# The New Markets Tax Credit Program: A Midcourse Assessment

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On December 21, 2000, only weeks before he left office, President Bill Clinton signed into law the bipartisan Community Renewal Tax Relief Act. The Act included two "New Markets" initiatives originally proposed by the administration.[1] These initiatives were designed to address the continued presence of "places left behind," which the administration identified as urban, older suburban, and rural areas of distress. These were locations whose residents had not shared in the strong economic growth of the mid-1990s (US Department of Housing & Urban Development 1999). At the ceremony, Clinton evidenced genuine pride in the bill, stating that it represented "the most significant effort ever" to help distressed communities by leveraging private investment (cited in Pappas 2001, p. 323).

The administration had considered a range of solutions to the problem of helping such communities, from traditional Democratic anti-poverty programs to more business-oriented policies that were designed to increase economic growth in the affected regions. The administration ultimately identified the problem of distressed communities as being driven by a lack of private capital. It thus crafted a solution of forming new public-private partnerships, which would help overcome barriers to investments in potentially lucrative "new markets" existing in the United States (Rubin and Stankiewicz 2001, p. 137). The resulting New Markets initiatives were good examples of President Clinton's personal preference for "Third Way" policies, ones that used market forces to better people's lives, while eschewing both traditional Democratic and Republican policy approaches.

The New Markets Tax Credit (NMTC) program, one of the two initiatives, was designed to combine public and private sector resources in order to bring $15 billion in new investments to impoverished rural and urban communities over a span of seven years. Passage of the legislation generated high hopes that this federal program would help create new jobs and community renewal in some of the nation's most disadvantaged communities (Walker 2002, p. 28).

Five years later, the New Markets Tax Credit program has awarded slightly more than half of the available tax credits in three competitive rounds, with the remaining tax credits scheduled to be distributed by 2007. Moreover, the New Markets Tax Credit Coalition, a group composed of over 100 community development organizations and investors, is working to convince Congress to reauthorize the program in order to provide additional funding for future years (New Markets Tax Credit Coalition 2005a).

[1] The two initiatives were the New Markets Tax Credit and the New Markets Venture Capital programs. For more information about the New Markets Venture Capital program see Rubin and Stankiewicz (2003).

With the New Markets Tax Credit program at the midpoint of its implementation, this seems to be an opportune time to evaluate the program's impact to date. While a comprehensive data analysis is still premature, we believe that this is the right moment for a different type of evaluation.[2] In 2003, we conducted extensive interviews with individuals who had helped craft the NMTC legislation, lobbied for its passage, and applied for or received allocations of credits in the first round. We also conducted our own analysis of the program's content and implementation. Based on this analysis, we raised a number of concerns regarding how effective the program might be going forward (Rubin and Stankiewicz 2003). In particular, we were concerned that the program was vulnerable to excessive compensation of private investors at the expense of a greater community economic development impact. Now, after two more rounds of allocations, this article re-examines the program's implementation to date and we believe that this concern remains valid (see also Armistead 2005).

## How the New Markets Tax Credit Program Works

The New Markets Tax Credit program builds on what the Clinton administration regarded as successful recent innovations in the federal government's approach to community economic development and poverty alleviation. These innovations include a reliance on financial intermediaries and the use of tax credits.

Financial intermediaries are organizations that broker deals between private sources of capital and the nonprofit and for-profit developers of housing and other community needs. By doing so, they help reduce private sector risk, and therefore encourage more private sector financing in distressed communities. Such institutions have come to play an increasingly important role in housing and community development (Vidal 2002; Walker 2002).[3]

The New Markets Tax Credit program relies on intermediaries to an even greater extent than previous initiatives, such as the Community Development Block Grant and the Low Income Housing Tax Credit (LIHTC) programs, which leave decisions regarding specific allocations to individual states and municipalities. In contrast, the New Markets Tax Credits are designed to go directly from the federal government to newly-created intermediaries, called community development entities (CDEs). Moreover, unlike intermediaries used in these other federal programs, CDEs are required by the legislation to be private and for-profit, though their parent entities can be public or nonprofit.

The New Markets Tax Credit program also uses tax credits rather than direct government funding to spur neighborhood revitalization. Tax credits are more palatable politically and

[2] The federal Office of Management and Budget also found in 2005 that the data was not yet available for a meaningful evaluation. See Government Accountability Office (GAO) (2005), Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined, GAO-05-690. Washington, DC: GAO, September, p. 71. To the degree that an analysis of this type can be undertaken, the Community Development Financial Institutions (CDFI) Fund of the U.S. Treasury Department has been facilitating this process by collecting data on individual transactions. The Fund, which administers the NMTC program, will make this data available to a vendor that its staff will select in order to conduct a multi-year evaluation of the program. This vendor selection process is currently in its early stages, and no evaluation is likely to be forthcoming for at least a year.

[3] The Enterprise Foundation and the Local Initiatives Support Corporation are examples of financial intermediaries operating nationally; other Community Development Financial Institutions serve in this role at the local and state levels.

easier to enact because they do not count as a direct budgetary expenditure. Instead, they are an opportunity cost to the federal government – revenues that would have been collected were it not for the tax credits (Burman 2003; Arnold 1990). The New Markets Tax Credits provide a 39 percent cumulative tax reduction to investors. The credits are designed to be used over seven years – allowing for a five percent reduction in taxes in each of the first three years, and a six percent reduction in each of the remaining four years (CDFI Fund 2005b). The credits are used as incentives to help attract private sector investors who, in exchange, provide the CDEs with capital that is used to finance projects designed to revitalize low-income communities.

## The NMTC Selection Process

The U.S. Treasury Department's CDFI Fund certifies CDEs and determines which ones will receive tax credit allocations. To be certified, CDEs must be a for-profit entity that has a primary mission of community development. CDEs can demonstrate their commitment to such a mission in their organizational documents and by focusing at least 60 percent of their activities on low-income communities or people, either directly or through other entities. They also must be accountable to residents of the low-income communities they serve by having such residents represented on the CDEs' governing or advisory boards. As of September 1, 2005, the CDFI Fund had certified 1,953 organizations as CDEs. Of this total, 146 organizations had received one or more New Markets Tax Credit allocations (CDFI Fund 2005a; New Markets Tax Credit Coalition 2005b).

In addition to certifying CDEs, the CDFI Fund also allocates the tax credits. The Fund has conducted three rounds of NMTC allocations to date, awarding a total of $8 billion in tax credits. The Fund currently is reviewing applications for a fourth round of allocations of $3.5 billion, with the results due to be announced in 2006. The Fund will award a fifth round, consisting of an additional $3.5 billion, in 2007. The selection process for these rounds has consisted of three reviewers independently reading and evaluating each application. The reviewers have included federal employees working on community development-related programs, along with individuals from the private sector who are knowledgeable about making investments of the kind allowed under the NMTC program.

CDEs apply for tax credits by submitting an application to the CDFI Fund that details their intended efforts in four areas: business strategy, capitalization strategy, management capacity, and community impact. Each of these four sections is rated on a scale of 0 to 25. Additionally, applicants can receive up to five extra points for having a track record of serving disadvantaged businesses or communities, and up to an additional five points for planning to invest substantially all the NMTC capital in unrelated entities.

The reviewers score the applications, tallying the four primary categories and the two extra categories, for a total of 110 points. The reviewers then recommend whether the applicants should receive an allocation and, if so, for how much. The scores of the three readers are added together and ranked. Fund staff review the applications with the highest scores to insure compliance in terms of program eligibility and regulatory matters. Those applications then are forwarded to the NMTC program manager for an allocation determination (CDFI Fund 2005b).

Recipients of NMTC allocations must sign an allocation agreement with the CDFI Fund, detailing the specific terms of their obligations. The allocation agreements utilize data from the applicants' proposed business plans to identify approved uses of the allocation and the geographic areas in which the funds must be invested. The agreements also incorporate those aspects of the business plan that likely increased the applicants' scores during the selection process (such as indicating that they will invest primarily in very distressed communities or in unrelated entities). The applicants are required to abide by the terms of the allocation agreement or risk losing any unused tax credits and being barred from participating in future rounds of NMTC allocations, or in any other programs managed by the CDFI Fund. All allocation recipients must invest at least 85 percent of their NMTC leveraged dollars in qualified low-income community investments.[4]

## Program Objectives

Our analysis of the New Markets Tax Credit program is based on the assumption that the program's intent is one of poverty alleviation – to better the lives of residents of distressed communities – rather than general economic development. Many of the drafters of the New Markets Tax Credit legislation intended the program to focus on poverty alleviation, and hoped that the program would be designed in such a way as to maximize the developmental impact of the tax credits on low-income communities. However, the authorizing legislation did not explicitly state a focus on poverty alleviation.[5] Congressional supporters of the NMTC legislation did indicate that "the program's goals are to direct new business capital to low-income communities, facilitate economic development in these communities, and encourage investment in high-risk areas" (GAO 2002, p. 1). Nevertheless, these goals are vague enough to leave open the question of whether the program is aimed at poverty alleviation or broader economic development.

The new Bush administration has been less interested in using community economic development as an avenue to address poverty alleviation, preferring instead to rely on faith-based organizations to take the lead on such issues while emphasizing overall economic growth objectives (Fletcher 2005). In 2004, the U.S. Treasury Department illustrated this shift in emphasis away from developmental goals by specifically identifying the New Markets Tax Credit program as an initiative useful for stimulating overall U.S. economic growth (quoted in Government Accountability Office 2005, p. 68).

While we feel it important to acknowledge this split over the goals of the New Markets Tax Credit program, we proceed under the assumption that the program's objectives are primarily anti-poverty. If that is to be the case, then New Markets Tax Credits should not be

[4] Such investments include making loans or equity investments in a business that has at least 40 percent of its tangible property located in a low-income community; at least 40 percent of its employees' services performed in such communities; or at least 50 percent of its total gross income derived from a qualified business within a low-income community. Additional qualified investments include the purchase of qualified loans from another CDE; equity investments or loans made to another CDE; and financial counseling or other business assistance services to businesses located in, and to residents of, low-income communities (CDFI Fund 2005b).

[5] Tax legislation does not generally include language regarding its purpose.

used to subsidize activities that have a limited community economic development impact. Furthermore, regardless of whether the goal is one of community economic development or of overall economic growth, we also assume that the NMTC program should not fund activities that would have occurred without the subsidy.

It is very difficult to determine if the program is in fact meeting these goals. First, the program is still new. Second, the individual deal data that the CDFI Fund is collecting are not yet available publicly. Third, even if such data were available, it is unlikely that the information would be sufficient to determine if specific deals would have occurred without a New Markets Tax Credit subsidy, or to allow for a true assessment of their community development impact. The former would require an ability to know what was inside the minds of the investors and the latter is always difficult at best to evaluate.[6]

In reviewing the available data and talking with participants, however, we stand by our original concern that the program likely is not meeting the objectives of maximizing the developmental impact of the NMTC dollars or of being utilized to subsidize only those deals that otherwise would not have been financially feasible. To understand why this is the case, it is important to review how the CDFI Fund implemented the NMTC selection process.

## Implementation

The drafters of the original New Markets statutory language intentionally left the legislation vague, giving the CDFI Fund the critical role of interpreting the legislation and shaping the way the regulations would be designed to meet the program's objectives. The drafters selected the CDFI Fund for this purpose because of its focus on community development objectives and its experience in providing capital to, and monitoring the compliance of, organizations that invest in distressed communities. The drafters believed that it was more effective to give the Fund the responsibility of ensuring that NMTC allocation recipients were utilizing the money for appropriate community development purposes, rather than to write specific enforcement language into the legislation. Delegating these tasks to the CDFI Fund also provided for greater flexibility in program implementation.

However, the NMTC program's creators did not fully anticipate the very different political environment in which the program would be implemented. The Bush administration has been significantly less friendly than its predecessor towards community development in general and towards the CDFI Fund specifically. Under this administration's priorities, the CDFI Fund has received less than half of the budgetary resources it enjoyed during the last years of the Clinton administration. Moreover, President Bush's fiscal year 2006 budget proposal effectively would have eliminated the Fund by reducing its yearly budget from $56 million to $8 million, to be used solely for administering the NMTC program and the

[6] For an excellent explanation of why an impact analysis of community economic development transactions is so challenging, see J. P. Caskey and R. Hollister, (2001), *Business Development Financial Institutions: Theory, Practice, and Impact*, Institute for Research on Poverty Discussion Paper no. 1240-01. Madison, Wisconsin: University of Wisconsin. Available at: http://www.irp.wisc.edu/

remaining portfolio of the Fund's other program awards (Congressional Budget Office 2005).[7]

Given a less supportive presidential administration, the CDFI Fund chose to minimize potential external criticism by limiting its own discretion in the selection process. This made a process like the one that the Fund uses for its other community development programs – e.g., first-round peer review, with subsequent site visits and additional due diligence by Fund staff – infeasible for the NMTC program.

The Fund's normal selection process had other limitations with regard to the New Markets Tax Credit. In an environment of dwindling budgetary resources, such an intensive approach was not cost effective for a program of this size. Moreover, the Fund did not have the staff necessary to conduct extensive due diligence. Finally, the Fund did not have experience dealing with many of the parent organizations that were applying for NMTC designation. These organizations were less concerned with, or knowledgeable about, community development issues and would have been more willing to use lawsuits to challenge unfavorable decisions.

As a result, the Fund implemented a selection process for the NMTC program that relies overwhelmingly on outside expert reviewers who evaluate the applicants utilizing a scoring system that the Fund created to facilitate the process. This scoring system has favored those applicants who are able to self-finance by relying on parent entities that can provide capital in exchange for the tax credits. It does so by allotting significant weight to those applicants who have the most solid capital commitments. A CDE's capitalization strategy section is worth 25 points, with the bulk of these points likely to be awarded to those applicants who have firm capital commitments in place, or a good plan for raising capital.[8] Applicants with secure capital commitments also are more likely to receive larger allocations, as the allocation process factors in what percentage of an applicant's capital already is firmly committed.

Applicants capable of self-financing overwhelmingly are profit-driven organizations, such as commercial and investment banks.[9] The NMTC legislation intentionally did not restrict participation in the program only to those organizations that had a community development mission because members of the Clinton administration believed that the amount of capital involved was too large to be managed exclusively by such entities. The administration also believed that opening the program to more traditional financial organizations would increase its impact and bring these financial sources into distressed communities on an ongoing basis.

[7] Future funding for all CDFI programs except the NMTC, along with 17 other community development programs from throughout the federal government, would have been transferred to the Commerce Department, where these programs would have had to compete for a pool of capital that would have been 33 percent smaller than their 2005 allocations (CDFI Coalition 2005).

[8] The CDFI Fund changed the NMTC scoring system for the third round of allocations to give greater weight to the business strategy and community impact sections. A CDE's capitalization strategy is still critical, however, as the score it receives on that section helps determine whether it will advance to the next stage of selection, during which the business strategy and community impact sections receive greater weighting.

[9] Although a CDE must have a primary mission of community development, its parent entity does not need to have such a mission.

Profit-driven entities that do not have a community development mission, by definition, see the program as an opportunity to increase profits. As numerous studies comparing nonprofit and for-profit providers in other industries have documented, entities motivated primarily by profits make decisions based on that objective, often regardless of the social impact of those decisions (Devereaux, et al 2002; Cleveland and Hyatt 2002). In the case of the NMTC program, this means that profit-driven entities will try to increase profits by utilizing the credit to support investments that do not need the NMTC subsidy and by making investments with limited community development impacts.

Another concern is that the selection process allows CDEs to demonstrate their ability to raise capital via non-binding letters of intent from potential investors. These investors may withhold actual funding until they can review specific deals. Since investors also have the option of creating a CDE and applying directly for tax credits, they have an incentive to commit fully only to those deals likely to provide the highest financial returns, as opposed to those that would have the greatest community development impact. This may be forcing CDEs without a funding parent to offer potential investors more financially profitable deals than is prudent in order to attract their capital.

Our final concern about the NMTC program's impact on low-income communities and overall efficiency is due to the program's lack of restrictions with respect to "double-dipping." Double-dipping occurs when program funds are used in combination with other development incentives. The program's legislation does not allow the NMTC subsidy to be used with most other federal tax subsidies, such as the federal Low Income Housing Tax Credit (IRS 2004). However, applicants can combine New Markets Tax Credits with the Historic Tax Credit and all non-tax based federal economic development incentives, as well as with all state economic development incentives, in order to obtain an even larger total subsidy.

It can be argued that such double-dipping is necessary, given the relatively shallow amount of subsidy provided by the New Markets Tax Credits, and the fact that double-dipping is a regular part of most community development organizations' tool kits. However, if CDEs already are utilizing the NMTC program to maximize financial return on individual transactions, any further government subsidies will only enhance that return, generating little or no additional impact, whether developmental or broadly economic.

A good example of this concern is the case of Advantage Capital, which received an NMTC allocation of $110 million in the first round and an additional $50 million allocation in the third round. Advantage intends to use its NMTC allocations for investments in nine states. In four of those states, Advantage also has the potential to qualify for 100 percent state tax credits for those same investments, through a state economic development effort called the Certified Capital Company (CAPCO) program.[10] Therefore, if Advantage invests $1 million in a qualified business, it could receive state CAPCO tax credits equal to $1 million

[10] The Certified Capital Company (CAPCO) program makes equity and debt investments in specific states in exchange for a 100 percent state tax subsidy (Barkley, Markley, and Rubin 2001). Advantage currently has CAPCO funds established in 4 of the 9 states in which it anticipates focusing its NMTC activities. These states are New York, Florida, Missouri, and Texas (New Markets Tax Credit Coalition 2005b).

and federal New Markets Tax Credits equal to $390,000. The significant state subsidy via the CAPCO program makes it difficult to argue that these transactions would have been financially unattractive without the additional benefit of the NMTC subsidies.

Other analysts have addressed these concerns about the NMTC program by arguing that the combination of the strenuous selection process, the detailed nature of the allocation agreement, and the data being collected by the CDFI Fund to evaluate the program make it very difficult to utilize the credit for deals where the extra subsidy is not truly necessary, or where the community development impact is likely to be very limited (see, for example, Armistead 2005). As we have pointed out, however, the current CDFI Fund selection process advantages CDEs with profit-driven parent entities.

In addition, while the allocation agreement is important, it is not a guarantee that the tax credits will be used primarily to benefit low-income communities or to subsidize deals that would not have occurred otherwise. It may be very difficult for the CDFI Fund to determine if an organization maximized the community development impact of a particular deal or utilized the credits only when necessary. That information often is available only to those making the investments. Furthermore, violating an allocation agreement triggers a default rather than a recapture penalty. Recapture penalties are severe, including negation of tax credits that investors already have utilized. The less stringent default penalties, by contrast, consist of termination or reallocation of any unused portions of tax credit allocations and prohibition from applying for future NMTC allocations or any other CDFI Fund programs (CDFI Fund 2004). Given that CDEs have up to three years following an allocation round to attract investors and begin making deals, it is possible for a CDE to time its investments so as to utilize its allocation fully, and make a substantial profit, before the Fund can take any action against it.

## Revising the New Markets Tax Credit Program

Given the possibility that the NMTC program is not being optimized developmentally or economically, and given the challenges we outlined regarding monitoring and enforcement, we argue that the program would be more effective if it required all CDE parents to be mission driven. Such a change would limit the profit-maximization incentive, thus providing greater assurance that the credit is being used primarily for poverty alleviation and only when a subsidy is necessary. This change would not meaningfully limit investors' interest in the program because investors who are currently setting up their own CDEs would still have the option to invest in unrelated, mission-driven CDEs.

This change could have been made when the NMTC program was first being proposed, and the NMTC Coalition advocated for just such a modification. However, the Clinton administration was concerned that this change might limit the magnitude of the program, and denied the Coalition's request. The NMTC Coalition subsequently asked the Clinton administration to allocate priority points to those CDEs that were unrelated to their investors. In the rush to pass the legislation prior to the end of President Clinton's second term, and in the frenetic environment that the end of an administration inevitably brings, this request was not incorporated into the legislation.

The significant challenge with implementing our proposal now lies in convincing those profit-oriented investors who already have set up their own CDEs to support this change. Since the NMTC Coalition currently is working to have the NMTC program reauthorized beyond its initial $15 billion funding, it would not be prudent politically to divide the reauthorization coalition by changing the program in this manner at this time.[11] It can, however, be a goal for the program to work towards.

## Conclusion

Compared to other federal community development initiatives, such as the Low Income Housing Tax Credit, the New Markets Tax Credit is a relatively modest program. Nevertheless, it represents a significant new source of capital for community economic development, and thus is greatly valued by many of those working to improve low-income communities.

In identifying what we see as potential limitations of the program in its current form, we do not want to lose sight of its many benefits. As case studies of NMTC investments and interviews with practitioners consistently demonstrate, the program has attracted new investors, and many of the NMTC transactions are being used to better the economic standing of distressed communities (New Markets Tax Credit Coalition 2005c; Armistead 2005; Rapoza Associates 2004). The NMTC Coalition also has been working to address some of the program's shortcomings, such as those that have favored real estate transactions over business equity (see Armistead 2005; Rubin & Stankiewicz 2003). Finally, the CDFI Fund has been responsive and flexible in revising procedures to reflect new knowledge and prior experience, as demonstrated by the numerous changes they have made to the application process.[12]

Ultimately, when evaluating the NMTC initiative, we must remember the critical lesson learned from the Low Income Housing Tax Credit program. Like the NMTC, the housing tax credit initially was authorized for a limited period of time. Despite opposition, supporters of the program were able to make the LIHTC permanent, in large part due to the political support generated by for-profit real estate developers and landlords who benefited from the credits (Weir 1999, pp. 150-151). In the current political environment, it may well be that the greatest potential limitations of the NMTC – its ability to be used for deals that are not optimal in terms of developmental impact as well as for those that would have occurred without the NMTC subsidy – will broaden the coalition fighting for the program's reauthorization and turn out to be critical to its continued existence. As one long-term community economic development practitioner said to us when discussing the NMTC program, "we must not let the perfect be the enemy of the good."

[11] The original New Markets Tax Credit Coalition was composed primarily of mission-driven organizations. The Coalition has subsequently grown to include more investors.

[12] In addition to the changes to the selection process discussed earlier, other examples of changes made by the Fund include adding questions to the fourth round application intended to gauge how much profit a CDE plans to build into its deals.

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