones and Enterprise Communities, which were first established in 1994, suggests that they have increased economic activity in targeted areas (Busso et al., 2012; Ham et al., 2011).

[2] Notably, most EZ programs involve employment tax credits and target high poverty areas. In contrast, the NMTC program uses investment subsidies and targets only moderately low-income areas.

[3] See the online appendix for additional details regarding the structure of the NMTC program.

[4] The original NMTC program was authorized to allocate $15 billion between fiscal years 2002 and 2006. In subsequent years, the program has been amended and reauthorized a number of times.

[5] The information in this section is derived in large part from the CDFI Fund's website (www.cdfifund.gov), which outlines CDE eligibility requirements in detail and provides a list of current CDEs.

[6] Though originally scheduled to begin in fiscal 2002, no allocations were made until 2003 owing to delays in launching the program (U.S. Government Accountability Office, 2007).

[7] Applications to the CDFI Fund require CDEs to describe their intended use of the funds in four areas. Those areas include business strategy, capitalization strategy, management strategy, and community impact. Each of these areas is given a score by each member of a panel of CDFI reviewers that ranges from 0 to 25. Extra points are also awarded if the applicant has a demonstrable history of serving disadvantaged communities or businesses, or if the NMTC plans to invest most of its capital in unrelated entities. Each reviewer tallies his or her own points and makes a recommendation of whether the CDE should receive funding and, if so, how much. CDFI staff then review the top proposals, and the NMTC program manager makes the final allocation determination (Rubin and Stankiewicz, 2005).

[8] CDEs may be for-profit or not-for-profit; the latter account for about one-fourth of CDEs that receive NMTC financing. However, to invest in eligible projects, a not-for-profit CDE must create a for-profit subsidiary.

[9] The QLICI data in the figure reflect reports to the CDFI Fund through December 2009. At $4.6 billion, total fiscal year 2009 investment was about 20% higher than what is shown in the figure. Because the outcome data cover only through calendar year 2009, I do not consider any investment that occurs in calendar year 2010.