At the Margin
Public Incentives and Community Investment
A Note for the Chicago Booth Rustandy Center for Social Sector Innovation

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Introduction

“The way I look at these things,” Dick Jones says, “is to ask: ‘what is the problem we’re trying to solve?’”

Jones, a 40-year veteran in social impact investing, is the Executive Vice-President of BlueHub Capital, a Community Development Financial Institution (CDFI) that’s invested in projects throughout the United States. When he speaks of ‘these things’, he means economic incentives: benefits provided by the public sector in order to direct the behavior of investors, developers, and entrepreneurs toward projects that will have--it’s hoped--broad social benefits. Economic incentives take many forms, from tax-based sweeteners to hortatory legislation that seeks to nudge businesses’ behavior. This note’s purpose is to examine a selection of some of the most important incentives in use today, from the viewpoint of a potential social investor. What are the most effective economic tools that the public sector offers to facilitate community investment? What are markers to look for in discerning the efficacy, durability, and potential impact of a given incentive’s design? What are some best- and worst-practices for the social investor to consider as she reviews this landscape of complex tools and considers the viability of partnering with the government in this way?

Before moving into some details, we should pause to acknowledge the Big Questions that undergird this discussion. Answering any is out of the question -- beyond not just the scope of this comparatively brief note, but beyond the scope of any current best-thinking consensus in academia, the public sector, or private investment. In other words: experts disagree on incentives. A lot. Three important reasons for this are that

1. empirical challenges of measurement and causality make it--practically speaking--very difficult, if not impossible, to fully understand a given incentive’s impact;

2. the topic engages normative, values-based assessments that don’t have correct answers. e.g., “What is, and what isn’t, the public sector’s responsibility?”; and

3. To compound the intractability, many of these Big Questions combine empirical opacity with subjective, even emotional, topics: “How efficient are private markets? Do they, in fact, ‘fail’? If so, how?” “Can the public sector increase social welfare by intervening in markets? If so, how?”

Many of the most important social and economic thinkers of the past century have worked on these topics and come to vastly differing conclusions -- from Milton Friedman’s free-market exhortations to John Maynard Keynes’ assertion that large-scale public sector fiscal policy can and should spur the “animal spirits” of private market actors if they flag. As we’ll see, even the discussion of a specific incentive can invite intractable good-faith debate -- and that’s just the ‘good faith’ debate, i.e., disagreement that arises before vested interests on either side have begun to weigh in.
This note, however, has the luxury of side-stepping all that. It is about the world as it is, currently in 2020. It is about how to best implement effective social investments within that currently-existing world. If it has a view, it is an anodyne adherence to middle-ground consensus: public-sector involvement in markets through economic incentives is a reality; public-sector incentives are part of a toolkit that both public- and private-sector actors use in their attempts to mitigate poverty, inequality, and disinvestment; economic incentives should not be the driving force or sole catalyst of any investment or revitalization project, but any investment or revitalization project that seeks to effect social change must at least consider them.

This note’s purpose, then, is to provide a high-level overview that occasionally dips into illustrative detail. Which, to commence, brings us back to Jones’ question:

*What is the problem you’re trying to solve?*

The question will recur throughout the following comments as a lodestone; it is easy to lose a sense of the forest amidst the dense trees of financial mechanics, abbreviations, and fraught political economies that characterize this topic. This complexity, of course, makes it all the more important that a social investor keep her goal, “her” problem, front-of-mind as she considers whether and how to use economic incentives to create projects that will hopefully increase human happiness and well-being.

### Tax Incentives

Tax incentives are probably the most well-known category of economic incentives offered by the public sector. It’s important to note that tax policy *overall* is itself part of this discussion; before thinking about specific credits, exemptions, or abatements, one should recognize that tax policy functions as a competitive lever between polities in all collectives, whether we mean different nations in the global economy, different nations within a loosely-connected collective like the European Union, or sub-sections of a single nation -- like the states of the United States. In each case, one way that political units compete with their neighbors is through tax policy designed to attract and retain investment.

But this inter-national or inter-state competition is only a piece of the puzzle. Governments at all levels also shape tax policy--including credits, exemptions, and abatements--to encourage or discourage certain behaviors -- to push companies (or individuals) to *do* certain things. Let’s examine that triumvirate: *credits, exemptions,* and *abatements*. All of them, ultimately, do the same thing. They increase the profitability of a given investment by reducing the tax burden of its investors. But each arrives at this end-point in a different, sometimes very different, way.

*Credits* are money earmarked to pay taxes. A tax credit doesn’t reduce taxable income or how much tax its holder is meant to pay. It’s just a means to pay that tax.
Exemptions are different: they reduce the tax burden itself, usually by reducing the taxable value of some underlying asset, exempting some portion of it from taxation.

Abatements, meanwhile, are defined by duration -- they function like exemptions, except they’re time-limited. For example, a property developer who receives an abatement might be only responsible for 60% of the taxes due on a given footprint of land for X years after the abatement is received; thereafter, the developer (or whoever controls that land) is once again responsible for all taxes due.

Arithmetically, a tax credit of $1 is more valuable to the recipient than an exemption of the same nominal value (see Exhibit 1). As a matter of investment (and public policy), it is of course expected that all participants in a market will price in the actual benefit they derive from a given tax instrument, however it is constructed. There can indeed be significant differences between these categories, but it is not that one is “better” or “worse” for investors or the government; rather, this basic structure is the first of many aspects of an incentive’s design that define its purpose, efficacy, and potential best use.

New Markets Tax Credits (NMTCs)

New Markets Tax Credits are a tax-credit “authority” administered by the U.S. Department of the Treasury. Their purpose is to “incentivize community development and economic growth through the use of tax credits that attract private investment to distressed communities.”¹ Legislated in 2000 and commencing in 2003, NMTCs are allocated in an annual, competitive process that as of 2018 had distributed nearly $60B in tax credit authority to eligible community development organizations.²

The NMTC program is complex and jargony, as the upcoming jog through its pathways reveals. But the point of pausing to examine this program--or any incentive--in some detail is not just to marvel at technocrat-ese or endless abbreviations beginning with ‘Q’; the point, and there is one, is to inspect key aspects of what defines the instrument and, in this case, makes it comparatively effective and well-regarded. Let this be the first of several times this is stated outright: a purely “high-level”, summary view of any specific incentive is one that almost certainly falls into one of the mis- or half-understandings that this note, in large part, exists to help you avoid.

That said, this will involve many abbreviations. To borrow a pithy summary from Marc Hirshman, the Co-founder and Principal of Twain Financial Partners in St. Louis, NMTCs are allocated by the U.S. Treasury’s

Community Development Financial Institutions (CDFI) Fund. Investors make Qualified Equity Investments (QEIs) into qualified Community Development

¹ https://www.cdfifund.gov/programs-training/Programs/new-markets-tax-credit/Pages/default.aspx

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Entities (CDEs) that make Qualified Low Income Community Investments (QLICIs) by investing substantially all proceeds into Qualified Active Low Income Community Businesses (QALICBs).³

The most generally useful of these abbreviations are “CDFI” and “CDE”; introducing them will continue the theme of details which are bureaucratic, jargony, and also important.

A CDFI is a Community Development Financial Institution, a “profitable, but not profit-maximizing”⁴ financial institution that is “100% dedicated to help[ing]...disadvantaged people and communities join the economic mainstream.”⁵ The CDFI Fund, as noted above, is a branch of the United States Treasury; established in 1984, its purpose is to “serve mission-driven financial institutions that take a market-based approach to supporting economically disadvantaged communities”⁶, i.e., CDFIs. One way it does this is by formalizing that status: an organization applies to the Fund, and once it is recognized as “CDFI” it can apply for various awards to help in its mission (see Exhibit 8). To apply for an NMTC allocation, however, a separate designation is required: CDE, or Community Development Entity. Also granted by the CDFI Fund, this label indicates a mission-driven organization that serves low-income communities and whose board governance represents those communities.⁷

Obviously, the Venn circles for CDFIs and CDEs are overlapping, though they’re not equal sets. CDE can be non-profits which might also be called community-development corporations (CDCs) or CDFIs. Either way, however, this cluster of acronyms is the nexus that drives much of the NMTC process -- these are the kinds of organizations that apply for the instruments and are generally the catalysts of their deployment on deals. This process of certification may seem burdensome. That’s because it is -- the justification being that NMTCs are challenging instruments that require technical capacity to deploy usefully, and it serves no one’s interests to even consider their allocation to organizations that lack that capacity.

The rest of the initialisms are specific to NMTCs, and describe the various players in the flow of capital from external investors into low-income communities that the credits are meant to encourage (see Exhibit 2). The final investment (QLICI) made by the CDE into the project (QALICB) can take many forms, from loan capital to equity investment to services. To be clear: the QALICB is just the legal entity behind what everyday language would call “the project” -- whether it’s a forestry conservation scheme, urban tech incubator, mixed-use retail development. NMTCs are often used to help fund ambitious, large-scale initiatives meant to have significant multiplier effects for a community or local industry.

⁴ https://ofn.org/what-cdfi
⁵ ibid.
⁶ https://www.cdfifund.gov/Pages/default.aspx
⁷ https://www.cdfifund.gov/programs-training/certification/cde/Pages/default.aspx

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The NMTC itself is what external investors get back for making their investment (the QEI) into the CDE driving the project (again, the QALICB), what CDEs have applied to the Treasury for the authority to distribute -- a seven-year stream of tax credits equal to 39% of the value invested. That 39%, in Dick Jones’ view, is an important part of the design. “It’s a fairly shallow subsidy,” he argues, observing that--in his experience--an NMTC won’t “particularly solve an investor’s problem unless it is a profitable deal -- unless you can get some of your benefit through the deal.” This brings up a point that will track throughout this note, a subtle measure of the viability of any specific incentive: what Jones is arguing is that NMTCs’ usefulness stems from the fact that they are neither too generous (thus distorting incentives or encouraging rent-seeking) or too stingy (thus failing to garner much investor interest). This balance means that the program drives capital towards well-managed projects at the margin: projects with a hope of achieving market or near-market returns, but which face significant challenges and might therefore be ignored by most market players without some incentive thrown into the mix. There are still many other factors at play here, of course: the Community Reinvestment Act, discussed below, pushes financial entities towards certain kinds of investment, meaning that an NMTC might serve two functions for such an investor, satisfying its CRA requirements while also diminishing its tax burden. But the “shallow”-ness of the NMTC--compared to, for example, a complete tax exemption or multi-decade abatement--still means that there is a pressure on the underlying deal to be promising and well constructed. The NMTC’s financial value--meaningful, but limited--is a feature, not a bug.

There are two other important reasons why NMTCs have emerged as an important tool for bringing investment into low-income communities. In summary, these points are that (1) they allow CDEs themselves to create an earned income stream that facilitates their survival and pursuit of social mission, and (2) the NMTC doesn’t just facilitate the initial investment (the QEI) that earns the initial investor the tax credit; their most significant impact is probably a knock-on effect whereby this initial investment unlocks subsequent capital inflows into the deal that do not require further NMTCs to secure.

Let’s look at (1) in detail. The NMTC creates a mechanism whereby the CDE can itself capture some of the value created for investors and communities, in a manner that rewards its initiative and--eventually--track record in putting together successful projects. This is because the CDE manages the process of coordinating the flow of investor capital into various legal sub-entities (i.e., into “the project”) and the provision of tax-credit authority out to investors, all of which entails a specialized set of regulatory and operational actions which earn the CDE income on a percentage of the capital flow. When a CDE brings an investor into a project using NMTCs, a seven-year term commences, throughout which the CDE receives income as it manages the tax credits’ unspooling. For organizations that operate at the tenuous border between markets and philanthropy, whose core mission definitionally limits them to deals that are viable-but-challenging, this one-two punch by which NMTC’s spur capital inflow to major projects and thus an income stream for the CDE has proven to be very valuable for the sector.
The second point is subtler but even more valuable to the industry (as well as to any given deal). It may, in fact, be the NMTC’s raison-d’être. The point is that the NMTC serves not just as a catalyst for bringing QLICIs into development projects in low-income communities; it also serves as a multiplier that brings in additional capital on top of that initial investment. How this works is this: the NMTC investor immediately starts seeing a “return” on their investment, since the tax credit’s seven-year stream begins the moment the QEI is made and is—barring an egregious lapse of the program’s requirements—assured regardless of the project’s outcome. This reliable credit means that this initial investor’s contribution generally takes the form of equity or low-interest, forgivable debt. In other words: a capital cushion. And this capital cushion, in turn, de-risks the deal for conventional, arms-length lenders—leveraged third parties who are willing to make market-rate loans to the project because of this capital cushion’s assurance. In this, the NMTCs succeed in inducing the tax-credit investor to play the same role that purely philanthropic dollars might previously have had to: de-risking and spurring participation by market-based leveraged lenders who can help provide the volume of financing that many major projects require.

In summary: the NMTC provides an incentive for investors to participate in deals in low-income communities. It provides a means for CDEs to earn an income by brokering and structuring these deals. And, most powerfully, it creates a capital buffer that unlocks subsequent market-rate lending to these deals—which might otherwise not have had access to the scope of capital they required. This is why its most potent use is on big, ambitious projects—this multiplier effect is probably the NMTC’s greatest impact and is why the credit has, per the CDFI Fund, “generated $8 of private investment for every $1 of federal funding” allocated to it.8

Low-Income Housing Tax Credits (LIHTCs)

The LIHTC (sometimes pronounced “ly-tek”) has had a significant impact on American development over the last several decades. Low-income housing tax credits exist at the federal, state, and sometimes city levels; this section will focus on the federal program, which has had the most widespread impact and served as a model on which others are based. Initiated by Congress in 1986, LIHTCs exist to serve a single, specific goal: encourage the development of affordable housing for low-income families. The manner in which they are allocated, however, once again demonstrates the importance of design in defining the breadth and usefulness of public economic incentives.

Like NMTCs, LIHTCs are allocated in a selective, discretionary process. However, the significant devolution of control over their allocation to state—and, in some cases, municipal—governments gives flexibility to their overall mandate to support affordable housing. While LIHTCs are always used towards this goal, local governments are given power to determine the way in which the credits are used and what kind of projects they support, meaning that their impact on policy and development varies widely in different geographies.

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8 As of 2016. Source: https://www.cdfifund.gov/programs-training/Programs/new-markets-tax-credit/Pages/default.aspx
The key detail is that, while the federal LIHTC is federally-funded, it is administered almost exclusively at these more local levels of government. States are given wide leeway in the parameters they set for distributing the allocation of federal credits they receive. Each state has discretion at two key points: first, it creates its own set of criteria--known as a Qualified Allocation Plan (QAP)--for how developers applying for LIHTCs are assessed. Second, it runs the selection process itself, discerning on a case-by-case basis which applications best serve the goals it has laid out. In other words, each state both makes and, as it were, grades the necessarily subjective test that any developer seeking an LIHTC must pass. As long as the QAP follows broad federal guidelines (that LIHTCs are used towards rental housing; that LIHTCs support low-income tenants), other crucial parameters are left to the states. John Mangin, Senior Counsel at the NYC Department of City Planning and self-described “regulatory guy”, outlines how important this leeway is:

So a state can try to use all of its allocation to try to create affordable housing in high-opportunity [i.e., wealthy] neighborhoods. Or it can say, “you know, we want a mix,” and set its QAP to create affordable housing throughout a mix of high-opportunity and low-opportunity [i.e., low-income] neighborhoods. Or it can say “we just want to build as much as possible” and create a QAP that guides applicants to mostly low-opportunity areas where real-estate values are lower, and therefore more development can occur.

Furthermore, the LIHTC is not triggered upon investment, or ground-breaking, or any other milestone of construction. Rather, the ten-year stream of credits begins when the first unit in the development is occupied by a qualifying tenant. This creates a clear parameter for recapture of an allocated credit if a developer--for any reason--fails to reach the point where low-income families are in fact occupying their building.

Historic Tax Credits (HTCs)

HTCs are another federal tax credit with a clear focus; in this case, to support the preservation of eligible historical properties. Managed by the National Park Service, HTCs offer developers a 20% federal credit, spread over a five-year period, for the restoration of eligible properties. The five-year period also serves as a minimum term for the refurbished property to be put to “income producing purposes”.

It’s helpful to add HTCs to this overview taxonomy because they demonstrate another important axis of design that differentiates various economic incentives. HTCs and LIHTCs, as noted above, are similar in that each is targeted towards achieving a specific policy goal: creating more affordable housing in the latter case and encouraging the preservation of historical structures in the former. An important difference between them, however, is this: HTCs are what is known as an “entitlement” or “as of right” credit, meaning that any project that meets certain preset criteria⁹ is entitled to the 20% credit. Those criteria are: (1) that the building is on the

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⁹ https://www.nps.gov/tps/tax-incentives/before-apply/eligibility-requirements.htm

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National Register of Historic Places or is certified as "contributing to the significance of a registered historic district"; (2) that the cost of the rehabilitation proposed exceeds the building’s pre-habilitation value (known as the “substantial rehabilitation test”); (3) that the rehabilitation is conducted according to standards set by the Department of the Interior; and (4) as noted above, that the building is used for “income-producing purposes” (i.e., no owner-occupied residential homes) for a five-year period after rehabilitation.

The point is not that these requirements are trivial. Getting on the National Register of Historic Places, for example, can take years. But this nonetheless means that the credit functions in a very different way from either LIHTCs or NMTCs. There is no competitive vying for a limited allocation of credits, and there are no further discretionary levers for the public sector to pull in steering which projects get the credit. This streamlined simplicity has strengths and drawbacks which we’ll revisit in detail later on in this case.

Opportunity Zones

Opportunity Zones are a tax exemption introduced in 2017 by the federal government. Every incentive discussed thus far--NMTCs, LIHTCs, and HTCs--has been a tax credit: a method of paying an (unchanged) tax obligation. Exemptions like Opportunity Zones entail a reduction in the recipient’s tax obligation, usually through an exemption of some portion of the underlying asset’s taxable value from calculation.

Opportunity Zones are in some ways a reboot of “Enterprise Zones”, another geographically-focused economic incentive that began in the 1970s and was mostly allowed to sunset throughout the ‘90s and early 2000s. Under the new program, a state’s governor (technically, its “Chief Executive”) is empowered to nominate census tracts within the state to be designated as Qualified Opportunity Zones (QOZs) in which Qualified Opportunity Funds (QOFs) may make investments. The investors in these QOFs are then entitled to capital gains tax relief. Any realization of profit that would have incurred capital gains tax, if invested in a QOF within six months of the liquidity event:

- will have that capital gains tax deferred until 2026; whereupon,
- if the QOF investment was made in 2019 or 2020, the capital gains tax levied will be reduced by 15%; unless
- the money remains invested in the QOF for ten years or more, exempted completely, including any additional gains made by the eventual liquidation of the QOF.

It’s this third, complete exemption where the real benefit to investors is found. Exhibit 3 outlines an example of how a QOF investment can function if held through the term, illustrating the

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10 ibid.
11 https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx
exemption’s potentially significant value. The key detail being that the final provision allows for capital gains upon capital gains to be earned untaxed -- if the initial gains are invested in a QOF, held for the ten-year term, and then sold at a profit.

The Opportunity Zone exemption combines this steep benefit to potential investors with the NMTC’s agnosticism about type of project with the HTC’s non-discretionary, “as of right” selection non-process: the sole parameter for a given project’s viability is that it be located in one of the census tracts named as a QOZ by the state’s chief executive. This means that a QOF “could be anybody,” notes Marc Hirshman. “A real-estate developer who was already building an apartment project, a developer raising capital, it could be...” he trails off, and then lists a few controversial political figures who made high-publicity moves to create QOFs in the program’s first years. These complications, and others raised by the program’s design, will be discussed in detail later on in this case.

Tax-Increment Financing (TIFs)

TIFs are a public financing mechanism that operates at the municipal level and is defined at the state level. A commonly reproduced chart (see Exhibit 4) illustrates “how TIFs work”; it’s a graph showing a developer’s property taxes leveling off for the duration of the TIF’s lifespan, then rising once again after the term (23 years, usually) is over. In other words, a textbook picture of a tax abatement. However, while this abatement-shaped graphic is materially correct in that it conveys a net-net sense of how the developer’s balance sheet is impacted by a TIF, “no: they’re not an abatement,” Jonathan Ferry corrects. “Those taxes still have to be paid.”

Jonathan Ferry’s correction is a good way to begin a rundown of TIFs, which are controversial and impactful and, therefore, important. It’s also a chance to emphasize a general point running throughout this note: with all these incentives, truth lives in details; the fiddly niceties that a “net-net” summary glosses are exactly where a given instrument’s efficacy, purpose, and best use can be gleaned.

Returning to TIFs, then: “they’re not an abatement.” Jonathan Ferry is clear about this. He’s the Major Projects Manager & Financial Analyst at St. Louis Development Corporation (SLDC), an “economic development organization operating on behalf of the City” that focuses mainly on real-estate use. As such he’s a user, skeptic, and reformer of TIFs: Ferry was named 2019’s Young Economic Development Professional of the Year by the International Economic Development Council, mostly for his work overhauling how the city of St. Louis assesses and implements these tax instruments.

Ferry’s breakdown of how a TIF functions is revealing in how it differs from the standard abatement-like graph illustration. “Basically, the developer gets a check back from the government,” he begins, based on “the ‘tax increment’, which is any new taxes generated from a project. ‘New’ meaning ‘new taxes generated on that particular piece of property’” as a result of its development, and “taxes” being defined--crucially--differently in different states. Some only
count new property taxes, while others--such as Missouri--also count any taxes levied on new business activity (often known collectively as "economic-activity taxes").

“So that’s the increment part of it,” Ferry continues,

the ‘T’ and the ‘I’. Now the ‘F’, the financing…it can be capitalized, meaning you take the predicted stream of values, calculate NPV given an interest rate and coverage ratio, and figure out the value of a note based on that, based on how much the predicted tax payments could support. Or, the other way, is the “pay as you go” method. That’s where the developer receives the revenues annually each year until the TIF expires: the incremental taxes are diverted back to the developer, to the TIF note, for the life of the TIF.

Both methods--a note from the government, or “pay as you go”--retain the same essential mechanism: a promised revenue stream from the government to the developer, the source of which is projected new taxes generated by the project in question; i.e., a project that hasn’t happened yet. The amount of “TIF” a developer receives is based, therefore, on _ex ante_ projections that are wrangled out in a negotiation between the developer and city government. The value to the developer is that the note is fungible--it functions like a bond, with a principal attached to a stream of interest-rate payments--and even the “pay as you go” method provides some opportunity for transfer and immediate monetization of these projected cash flows. And “that’s exactly what they do,” Ferry confirms: the developer sells the note on to investors at some discount on the dollar, countenancing investors’ demand for risk-protection, and uses the immediate liquidity to “lower the amount of equity that they have to inject into the deal in order to create more leverage and get a higher return.”

The Community Reinvestment Act

The Community Reinvestment Act (CRA) was established in 1977 in response to discriminatory lending practices in how banks operated in--or failed to operate in--low-income communities, particularly areas made up mostly of minority residents. It has since grown into a set of regulations and guidelines that significantly influences the behavior of the country’s financial sector, although the impact and materiality of this influence is sharply debated.

The language of the CRA is simple and vague. Any bank that is part of the Federal Reserve system--i.e., any bank that receives Federal Deposit Insurance Corporation insurance--is subject to “the Federal Reserve and other federal banking regulators to encourage financial institutions to help meet the credit needs of the communities in which they do business, including low- and moderate-income (LMI) neighborhoods.”  

13 The act does not stipulate targets, values, or requirements for what this criterion means. Rather, it allows for a contextual, case-by-

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13 [https://www.federalreserve.gov/consumerscommunities/cra_about.htm](https://www.federalreserve.gov/consumerscommunities/cra_about.htm)
case examination of each bank’s circumstances and performance on the part of the regulator in assessing whether the bank has met this CRA requirement.

In practice this boils down to two things: investment guidelines and lending tests. In both cases, the direction of impact (good, bad) and scale (major, minor) have been hotly debated since the Act’s inception -- and that debate has evolved in recent years. We will revisit this discussion in the next section; for the time being, it is probably safe to assert that the CRA has had a significant impact on important U.S. markets in tax equity and housing since its inception decades ago.\footnote{https://fas.org/sgp/crs/misc/R43661.pdf}

The investment guidelines, by nudging commercial financial institutions to invest in communities they’d formerly shunned, “drive a lot of the tax-credit investment world,” Marc Hirshman notes. Since the Act’s investment criteria, while subjectively assessed, nonetheless unambiguously encourage banks to put capital towards projects in low-income communities or otherwise distressed markets; and since these projects are exactly the sort of “challenging” propositions that are often managed by CDEs and utilize the kind of tax incentives we’ve been discussing, one effect of the CRA has been to drive dollars towards the use of these incentives, and therefore spur the growth and complexity of the tax-credit equity markets that have grown up around their use, as well as individual institution’s guidance and behavior with respect to capital allocation and investment targets.

The lending tests, like the investment guidelines, are subjective and qualitative. But there is evidence (see Exhibit 5) that this regulatory spur does indeed impact bank behavior by addressing “a market failure based on bias, poor information, lack of information,” Dick Jones asserts. The fact that the Act was “initially unprescriptive” did mean that

lots of banks got away with doing business as usual since there was little definition of what [their] obligations were. However, for others, it opened them up to public challenges from community groups who could use the lack of firm definition to define [the obligations] themselves and challenge the bank’s applications, in both regulatory and public forums. For the most part, these groups said that the banks were not making perfectly bankable loans, not that they were looking for handouts. When the banks agreed to make the loans to get a better rating or some regulatory approval, it turned out both that there was an underserved demand and that it was bankable.

The CRA’s silence on causes and intentions and lack of hard requirements may have served, and still sometimes serve, as an asset -- by creating enough material pressure to change bank behavior, without imposing the rigid requirements or punitive framing that might lead to more forcefully voiced resistance within the industry. “Box-checking” can be better than nothing at all.
However, it is also widely agreed--by both the CRA’s supporters and detractors--that it is no longer optimally formulated for today’s markets. This skepticism is felt even by those charged with enacting it, and in December 2019 the FDIC and the Office of the Comptroller of the Currency jointly announced an overhaul of the Act. The goal is to “clarify what qualifies for credit under the CRA, enabling banks and their partners to better implement reinvestment and other activities that can benefit communities,” and acknowledging that “the banking industry has changed dramatically since the law’s enactment and its regulatory changes in 1995,” the only time that the Act was significantly revised, “[and] the current CRA framework has not kept pace with such changes, which can adversely affect the very communities the CRA was intended to help.”

Assessment and Implications

The purpose of this note is to examine a selection of important economic incentives by type and by feature, in order to consider their uses for social investors. As we observed at the start, a brief “note” of this kind is insufficient to engage the debates that fire up around these incentives -- the empirical arguments about their efficacy, the subjective disagreements that attach to this topic, and especially the knotted questions that encompass both categories.

Nonetheless, a framework for assessing these programs is valuable. This section will review the “consensus view” of some of the examples discussed in the pages above and synthesize them into a few limited conclusions of its own. The prospective investor should know the “consensus view” -- even if only to disagree with it. More importantly, this note’s own conclusions will focus on developing a framework of general analysis that the reader can carry forward into her consideration of any incentive and its pitfalls, purpose, and potential.

Incentives are limited...

The first point to recognize is that even the most well-designed and widely used public economic incentive has limited power. “I think the tools can make problems better or worse,” says Dick Jones, who has dedicated decades to creating social impact using these very instruments. “But it’s really at the margins. Ultimately, larger demographic issues, economic issues and choices...those are what drive things.” Jones cites the example of Jamaica Plain, the Boston neighborhood where he and his family have lived for years. Jamaica Plain and the surrounding areas have, like many major American cities, been transformed over the past quarter-century. Working families and many people of color have been gradually priced out as the price of a single-family home rose by 47% between 2006 and 2016 in Jamaica Plain and as much as 64% in nearby Brookline and 87% in Charlestown, another area of Boston. The factors leading to transformative changes like this are multifaceted and tied to fundamental

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forces in local, state, national, and even international economies. No NMTC or LIHTC or HTC or “Zone” can fight that; the array of factors that shape a place the size of Jamaica Plain, never mind the size of Boston or New York, is well past the scope of any incentive’s intervention.

Thus a key-point reemerges: the value and necessity of using incentives to work—as Jones says—“at the margin.” Taking a step back one might wonder: why, when facing off against structural economic forces, forces against which most incentives are already going to be powerless most of the time, does the collective of public- and private-actors that shapes these instruments ever impose more limitations -- on what kind of entity can receive a given incentive; on the value of an incentive; on the purposes towards which an incentive can be put. Is this not like strapping weights to one’s body before swimming across the loch? The answer is “yes” -- but there are some good reasons. One is that (sticking with this metaphor), handing out motorboats (1) is extremely expensive and (2) encourages their use by people who don’t really need to get across the lake, or could have just flown over, etc. The second, subtler reason is that it’s deliberate: placing further limitations on incentives’ already limited power (LIHTC’s specificity; NMTC’s comparatively “shallow” tax benefit) acknowledges the reality that there are no shortcuts, there is no “swimming straight across” this lake. It’s too deep and the currents are too strong; you’ll drown. But you might arrive there on that opposite shore, or at least at consecutive points closer to it, if you carefully swim your way along the border -- not going too deep or cutting across, but tracing the margin in careful stages. The key for the investor, then, is to acknowledge this limitation and use it to maximize her investments’ impact -- with the help, if available, of effective incentives. And if we define an effective incentive as one that is used as intended and whose use at least seems to have measurable impact, then one takeaway is that the serious social investor is best served looking at incentives that tap into existing markets. It may be possible to triage or rent-seek on poorly designed incentives that seek to create new markets or provide generous benefits for off-market behavior, but in order to guide and foster transactions that almost would have happened anyway, deals for which a case can be made, the impact investor is well-served by focusing on those incentives that successfully tap into and seek to nudge behavior in existing, active markets.

John Mangin agrees. Working at the epicenter of New York City’s efforts to manage its housing stock, the lawyer argues that operating “within an existing market, rather than trying to make a market” protects against capture by niche interests and assures an incentive’s useful deployment, in contrast to “things that don’t pencil out at the margins.” Jonathan Ferry, from the perspective of economic development, seconds that view. “Incentives aren’t enough to convince a retailer,” he notes, sharing how reforms that dramatically increased the TIF tax benefits of development in certain low-opportunity areas while sharply reducing this subsidy in more central, developed districts “didn’t really lead to more development, no. When you’re talking about those [disinvested] areas you’re talking about broken markets, and incentives in themselves can’t fix a broken market.”
...and their design matters

There’s no single metric or parameter to look for as a red or green light on an incentives’ prospects; as even this cursory overview has demonstrated, a specific policy’s design is a lattice of interwoven contextual factors. In this section, we’ll try to pull out a few of the brightest, clearest threads -- features of design and implementation that are an important part of any incentive. While the taxonomy of specific incentives above has dipped into the baroque complexity of attaining and implementing many of them, it has also repeatedly turned on a few central themes: specific, repeated continua of design along which it is useful to distinguish different incentives. This section will make some of these continua explicit.

Specificity

How specific--or vague--is the outcome the incentive seeks to effect?

Some incentives, such as LIHTCs and HTCs, are tailored to explicit, targeted policy goals -- the creation of affordable housing, or the preservation of historical structures. Others, like NMTCs and Opportunity Zones, are agnostic about what type of project they’re used on -- it could be a housing development, or a preventative care clinic, or a business incubator. Their stated intention is place-based investment: to pull capital into zip codes that need it. And then other policies, notably the CRA, are broader still: applying subjective, case-by-case criteria to broadly-framed activities (investment, lending) in order to combat a loosely defined social ill (geographic, social, or racial bias in patterns of bank lending and bank services).

John Mangin is clear:

Specific’s better, basically. Vague, almost hortatory requirements often wind up ineffective. If you can’t be specific with your mandates and requirements, then they’re not enforceable -- they’re not a mandate, not a set of rules, not even an incentive necessarily. It leads to these perpetually-in-need-of-reform things that make some people feel good but don’t achieve much. It’s just really hard to get private actors or local governments to do things they wouldn’t otherwise unless you specify it.

The CRA--which is, indeed, slated for reform--is what Mangin and others hold up as the archetype of “vague, hortatory” requirements. Marc Hirshman stresses the “very high level of subjectivity” to how banks are assessed by federal regulators. “There are general guidelines, but they’re not given definitive numbers to hit.” The result is that the CRA, over time, has become “a bureaucratic box-checking exercise”, in Mangin’s observation; it captures the worst of both worlds by increasing compliance costs for banks without meaningfully improving low-income communities’ access to capital or services.
Control vs. Simplicity

Another distinction that clearly emerges is between incentives which must be won through a competitive, discretionary process vs. those which can simply be claimed upon demonstration of eligibility.

Different language is used in relation to this presence or absence of case-by-case selective criteria. Marc Hirshman, a transactional expert who has spent years sourcing and structuring deals with these tools, speaks of “allocated” vs. “entitlement” incentives. John Mangin, the lawyer and “regulatory guy”, uses the legalistic terms “discretionary” and “as of right”. The different words each articulate the opposite possible answers to the question: is the process by which a project or applicant receives an incentive allocated by a governing agency after weighing that specific application on its merits, often in competition with others for a limited pool? Or is the incentive “as of right”, meaning that any project that can demonstrate that it fits pre-specified criteria is entitled to it, without regard to competition from other projects?

This is a balance between control and simplicity -- and is complex either way, because politics are involved. NMTCs are largely defined by their highly discretionary allocation process. An organization must be, firstly, certified by the CDFI Fund (i.e., the U.S. Treasury) as a CDE to even apply. It must then undertake a complex and lengthy application--akin to a major grant proposal. And it must then adhere to the NMTC program’s criteria or be subject to the instrument’s rigorous (Hirshman calls them “very punitive”) clawback provisions, which allow the Treasury to recapture the NMTC allocation from any CDE that fails to meet the parameters throughout the seven-year term.

Opportunity Zones, by contrast, are textbook “as of right”. The distinction between them and NMTCs is particularly illuminating, since the mechanics of the two programs are in many other respects so similar. Both NMTCs and Opportunity Zones are agnostic with respect to the kinds of projects they finance. Both feature a tiered structure (that involves many “q”s): a qualifying legal entity, in each case, undertakes a qualifying project, into which investors may make investments that qualify for tax benefit. But the fact that the Opportunity Zone program is unspecific with respect to the kind of projects it seeks to fund (like NMTCs) while also being wholly non-discretionary in its allocation (unlike NMTCs)--since any investment made in an eligible census tract is entitled to the credit--can be seen as this troubled incentives’ key weakness.

The Opportunity Zones themselves--the census tracts within which qualifying, tax-shield investments can be made--were selected by state governors who controlled the process and thus were able to define the program’s key “as of right” parameter without meaningful oversight by federal or state legislatures. This has led to “a wave of developments financed by and built for the wealthiest Americans”,16 according to the New York Times. John Mangin expressly

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fingers Opportunity Zones a misguided, or dubious, use of the “as of right” design. “Planning should happen either at the front-end or the back-end,” he says. “Programs where not a lot of planning happens at either end, like opportunity zones, can lead to pretty perverse outcomes.” These outcomes include widespread distribution of tax exemptions to developments that were happening already in areas that, for whatever reason, received Opportunity Zone status. Further—as the Times story notes—these projects tended to serve incoming, higher-income, gentrifying populations as they entered into transitional areas. Thus, a significant outcome of the incentive is to accelerate and reduce the costs of development that directly prices low- and middle-income families out of neighborhoods in which they already live; even for an incentive with an open remit, it seems unlikely that this was anyone’s stated intention for an economic development tax incentive.

Dick Jones frames it bluntly in terms of his own core question. “The ‘problem’ they were trying to ‘solve’,” he asserts, “was finding a way to shelter capital gains tax for real-estate investors.” Mangin agrees, phrasing the ‘problem’ thus: “How can we enact this tax-shelter in a way that is politically presentable?” Marc Hirshman is more circumspect; while no fan of the program, which he feels is poorly designed and destined for quick senescence, he notes that there is a legitimate argument for choosing—for example—a “transitional” neighborhood over a truly low-opportunity one for incentives like this. It flows from the importance of working at the margins, and is reflected in Ferry’s comments about broken markets: the very lowest-income census tracts may not be un-ready for investor capital of this nature without significant political and social assistance first. Hirshman acknowledges, however, that this defense—while sensible in the abstract—is undercut by the Zones’ presence in so many areas where development was already occurring, rather than utilization as a spur to new investment.

The point is not that an “as of right”/entitlement structure is definitionally suspicious or of poor design. With robust preset parameters—where, as John Mangin noted, thoughtful planning does take place “at the front-end”—an entitlement incentive offers some advantages over a discretionary one. It is much simpler for both the public-sector agency managing it and the private businesses or individuals seeking to use it. A “box-checking” rule that determines whether an applicant is eligible asks less of everyone than an application process. And the boxes to check needn’t be trivial; for example, the HTC is an open entitlement -- the credit is there for any project that meets its parameters. But to get the credit,17 the renovated property must be a certified historic structure...listed individually in the National Register of Historic Places—OR—a building that is located in a registered historic district and certified by the National Park Service as contributing to the historic significance of that district.”18 Neither of these requirements is trivial. In fact, it can take years to get either of them. So the parameter helps assure that the HTC will indeed be used to facilitate the kind of projects for which it was intended, while maintaining the simplicity of a non-discretionary process.

17 These rules apply to the 20% HTC; those for lesser credits are less stringent (see link in next footnote).

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Durability and Consequences

So far we’ve addressed the specificity of an incentive—how limited the uses to which it can be applied are—and the balance of a discretionary incentive’s control vs. an entitlement incentive’s simplicity of use. All of these factors are of course interwoven and—taken together, over years and decades—create another axis along which public market interventions can be assessed: not only whether an incentive successfully encourages the behavior it seeks to, but whether it inadvertently creates other—sometimes undesirable—unintended consequences.

In the case of the CRA, for example, many have argued that the Act’s wooliness—the lack of specificity that may have been an asset at the time it was put in place—created wide-reaching negative consequences decades later. In influencing two important parts of the American housing market by (1) pushing banks to offer retail mortgage products to low-income borrowers; and (2) pushing banks and, alongside them, giant government-sponsored enterprises Fannie Mae and Freddie Mac, to participate in and grow the global market in mortgage-backed securities, the CRA played a role that many feel contributed to the overreach of insecure, securitized mortgage debt that metastasized catastrophically into the financial crisis of 2008-2009.

Dick Jones gives another example—less systemic and therefore, perhaps, more knowable. This time it is LIHTCs on the hook:

A lot of these credits came attached to subsidized mortgage financing—a twenty-year mortgage, say, at some very low rates. So a borrower [a developer] could, when they were ready, pre-pay the loan and get rid of the affordability requirement. So you have these neighborhoods and these houses got built, things got built, and it’s twenty years later and they’re healthy neighborhoods now so now it’s far more profitable for the developer to pre-pay the loan, fix up the property, evict all the tenants and sell it as condos. As market-rate housing. So, you had hundreds of thousands of units around the country with the owners realizing the residual value, saying “I took this risk, I maintained the building” and wanting to cash in...the policy wasn’t so much market-distorting as market-ignoring, and then all of a sudden here’s the market saying that it’s worth way more [to the developer] to get rid of these people. And if there’s no program in place to secure them...

The situation Jones describes led to widespread evictions of vulnerable tenants, which in turn led to a social and political response to organize these vulnerable tenants, who in turn advocated for policy change that came in the 1990s in the form of LURAs (Land Use Restrictive Agreements), parameters now attached to all LIHTCs that uniformly mandate standard LIHTC rental restrictions, often include further restrictions, explicitly survive any transfer of ownership and extend the period during which the property’s
owner—whoever they are—must abide by the original LIHTC’s specifications.19 In Jones’ view, all of this turmoil was caused by a “failure of long-term planning” -- a failure to think carefully about really solving a problem. If you look at these earlier programs,” he continues , “you had a set of incentives for the construction of projects, and the tax benefits were sufficient to get the things built. Lots of things got built. But there was no incentive or oversight for recapture if the buildings weren’t built well, weren’t financed well,” or if—as transpired—market changes over a relatively short time-span pulled the property’s owners (as market-driven actors) away from serving these tenants.

This failure to “understand the end-timing of the incentive” not only diminished the efficacy of some early LIHTCs in fulfilling their stated goal, but in fact created a cascade of new complications in real-estate markets, many of which local governments and communities are still grappling with.

Details, Details, Details

The overview of TIFs in the previous section outlined that incentive’s basic structure: a promised cash flow from a city government to a developer; which cash flow is to be drawn from the projected new tax revenues generated by the project being financed; the value of which must therefore be agreed upon months or years before any taxes start coming in; meaning that TIFs begin with a negotiation between the developer and the city over what kind of projections make sense to assume.

There is nothing ex ante broken in this framework. Even if one allows for moderate, inevitable imperfections in the projections’ accuracy, both the city and the private developer stand to gain from the partnership. The city provides the developer with a debt instrument, essentially, which the developer can immediately monetize through its sale to investors, thus--the idea is--allowing it to undertake projects that wouldn’t have been financially feasible but for TIF assistance. This is, in fact, known as the “but for” test, and it is--or is meant to be--one of the things the developer demonstrates to receive TIF support. The city, on paper, gets a new development whose worth in tax revenues and knock-on economic effects eventually exceeds the stream of initial tax revenue the city gave up to finance the development happening in the first place.

TIFs are widely used, and have been an important part of many major projects that enjoy good reputations within and outside their communities, such as a decade-long revitalization of the Pullman District in Chicago’s South Side.20 Yet they remain controversial: many op-eds that decry (or news articles that expose) dubious use of government funds involve TIFs.21

The reason for this is that the actual process by which TIFs are structured is seldom as cut-and-dry as that idealized case. And in fact, trouble starts before the negotiation; that back-and-forth between developer and city over how much tax revenue the project will bring in is an obvious lever to examine, but the negotiation itself is bounded and driven by underlying structural factors governing how TIFs function within a given market.

The first, already noted, is determined at the state level: how “new taxes” are defined. The distinction is between states which only count the projected increase in property taxes towards a TIF’s value vs. those that allow increases in both property and economic-activity taxes to drive how much cash flow the developer receives. Developers obviously prefer states like Missouri, which count both. Less obvious is the different ways in which they benefit from this. Including economic-activity taxes does not just, or even primarily, mean that the developer gets more of its own taxes back in the state’s TIF payments. It means that the developer receives a share of the taxes paid by all tenant businesses that come to operate in its new development. “This makes the TIF much more valuable,” notes Ferry. “And is also, I think, much more potentially dangerous to the city.”

This risk can be sharpened by other variables in how TIFs are constructed; in worst case scenarios, poor design can turn a TIF incentive into something more damaging than simply a bad bet on a project that failed to perform. It can create a systemic drain on a city’s finances.

This can happen several ways. The simplest is geographic; Ferry summarizes:

The main arguments against TIFs stem from the impact that they have on school districts. School districts are funded by local property taxes and--apart from any specification spelled out within a redevelopment agreement providing otherwise--the default position for any revenues generated within a TIF district is that they must be made available by the City to pay off a revenue bond. Thus, if the TIF District covers a very large area, it can impact the revenues from that entire area.

This was the situation that the city of East St. Louis put itself in by covering almost 3/4s of its footprint with two separate TIF zones (see Exhibit 9). This means that, within each zone, all taxable revenue—including those having nothing to do with any particular development—can be claimed by any developers working under a TIF, potentially choking off the city’s finances for years. It’s for this reason that California--where TIFs originated and were used extensively in post World War II urban revitalization efforts--abolished TIFs entirely in 2012.22 And this is why, where TIFs are used, public-sector technocrats like Ferry and Mangin think carefully about the pros and cons of how they are geographically districted.

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22 Technically, California abolished the redevelopment agencies (RDAs) through which TIFs were run in the state. ([https://www.dailykos.com/stories/2012/2/5/1062126/-](https://www.dailykos.com/stories/2012/2/5/1062126/-), [https://www.planningreport.com/2014/07/24/demise-tif-funded-redevelopment-california](https://www.planningreport.com/2014/07/24/demise-tif-funded-redevelopment-california))
The tradeoff is between the benefits of increased development vs. the risks of drained tax revenues, and it characterizes another key aspect of a TIF’s construction. Ferry singles out the “crucial distinction” of whether the city’s obligation to pay out to the developer is structured as pay-as-you-go, a revenue bond, or a general obligation bond. The difference is purely legalistic if everything goes to plan: if the project, a success, generates new taxes equal to or in excess of the promised cash flow back from the city, meaning the city can meet the TIF’s obligations, so the payments go out to the developer (or whoever holds the note) as promised. The note might even get paid off before its coupon comes due -- usually in 23 years; in some states this is extendable to 35. But regardless: win-win.

Failure looks different. And failure happens, as Ferry confirms: “I’ve seen countless examples, they’re fifteen years in [to the TIF agreement], they haven’t paid off any of the principal -- I’ve seen cases where the interest is growing faster than the payments.” The project was built but is underperforming, and the tax receipts are lower than anticipated: this is when the distinction between the different kinds of obligation becomes important.

Under a pay-as-you-go agreement or revenue bond, the developer (or whoever holds the debt) loses out. These structures entitle the holder to a portion of a specific revenue stream: the projected new tax revenues from the development of a specific parcel of land. Insufficient revenue means diminished--or, in extreme cases, nugatory--payouts.

But if the TIF cash flows are contracted under a general obligation note then it’s like East St. Louis -- any city revenue is fair game in ensuring that the note’s payment obligation is honored. So a shortfall in the project’s tax revenues means that the money has to come from other sources; the city is on the hook whether or not the project succeeds.23

Combined with the inevitable imperfection of even best-faith efforts to project the future, TIFs have the capacity to become damaging burdens to the very cities and communities they’re meant to assist. This discussion has skimmed the surface of the churning waters that reformers like Ferry are seeking to improve; for a more detailed discussion of reforms in St. Louis see Exhibit 6.

Here, in this overview/summary note, we can only dip our toes in these churning, white-capped waters; the points of having done so--even briefly--are these: first, yes, it is useful to know about TIFs, which are significant, very useful, and problematic at once. Secondly, and more generally, 23 There is a reason for the city to nonetheless choose to frame a TIF as a general obligation bond: the interest rate. If the city is confident in a project’s tax revenue projections, then choosing a general obligation bond can make the TIF cheaper for the city overall. This is because the perceived risk of a general obligation bond is less than that of a revenue bond; for the latter, investors generally require “a debt coverage ratio of around 1.25 and an interest rate of even 6.25 - 7%,” Ferry notes. A general obligation bond is viable if those numbers are considerably lower; the same thing that makes it less risky for the city makes it riskier for whoever holds the note.
it is to provide an object lesson in how the political economies of most incentives, not just TIFs, combine a similar mix of conflicting interests, public opinion, “politics”, and complex financial mechanics. The politics and policy aren’t the investor’s job. But understanding them, and understanding the value of public partners who have the capacity and will to dissect and improve those “complex financial mechanics”, is an important part of the impact investor’s toolkit. The question of whether an incentive is effective or not is not of academic or background interest to the social investor; it’s self-evident that an incentive that drains a city’s grade-school coffers for decades is probably not “solving” any problem, net-net. So any investor whose concerns are both IRR and social impact, successful projects and positive knock-one effects, must be awake to the importance of nuance and complexity. She needn’t be an expert; she needn’t know all the details of every incentive. But she should be aware of how important learning them will be, and know what questions to ask to get her head around them. This is especially true because the impact investor will often be an intermediary between the public sector, civic society partners like NGOs and community groups, and commercial investors who won’t be so concerned. The distinction of impact investing is that it is concerned with broad outcomes -- and a good social investor must, therefore, develop her capacity to thoughtfully interrogate what those outcomes could be.

“This is the system we have,” sighs Dick Jones -- speaking not just of TIFs, but the whole mishegoss. “It’s the system we have and so, to some extent, it’s a choice between having no system or making the system we have work as well as we can.” But he urges the need for reformers like Ferry: technocrats and advocates who tackle the tools at a granular level in order to improve them, because “that initial ‘system we have or no system’ choice...it may be a reality, but it’s also an easy way to avoid the problems. And at some point--like now?--the system’s so insufficient that it collapses.”

Conclusion: What to Do, Now

The investor should know of reforms like St. Louis’s -- why they are needed and how they might help. She should be aware of the concerns of experts like Ferry and Jones -- agree, disagree, but to see the landscape. She may even become an “expert” herself, or reformer or advocate -- that’s not uncommon. Many CDFIs' leadership plays all these roles.

But to the extent that the investor is, in fact, an investor, she must also operate in “the system we have.” To which end this brief note has outlined its features -- far from comprehensively, as we’ve said several times. The purpose has been to begin to examine how an impact investor might use these instruments to forge partnerships that bring about and strengthen high-potential investments. Even this bird’s-eye summary, however, has lapsed into both minutiae and subjective concerns; one lesson being, perhaps, that these are unavoidable facets of this space. Economic incentives are imperfect instruments seeking to do something very important. They

24 Significant incentives passed over include PACE (Property Assessed Clean Energy) financing and the whole ecosystem of tax-based “green” incentives, as well as creative solutions like social impact bonds.
are subject to both purposeful and unintended misuse. They are also potentially valuable and frequently used to positive social effect.

What, then, are the takeaways?

The first is the importance of technical expertise. Even this cursory review of specific policies makes it clear how involved and complex the process of applying for, utilizing, and remaining in compliance with any tax abatement or credit incentive can be. In response to this, a transformative change has taken place in the social sector over the last several decades. The general partners on these deals—i.e., the CDCs and CDEs and community banks and non-profit organizations whose mission is to empower low-income communities through economic development and growth—have grown significantly, not in size but in capacity and sophistication. Jones remembers when “a church would put together a legal entity that put together a non-profit legal entity, and then the lawyers and accountants ran everything, right through to construction” on real-estate development deals serving low-income people. Now, CDFIs like BlueHub Capital are lean, brainy outfits that initiate and manage complex, multi-year details; entities like Twain Financial offer highly specialized expertise in public private partnerships; the space is defined small but high-capacity institutions stocked with experts in tax policy, deal structure and flow, corporate strategy, and public policy.

This strengthening of individual organizations is matched by industry-level capacity building. The CDFI Fund has emerged as a prominent, impactful part of U.S. Treasury operations. Non-governmental convening authorities, perhaps most notably the Opportunity Finance Network, bring together the whole alphabet soup of CDEs and CDCs and CDFIs to share learning, skills, resources, and contacts. All of this strengthens the industry and raises the bar on what it can hope to achieve.

It also reinforces the sector’s resilience in the face of inevitable market shocks and downturns. Speaking in the second quarter of 2020, as a novel respiratory infection shut down markets and the global economy spasmed downwards, Jones acknowledges first that the nascent recession may be “far, far different than ones in the past.” But he is also, if not optimistic, hopeful because at least “it’s not as if we didn’t plan for it. It’s our fourth. It’s the second pandemic, specifically, that we’ve planned for. We always talk about having enough runway—liquidity, balance sheet, staff capacity, relationships—to deal with what comes up. We didn’t predict this...but we did know that dramatic and cataclysmic things can and do happen. Healthy communities have strong organizations that have the capacity, resources, culture and leadership to recognize and respond.”

All of which is to say that the bar is now high. Leading large-scale deals as an “impact” or “social” investor is competitive; even participating as anything other than silent capital requires “capacity, resources, culture, and leadership.” In fact, as social investing projects that are market-based but in challenged geographies or industries find themselves in competition with
more straightforwardly market-based alternatives—in wooing a potential corporate partner, for example—the use of incentives is often necessary to “make the numbers add up.”

The second key point is to make use fit purpose. Everyone acknowledges that incentives have limits. Using them to get private actors to undertake categories of action they wouldn’t otherwise do (rather than shift their activities within an existing category) will often either have no effect or, worse, lead to unintended consequences; flooding regions where markets are broken or nonexistent with incentive opportunities may similarly have very little effect. This continuous recognition of limits, however, can also be used to shape deals that could help lift up local or sectoral economies, if executed with care. Jonathan Ferry, in St. Louis, talks about getting “manufacturing, producers” into areas where the bottom has dropped out on retail and real-estate markets. It can be effective, he argues, “to use incentives in an area like that to try and draw activity that’s insensitive to the broken-ness dynamic of some commercial real-estate markets.” Effective both in the sense that (1) deals may happen, and (2) “if incentives are used to assure that you have at least middle-wage jobs, lower to mid-skilled and enough money to make a living...that adds to the secondary effect of [a development project] by providing income to people who otherwise don’t have a lot of options.” In Illinois, Ferry notes, incentives are widely thus used—for manufacturing or light manufacturing—in particular TIFs that mitigate property taxes, since manufacturing “spins off a lot of property taxes.”

The third takeaway is that the details matter. This is worth stressing precisely because they can be so daunting and complicated (in some cases, many argue, they’re overly so). Most incentives at the level of implementation descend into eye-crossing clouds of acronyms and paragraphs of legalistic jargon. The point isn’t that the investor must become an “expert” -- any professional investment entity can, should, and often does retain or contract with experts in the relevant geographies / industries / capital stacks for a given deal. The point is that the investor must use expertise, “sweat the small stuff”, and attend to detail. They may be very important in assuring that a project is successful across all its goals.

Which brings us back to the question with which we began, the answer to which requires being able to work back-and-forth on a chain that links

- a given instrument’s benefit to investors, assuring capital is interested
- to creative projects that will benefit local economies and justify the use of public funds
- to the underlying challenges in a local economy or sector; i.e.,
  - What is the problem you’re trying to solve?

The question is simple. Answering it isn’t.

What, for example, is a useful working definition of what a healthy community is? How can you achieve a clear understanding of how a given area (or sector) is not “healthy”, yet? What is the goal towards which, in alleviating this problem, the investor seeks to move some small piece of the world? Effective social investing--which almost by definition means the effective use of
economic incentives--means contemplating how different financing and execution tools can work together in a durable way over time to create lasting, specific outcomes (and not accidentally create undesirable ones). It means stepping back to assess the macro view: how and whether your investments will or won’t percolate out from a core of impact to affect the areas and people adjacent to them. And it means tackling and--unlike this short paper--taking a firm view on some subjective questions. Is the goal to push economic revitalization in low-opportunity areas? or to help low-income people into higher-opportunity zip codes? Is the goal equity, or opportunity? Or do you reject the distinction?

These are all questions that potential partners, community leaders, and public agencies will reasonably expect rigorous answers to. More to the point, answering them comprises a theory of change that can evolve while, nonetheless, pushing effectively towards goals. It is difficult to get big investments together, and there will always be elements of opportunism as such. But the fact that an incentive is there, or that it can facilitate a given deal happening, or even that there is a promising place for it in the capital stack -- these are necessary-but-not-sufficient conditions, and leaving it there is an error that’s led to some of the failed efforts and unintended consequences touched on in these notes. “The way we’ll make new mistakes,” Dick Jones says, almost laughing, “is to ignore the fact that things will always be changing.” A big investment project lives for decades, or more. Over that timeframe, then: what problem is it going to solve?

No strategy, however well considered, can perfectly predict the future. No incentive, no matter how well-made and used, will be without complications and pitfalls. But problems exist that investment can mitigate; strategy can help these solutions take root; and incentives--imperfect, powerful, and frustrating--can be part of a toolkit that improves the world.
### Exhibit 1: Tax Credit vs. Tax Deduction

<table>
<thead>
<tr>
<th></th>
<th>Base Case</th>
<th>Deduction</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income</strong></td>
<td>$100</td>
<td>$100</td>
<td>$100</td>
</tr>
<tr>
<td><strong>Tax (at 30%)</strong></td>
<td>$30</td>
<td>$30</td>
<td>$30</td>
</tr>
<tr>
<td><strong>$10 Deduction</strong></td>
<td>--</td>
<td>$10</td>
<td>--</td>
</tr>
<tr>
<td><strong>Income after deduction</strong></td>
<td>$100</td>
<td>$90</td>
<td>$100</td>
</tr>
<tr>
<td><strong>Tax (at 30%)</strong></td>
<td>$30</td>
<td>$27</td>
<td>$30</td>
</tr>
<tr>
<td><strong>$10 Credit</strong></td>
<td>--</td>
<td>--</td>
<td>$10</td>
</tr>
<tr>
<td><strong>Taxes paid</strong></td>
<td>$30</td>
<td>$27</td>
<td>$20</td>
</tr>
<tr>
<td><strong>Cash, after tax</strong></td>
<td>$70</td>
<td>$73</td>
<td>$80</td>
</tr>
<tr>
<td><strong>Benefit</strong></td>
<td>$0</td>
<td>$3</td>
<td>$10</td>
</tr>
</tbody>
</table>

Exhibit 2: NMTC Flow Chart

Third-Party Lender
*(bank or affiliate)*

```
Investment Fund
Funds $10MM QEIs
100% owned and managed by NMTC equity investor
```

Subsidiary CDE
99% owned by Investment Fund, 1% by Sponsor CDE

QALICB
*entity operating the project*

“NMTC Equity Investor”

Sponsor CDE
*Receives authority to allocate NMTCs*

US Department of Treasury CDFI Fund
*Awards NMTC allocation authority to CDEs*

*Based on infographics provided by Twain Financial Partners, December 2019.*
**Exhibit 2, Key**

New Markets Tax Credits flow from the US Treasury to the Sponsoring Community Development Entity (CDE), which then allocates the tax credits to the “NMTC Investor” via pass-through entities; the value of the tax credits exceed the Investor’s contribution to the project.

The “NMTC Investor” provides equity or a low-interest rate loan to the Qualified Active Low-Income Community Business (QALICB) via pass-through entities; the QALICB can be another sub-entity or the operating business on the site.

The NMTC Investor’s cushion of capital, positioned to absorb initial losses, facilitates the acquisition of third-party market-rate lenders or equity investors; these “third-party” investors may be affiliates of the Sponsor CDE or true commercial third-parties.

As part of the deal’s financials, the Sponsoring CDE earns a fee for the provision of its CDE allocation; a portion of this goes to transactional costs in legal and accounting, and a portion can be reinvested in other areas of the CDE’s work.

*Based on infographics provided by Twain Financial Partners, December 2019.*
### Exhibit 3: Opportunity Zone Illustration

<table>
<thead>
<tr>
<th>Event</th>
<th>2000</th>
<th>2019</th>
<th>2026</th>
<th>2030</th>
</tr>
</thead>
<tbody>
<tr>
<td>Apple share purchased for $100</td>
<td>Apple share sold for $1,000,100; $1MM invested in OZ within six months</td>
<td>OZ investment sold for $2.5MM</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital gains</td>
<td>$1,000,000</td>
<td>$1.5MM</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxes (at 20%)</td>
<td>$200,000</td>
<td>$300,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxes (with exemption)</td>
<td>$0 (deferred until 2026)</td>
<td>$170,000 (15% deduction on deferred taxes)</td>
<td>$0 (investment held longer than ten years)</td>
<td></td>
</tr>
<tr>
<td>Taxes saved (cumulative)</td>
<td></td>
<td></td>
<td>$30,000*</td>
<td>$330,000</td>
</tr>
</tbody>
</table>

*ignoring probable inflation effects

*Based on a model calculation offered in “Tax Credits 101, Pace, and Opportunity Zones”. Presentation by Marc Hirshman, Twain Financial Partners (https://twainfinancial.com). 2020.*
Exhibit 4: The standard, “net-net” TIF chart

Basic TIF Model

- Revenues diverted for TIF-eligible purposes:
  - Pledges to support bond debt services
  - Pledges to developer note
  - Fund Infrastructure

Incremental Taxes

New Tax Base Revenues flow to normal taxing bodies

Statutory life of TIF district


Note: In both cases, the graph is materially correct but smooths over the mechanics of how a TIF functions. The taxes are not in fact frozen at an existing base; as the narrative accompanying the second chart (below) describes:

“The new investments begin to induce development, and total property values within the TIF district begins to rise. This growth in property value translates into an increase in the properties’ assessed value, which generates incremental property tax revenue above the baseline value, which then flows into a special TIF fund. If bonds were issued, TIF revenue will be used to repay the bonds; otherwise, the incremental revenue will be used to fund expenditures on a pay-as-you-go basis or to reimburse developers for their upfront investments. The incremental tax revenue continues to flow into the TIF fund until the district expires.”
Exhibit 5: Evidence of the CRA’s impact

Note: The authors of this paper took advantage of “a natural experiment created in 2013 when the federal Office of Management and Budget (OMB) revised its delineations of the nation’s MSAs and MDs” in such a way that census tracts which were unchanged in other respects did lose or gain CRA eligibility.


Graphs also available here: 
Exhibit 6: TIF Reform in St. Louis

The following is a lightly revised version of Jonathan Ferry’s “Incentives Scorecard Presentation” for the St. Louis Development Corporation. 2017.

In 2016, the City of St. Louis was hit with a triple notch credit rating downgrade from Moody’s. The reason for the downgrade was two-fold: a low cash reserve and, as importantly, the fact that St. Louis’ use of incentives resulted in a stagnation of city revenues, preventing the City from benefiting financially from a surge in investment ($25 billion in new investment since 2000).

St. Louis has two fundamental problems when it comes to the use of tax incentives. They are:

1. The overuse and miscalculation of tax incentives; and
2. The mis-pricing of variable and fixed costs

The Over Use and Miscalculation of Tax Incentives

When a city grants an incentive (to an otherwise worthy project) without taking into account the amount of the taxes generated by the project that will simply be cannibalized from other businesses throughout the city (also known as the substitution effect). The following tables provides an example illustration for how this works:

<table>
<thead>
<tr>
<th></th>
<th>PROJECT A#1 (RETAIL STORE W/O SUBSTITUTION EFFECT)</th>
<th>PROJECT A#2 (RETAIL STORE W/ SUBSTITUTION EFFECT)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>New Sales Tax Receipts</strong></td>
<td>$2 M</td>
<td>$2 M</td>
</tr>
<tr>
<td><strong>- 50% Sales Tax TIF/rebate</strong></td>
<td>($1 M)</td>
<td>($1 M)</td>
</tr>
<tr>
<td><strong>NO substitution effect</strong></td>
<td>$0 M</td>
<td>- 55% substitution effect ($1.1 M)</td>
</tr>
<tr>
<td><strong>Net New Sales Tax</strong></td>
<td>$1 M</td>
<td>Net New Sales Tax ($100 K)</td>
</tr>
</tbody>
</table>

By failing to account for substitution, cities can vastly overestimate the fiscal benefits of potential projects, which can lead to an over-commitment of incentives beyond what the project will yield.

The mis-pricing of variable and fixed costs

Many projects do not in fact generate enough revenue to pay for the long-term maintenance of the infrastructure and public services necessary to maintain them, even if preliminary marginal analysis would appear to suggest that they do.

When conducting a cost-benefit analysis for incentives on a project, it is common for cities to look at the immediate infrastructure or service costs required; i.e. the “marginal” or “variable” costs. What is often
neglected is the cost of maintaining not only new, but existing infrastructure, also necessary to serve the site. Land use and density are big factors that play into calculating the cost for maintaining infrastructure. The more spread out developments are, the more infrastructure has to be maintained, and the less revenue the land will generate to support that infrastructure. Furthermore, land is one of any city’s principal assets, and it is limited -- “giving” it away too cheaply, i.e., with overly generous incentives, can impair the city’s long-term fiscal stability in the face of these increased fixed costs.

*It is important to compare the revenue generated per acre of land to the cost to maintain infrastructure per acre of land.* The following are two real life examples in St. Louis.

<table>
<thead>
<tr>
<th></th>
<th>Big Box Retail</th>
<th>Mixed-Use Project</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land Consumed (acres):</td>
<td>11.0</td>
<td>1.2</td>
</tr>
<tr>
<td>All Property Taxes per Acre</td>
<td>$14,020</td>
<td>$525,820</td>
</tr>
<tr>
<td>Property Taxes per Acre to City</td>
<td>$2,974</td>
<td>$111,541</td>
</tr>
<tr>
<td>Retail Taxes* per Acre to City</td>
<td>$104,170</td>
<td>$169,225</td>
</tr>
<tr>
<td>Residents per Acre</td>
<td>0.0</td>
<td>324.0</td>
</tr>
<tr>
<td>Jobs per Acre</td>
<td>14.2</td>
<td>58.9</td>
</tr>
<tr>
<td>Earnings/Payroll† Tax per Acre</td>
<td>$3,560</td>
<td>$14,112</td>
</tr>
<tr>
<td>Total Tax‡ per Acre (to City Only)</td>
<td>$110,704</td>
<td>$294,878</td>
</tr>
<tr>
<td>City’s Estimated Cost per Acre**</td>
<td>$64,618</td>
<td>$64,618</td>
</tr>
</tbody>
</table>

*Estimated from public reports of annual sales per sq. ft.
† Workers Only, excludes residents
‡ Only includes real property, sales and earnings/payroll tax (excl. earnings tax paid by residents)
** Based on City-wide average annual cost per sq. ft. for commercial property of $1.95 (see tech. memorandum).
Opportunity Cost in Land-Use Economics

Not all property is created equal. Some property has interstate access, or is located in a bustling downtown. That property is worth more, and should be expected to generate more in taxes than, say, a property in a single family residential neighborhood.

As such, in St. Louis, we allocate infrastructure maintenance cost based on a model that measures the economic opportunity for land area based on taxes generated per acre of land. The amount of taxes generated varies by the land use type (e.g. industrial vs. residential vs. mixed-use commercial) and by location. This is done by calculating the percentage of all revenue that each land use/location combination generates and applying that percentage of the city’s overall infrastructure maintenance expense to that area. The following is an example of how this might work:

**District:** Commercial High-Rise District in Downtown

**Total Revenue Generated by District:** $60 million

**Total Revenue Generated within City:** $600 million

**District percentage of City Revenue:** 10% (60 divided by 600)

**Total City-wide Annual Infrastructure Maintenance Cost:** $85 million

**Infrastructure Cost Allocated to District:** $8.5 million

For analysis purposes, this cost is then converted to a cost per acre (or per square foot) of tax generating land in the District. In this case, if the District contains 100 acres of taxable property, then the cost per acre would be $85,000 per acre, annually ($8.5 million divided by 100). For a proposed project to be meeting its requirement in this District, then, it would need to generate at least $85,000 in net tax revenue to the City after accounting for any incentives given, and after accounting for any loss from the substitution effect.

With that in mind, let’s return to the previous example.

<table>
<thead>
<tr>
<th></th>
<th>Big Box Retail</th>
<th>Mixed-Use Project</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Tax per Acre (to City Only)</strong></td>
<td>$110,704</td>
<td>$294,878</td>
</tr>
<tr>
<td><strong>Tax Incentive per Year</strong></td>
<td>($54,464)</td>
<td>($173,846)</td>
</tr>
<tr>
<td><strong>10% Substitution Effect</strong></td>
<td>($11,070)</td>
<td>($29,488)</td>
</tr>
<tr>
<td><strong>Net Tax to City per Acre after Incentives</strong></td>
<td>$45,169</td>
<td>$91,544</td>
</tr>
</tbody>
</table>

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In the case above, providing tax incentives to the big box retailer results in a loss to the City, annually, even with just a small, 10% substitution effect in place. Often, however, retailers have much larger substitution effect rates than 10%.

Our research finds that not all building and development typologies generate enough tax revenue to be able to financially sustain the infrastructure built to support them. This is especially the case for low-density developments. However, as our model also implies, the solution to this problem is not to simply prohibit low-density developments, but to find the right balance between high, mid and low density. However, when it comes to incentive strategy, as long as your city has a sufficient massing of high tax-generating, high density developments, you could plausibly still get away with allowing and even lightly incentivizing lower density projects. However, as a strategy, we believe that priority must be given to projects that generate healthy tax revenues on a per unit of land basis.

What happens if the substitution effect ends up being higher than what we have used here, and even the Mixed-Use Project ends up with negative net revenues? In this case, our St. Louis model is calibrated to be able to easily adjust the amount of the incentive, and immediately see how it affects the City’s return, and the developer’s rate of return, as well, making it a very valuable negotiation tool. And, though it has not been used for this purpose in St. Louis, yet, it can also be utilized for negotiating the amount of incentive that might be clawed back if a project had higher substitution than was originally projected.

One example where this might work well is the office development project that projects new jobs to the City, but in actuality just relocates a firm from elsewhere in the City.

**Long-Term vs. Short-Term Revenue**

When it comes to incentivizing projects, it is inevitable that a project will do the following:

1. Generate new immediate revenue, but not enough to be considered sustainable
2. Generate significantly more than the sustainable amount of revenue in the long-term when the incentive period expires.

In such a case, what should a City do?

In our case, we developed a formula that weights the long-term revenue (the amount post-incentives) and the short-term revenue (the amount during the incentive period), and takes both into account. However, because future revenue is both less certain and subject to the time value of money, we weight short-term revenue three times higher than long-term revenue. And, the longer the incentive period, the greater the differential between the short-term weight and the long-term.
Non-Financial Criteria

The above described financial cost-benefit model represents 40% of the scoring criteria that we use when evaluating projects in St. Louis. The other parts include an architectural review and an urban design review.

For the Architectural Review we consider:

1. Blighting & Conditions
2. Proposed Uses & Program
3. Investment Team Track Record & Level of Investment
4. Building Typology & Character
5. Building Materials & Detailing (including use of sustainable materials)

For the Urban Design Review we consider:

1. Placement & Build-Out
2. Height & Bulk
3. Frontage & Articulation
4. Land-Use & Unit Mix
5. Access & Parking
6. Site & Landscaping
7. Streetscape & Public Space

Each of these two parts are worth 30% of the possible score.

In order to get a passing grade, a project must get at least 60% of points possible on each individual component of the scorecard, and must get a 70% overall score.

The scorecard is calibrated so that a 70% scoring project meets the minimum viability requirements. In the case of the financial review, 70% equates to a financially sustainable project for the City.

This means that a project can pass with slightly less than sustainable levels of revenue, if it exceeds requirements in one or both of the other two areas.

‘But-For’ Test

It is important to note that the financial portion of the scorecard is based simply on the cost-benefit to the City for the project, with land-use opportunity cost factored into the equation.

The City also uses a But-For Test, as well, which is done concurrently, but is reported separately from the scorecard.

Our ‘But-For’ Test, however, is done very similarly to many other cities around the country, where we calculate the ten year unlevered Internal Rate of Return to the project, and compare that with market data, which we purchase, to see if the rate of return is in line with the market, or excessive. If it is excessive, then the amount of the incentive will either be reduced from the requested amount, or, if no incentive is deemed to be necessary, rejected altogether.

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Exhibit 7: Estimated total local and state incentives (billions, in 2015 US dollars)


Exhibit 8: CDFI Fund programs and certifications

WHICH CERTIFICATION IS RIGHT FOR YOUR ORGANIZATION?

The first step to accessing many of the CDFI Fund's programs is applying for CDFI or CDE Certification. Although there are some exceptions, certification is the gateway to accessing the CDFI Fund's award programs. Full details about eligibility requirements for the CDFI Fund's award programs can be found on the individual program pages available at www.cdfifund.gov/programs. Follow the links below the table to learn more about how to apply for CDFI Certification and CDE Certification.

<table>
<thead>
<tr>
<th>PROGRAM</th>
<th>TYPE OF CERTIFICATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank Enterprise Award Program *</td>
<td>CDFI Certification</td>
</tr>
<tr>
<td>Capital Magnet Fund **</td>
<td>CDFI Certification</td>
</tr>
<tr>
<td>CDFI Bond Guarantee Program</td>
<td>CDFI Certification</td>
</tr>
<tr>
<td>Community Development Financial Institutions Program</td>
<td>CDFI Certification</td>
</tr>
<tr>
<td>Native American CDFI Assistance Program</td>
<td>CDFI Certification</td>
</tr>
<tr>
<td>New Markets Tax Credit Program</td>
<td>CDE Certification</td>
</tr>
</tbody>
</table>

* FDIC-insured depository institutions  
** Non-profit affordable housing organizations

Source: CDFI Fund website, “Certification”.  
Exhibit 9: East St. Louis TIF Districts

Source: The City of East St. Louis.